



**MICROFINANCE CENTRE**  
for Central and Eastern Europe and the New Independent States

# THE STATE OF MICROFINANCE in Central and Eastern Europe and the New Independent States

*Sarah Forster, Seth Greene, and  
Justyna Pytkowska*



Supported by



Open Society Institute

US Agency for  
International  
Development

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**in Central and Eastern Europe**  
**and the New Independent States**

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***Sarah Forster, Seth Greene, and Justyna Pytkowska***

***A Microfinance Centre project supported by CGAP, the Open Society Institute,  
and the US Agency for International Development***

**CGAP Washington, D.C.**

Published 2003 by CGAP, the Consultative Group to Assist the Poor

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Washington, DC 20433 USA

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First printing June 2003

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*Bottom left:* Bosnian man in workshop, Bosnia and Herzegovina (©2001, The World Bank Photo Library/Chara Tsitoura)

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## Foreword

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**Maria Nowak and Elizabeth Littlefield**

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**MICROFINANCE CENTRE**  
for Central and Eastern Europe and the New Independent States

**MARIA NOWAK**  
*Founding Chair*

*Microfinance Centre for Central & Eastern Europe  
and the New Independent States*

In the early 1990s, the concept of microcredit was virtually unknown in Central and Eastern Europe and the New Independent States. At most, savings and credit cooperatives, established at the end of the nineteenth century and inspired by the Raiffeisen movement, were recalled in some postsocialist countries. But the majority of governments considered the prospect of encouraging self-employment or microenterprise, by offering small loans to low-income people, absolute nonsense.

Workers themselves were the ones to realise that they would never reclaim the jobs they lost with the demise of the region's large state-owned enterprises. They took the step of trying to start their own income-generating activities in order to survive. And it was their demand for credit—demonstrated by a few pilot microcredit projects—that convinced the governments of these countries of the potential of microfinance. Since then, with the financial and technical support of international aid, microfinance has developed throughout the region.

In 1996, three practitioners—Rosalind Copisarow, Ken Vander Weele, and myself—had the idea to create the Microfinance Centre for Central & Eastern Europe and the New Independent States (MFC). Our aim was to address the lack of basic information, training, and technical assistance which plagued the region's microfinance programmes, basically necessitating each one to reinvent the wheel. Managed by Grzegorz Galusek, the MFC today plays an important role in improving the capacity of the region's microfinance institutions—via training and consulting services, the dissemination of best practices, the development of mutual learning and exchange networks, and work to create legal environments supportive of microfinance.

This report, *The State of Microfinance in Central and Eastern Europe and the New Independent States*, examines the remarkable progress microfinance and, in particular, microcredit have made in the region. Microcredit has played—and will continue to play—an important role in the economic development of the region. It breaks through people's "imagination barrier," encourages initiative, and builds economic empowerment. It creates employment by supporting enterprise development from the bottom up, rather than in the top-down style of the past socialist regimes. It helps modernise agriculture and reduce rural poverty. For these reasons, microcredit must be harnessed by every country in the region, from those fully in the grip of transition to the 10 nearing membership in the European Union.



The influence of microfinance in Central and Eastern Europe and the New Independent States has already begun to move beyond the region's own borders, particularly westward. Right now, most microcredit operations in Eastern Europe are ahead of those in the EU, particularly in terms of their scale of operations and sustainability. The MFC is building relationships with microfinance institutions in the West and has pledged to be an active partner in establishing a sister centre in the European Union, so beginning a transfer of microfinance experience from East to West, and vice versa.

One fundamental lesson that the Central and Eastern European experience offers Western welfare-state economies is this: entrepreneurship never dies. Even if forbidden for 40 years, it re-emerges when the environment is again favourable. This has been proved by Albanian peasants, Bosnian refugee women, and Polish labourers with no more than state-farm work experience—all assisted by microcredit. What microcredit does is bring together two basic ingredients of any production process, capital and trust. These are fundamental requirements for supporting people's initiative and entrepreneurial spirit. This is as true in the West as in the East.

The promise of microfinance is that it will relocalise the world's economy and balance the trend of globalisation, on the rise since the end of the nineteenth century. At that time, one hundred million people left Europe to escape poverty, globalising labour. Today, capital is being globalised as large, international banks encourage massive increases in global financial flows. Yet, the resulting global financial system benefits only a tiny minority of the world's population. Microfinance challenges and helps reverse this trend—by providing access to finance to those who are financially excluded, particularly the poor. It focuses on building financial systems that work for the poor. Without microfinance, we risk a commitment of capital away from the real economy to the virtual economy, where financial flows do little to improve people's quality of life or to reduce inequality and poverty.

For these reasons, microfinance has a brilliant future, not only in developing countries but also in the industrialised world. Our hope is that this study will drive interest in this emerging subsector of the financial market and will foster partnerships between donors, banks, private investors, and microfinance institutions.

## Foreword *(continued)*

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**ELIZABETH LITTLEFIELD**

*Director*

*CGAP, The Consultative Group to Assist the Poor*

Countries all over the world are beginning to see the staggering potential of microfinance. It is a potential far greater than an effective credit methodology or a specialized niche of development. Today, microfinance means designing entire financial systems in developing and transition economies that, for the first time, serve the majority of poor people. It means taking down the walls that separate our efforts from those made on behalf of the formal financial system, domestic capital markets, and development. It means enlisting a wide range of financial and nonfinancial institutions and delivery channels to provide low-income households and small businesses with the financial services they need to grow and participate fully in their countries' economies. This vision means every household will have a safe place to save money, access to affordable loans, or a secure means of transferring funds from cities to rural family members.

