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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).

BRIEFS FROM THE WORLD

Increasing Access to Financial Services While Balancing Supervisory Interests

Ricki Tigert Helfer, Independent Consultant, Financial Regulation and Reform International and Former Chairman, Federal Deposit Insurance Corporation of the United States

Introduction

Financial services lubricate economic activity in individual countries and the world at large. Without financial services a thriving economy would not be possible. Segments of a country's population that do not have access to financial services cannot meet their own financial needs and cannot participate effectively in the country's economic activity.

It has been estimated that the microfinance industry serves over 50 million clients worldwide. While that may seem like a small number compared to the approximately three billion people who live in dire to moderate poverty, receiving a microfinance loan often has become the first step on the path by which people in many countries move toward future economic achievement and ultimately the middle class. This movement leads to greater economic and social choices for families and more opportunity to contribute to the future economic well-being of themselves and their countries. (See Remarks of Stanley Fischer, Former First Deputy Director of the International Monetary Fund and Vice Chairman of Citigroup, at the Asia Society and Women's World Banking Annual Microfinance Conference, May 13, 2003, on the importance of microfinancing in fighting poverty.)

The microfinance industry is now at an important crossroads. As the industry has matured, it has attracted regulatory attention. Concerns about the risks involved in financial services may have led some regulators to move toward greater regulation of microfinance. Understanding those risks may help financial regulators make cost effective judgments about where best to focus their attention. Sound regulatory judgments are critical because over-regulation can unnecessarily stifle credit for underserved populations and may impede economic activity and innovation.

Risk is Inherent in Financial Services

The nature of the business of financial services is to take risks. In the conduct of financial services the provider of the service assumes certain risks in order to meet the needs of its customers. In exchange for assuming those risks the provider of financial services is compensated. At its most basic level, the provider loans money to the customer in exchange for interest payments. As financial services increase in sophistication, the nature of the risks changes. Economic activity is only possible because there are financial services firms willing to assume certain risks that promote economic growth. If there were no risks undertaken, there would be no economic activity.

Banks are the most traditional of various financial intermediators that translate savings from one set of customers into loans or guarantees for others who make investments and create economic growth. The loans are leveraged off the capital of the banks, which means that the capital provides a cushion against losses from operations and economic shocks. As banks expand their services, the range of risks presented by their activities expands with the complexity of the banking operations.

Not all financial services firms present the same range of risks. At its most fundamental level, lending

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EUROPEAN UNION

EU New Directive – What is Micro in EU?

Marcin Fijalkowski, Legal and Regulatory Program Coordinator, MFC

The proper understanding of the meaning of "micro, small and medium businesses" in different countries is crucial not only for statistical purposes but also for comparing basic data between regions. In other words, a CEE or NIS enterprise treated as small or even medium according to local standards might be micro in EU nomenclature. This lack of mutual understanding could harm discussions between parties not cognizant of the difference.

On May 6, 2003, the European Commission adopted a new definition of micro, small and medium enterprises in European Union. The new recommendation replaced the former Recommendation 96/280/EC, taking into account changes that took place since 1996 as well as the growing interest of the Commission in microfinance.

As of today, there are over 19 million micro, small and medium enterprises in the EU, which accounts for 99,8% of all enterprises providing 65 million jobs. 93,3% of the sector constitutes microenterprises.

The new recommendation plays an extremely important role as access to both EU and national support mechanisms is very often restricted to certain categories of entrepreneurship. Therefore the proper definition of the business might decide whether the business will get access to certain advantages.

The ultimate goal of the new recommendation is to promote entrepreneurship, investments, legal certainty and innovations, while reducing possibilities of misusage of funds directed to SME sector.

As a result of public consultations conducted in 2001-2002, the European Commission reworked thresholds defining the SME sector. The Commission took into account the increase in prices and productivity as well as investments since 1996 and therefore increased the thresholds for turnover and balance sheet while maintaining staff ceilings.

	Category	2003	1996
Turnover (*mln Euro*)	Medium	≤50	≤40
	Small	≤10	≤7
	Micro	≤2	
Balance sheet (*mln Euro*)	Medium	≤43	≤27
	Small	≤10	≤5
	Micro	≤2	
Staff	Medium	<250	<250
	Small	<50	<50
	Micro	<10	<10

MOLDOVA

Saving and Credit Association of Citizens

Igor Gheorghita, Legal Advisor, State Supervision Unit for Saving and Credit Association of Citizens

Introduction

The microfinance sector in Moldova is mainly represented by credit unions called Saving and Credit Association of Citizens (SCAs).

The credit union movement, which plays a dominant role in the microfinance landscape in Moldova, has a long history whose origins can be traced to the middle of the 19th century. After the 50+ year hiatus, which followed the Moldova incorporation to Soviet Union in 1940, the hope for a new credit union sector returned in 1996 with the implementation of the Rural Finance Project – a joint World Bank and the Moldavian Government program focused on developing CUs in Moldova. As a result of the Rural Finance Project, first 11 SCAs were founded in 1997 marking the renaissance of the credit union movement.

Today there are registered 520 SCAs with over 68,000 members. Their loan portfolio totals MDL 201 millions (USD 14 millions) and the assets amounts to MDL 221 millions (USD 16 millions). Most of SCAs operate in rural areas serving mainly private farmers and village entrepreneurs. Their scale of activity remains still small as only the biggest SCAs crossed the threshold of 800 members. Most SCAs are gathered within the National Federation of Savings and Credit Associations.

The picture of the Moldavian credit union system wouldn't be complete without referring to the Rural Finance Corporation and the Moldova-Agroindbank, which lend to SCAs as well as to the Moldovan Microfinance Alliance and the Rural Development Center, both of which perform the role of development and consulting organizations.

Regulation of SCAs

The legal basis for the operations of SCAs is the Law on Savings and Credits Associations of Citizens (law on SCAs) passed in 1998 and the government decree on State Supervision over SCAs Activities.

The law on SCAs defines the legal status of SCAs, the rights and obligations of the SCAs members, the creation and the registration of associations, the scope of permitted activity, the protection of rights and interests of their members.

With the purpose of creating a viable microfinance system and reducing the potential threat for members' savings, the Decree on State Supervision over SCAs Activities has established, within the Ministry of Finance, a special unit responsible for the supervision of SCAs – the State Supervision Unit (the Unit). Additionally, prudential norms for SCAs were implemented. Further, a number of additional normative acts were passed among which the most important are: Accounting Standards for SCAs, Performance Appraisal Methods and the Conditions on Granting Licences to SCAs.

The law defines a SCA as a non-commercial organization that (i) accepts the personal savings of its members and offers them special purpose loans, (ii) does not have the goal of obtaining profits and (iii) does not

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LITHUANIA

Lithuanian Credit Unions: Overview of Legal Environment

Jurgita Igaryte, Legal Advisor, Association of Lithuanian Credit Unions, Lithuanian Central Credit Union

Introduction

The Law on Credit Unions was passed by the Parliament of Lithuania in the beginning of 1995 marking at the same time the start of the credit union movement. The first credit union (CU) was created at the end of 1995. The credit unions' mission is to provide financial services to unbankable people and businesses. Today the Lithuanian CUs' movement unites over 27,000 members with accumulated savings of over EUR 20 millions and over EUR 21 millions of disbursed loans. Obviously impressive growth results of Lithuanian CUs wouldn't be so successful without a proper legal environment.

Credit Union Model in Lithuania

Under the Lithuanian law, only commercial banks and CUs are allowed to disburse credits and mobilize savings from non-professional participants of the market. Credit unions operate under the Law on Credit Unions (Law on CUs) passed on February 21, 1995 and substantially amended on May 18, 2000, while commercial banks work under the Law on Commercial Banks and the Law on Joint Stock Companies. Additionally, the Central Credit Union is regulated by the Law on Central Credit Union.

According to the Law on CUs, credit unions are member-based organizations grouping persons who share similar features:

- Employment in the same enterprise, institution;
- Belonging to the same professional group;
- Belonging to a certain formal registered association;
- Residing in the same location – township or village.

CUs' members can be divided into two groups: real members and associate members. The minimum legal number of real members in a credit union is 50. Pursuant to the law, an associate member has all the rights of a real member, except the right to vote and to be elected to CU bodies. The number of associate members in a credit union may not exceed the number of the real members.

Real members can be either individuals or legal persons: public organizations, organizations of trade unions, religious communities and agricultural co-operatives.

The following entities may be associate members of a credit union:

- Legal persons: sole proprietorships, economic partnerships, agricultural co-operatives and private companies, provided that (i) the controlling block of shares of any such company is owned by the CU's members and (ii) annually, on average, the number of its employees does not exceed 49;
- Individuals, who live, work or study in the territory of the ward in which the CU's headquarter is located or individuals – former CUs real members who do not anymore match membership criterion.

The credit union's capital consists of the share capital, reserves and supplementary capital. The CUs minimum share capital shall not be less than LTL 15,000 (EUR 4,340). Additionally the minimum value of a single share for individuals shall be LTL 100 (EUR 29) and the minimum value of a legal person share shall be LTL 1,000 (EUR 290).

Credit unions' key activities include:

- Mobilizing time and demand deposits from its members, associations of credit unions, public organizations, religious communities and associations, organizations of trade unions, charity and sponsorship foundations registered in the Republic of Lithuania, institutions authorized by the Government of the Republic of Lithuania and/or local authorities, international charitable (sponsorship) foundations and/or such foundations of foreign states, as well as, before a credit union joins the Central Credit Union, from other credit unions which are not the members of the Central Credit Union;
- Disbursing short-term and long-term loans – business as well as consumer loans – to members;
- Purchasing with free funds securities issued by the State or the Bank of Lithuania;
- Engaging in other activities appropriate for credit institutions and set forth in the bylaws.

The initial CUs model, described by the Law on CUs enacted in 1995, was not favorable for the creation of the CU network in Lithuania. Thus amendments to the Law on CU were introduced in 2000. Below are listed the main amendments to the Law on CUs which enabled CUs to develop and extend their activities:

- Membership share was reduced from LTL 300 (EUR 87) to LTL 100 (EUR 29);
- Legal entities were permitted to become members of credit unions;
- Definition of an associate member was extended (under the initial draft, the associate member status was reserved for present CU members (individuals) who no longer met the membership criteria);
- The law allowed to set several membership criteria with the obligation of matching at least one of them – previously only one membership criterion could be set in the bylaws;
- The CU's profit was allocated to the members in proportion to the amount of each member's deposits and received loans (circulation)[1]. Previously, the dividend was distributed only in proportion to the value of shares.

Alongside the process of amending the Law on CUs, the Lithuanian credit unions were lobbying for an exemption from the European Union financial directives regarding credit institutions. (The term credit institution, as defined in Lithuanian legislation, currently includes credit unions; the Association of Lithuanian Credit Unions strongly lobbied to incorporate this term in the national legislation in order to address the authorities tendency to forget about credit unions and draft legal acts only for banks.) For the Lithuanian Credit union movement, it was a question of survival. Should the exemption not have been accorded, the current status of credit union as a type of credit institution would be abolished with all the negative consequences.

Fundamentals for Establishment of a Central Credit Union

Consultations regarding the establishment of a central financial facility in Lithuania started in 1999. The first draft of the Law on Central Credit Union was prepared with the help of J.Bernier and A.Lacroix, two Canadian legal consultants from Desjardins credit unions

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Standards		Cred. Unions	LCCU	Banks
Capital adequacy ratio		≥13%	≥13%	≥10%
Liquidity ratio		≥30%	≥30%	≥30%
Maximum open position in foreign currencies	common position	≤25% capital	≤25% capital	<25% capital
	single currency	≤15% capital	≤15% capital	<15% capital
Maximum exposure to a single borrower		–	≤25% capital	≤25% capital
Large exposure		–	≤800% capital	≤800% capital

movement. At the beginning, the drafters envisaged preparing two separate laws – one on the Central Credit Union and another one on the Stabilization Fund, but later, they decided to create only one law. The Law on the Central Credit Union was passed on the 18th of May 2000, together with the amendments of the Law on Credit Unions, the Law on Deposit Insurance and the Law on Legal Persons' Profit Tax.

Due to a complicated founding procedure, the Lithuanian Central Credit Union (LCCU) was established only in November 2002.

The Lithuanian Central Credit Union is a credit institution organized on cooperative basis and established by at least 20 credit unions and the Government of the Republic of Lithuania.

According to the law, the minimum initial capital of the LCCU shall be LTL 5 millions (EUR 1,45 millions). The minimum value of the LCCU "main" share shall be LTL 1,000 and the value of additional shares shall be LTL 1,000. A member may have only one main share and an unlimited number of additional shares.

Following negotiations with the European Union, the EU requirement for the minimum initial capital amounting to EUR 1 million was prescribed to the LCCU. Nevertheless Lithuanian credit unions couldn't form the initial capital of the LCCU without the help of the Lithuanian Government. Thus the Government had to buy 1 main share and 5299 additional shares (which do not carry voting rights). At the moment, the Lithuanian Government owns the largest part of LCCU share capital. In the long term, share capital should be bought from the Lithuanian Government. Although the Government owns the largest part of the share capital, it does not have exclusive voting rights.

The main functions of the LCCU are to ensure the liquidity of credit unions and to restore the impaired solvency of credit unions. In order to fulfill properly these functions, LCCU has established for its members a stabilization fund and a liquidity reserve. The liquidity reserve is accumulated from credit unions savings – credit unions are obliged to keep a certain percentage (currently 1.2%) of their deposits in the reserve. Liquidity loans from the liquidity reserve may be provided to credit unions for a maximum period of six months. The stabilization fund was established to ensure the stability and continuity of the activities of a credit union, and functions as a last resort lender in order to restore the impaired solvency of CUs. The stabilization fund shall not fall below 1% of average assets of credit unions. Credit unions' contribution to the stabilization fund are treated as expenses of the credit union.