In just over a decade, microfinance in Central and Eastern Europe and the New Independent States has grown to serve two million active clients (including savers). Leading institutions there have proved that providing financial services to the poor can be as commercially viable as it is in other regions. And a regional consensus about what is needed to make microfinance work is growing—a supportive policy environment, interest rates that cover costs, demand-driven products, and a relentless focus on efficiency.

The region's route to its early accomplishments has been different from that of other regions—it has provided important lessons, just as we engage a wider range of institutional models to deliver financial services to the poor worldwide. This study highlights the predominance of credit unions and cooperatives, which dwarf the NGOs' breadth of client outreach. On the other hand, commercial banks in most of these countries have been slow to engage in the sector, either as lenders to microfinance institutions or as direct service providers. This is true despite the relatively stronger banking sectors emerging from the current reform process, along with, for the most part, better-functioning titling and judicial systems.

In Kazakhstan, Russia, and Bosnia, innovative models have successfully integrated microfinance into the formal financial system, moving away from limited-scale donor dependence. Banks in Bosnia have been lending to NGO microcredit providers for several years already, while in Kazakhstan, EBRD-supported and IPC-assisted commercial banks are reaching further down the market than they previously thought feasible. The Microfinance Bank in Georgia is sharing branch facilities with Constanta, a microcredit NGO, as an

inexpensive way to test new secondary-market locations. Savings and credit associations in Moldova, with the assistance of CGAP and the World Bank, have created partnerships with commercial banks as vehicles for ongoing funding and cross-selling.

Yet, still deeper and more extensive contractual and ownership arrangements are needed, which build on the comparative strengths and interests of non-banks and banks. Such integration is essential if microfinance is to grow dynamically, reach significant scale, and become a permanent provider of financial services. Without intermediating domestic capital, the growth of microfinance will always be curtailed.

The elements needed to scale up and diversify financial services in Central and Eastern Europe and the New Independent States are in place—or are being put into place. A strong understanding of the requirements of sustainable microfinance exists, thanks in large part to the MFC. Leading microfinance institutions have achieved impressive financial performance, and the region's standards for financial reporting and transparency are rising to levels considered to be good practice internationally. Enabling governmental policies are slowly developing as unsupportive ones are being dismantled. Microfinance in this region, by capitalizing on these and other accomplishments, is now positioned to become a beacon for the rest of the world working to develop vibrant, inclusive financial systems.

This report, *The State of Microfinance in Central and Eastern Europe and the New Independent States*, showcases these accomplishments to the policy-makers in CEE and NIS and to both commercial and donor funders, as well as to the rest of the world's microfinance practitioners. It announces the ultimate potential of microfinance.

CGAP would like to thank the MFC and, particularly, Sarah Forster for this critical contribution to the microfinance literature. We would also like to thank USAID and OSI for their joint funding, and all those microfinance providers, networks, and funders that joined in this study by providing valuable information.

The story told in this report is an inspiring one, motivating us all for the awesome task ahead. With an estimated 95% of the region's microfinance demand still unserved, it will take committed, generous, and collective action to provide the commercial financial services needed by those of low income who live there. But such services will enable these people to build assets, educate their children, seize opportunities, and chart their own paths from poverty to prosperity.

## Acknowledgements

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The publication of this report would not have been possible without the contributions of both MFIs and funders in Central and Eastern Europe and the New Independent States. Our thanks to all those who provided data for the study. In particular, we would like to thank those who, in addition, gave their time to be interviewed or provided case study material. Specifically, from the MFIs, we would like to thank Helen Alexander from IMI in Germany, Tima Becirović from MI-BOSPO in Bosnia, Deborah Burand from FINCA International in Washington, D.C., Sanin Campara from Mikra in Bosnia, Csaba Kalman from Opportunity Microcredit in Romania, Laura Fainzilberg from FINCA International in Russia, Anna Gincherma from Women's World Banking in New York, Albina Iljazović from Partner in Bosnia, Rusudan Kharabadze from World Vision in Georgia, Sean Kline from Prizma in Bosnia, Aleksandar Kremenović from MIKROFIN in Bosnia, Tamar Lebanidze from the Constanta Foundation in Georgia, Jason Meikle from FINCA in Kyrgyzstan, Damir Miljević from Sinergia in Bosnia, Heather Moncrief from FINCA in Georgia, Bajram Muca from the BESA Foundation in Albania, Nejira Nalić from MI-BOSPO in Bosnia, Neil Ramsden from Bannock Consulting in London, Chris Reedy of the FORA Fund in Russia, Janice Stallard from ACIDI/VOCA in Kazakhstan, Witold Sz wajkowski from Fundusz Mikro in Poland, and Gagik Vardanyan from MDF Kamurj in Armenia.

And from the funders, our particular thanks to Jean Philippe De Schrevel from Blue Orchard Finance; Asad Mahmood from Deutsche Bank; Steven Bovens, Charlotte Gray, Elvira Lefting, and Elizabeth Wallace from the EBRD; Werner Breden from DEG; Emile Groot from FMO; Anne Ritchie from the IFC; Arlina Tarigan from KfW; Gert Van Maanen from Oikocredit; and Nelleke Veenstra from Triodos International.

Several people have also taken the time to review draft versions of this report and provide their comments and insights which have helped shape this final version. For this, particular thanks to Maria Nowak and Gert Van Maanen of the MFC Board for their challenging comments on an early draft. Also, grateful thanks to Doug Pearce of CGAP who provide invaluable feedback and support along the way.