In addition LCCU acts as a clearing center for credit unions, supervises and controls CUs to ensure the soundness and safeness of their operations, administers credit lines through CUs and provides other financial and non-financial services. All services of LCCU may be provided only to credit unions – LCCU members.

Prudential Regulation and Other Safety Instruments

Stability and safety of the Lithuanian CUs movement is also ensured by the state supervision over CUs performed by the central bank (the Bank of Lithuania)[2] and the State Deposit Insurance.

The department of credit institutions at the Bank of Lithuania is responsible for the supervision of banks and credit unions. Credit unions shall report quarterly balance sheets, profit & loss reports and other documents to the Bank of Lithuania. The Bank of Lithuania performs regular inspections of credit unions – each credit union is inspected approximately every 18 months. Representatives of the Bank may attend meetings of the bodies of management and general members' meetings as well. The Bank of Lithuania supervises credit unions according to prudential requirements set in the Law on CUs and the Law on Central Credit Union.

The prudential requirements established for all credit institutions by the Bank of Lithuania are listed in the table below.

Only three standards are applied to credit unions and five standards to the LCCU as it could be seen from the table above. However the Law on CUs stipulates that one member cannot obtain a loan exceeding ten times his share contribution and 10% of the deposits accumulated in the credit union and loans taken by the credit union.

The capital adequacy ratio for credit unions and LCCU still remains higher than for the banks despite several negotiations with representatives of the Bank of Lithuania.

Deposits of credit unions and the LCCU are insured by the State Deposits' Insurance Fund. The deposits in all credit institutions are insured at the same level – LTL 45,000 (EUR 13,080). From January 2, 2008, the LTL equivalent of EUR 20,000 of deposits will be insured.

The annual rate of an insurance premium is 0.2% for credit unions and LCCU, while 0.45% for commercial banks and branches. The law stipulates a smaller insurance premium for credit unions because almost all credit unions are members of Central Credit Union, which provides additional safety and stability instruments for CUs.

The instruments ensure continuity of credit unions activities and safety of deposits, established in Lithuania's legal environment, therefore credit unions may attract deposits from the market in equal rights with banks.

Challenges Faced by Lithuanian Credit Unions Movement

In the process of integrating Lithuania into the European Union, the Parliament of Lithuania passed the Law on Financial Institutions in September 2002. (The law came into force on July 3, 2003.) The purpose of this law is to establish grounds for the activities of financial institutions, to set requirements for founders, participants and management bodies of financial institutions and to specify what kind of services are defined as financial services.

In order to harmonize the Law on Financial Institutions with the existing laws, the Parliament planned to amend the laws regulating the activities of credit unions, commercial banks, brokers and investment funds before the entrance into force of the Law on Financial Institutions. However these amendments have not yet been passed. Therefore, at the moment, there are conflicting provisions in the Law on Financial Institutions and laws governing the activities of some financial institutions including credit unions.

The Bank of Lithuania and the Ministry of Finance prepared the amendments to the Law on CUs and the Law on Central Credit Union and currently present it for further considerations. After evaluation of the drafts by the Association of Lithuanian Credit Unions, it became obvious that the Bank of Lithuania and the Ministry of Finance intend to pass, behind the curtain of the new law on Financial Institutions and the new

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Civil Code, a series of unrelated amendments that would significantly limit activities of credit unions. Among other things, the amendments restrict membership, lending and other conditions influencing the CUs' operations, establish compulsory audit of CU's financial statements, enhance powers of supervisory authorities. Although credit unions received the exemption from the European Union financial directives, the requirements set in these directives are transferred to the Lithuanian legislation through amendments to the Law on CUs.

The upcoming fall seems to be a difficult period for the credit union movement. Hopefully credit unions are ready to protect their rights for further development and growth in Lithuania's financial sector. ■

1 Example 1 according to the Law on CU (as passed in 1995): Dividends to be allocated to members – 22 USD. Member A – hold a share of 1,000 USD, member B – hold a share of 10,000 USD. At the end of the year member A will receive 2 USD and member B will receive 20 USD.
Example 2 according the Law on CU (after amendments passed in 2000): Dividends to be allocated to members 22 USD. Member A – has no deposits and loans, member B – has a deposit of 1,000 USD, member C received a loan of 10,000 USD. At the end of the year member B will receive 2 USD, member C will receive 20 USD and member A will receive no dividends.

2 The Bank of Lithuania provides state supervision: it establishes prudential requirements, make field inspections and may apply sanctions to credit unions. LCCU supervises only its members: makes regular inspections and issues recommendations, but has no right to apply sanctions to credit unions. Bank of Lithuania and LCCU can share the inspections results and LCCU can advice Bank of Lithuania on applying sanctions to credit unions. In the future LCCU and the Bank of Lithuania intend to set together a schedule of inspections in order to avoid "double-visits" to CUs.

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Saving and Credit Association of Citizens

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distribute profits to members but uses them for development of its operations.

An SCA is exempt from profit tax provided that it complies with the prohibition on distributing its income and property among its members (including during the reorganization and liquidation processes). The Law on SCAs prohibits the transformation of SCAs into another legal form.

According to the law, only individuals can be founders and members of an SCA. The minimum number of members is 10 and there is no cap on the number of members. Each member, who meets the below listed criteria, holds one vote:

- Enjoys capacity to perform legal transactions;
- Is aged over 18 years old;
- Has contributed in full its share capital contribution (MDL 90, USD 6);
- And resides in the village or town where the SCA operates (nationality is not a criterion).

It must be noted that the law on SCAs limits SCA activity to one village or town, which seriously impedes the development of SCAs.

SCAs can be financed through credits, loans, grants from donors and donations from individuals as well as legal entities regardless their provenance. The analysis of SCAs' financial performance shows that currently members' contributions are not sufficient to respond the demand for loans, which makes credit unions fully dependent on external sources of capital like credits. Thus, the activity of SCAs is basically reduced to on-lending to members and earning on the spread between interest rates, which constitutes, in my opinion, a systematic problem. Such a situation negatively influences the SCAs' profitability, impeding their financial stability and, thus, slowing down their development.

Supervision over SCAs Activities

As it was mentioned above, the supervision of SCAs' operations is carried out by a specialized state body – the State Supervision Unit located within the structures of the Ministry of Finance. The Unit is staffed with 7 experts and fully financed by the state budget; the SCAs do not pay any fees to the Unit for supervision services.

The Unit's mandate encompasses the following:

- Supervision of SCAs operations and their associations,
- Elaboration of normative acts, including prudential norms, related to the law on SCAs and submission of the acts to the Government,
- Representation of SCAs and their members' rights and interests.

It must be stressed the Unit has under its authority all registered and licensed credit unions operating in Moldova.

Certification of SCAs Managers

The SCAs managers are subject to a mandatory certification process run according to the rules set by the Minister of Finance. The issuance of a certificate confirms the ability and the right of the certificate holder to occupy executive positions in SCAs. According to the law, an SCA will not obtain a license if the executive director or chief accountant have not passed positively the certification procedures. Further the law requires replacement, within 90 days, of any certified employee who has left the SCAs. Failure to replace the employee within the 90-day period may result in the institution losing its license.