Finally, thanks to our funders who have made this report possible. Specifically, we are grateful to Elizabeth Littlefield of CGAP, Piotr Korynski of the Open Society Institute, and Kate McKee of USAID.



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## CHAPTER 1

### INTRODUCTION

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*Chapter 1 describes the study's goals and the definition of microfinance on which it is based. It also contains a list of the many countries in Central and Eastern Europe and the New Independent States, categorised by subregion. Finally, the chapter identifies the audiences for whom we expect this report to be particularly useful, and suggests some ways in which to use it.*

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### The Goals of the Study

This report is based on the first empirical study of the microfinance industry in Central and Eastern Europe and the New Independent States (CEE and NIS). The main source of its findings is a survey of the region's microfinance institutions (MFIs) and funders conducted in 2001 by the Microfinance Centre for Central & Eastern Europe and the New Independent States, headquartered in Warsaw, Poland.

The study achieved its four main goals:

- The creation of an empirically based, comprehensive picture of the current state of the microfinance industry in the region
- A comparison of the performance of the region's main organisational models for microfinance delivery—credit unions, nongovernmental organisations (NGOs), “downscaling” commercial banks, and “greenfield” microfinance banks
- An analysis of the main barriers to growth and development confronting microfinance in the region—specifically, access to finance and legal and regulatory constraints
- A framework for action for the region's various microfinance actors, the goal being to increase the scale, outreach to the poor, financial viability, and impact of microfinance in the region

The first three goals in this list are, however, subject to some data limitations. These limitations reveal areas for further study but do not, we believe, significantly call the accuracy of the study's findings into question.

The first goal—an empirical picture of the region's microfinance industry—depended heavily on the study's survey responses. These responses, supplemented with secondary-source data from annual reports and Web sites, gave us the data we needed. Not surprisingly, we still ended up with less than 100% of the data sought. Of the MFIs we were able to identify, 15% of the region's credit unions, 43% of the NGOs, 38% of the commercial-bank downscaling programmes, and 67% of the microfinance banks responded to our survey, as did 71% of the funders. When combined with secondary-source data, the study's coverage increased to 95% of identified credit unions, 74% of NGOs, 100% of microfinance banks, and 73% of downscaling programs, along with the same 71% of funders. Hence, while the study's findings present a reliable picture of the size and performance of a significant majority of the region's microfinance industry, it does not necessarily represent the entire sector. (Appendix 2 has further details of the study methodology and data limitations.)



Furthermore, for some areas of analysis we had fewer survey responses than for others; in other words, all respondents did not answer all of the survey questions. For example, we received nearly a 100% response on questions asking for outreach indicators (number of clients, portfolio size, etc); however, on operating-efficiency and profitability data, we received responses from less than 5% of the credit unions and downscaling commercial banks, from 35% of the NGO MFIs, and 90% of the microfinance banks. Where necessary and appropriate, we extrapolated the available data so conclusions could be drawn on a sectorwide level.

The second goal—a comparison of the performance of the region's four main MFI models—particularly depended on having reliable and standardised information from the MFIs. In actuality, the availability and quality of their data varied widely, which limited our ability to form definitive assessments of performance. Where relevant, we noted these limitations, along with the findings. This shortage of standard, reliable data underlines the need for improvements in the quality and transparency in the reporting of these MFIs.

The third goal—a largely qualitative assessment of the barriers to microfinance growth in the region—depended on survey answers from the MFIs and funders, as well as an analysis of the financing available and laws and regulations affecting microfinance in the region. As stated above, the survey answers used came from 15% of the identified credit unions, 43% of the NGOs, 38% of the downscaling commercial banks, 67% of the microfinance banks, and 71% of the funders. The supplementary, in-depth analysis covered the financing and legal aspects of microfinance in about half of the region's countries. We consider the resulting data, while not fully comprehensive, to be sufficient to allow an accurate assessment of the barriers to microfinance growth and development facing CEE and NIS.

## **Identifying the Microfinance Clientele in the Region**

The target clients and, to a lesser extent, types of services that fall under the umbrella of microfinance are issues that are debated, sometimes fiercely, among all microfinance stakeholders and would-be stakeholders. Traditionally, these have largely been the donors, as the primary funders of microfinance, but today also include practitioners and, to a lesser extent, commercial funders and governments.

As a consequence, those conducting studies such as ours do not have the luxury of relying on concretely defined terms and parameters. Instead, in order to determine the scope of their studies, they must—necessarily—take a position in this debate of definitions. Some do so implicitly, sometimes even unknowingly. We have preferred to take a more deliberate and explicit approach to these questions.

Part of the debate over the identification of services that qualify as microfinance has largely been put to rest. Today, there is a consensus among microfinance stakeholders worldwide that the field now encompasses all financial services, including credit, savings, and insurance. This development—moving away from the field's roots of providing solely microcredit to poor microentrepreneurs—has been driven by a new emphasis on the use of noncredit services by the poor to build assets and financial security.

Our study is aligned with this new consensus; that is, we looked at both the provision of credit and savings services. Other microfinance services are not included in the study's scope only because they have not yet developed to a significant extent within the region.