Licensing

The legislation of Moldova requires each SCA to obtain a license before beginning its operations. The licenses are issued by the License Chamber (a specialized governmental body) for a five-year period. The license costs MDL 1,800 (about USD 130). In order to determine the Unit's level of participation within the licensing process of SCAs, the License Chamber and the Unit have signed a Memorandum, according to which, the Unit gained the power to approve SCAs' licenses and the right to order the termination or suspension of the SCAs activity.

Reporting

Pursuant to the general legislation on book keeping and the Accounting Standards for SCAs, SCAs are obliged to file their reports quarterly with the Unit. The Unit is equipped with specialized software used for data collection and storage allowing the verification of the reports' accuracy and permitting the analysis of the information for supervision purposes. The Unit presents the consolidated report on the credit union system to the Ministry of Finance, Ministry of Economy, National Bank of Moldova and the Department of Statistics.

Planned Changes in the Legislation

Fast development of the SCAs network in Moldova, both in quantitative and qualitative aspects, have resulted in an acute need to amend the existing legislation. The normative acts, which are subject to change, are the Law on SCAs and the prudential norms.

We consider that the reforms will create a more favorable legal environment for the credit unions' development, reduce the risk connected with the SCAs' activity and lead to financial stability of SCAs and their network in general. ■

Increasing Access to Financial Services While Balancing Supervisory Interests

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money by a small non-depository institution presents very limited risk to the public and the government and would therefore require very little regulation. If the loans are not repaid, the lending institution may face financial difficulties but the borrower is not harmed and the financial system is not damaged.

Even financial institutions that access deposits from the public and use those funds to on-lend to other customers-basic financial intermediation-present great variations in risks depending on the level of sophistication of the various financial services activities and the size of the asset pools in relation to the overall financial system. It is generally accepted that financial institutions engaged in deposit-taking activities from the general public should be subject to prudential regulation, that is, regulation that seeks to protect the financial system as a whole from upheaval as well as to safeguard the safety of individual deposits. Nevertheless, the nature of that regulation and the intensity of supervision can vary with the kinds of specific business activities. For example, more limited deposit-taking among members of a common cooperative who are helping to meet each other's financial needs might well require less extensive regulation and supervision, as has occurred historically with credit unions and cooperative banks in the United States.

In market economies the goal of financial regulation is to achieve a balance between, on the one hand, protecting the financial system from significant risks and the public from unscrupulous business practices and, on the other hand, not stifling innovation and entrepreneurship. In contrast, central planning in former communist economies stifled initiative and produced economic stagnation. Indeed, the Soviet states persisted in imposing rules that had no underlying economic or protective rational and were often enforced arbitrarily and inefficiently. The result was depressed economic activity and little or no economic growth.

As Alan Greenspan, Chairman of the Federal Reserve of the United States, has observed: *"[G]overnments, including central banks, must balance the responsibilities they have been given related to their banking and financial systems. We have the responsibility to prevent major financial market disruptions through development and enforcement of prudent regulatory standards and, if necessary in rare circumstances, through direct intervention in market events. But we also have the responsibility to ensure that the regulatory framework permits private-sector institutions to take prudent and appropriate risks, even though such risks will sometimes result in unanticipated bank losses or even bank failures."* (Remarks by Chairman Alan Greenspan, International Financial Risk Management, November 19, 2002.) [www.federalreserve.gov/boarddocs/speeches/2002]

For innovation and economic development to occur, financial regulators must recognize the necessity of risk-taking within parameters that can be justified through sound cost benefit analyses.

The consequences of excessive risk aversion on the part of financial regulators in transition economies can be especially problematic because of the immediate needs of the general population for the benefits of economic growth. Financial regulators everywhere have the strong desire to establish a sound and credible financial system in their respective countries. They also have a strong desire not to preside over bank failures while they have oversight responsibility. There is an American expression "not on my watch" (meaning "not while I am in charge") that seems to fit here.

Banks become insolvent when management makes mistakes or fails to anticipate market developments. When a bank is insolvent it should be closed or it becomes a danger to healthy institutions by competing, often recklessly, for funding. When I was Chairman of the U.S. Federal Deposit Insurance Corporation in charge of supervising the Bank and Savings Insurance Funds, which protect insured depositors from the consequences of bank failures, a few banks became insolvent. For example, in the case of one small bank failure an employee committed fraud of sufficient size that it wiped out the capital of the bank. In the case of another bank management made the wrong bet on the course of interest rates and in still another the weak management made a series of inept management decisions that led to the failure of the bank. These banks should have been closed, and they were. All one has to do is to look at Japan to understand the consequences of allowing badly management, insolvent financial institutions and other insolvent companies to stay open. They become a drag on the whole economy.

The great difficulty for financial regulators who seek to achieve a sound balance in regulation is that the regulated activity is a moving target that is always changing. Flexibility is critical to financial regulators because the innovations of the global marketplace and the speed of telecommunications has made change inevitable; yet, too much change in regulations that establish the rules of the game can lead market participants to be nervous about the lack of predictability in the rules and to be less willing to make substantial investments in an economy. Turning again to Chairman Greenspan, he has noted the elements of this seeming dichotomy: *"A tension has always existed between a desired continuity in the laws and regulations governing trade and business practices, and the necessary updating that is required to keep pace with a growing and, hence, changing economy. ...A more general concern is that laws can never be fixed in perpetuity. As societies and economies evolve, the details of the law, though generally not its fundamental principles, need to change. But any uncertainty about the clarity and fixity of the law adds to the risk of trade, which as I noted, is reflected in a higher real cost of capital."* (Remarks by Chairman Alan Greenspan, Market Economies and Rule of Law, April 4, 2003) [www.federalreserve.gov/boarddocs/speeches]

The challenge for financial regulators can be substantial. They must balance the need to respond to change against the necessity of assuring that the laws and regulations are sufficiently reliable to encourage economic activity and new investment. That balancing act can be more readily achieved if the aid of the marketplace is enlisted in rewarding safe financial activities and strong operations while punishing unsafe and unfair financial practices and highly inefficient operations. One way to enlist the market's help in regulation is by requiring more transparency in disclosures to the public on individual financial institutions. When I was Chairman of the FDIC, we put quarterly banking statistics for every bank in the United States on the FDIC website. Such disclosure can let creditors, including depositors of banks, and shareholders evaluate for themselves the risk profile of the banks. For other financial institutions that may not be regulated as banks, including microfinance institutions, public availability of audited financial statements may well provide the mechanism by which the market can help regulators oversee the health and safety of the institutions.

In keeping with the discussion above, another way to enlist the market's help in regulating financial institutions is to avoid issuing government guarantees that allow failing or insolvent institutions to remain open. That also avoids the distortions in the financial market place that arise from allowing failing institutions – desperate for funding-to bid up the cost of funds to the detriment of healthy financial institutions.

In summary, using Greenspan's formulations then, the goal of legal rules and regulation of financial services has got to be to regulate only as necessary to avoid stifling innovation and to develop rules that are clear but flexible in response to changing circumstances. For purposes of developing legal rules

and regulations, financial regulators should seek those fundamental principles that are immutable while developing some details in the rules that can be flexibly amended as circumstances change. My own corollary, from years of experience as a bank regulator at two of the federal bank regulatory agencies in the United States – the FDIC and the Federal Reserve-is that too much detail in a law applicable to financial services can be difficult to change and can hinder economic progress like barnacles on an ocean-going vessel.

Regulation by Risk

Among developed and developing countries there are a variety of approaches to providing oversight of companies that engage in financial services. Sometimes for historical reasons the approach used for particular kinds of financial institutions is dictated by a country's laws, even though those laws are outdated and are not necessarily economically sound today. Gradually over the past two decades, efforts have been made in the developed world and in many developing countries to reform outdated statutes and to regulate financial institutions in accordance with the risks they present to the financial system and to customers. Even with those changes not all financial institutions present the same range of risks and not all are regulated the same way.

The United States has significant experience with financial institutions that are not banks and are not faced with prudential bank regulation but provide significant levels of financing to the U.S. economy. Research by the Federal Reserve on financial services used by small businesses in the United States in 1998 showed that suppliers of financial services included not only regulated financial institutions, such as commercial banks and thrift institutions, including savings banks, savings associations, and credit unions, but also nondepository institutions, such as finance, leasing, mortgage, brokerage, and insurance companies. That research shows that nondepository financial institutions were a source of financial services for about one-third of small businesses in the United States in 1998 (the latest available information) as compared to about 95 percent of small businesses who received at least one financial service from a depository institution regulated as a bank. However, breaking down the statistics by number of employees revealed that the percentage of small businesses using each category of financial institution (as a supplier of financial services) increased as the number of employees (per business) increased. For example, among small businesses with more than ten employees, over half used nondepository institutions to provide financial services and for those with more than one hundred employees over 70 percent used nondepository financial institutions to provide those services. (M.P. Bitler, A.M. Robb, and J.D. Wolken, "Financial Services Used by Small Businesses: Evidence from the 1998 Survey of Small Business Finances," Federal Reserve Bulletin (April 2001) pp. 194-195.)

Thus, a significant share of financial services to small businesses in the United States is being provided by non-bank financial companies that are not supervised and regulated as banks, which means they are not the subject of prudential banking regulation and are not the subject of regular examinations as banks are. They may be subject to enforcement actions if they engage in unfair or deceptive practices, including unfair credit activities, overbearing debt collection, fraud, or other inappropriate conduct, but they are not the subject of regular examinations as banks are and they are not required to meet bank regulatory standards. This may be a reasonable model for regulating microfinance institutions that do not accept deposits from the general public.

As noted above, banking regulation in developed and many developing countries recognizes that the nature and extent of banking regulation will vary with the types of risks to which a financial institution is exposed. The principle of regulation by risk can be simply stated as follows: the more complex the risks, the more extensive the supervision and regulation of the financial institution. Microfinance does not present the range of risks posed by internationally active banks, and the impact of default on customers and the financial system is proportionately much less. Moreover, common sense, risk-based regulation of the microfinance business will produce more reliable results without impeding the economic activity that microfinancing represents.

Even so, a balance in the approach to regulation is critical depending upon the risks the microfinance institution undertakes, the nature of its dealings with the public, and the size and complexity of its operations. Taking these factors into account constitutes regulation by risk. It seems to be generally agreed that microfinance organizations should not be subjected to the full range of prudential bank regulation unless they accept deposits from the general public. The act of lending funds obtained from other sources in small denominations to customers engaged in microenterprise presents little or no risk to the borrowers and very little to the government of the country in which the organization is located. The government's principal interest is in assuring that the customers of microfinance institutions are treated fairly and openly. That is, that the borrowers have full information on the interest rates they are paying for the funds they borrow and on the terms of repayment and in preventing overbearing debt collection techniques to be employed to achieve repayment.

We have found in the United States that microloans are administratively expensive for a financial institution to make unless it has (i) experienced loan officers who are good at evaluating potential borrowers, (ii) procedures in place to process these loans efficiently, and (iii) effective controls for monitoring and mitigating the risks presented by the loans. We have also found that lending to customers with little or no prior credit history can be problematic without skill and experience on the part of the lender to choose borrowers that are substantially more likely than not to repay their loans. The financial institutions who make microloans must therefore charge higher interest rates in order to cover their costs and assure that sufficient funds are available to lend to other customers when the loans are repaid, while preserving for the financial institution an adequate capital cushion against potential problems. Finally, there is a need for financial regulators to recognize that the nature of the business of microfinance requires flexibility in applying supervisory and regulatory standards to microfinance institutions. For example, the loan files of a microfinance institution will not include detailed documents on the financial condition of borrowers, unlike banks with sizable commercial credits.

Applying the principle of regulation by risk, the nature of the business of a microfinance institution should determine how it is regulated. If the institution makes only small denomination loans, regulation can be quite minimal and may exist only in the form of a registration requirement so the government will know the institution is doing business there. If the institution accepts deposits from the general public, it should be regulated as a bank is, but the detailed nature of the regulation will vary with the range and complexity of the risks it undertakes.

The second part of this two-part series of articles will analyze how regulation by risk could be applied to microfinance institutions. It will focus on how the minimum international standards for banking supervision in the form of The Core Principles for Effective Banking Supervision developed by the Basle Committee on Banking Supervision could be applied to regulation of microfinance. ■

This is the first of two articles on regulation of microfinance by Ricki Tigert Helfer, a well-respected independent consultant on financial reform and a former U.S. bank regulator. This article is based upon her speech to the 2nd NIS Policy Forum on Microfinance Law and Regulation, co-sponsored by the MFC in Krakow, Poland, June, 2003. The second article, which will be published in the next issue of the Policy Monitor, will apply the principle of regulation by risk to microfinance in more detail.

Regulatory Requirements for Microfinance

By Stefan Staschen, Independent Consultant

A common statement regarding microfinance regulation is that it is still too early to determine "best practices" as the topic is relatively new and existing evidence remains inconclusive. After all, it is only in the long-term that the effectiveness and appropriateness of regulatory requirements in their specific country circumstances can be proven.

A recent study by GTZ takes a different approach: instead of defining "best practices", the study looks at current practices, irrespective of how effective these practices are[1]. The method of analysis is first and foremost descriptive (in contrast to the normative approach involved in defining best practices). It relies heavily on the analysis of existing legal texts for microfinance in the 11 countries under consideration[2]. In addition, the author consulted widely with experts from the respective countries and drew on available literature in the field of microfinance regulation. The study does not always desist from making any judgements if sufficient information is available.