The other part of this debate—the identification of microfinance's target clientele and, by extension, the identification of microfinance service providers—remains unresolved. Microfinance stakeholders largely subscribe to one of two perspectives. The first sees the goal of microfinance exclusively as providing financial services to the

poor; that is, it sees the poor as the sole target clientele. Consequently, it sees NGOs and other poverty-focused organisations as the only legitimate microfinance service providers. The second sees the goal of microfinance as the provision of financial services to all who lack access to mainstream financial services because they are considered unbankable by mainstream banks. Adherents to this perspective identify a broader target clientele, one that includes the poor as well as higher-end micro and small enterprises. Consequently, this perspective looks to recent, bank-based microfinance operations, along with the NGOs, as the primary providers of financial services for the poor.

This study subscribes to the latter perspective. Our data covers the broader range of clients and providers in the region. Our alignment with those who see a broader target market for microfinance is primarily founded on a practical observation: the debate within microfinance appears to be moving in favor of this broader perspective. Worldwide, the number of stakeholders who see the purpose of microfinance as serving all without access to mainstream financial services is increasing, at the expense of those who see it serving only the poor. By going with the trend, rather than against it, we believe our data and conclusions will be more relevant to the microfinance community for a longer period of time.

Our judgement of the direction of the debate over the identity of microfinance's target clientele is, we believe, grounded in significant evidence. For example, in the region of CEE and NIS itself, the trend has been dramatic. Today, the microfinance stakeholders in CEE and NIS that favor a broader goal and target clientele for the field greatly outnumber those who would focus exclusively on the poor. Even the region's NGO microfinance providers have not been as focused on reaching the poor (who are the traditional clientele of this type of MFI) as are their counterparts in other developing regions (see Chapter 6). Instead, their focus is on providing financial services, particularly credit, to micro and small enterprises that lack access to other financing. This has been these NGOs' strategy to increase their self-sufficiency and scale of outreach—goals that they balance more evenly with poverty outreach (as do other MFIs) than do NGO MFIs elsewhere.

## Identifying the Microfinance Service Providers in the Region

Given the description of microfinance services and clients that we have adopted for this study, we identified four main types of organisation in CEE and NIS as microfinance service providers.

**Credit unions (CUs).** Along with other mutual savings and credit institutions, CUs are member-owned and -governed, deposit-taking organizations that provide services only to their members. Traditionally, credit unions have not been considered microfinance providers, given their focus on deposit services and consumer lending. However, with the new consensus that microfinance includes a broader range of services, CUs are acknowledged providers. In fact, this is one of the earliest statistical studies of a region to incorporate CUs on an equal footing with other MFIs.

**Nongovernmental microfinance institutions (NGO MFIs).** NGOs are nonprofit organisations that specialise in lending to the self-employed and microenterprises but that are not licensed to take deposits. Within this category, we include nonprofit associations and foundations, as well as those MFIs registered as private or public companies that operate on a nonprofit basis.<sup>1</sup>

**Commercial banks.** Banks that provide microfinance are mainstream banks that, at some point after their inception, introduced specialized lending services for micro and small enterprises.<sup>2</sup> This approach is often

<sup>1</sup> Given the small number of MFIs that are registered as companies (less than 10), these were not treated as a separate category.

<sup>2</sup> "Microlending" by commercial banks is defined as involving loans less than US\$5,000.

referred to as “commercial-bank downscaling.” Within downscaling, in line with our definition of microfinance, we only include the portion of a bank’s loan portfolio that has grown out of initial loans of less than US\$5,000.

**Microfinance banks.** These banks are fully regulated, for-profit, commercial banks that offer a broad range of products and services. But from their inception, they lend to micro and small enterprises as their primary business purpose. Such MFIs are often referred to as “greenfield banks.”

Because of a lack of data, this study does not cover the role of remittances, informal lending mechanisms, money lenders, consumer lenders, or leasing companies. However, for the record, we recognise that these vehicles play an important role in the provision of financial services in the region.

## Definition of the Subregions

The region of Central and Eastern Europe and the New Independent States consists of 28 countries, with a total population of 417 million people. These countries are not only geographically contiguous, but they are all in the midst of the transition from a state-controlled economy to a market-oriented one. Indeed, the region consists of an unprecedented concentration of countries undergoing this transition.

However, it must be acknowledged that this region is more diverse than many others in the world. Within it are some highly developed countries (eg, Slovenia and Estonia) but also some of the poorest in the world (eg, those in Central Asia). For analytical purposes, we have therefore divided the region into five subregions, each containing countries with socio-political and economic similarities. These subregions include the countries listed below.<sup>3</sup>

- **The Balkans:** Albania, Bosnia and Herzegovina, Croatia, Kosovo,<sup>4</sup> Macedonia, Serbia and Montenegro, and Slovenia
- **Eastern and Central Europe (ECE):** Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Moldova, Poland, Romania, and Slovakia
- **The Caucasus:** Armenia, Azerbaijan, and Georgia
- **Central Asia:** Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, Uzbekistan, and Mongolia (Although Mongolia is not geographically part of Central Asia, we include it in this subregion because of its similar demography and topography.)
- **Russia, Ukraine, and Belarus:** Russia, Ukraine, and Belarus

Other country groupings referred to in this report are as follows:

- **The Baltics:** Estonia, Latvia, and Lithuania

<sup>3</sup> Throughout this paper, the region of Central and Eastern Europe and the New Independent States is referred to as “the region” or “this region,” unless otherwise indicated.

<sup>4</sup> Kosovo is not an independent country but a province of Serbia and Montenegro, currently under United Nations administration. It is treated separately from Serbia and Montenegro for the purposes of this study, given that it has its own government and legal system and has seen rapid development of a microfinance sector within this local context.

- **The New Independent States (NIS):** Those countries that were the republics of the former Soviet Union<sup>5</sup>
- **The European Union accession countries:** Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia

## Target Audiences

This report is meant to be useful to three primary audiences.