An important disclaimer must be made on the selection of the country cases. The sample is not representative for the industry as a whole. All eleven countries have introduced a separate legal framework for microfinance institutions (MFIs). We do not suggest that the introduction of a separate microfinance window is preferable to the approach of promulgating exemptions from or making adaptations to existing laws. Of relevance is the fact that the characterisation of microfinance-specific requirements can be done more easily by looking at separate laws[3].

This article summarises some of the results of interest to a wider audience. The publication includes two-page summary tables for each country. The focus of the study is on pointing out regulatory options and, if possible, indicating the benefits and drawbacks of these different options. For those involved in drafting microfinance legislations and therefore interested in the nitty-gritty of legal provisions, more comprehensive country tables will be developed and made available through a soon to be launched database on microfinance regulation on the Microfinance Gateway (www.microfinancegateway.org).

Defining the Microfinance Window

Two main levels of legislation can be identified. Primary legislation is usually promulgated by Parliament and referred to as a 'Law' or 'Act'. At this level, general guidance – also referred to as standards – for the conduct of financial business is given. Secondary legislation sets out the rules of the game more specifically – it stipulates concrete benchmarks or more detailed requirements with regard to procedures and policies. Primary legislation is more difficult to change as it is subject to parliamentary scrutiny. Secondary legislation, e.g. statutory regulations or normative acts (the latter term is more often used in the NIS region), can be changed without going through an onerous and time-consuming legislative process. As a supplement to existing legislation, supervisory authorities may also disseminate more in-depth information on laws and regulations in the form of guidelines, although such guidelines have a weaker legal basis.

A first interesting question is how much rule-making power the government has delegated and to whom. Looking at our sample of countries, in the majority of cases the supervisory authority also has the authority to make secondary legislation. Yet in some cases (Nepal and Pakistan), rules made by the central bank as the supervisory authority must be approved by government. In Ghana, the Minister of Finance is responsible for promulgating regulations and in doing so must consult only with the central bank. In Bolivia, the tasks of rule making and supervision have been separated institutionally. The National Economic Policy Council (CONAPE) promulgates regulations for all kinds of financial institutions while the Superintendency is the supervisory authority.

There is no clear-cut definition of what to stipulate at which level. Taking the example of minimum capital requirements, it can be seen that the degree to which rule-making power has been delegated varies widely – from no delegation to complete delegation with several intermediate solutions (e.g. stipulation in the law, with possibility for changes through the Central Bank or the responsible Minister).

A second issue worth investigation is the level at which microfinance-specific requirements are made. Bolivia and Indonesia do not have a separate law for MFIs, but have passed secondary legislation (called 'Supreme Decree' and 'Regulations', respectively) under the general banking law. This secondary legislation clearly defines microfinance-specific provisions. All other countries in our sample have "second tier-legislation", i.e. a law separate from the banking law. This clearly shows that there are other options which might be easier to implement than promulgating a separate law for microfinance, as they would not be subject to parliamentary scrutiny. Table 1 summarises the main legal texts included in the study[4].

Criteria for 'Line-Drawing'

Introducing a special legal framework for MFIs involves defining the upper and lower boundary of the microfinance window (or tier, as it is also called). This 'line-drawing' is a multidimensional undertaking. A good way to look at the problem of differentiating between the microfinance tier and other tiers is to ask the question: what incentive might an institution have for preferring one regulatory window over another? All regulatory requirements play a role in the delineation of tiers as the impact of requirements varies with the kind of business activities financial institutions pursue.

The definition of permitted and prohibited business activities and of product characteristics plays a great role in the distinction between tiers. All 11 legal frameworks contain a section on prohibited business activities through which the risk-taking behaviour of MFIs can be controlled and, at the same time, through which traditional financial institutions can be deterred from taking advantage of more lenient regulatory requirements in other areas (e.g. lower minimum capital requirements). Typical prohibited activities are: offering current accounts, dealing in foreign exchange and buying and selling real estate (unless it is for the institution's own operations).

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2nd NIS Policy Forum on Microfinance Law and Regulation

Kazakhstan delegation at work

The 2nd New Independent States (NIS) Policy Forum on Microfinance Law and Regulation was an "invitation-only" event held in Krakow, Poland, June 26-28, 2003, that the MFC organized in partnership with USAID and OSI. The forum successfully brought together a selected number of top-ranking public officials and policymakers from 10 NIS countries-Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russian Federation, Tajikistan, Ukraine, and Uzbekistan-along with donor representatives and other officials involved in microfinance and financial sector policies. The forum participants discussed key microfinance regulation and supervision issues.

The forum began with several presentations on key microfinance issues in the legal and regulatory environment, gave an overview of legal and regulatory terminology, and asked the participants to examine and discuss microfinance regulation-its scope and its relationship to bank regulation. Over the three days, each country delegation gave a short presentation on its country's legal and regulatory framework and challenges. As the forum proceeded, participants heard from a U.S. bank regulator, discovered results of studies on microfinance legal requirements in specific countries, heard about the impact of the new Basel Accord on microfinance, and had further opportunities to discuss how best to address the country-specific challenges of integrating microfinance into the formal financial system. The forum included plenary presentations, group discussions, seminars, concurrent working sessions, and breakout groups as well as a reception and dinner to welcome the participants and facilitate networking.

At the forum's conclusions, each country delegation presented its next steps in microfinance regulation and supervision. The next step highlights were as follows:

- **Armenia:** A special working group will analyze legislative issues with the new 3 year USAID microfinance project.
- **Azerbaijan** will further develop the legal and regulatory environment for credit unions.
- **Georgia** will envisage building a legal framework for microfinance institutions.
- **Kazakhstan** will continue attempts to increase the population coverage of microfinance services, particularly by banks, and work to adopt a new Law on Credit Bureau and the Law on Non-governmental organizations (NGOs) and Social Orders.
- **Kyrgyzstan** will be implementing a new law on integrating MFIs into financial markets and provide training to examiners an supervisors.
- **Moldova:** The government is set to adopt prudential norms to CUs as well as expand MFI accessibility and support the MFIs' financial stability.
- **Russia** focused on the Voronezh oblast where ongoing efforts with the Savings Bank and State Fund are supporting microfinance because of its role in SME development.
- **Tajikistan:** The Parliament is set to adopt a law on MFI supervision. Normative acts will need to be developed. With donor support, the delegation will continue to develop the banking system and MFIs.
- **Ukraine** plans to restart dialogue on regulating microfinance activity, establish links with credit unions, and study market linkages.
- **Uzbekistan** will continue regulatory action in microfinance and the legal and regulatory environment. In 2004, the Parliament will discuss the draft microfinance law.

The MFC proposed to use its upcoming videoconferences through The World Bank as a way to continue the regional discussions and keep the information flowing between countries. Additionally, MFC considers organizing study tours for policymakers with the support of OSI and set a list-serve for policymakers.