**Microfinance institutions.** MFIs span the region, from rural, western Poland to Russia's Yakutia in the Far East, and from northern Estonia to the southern mountains of Tajikistan. MFIs can use the information in this report in three ways. First, it provides a picture of the state of microfinance and MFI performance throughout the region, against which any individual MFI can benchmark itself. Second, the report is a vehicle for the exchange of knowledge; it offers insights and practical information gleaned by various MFIs in the region, particularly on the topics of outreach to the poor, accessing commercial finance, and overcoming legal and regulatory barriers. Third, it is a source of detailed information regarding the public and private funders operating in the region.

**Funders.** Both donors and commercial funders can use this report to guide their funding strategies at institutional and regional levels. It provides the first statistical overview across the region of the amount of microfinance investment, the numbers of clients reached by the different MFI types, and their financial performance. In addition, it presents findings on the main barriers to growth confronting the MFIs and makes suggestions regarding how funders can help overcome these barriers.

**Government policy makers.** Policy makers can use this report as a briefing on microfinance in the region and, specifically, on the role it can play in supporting their development agendas. Throughout the region, poverty alleviation and the development of micro and small enterprise are important parts of development policy. This report recommends that governments look at MFIs as partners in the development process. For example, the report highlights the measures that governments could take to create a more conducive policy and legal environment for microfinance development.

## Report Structure

The chapters of this report are divided into four main sections.

- **Background.** Chapters 2 and 3 provide background on the development of microfinance in the region. Chapter 2 describes the economic context in which microfinance is developing, focusing on the driving forces behind it. Chapter 3 explains the key features of the different MFI organisational models—credit unions, nongovernmental MFIs, downscaling commercial banks, and greenfield microfinance banks. The origin of each model, its key organisational features, and its target client markets are described.
- **Study Findings.** Chapters 4, 5, and 6 present the study's findings. Chapter 4 looks at the industry's performance and current trends overall by MFI type and by subregion. Chapter 5 offers a more thorough

<sup>5</sup> The New Independent States has recently been renamed the "Commonwealth of Independent States" (CIS) by an agreement between the former republics. However, our study uses the name "New Independent States," since this name is more commonly known and appears as a component in the longer name of the MFC.

analysis of the extent of poverty outreach by the region's MFIs. Chapter 6 assesses the MFIs' financial performance and the relationship between poverty outreach and financial sustainability.

- **Barriers to Growth.** Chapters 7 examines the MFIs' access to funding, and Chapter 8 discusses the region's legal and regulatory environment. These are the two factors identified by the MFIs themselves as the major barriers to microfinance development and growth in the region.
- **A Framework for Action.** Chapter 9 presents an outlook for microfinance over the next decade, followed by a series of recommendations aiming to improve this outlook. Not only does this chapter broadly suggest what needs to be done, but it also suggests how—by proposing concrete actions that MFIs, policy makers, funders, and microfinance support organisations could consider as a means of implementing each recommendation.

## **2002 Update**

In the beginning of 2003, a follow-up study was conducted to check on developments in the region between the end of September 2001 and December 2002. The follow up measured MFI outreach—breadth (number of clients and volume of loans outstanding) and depth (average loan balance)—in a sample of MFIs of each institutional type in all subregions. Furthermore, key indicators of financial condition and portfolio health were also checked in a sample of MFIs, consisting of 68 NGO MFIs, 10 microfinance banks (all banks were operational in September 2001), and 19 commercial banks in the EBRD downscaling programme. The NGO sample represented the largest organisations, including all partners of such international networks as CRS, FINCA International, Opportunity International, and Mercy Corps, as well as a number of non-affiliated local NGOs. Altogether, they managed 95% of the NGO outstanding loan portfolio.

## CHAPTER 2

### THE CEE AND NIS REGIONAL CONTEXT FOR MICROFINANCE

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*This chapter describes the origin, development, and broader role of microfinance in Central and Eastern Europe and the New Independent States—all in the context of the larger macroeconomic environment. Specifically, it explains how a rise in unemployment and poverty, in the transition from socialist-run economies, has triggered the growth of micro and small enterprises. It is their needs for financing that have, in turn, spurred the development of microfinance in the region.*

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#### The Rise of Unemployment and Poverty in the Region

The countries of Central and Eastern Europe and the New Independent States are diverse in their traditions, cultures, and histories. Yet, they share two important historical elements. First, at some point after 1917, each was ruled by a communist regime—whether the soviet, state-bureaucracy variety or Yugoslavia's self-management variety. Second, for more than a decade now, each has been in transition toward democratic rule and a market economy.

Different countries in the study are at different stages in this transition. The 10 EU accession countries (Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia) are the most advanced. They have successfully developed more democratic governments and active private sectors. In many of the other countries, particularly those in the Caucasus and NIS, democracy is less established, and the private sector remains underdeveloped.

Despite finding themselves at different stages of transition, all of the countries in the region share certain fundamental macroeconomic characteristics. Most important is that poverty has increased significantly in each over the last 10 years. While the transition toward a market economy has brought new opportunities to many people, it has brought material hardship and the loss of economic security to others.

The development of poverty in these countries differs from its development elsewhere by the speed and magnitude of its onset. Here, unlike in developing but nontransitional countries, poverty has been a new and sudden condition. It emerged instantly in the 1990s, as a decline in the well-being of much of the population, and created an enormous class of “new poor.” Between 1988 and 1998, absolute poverty rates increased from 2% of the region's population to 21%.<sup>1</sup>

Today, the percentage of people living below the poverty line is as high as 68% of the population of Tajikistan, 50% of Kyrgyzstan, and 40% of Armenia. By contrast, such poverty is virtually nonexistent in most of the countries of Central Europe. The main cause of the region's poverty is unemployment. In many of these countries, unemployment has become a persistent problem due to ongoing privatization and low levels of growth. The

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<sup>1</sup> World Bank, *Making Transition Work for Everyone: Poverty and Inequality in Europe and Central Asia* (Washington, D.C.: World Bank, 2000).

regional variation in unemployment levels is pronounced, ranging from less than 10% in Hungary, Latvia, and Lithuania, to as high as 40% in the Balkans and Central Asia.<sup>2</sup> Even within individual countries, great disparities are seen. Poverty and unemployment are more serious in rural areas than in urban areas. And, in most of these countries, certain regions are much poorer than others often due to the contraction of industry and loss of jobs at state-owned enterprises and rural cooperatives. Particularly hard hit are one-company towns, such as those that sprang up around coal mines. In these communities, downsizing or closing the enterprise can lead to mass unemployment and high rates of poverty.

Several countries in the region have also been torn apart by conflict, which has further impoverished their people. Although the region contains only 7% of the world's population, it is home to an estimated 15% of the world's refugees and internally displaced persons.<sup>3</sup> Conflicts in the Balkans (Bosnia and Herzegovina, Croatia, and Kosovo), the Caucasus (Armenia, Azerbaijan, and Georgia), Russia (Chechnya, North Ossetia, and Dagestan), and Tajikistan have displaced almost 4.5 million people. Although some have returned home (as in Kosovo), displacement in most cases has had pervasive effects. Many of these displaced persons have suffered multiple losses—family members, homes, assets, livelihoods, and social networks—and today make up some of the most vulnerable groups in society.

The poor in the region have much in common with the poor elsewhere in the world—notably, a lack of assets, little access to resources and services, a low standard of living, and feelings of powerlessness and insecurity. However, the region's socialist heritage and current economic transition have also made the experience of post-socialist poverty unusual in two main respects.

- Many of the poor are actually among the “new poor.” Before the transition, people had secure jobs and anticipated regular pensions following retirement. The transition toward free markets ended their guaranteed employment and retirement security. Many people lost their jobs as state-owned enterprises reduced their workforce or closed entirely due to hard budget constraints and increasing competition. In rural areas, many agricultural cooperatives collapsed, leaving farm workers unemployed. These unemployed workers comprise the majority of the region's new poor. They have had to look for new types of employment and, in many cases, have turned to self-employment and small-business development as the only available alternatives.
- It is unusual that most of the poor in this region, unlike the poor in other developing countries, are literate, and many are well educated. Accomplishments in education were among the triumphs of socialism. Adult literacy was generally universal, and the participation and completion rates of both genders in all levels of education were high.

During the first decade of the economic and political reform, growth in GDP declined in most of the countries in CEE and NIS. Many went into recession. Only since 1999 has the decline in real GDP been reversed. Today, it continues on a positive trend in almost every country in the region. In 2001, the region's GDP grew by 4.3%, outperforming most emerging economies, the EU, and the US. In 2002, GDP has continued to grow at 3.4%.<sup>4</sup>

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<sup>2</sup> World Bank, *Making Transition Work*, 2000.

<sup>3</sup> World Bank, *Making Transition Work*, 2000.

<sup>4</sup> European Bank for Reconstruction and Development, *Transition Report 2002: Agriculture and Rural Transition* (London: EBRD, 2002).

However, this growth has yet to be translated into an improved quality of life. Despite increases in GDP, the UNDP's human development index has shown little change in standards of health, education, and employment over the past few years.<sup>5</sup> In fact, according to a World Bank survey, poor people in the region report that their living conditions have worsened during the last decade.<sup>6</sup>

## Private-Sector Development and the Role of Micro and Small Enterprise

The reduction of poverty and unemployment across CEE and NIS depends upon further robust, stable, and equitable economic growth. There is no practical alternative to the new private sector to drive this growth, as well as employment opportunities. The private sector needs to continue growing and developing, until it adequately fills the central economic role once played by the state and state-owned enterprises.

It is small businesses that make up the bulk of the private economy. However, the level of small-business development varies across the region. If one examines the percentage of the total number of people employed by small enterprises (defined as those with fewer than 50 employees), two groups clearly emerge. In the countries of Central Europe and the Baltics, such as the Czech Republic, Hungary, Lithuania, and Poland, new small enterprises have grown very rapidly. They now account for over 50% or more of the total employment—the same level as in the countries of the European Union. But the countries of the NIS, such as Kazakhstan, Russia, and Ukraine, have seen modest or no growth in new, small enterprises, which employ 20% or less of the people working.<sup>7</sup>

Many of the region's new, small businesses are, indeed, very small. Enterprise surveys in many of these countries reveal that 95% of all businesses have fewer than 10 employees. And a large proportion of these businesses are likely to be microenterprises, employing fewer than five employees. Similarly, self-employment has increased dramatically in the region. By 1994, after five years of transition, 10–15% of the economically active labour force in, for example, the Czech Republic, Hungary, and Poland were estimated to be self-employed.<sup>8</sup>

In most of the world's developing countries, millions of poor people have traditionally made their living in small businesses, often in informal-sector activities. In CEE and NIS, however, the new poor, having more recently lost their jobs in the market transition, are newcomers to microenterprise. They include both those with entrepreneurial skills who have voluntarily turned to small business—representing a new entrepreneurial class—and those who have turned to it only out of necessity, because of the current lack of alternative job opportunities. This latter group includes unemployed labourers and office workers, who would likely give up their self-made businesses if offered permanent employment.