More information on the 2nd Policy Forum are available on the MFC website www.mfc.org.pl

Ricki Tigert Helfer, former chairperson of Federal Deposit Insurance Corporation

Probably the best-known distinction between the microfinance tier and other legal frameworks is limitation of the types of deposit facility that may be offered. Consensus has emerged among experts in the field that all MFIs mobilising deposits from the public should be prudentially regulated. Thus the lower boundary of the tier hinges on the question of whether deposits are taken from the general public or from members only (e.g. in Uganda). Furthermore, some countries in the sample restrict on the basis of liquidity of deposits (savings deposits vs. time deposits and time deposits with specified duration).

For lending business, a common regulatory provision is to stipulate a maximum loan size, expressed as a percentage rate of capital or as an absolute amount. Tying the loan size to the amount of capital has the advantage of creating an incentive for the institution to increase its capital when taking higher risks.

Major Regulatory Instruments for MFIs

An interesting observation is that the selection of regulatory instruments and tools used for MFIs is not much different from those used for traditional financial institutions. Yet even when the instruments are the same, the specifications for MFIs are different. This section summarises some of the major regulatory instruments for MFIs.

Table 2 shows the minimum capital requirements for a number of countries (in current US Dollars). The table should be read with great care, as it includes very different types of MFIs operating in vastly different environments. Yet what becomes clear is that minimum capital levels vary considerably. Interesting options in some countries are to define minimum capitalisation according to the geographic area of operation of the institution (Pakistan and Indonesia), and to define the capital amount in currency points instead of local currency amounts (which can be changed more easily) (Uganda).

Risk-weighted capital adequacy requirements also vary greatly: from 6% for Rural Banks in Ethiopia to 20% for Micro Deposit-Taking Institutions in Uganda. Yet for a proper comparison it would be necessary to look at the exact definition of capital (the two figures given here refer to total capital, i.e. primary and secondary capital) and the risk-weights used. Some countries use only two risk-weights (0% and 100%), while others follow more closely the recommendation of the 1988 Basel Capital Accord and distinguish between four different risk-weights.

A third quantitative requirement is the definition of compulsory provisioning ratios for loans with payments overdue. Again, there is a wide range to be found in the 11 countries under consideration. Uganda is most strict with a requirement to provide for the full loan amount if payments are overdue for 90 days or more. Some other countries leave up to 360 before 100% provision have to be built. Interesting cases are Uganda and Ethiopia, which use an even stricter provisioning schedule for rescheduled loans.

Other widespread quantitative requirements are minimum reserve and liquidity ratios and maximum percentages for ownership stakes. Qualitative requirements (e.g. concerning the role of the board and management) are more difficult to compare, even though they are of equal importance to quantitative requirements. These requirements are not the focus of this comparative study.

The study ends with some recommendations for in-depth country studies. Important aspects of the regulatory system that have not been covered in this study are capacity issues and incentives for enforcement (by the supervisory authority) and compliance (by the MFIs). These aspects should form part of more comprehensive studies.

Part of the outcome of the current exercise is a list of criteria for the assessment of legal frameworks for microfinance (Annex 2 of the study). This list can assist both in assessing existing legislation and in developing new, more microfinance-friendly legal environments.

Table 1. Legal Texts for Conducting Microfinance

Country	Primary Legislation	Secondary Legislation
Separate Law for Microfinance		
Bosnia-Herzegovina	Law on Microcredit Organisations	Rules
Ethiopia	Micro Financing Institutions Proclamation	Directives
Ghana	NBFI Law	Business Rules
Honduras	Law on Financial Private Development Organisations	Resolutions
Kyrgyz Republic	Law on Microfinance Organisations	Normative Acts (not yet available)
Nepal	Financial Intermediary Societies Act, Cooperative Act and Development Banks Act	Directives
Pakistan	Microfinance Institutions Ordinance	Prudential Regulations
Uganda	Micro Deposit-Taking Institutions Act	Regulations
Only Secondary Legislation Microfinance-Specific		
Bolivia	Law on Banks and Financial Entities	Supreme Decree
Ghana	Banking Law	Regulations
Indonesia	Banking Law	Regulations
South Africa	Usury Act	Exemption Notice

Table 2. Minimum Capital Requirements

Country	Type of Institution	Absolute amount in USD
Bolivia	Private Financial Fund (FFP)	870,000
	Open Savings and Loan Cooperative (CAC)	From 207,000
	Category 1 to 4	to 7,600,000
Ethiopia	Micro Financing Institution	24,000
Ghana	Rural Bank	62,000
	Deposit-taking NBFI	1,900,000
Honduras	First Tier Financial Private Dev. Org. (FDPO)	60,000
	Second Tier FDPO	600,000
Indonesia	BPR (People's Credit Bank) in rural areas	56,000
	BPR in provincial capitals	112,000
	BPR in Greater Jakarta	224,000
Nepal	Cooperative Society with a Limited Banking	From 13,000
	License	to 130,000
Pakistan	MFI operating district-wide	1,700,000
	MFI operating province-wide	4,300,000
	MFI operating country-wide	8,600,000
Uganda	Micro Deposit-Taking Institution	270,000

1 Staschen, Stefan. 2003. Regulatory Requirements for Microfinance: A Comparison of Legal Frameworks in 11 Countries Worldwide. Eschborn, Germany: Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ). The study can be downloaded from http://www.gtz.de/wbf/doc/staschen.pdf or ordered by sending an email to financial.systems@gtz.de.

2 The 11 countries covered are the following: Ethiopia, Ghana, South Africa and Ghana in Africa, Bolivia and Honduras in Latin America, Bosnia-Herzegovina and Kyrgyzstan in the CEE/NIS region and Indonesia, Nepal and Pakistan in Asia.

3 In two of the countries, Bosnia-Herzegovina and South Africa, special legal frameworks have been introduced for the non-prudential regulation of credit-only MFIs. These are special cases and will not be part of this summary article.

4 Ghana appears twice in the table as both Non-Banking Financial Institutions under the NBFI Law and Rural Banks under the Banking Law have been included in the study.

Taking Care of The Mission Means Taking Care of The Client

Ximena Arteaga, Regulation and Policy Specialist, FINCA International

An ongoing challenge for microfinance organizations is to find ways to better accomplish their social and business objectives and find ethical standards that will help attain these goals. One of the greatest ethical concerns is related to the organization's relationship with its clients. Lately, not in isolation from a worldwide demand for a more ethical way of conducting business, microfinance organizations have wondered how they can develop ethical standards and measurements to guide their relationships with clients. One way to answer this concern is through the creation and implementation of a Code of Practice. This article explains what a Code of Practice is, why it is useful to establish one, and how this can be done.

What is a Code of Practice?

A Code of Practice is the map or the declaration of how a microfinance organization will encourage its employees to conduct, enhance and control the relationship with clients. A Code of Practice will include specific statements for which the employees of the organization will be held accountable; it will elaborate the standards present in the values, the mission, and/or the code of ethics, if the organization has one.

Why Have a Code of Practice?

A Code of Practice has several applications in an organization, which can result in a variety of benefits. The applications can be classified in two categories, internal and external.