Although micro and small enterprises are making a vital contribution to the region's economy and already account for the majority of its jobs, there is a widespread mistrust of the individual entrepreneur, particularly those operating in the informal economy. Consequently, the tendency of most of the region's governments, particularly in the NIS, has been to control small-business activity, rather than to create an enabling environment for its growth.

<sup>5</sup> United Nations Development Programme, *Human Development Report 2001* (New York: UNDP, 2001).

<sup>6</sup> Deepa Narayan, with Raj Patel, Kai Schafft, Anne Rademacher, and Sarah Koch-Schulte, *Voices of the Poor: Can Anyone Hear Us?* (New York: Oxford University Press, 2000).

<sup>7</sup> World Bank, *Transition: The First Ten Years* (Washington, D.C.: World Bank, 2002).

<sup>8</sup> Organisation for Economic Cooperation and Development, *Small Business in Transition Countries* (Paris: OECD, 1996).



The result is that the business environment has remained extremely difficult in many countries, particularly for the smallest businesses.

Major obstacles instituted by these governments include high tax burdens and excessive regulation. This is particularly true, for example, in Ukraine, where more than 100 different governmental agencies are empowered to inspect enterprises. As a result, businesses undergo an average of 80 government inspections per year. Micro and small enterprises, in particular, find it difficult to afford the time and money to deal with these inspections or to comply with government rules, permits, and audit requirements. Ultimately, such business environments undermine people's entrepreneurial spirit and ability to develop businesses successfully.

## The State of the Mainstream Financial Sector

A developed financial sector is typically a precondition for private-sector development because it provides the capital for business growth. However, the financial sectors in the region remain underdeveloped. During the communist era, central banks and state-owned commercial banks had highly limited mandates. Their purpose was either to accommodate and passively monitor the payment flows from one state-owned enterprise to another, as dictated by central planners, or to fulfill financing targets by extending subsidized credit to specified locations, such as rural areas. In no way was the financial system actively involved in allocating resources to maximise the efficiency of their use. When the economic transition started, around 1990, mainstream banks had almost no experience assessing and managing credit risk or using key elements of financial intermediation, such as loan security and credit monitoring. Thus, the transition economies had "to create a functioning financial system where none had existed before."<sup>9</sup>

At the beginning of the transition, state-owned commercial banks were restructured, recapitalised, and put up for privatisation. In addition, newly founded private banks—in many cases, favoured by fairly liberal licensing regimes—entered the market. As a result, almost 4,000 banking institutions operated in CEE and NIS in the mid-1990s, most of them in the Caucasus, Central Asia, Russia, and Ukraine.

Nonetheless, the first decade of financial development has been disappointing for most of these countries. Severe governance problems at both state-owned and newly established private banks have caused many to become so-called "pocket banks." These banks are not agents of change. Instead, they defend the status quo ante by granting bad loans to prop up ailing, former state-owned enterprises or by financing other companies belonging to the banks' owners. Consequently, almost all of these transition countries were confronted with financial crises during the 1990s, as bad lending practices led to the insolvency of many banks. Banks and entire banking sectors collapsed, currencies tumbled, and the value of money and financial assets vanished in hyperinflationary episodes. In the end, the financial sectors of these countries were left almost completely marginalised, with limited assets and banking activity.<sup>10</sup>

In light of these crises, most central banks have now tightened their bank licensing standards and supervisory regulations. Through the implementation of tougher licensing standards, such as increased minimum capital

<sup>9</sup> EBRD, *Financial Sector in Transition* (London: EBRD, 1998).

<sup>10</sup> Except in the most advanced accession countries, the capital markets, insurance sectors, and nonbank financial intermediaries remained largely underdeveloped, playing an even smaller role than the banking sector. In some countries, nonbank financial intermediaries triggered financial crises by operating as pyramid schemes, eg, in Albania.

requirements, central banks and bank supervision agencies are overseeing the liquidation of insolvent banks and the consolidation of those that remain. This has led to a significant drop in the number of local banks in the region.

The presence of foreign banks, however, has increased dramatically, particularly in the EU accession countries and the Balkans. For example, in Poland, Slovakia, Bulgaria, and Croatia, all of which had virtually no foreign banks prior to the transition, the share of foreign-owned banks, by total assets, reached 88% in 2000.<sup>11</sup> This increase in foreign ownership has come about differently in different countries; the accession countries have mostly witnessed the privatisation and sale of local banks to foreign banks, while the Balkans have seen green-field investment by foreign banks.

Most Western banks have set up operations in transition countries to serve either enterprises from their own countries or local enterprises working with Western firms. At least initially, these institutions have confined themselves to wholesale banking, focusing on areas that generate fees and commissions (eg. money transfers and, in the accession countries, share issues). A few foreign banks have also engaged in retail operations.

Few commercial banks, either local or foreign, have shown a strategic interest in lending to micro and small enterprises. Most micro and small businesses in the region have neither a track record nor the amount of collateral required by banks. This precludes the use of the credit technology increasingly applied by these commercial banks, primarily credit scoring and self-selection instruments, especially collateral. Moreover, in some countries of the NIS and the Balkans, current laws and enforcement practices do not support successful collateral-based lending, even if borrowers could provide standard forms of collateral. Also, information about clients (documentary evidence as well as the experience of long-standing bank-customer relationships) is usually unavailable or unreliable, which acts as a further barrier to small-business lending by banks. Therefore, most micro and small enterprises go unserved by the banking sector and have been forced to operate below the formal “financial frontier”—relying mainly on internal financing and the informal financial sector (namely, families, friends, and moneylenders) for funding.