Internally, a Code of Practice can be a control mechanism, because it can be the standard against which employees will be measured in their dealings with clients. This is possible because the Code of Practice provides guidelines regarding the needs, purpose and activities of the organization in conducting the relationship with clients; this is why it functions as an accepted base of shared values. In other words, the Code puts personal views and assumptions in a specific context of responsibility towards the clients. If there is an employee who does not conform to the mission, the values, and ultimately the goals of the organization, the organization can hold the employee responsible for not following the Code (it can be very difficult to prove that the employee does not follow the mission, but it becomes easy to prove deviation from the Code, since it has specific statements). The benefits of this internal application of the Code are highly committed employees that will feel comfortable following the mission and accountable for their actions with clients. Another internal benefit is the insight an organization gains from going through the process of drafting a Code of Practice. Because this process is very introspective, it may serve as a self-analysis that will yield not only practical standards reflected in a Code, but also a change in the business philosophy to a consumer orientation.

The most obvious external use of the Code of Practice is at the moment of establishing the relationship with each client. If Code is made publicly available, it informs the client, from the onset of the relationship, what to expect from the organization (since a relationship involves the two parties, the client also learns what the organization can expect from her/him). The benefit of using a document available to the public, such as a Code, is the transparency that is created in the relationship (between the client and the organization). Transparent relationships can foster client loyalty, which is particularly important when a microfinance organization faces an increasingly competitive market. Another benefit provided by the Code is the ability to differentiate oneself from competitors. Having a Code of Practice is already a differentiating element, but the truly differentiating point is using the Code to reflect the mission of the organization in the daily actions of its employees. Since the mission is unique and the Code reflects the mission, the employees will carry the relationship with a unique approach; this is the real differentiation.

Once the organization understands the Code of Practice and identifies the benefits it can obtain from its application, the next step is to draft its own Code that reflects the particularities of the organization.

How Does One Draft a Code of Practice?

Although there is no "recipe" for drafting any code, an organization should think about certain elements that a code could include to be a robust, living document[1]. These elements (as discussed more fully below) include: (i) a commitment statement, (ii) an explanation of the organization's operations and its products and services, (iii) a statement about how transparency is served by disclosure and accessibility, (iv) a discussion on community engagement, (v) how the organization will handle accountability through compliance with the Code and how it handles complaints and (vi) relevant provisions ensuring that the Code is consistent with the local legal framework. Please, note that these are suggested elements that, when used, make the Code of Practice the rounded document that will provide the benefits mentioned before.

- The commitment statement mentions the organization's commitment to establishing and maintaining a transparent relationship with the client; in other words, the commitment statement presents the reason why the organization has written a Code of Practice.
- An explanation of the organization's operations, products and services serves to explain marketing practices of the products/services as well as the organization's debt collection. Marketing includes the product and its characteristics, how the organization prices it, and the promotion and distribution techniques that the organization will use. Debt collection is a delicate topic, because this is the area where client-provider relationship may go

astray. Although many organizations may not be inclined to mention collection practices in a document that will be made known to the client, it is highly probable that they already have written or unwritten policies in place. Drafting the Code may induce the organization to revise these policies to reflect a greater consumer orientation.

- A statement on transparency mentions whether and how often the organization discloses information such as financial statements, interest rates, loan agreements. Moreover, the Code may disclose this information in a format that is easier to understand than the conventional financial statements.
- Community engagement shows how concerned the organization is in participating in community activities, sponsoring education of its clients (e.g. financial literacy), or avoiding questionable practices. Questionable practices in this context refer to the actions accepted culturally. These may not be illegal, but are unacceptable for the organization.
- Accountability addresses how the organization demands employees' compliance to the Code and how it will respond to complaints from clients. As mentioned before, a Code can be used as a tool of control, which means that the organization would measure behavior of the employees against the standards elaborated in the Code. If the organization has an internal auditor, this person could include compliance with the Code as part of her/his regular control activities. Responsiveness to complaints is a key element of maintaining healthy relationships. The best response begins with a clear path of how and by whom the complaint will be handled. If the Code states this path, the easier it will be for the clients to communicate complaints and for the organization to resolve them.
- It is important to consider whether the Code of Practice should include one or more statements to make it consistent with the local laws. In practical terms, none of the points mentioned above should have inconsistencies with local laws.

Different organizations may find different comfort zones for how much they want to "disclose" in a Code of Practice. However, without going into details of elaborating the elements mentioned above, the Code of Practice typically would reflect the organization's mission and values and a commitment to a transparent relationship with the clients.

Once an organization has determined how the Code of Practice will look, the next step is to adopt it. However, there may be some barriers that can be encountered along the way. One of the first reactions among the employees could be apathy. Apathy normally is the result of cynicism. Cynicism towards a Code of Practice in client relations may arise because employees of the organization doubt its value. This behavior can be dispelled by the fact that clients will prefer the transparent organization; however, this takes time. The organization has to stick to its principles and the benefits will accrue over time. Another barrier encountered in instituting a Code of Practice may be the lack of know-how to draft such a Code. Usually this barrier can be overcome by appealing to groups in the sector who are already working this issue[2] or in some cases to consultants that can guide the organization in the process to draft the Code. Legal worries may also create a barrier to establishing a Code of Practice. As mentioned earlier, a robust Code of Practice will take into consideration local law and will not have statements that either trample the law or put the organization in a weak legal position in its contractual relationship with its clients. To great extent, legal concerns go hand in hand with lack of know-how; both issues can be minimized by consulting legal counsel, similarly to what is done when a loan contract is drafted. Another barrier to adopting a Code of Practice may be fear that the document will be constraining, i.e., a straight jacket that will limit the relationship with clients, because every action has to fall within the parameters of the Code. This concern may be addressed by explaining and ensuring that the Code of Practice addresses specific issues in a broad enough manner; in other words, it acts as guidelines, not of rules, of interaction. As mentioned earlier, it is more important to commit to transparency and a customer orientation because the actual wording of the Code can be changed if it restricts desirable actions. It is possible that initially, the organization may choose not to have an extensive Code. The more familiar people become to working under a Code of Practice, the more ample the comfort zone regarding disclosure (to clients) may become. Once all these barriers have been worked out, then the organization may be ready to live under a Code of Practice.

Conclusion

Microfinance organizations were established with a clear client orientation reflected in their mission. Today, microfinance organizations are seeking more than financial sustainability, they are looking for better ways of measuring how the mission is accomplished. Additionally, it is becoming increasingly important to protect clients from the imminent dangers that a more complicated supply of financial services can bring along. A Code of Practice for guiding the relationship with clients could help an organization foster good business and social practices through a consumer protection orientation. In practical terms, a Code of practice will take a microfinance organization to a new level of mission accomplishment and to a better relationship with its clients, because, ultimately, without a client there is no need for a mission.

1 A group of practitioners has formed a Task Force on Consumer Protection at the Small Enterprise Economic Promotion – SEEP Network. The template, which contains the elements mentioned in this article, can be found at www.seepnetowork.org.

2 Hopefully, in the near future, local networks or associations will assume a leadership role in promoting the adoption of Codes of Practice in consumer protection and could thus become a resource to their members.

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