## **The Role of Microfinance in the Region**

Microfinance institutions have emerged in the region largely to meet the unfulfilled financing needs of the self-employed and of micro and small enterprises. For such endeavors to develop, fledgling entrepreneurs must have long-term access to capital. MFIs have been able to fill this demand because they focus their loan analysis on clients' character, cash flow, and commitment to repay the proposed loan, rather than on collateral or business experience. In this way, MFIs take into account the special characteristics of the new private sector in CEE and NIS.

Together, the different types of MFI in the region serve a range of clients. At the lower end of the spectrum are clients with no or limited business experience, whom transition or war-related circumstances have left as a new category of poor and unemployed. This category is diverse. It ranges from those who have started their own income-generating activities after being made redundant at state-owned enterprises to women widowed during regional conflicts who suddenly become their families' breadwinners. These clients require small amounts of

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<sup>11</sup> R. Nicastro, A. Steinbichler, and D. Revoltella, “Banking Sectors in Transition, Comparisons, Experiences and Results,” in *Národná Banka, Slovenska, BIATEC* 10, no. 3 (2002): 23–7.

**Box 2.1 Frustrated by Collateral Requirements, a Store Owner Turns to Russia's Counterpart Enterprise Fund**

The bank loan would have meant displacing her family. Ms. Elena Zubareva needed to borrow what amounted to about US\$500 to expand the line of clothing she could offer in her tiny Russian store. But the only terms a commercial bank in Khabarovsk would consider meant she'd have to put her family's small apartment up as collateral. Worse, the bank insisted that the apartment be left vacant for the life of the loan. This was directly counter to Ms. Zubareva's priority of keeping a familiar roof over her children's heads.

Now a 37-year-old wife and the mother of two, Ms. Zubareva had worked as a schoolteacher in Khabarovsk from the time she graduated from the university until the late 1990s. That was when inflation and inconsistent pay pushed her to look for another job. First, she ended up working as a clerk at the State Heading Record Office. But after a frustrating series of low-paying jobs, she decided to start her own business.

Borrowing some money from friends, Ms. Zubareva rented a tiny space in a nearby shopping mall and opened her own clothing store. Her education, life experience, and good taste made the business an immediate success. In fact, after six months, it had grown enough that she had to hire her first employee. Nonetheless, she could see that the store, offering only the limited variety of styles she could afford to sell, would never generate the capital necessary to achieve her dream of further expansion. She needed to offer her customers a larger variety, and that meant finding additional financing.

That was the reason Ms. Zubareva applied to the commercial bank in Khabarovsk for a loan. But its terms were too difficult—she wouldn't displace her family.

Discouraged, she continued to search for funding. She saw a newspaper advertisement announcing a public information session to be held by the Counterpart Enterprise Fund (CEF), an NGO MFI. Though she had never heard of CEF before, she went. Her attendance led to enrollment in a CEF business training course, which taught her how to evaluate her business's current state in order to determine the optimal loan size warranted for her needs.

Using the cross-guarantee of the members in a CEF loan group, Ms. Zubareva received her first six-month CEF loan, worth \$500, in August 2000. She expanded the assortment of styles and items her store offered from 30 to almost 50 brand names. She also added children's clothing as the school season approached. As a result, her sales doubled—virtually immediately—from US\$30 to nearly US\$60 per day.

That December, Ms. Zubareva repaid the remainder of that loan and, to prepare for the Christmas shopping season, took out a second loan, this time for US\$1,000. She has used the CEF loans to make her business more stable and profitable. Her credit history remains excellent today. Most important, she is saving money to move her family out of its small apartment and into a larger—but certainly not temporary—one.

*Source: Counter Enterprise Fund, Russia (from an interview with Elena Zubareva, client of CEF).*

working capital, along with perhaps other business support, to start or expand small-scale businesses. Initial short-term loans of up to US\$1,000 are usually sufficient to meet their needs. But, typically, they have limited assets and no form of collateral acceptable to traditional banks. Consequently, group lending techniques are often most appropriate for this clientele.

In the middle of the spectrum are the more established microenterprises. These generally are owned by someone with more business experience, employ 1–2 other people, and are family run. The owners often either work small farms or set up business in the trades-and-services sector—for example, as mechanics, hairdressers, retailers, or carpenters. But the group also includes doctors and dentists in private practice and young entrepreneurs entering IT-related and other new businesses. Initial loans of up to US\$2,500 are normally sufficient to finance their working-capital and investment needs (eg, their purchases of raw materials and equipment or the renovation of workspace).

At the other end of the spectrum are larger microenterprises with 5–10 employees. These businesses are mostly in the trades-and-services sector or production. They may have existed under the previous socialist regime but had limited potential for growth due to the lack of market opportunities. With the transition of the economy, these businesses often need capital now to support growth and expansion. They may be able to utilize loans of US\$5,000 to US\$10,000 with terms of 1–3 years. Some MFIs lend to even larger businesses with as many as 20 employees, with loans of US\$20,000 or more. However, making such large, longer-term investment loans requires more sophisticated business and cash-flow analyses than making smaller, shorter-term working-capital microloans.

By supporting such enterprises, MFIs are helping develop businesses from the bottom up, in contrast to the top-down, state-run businesses of the communist past. They are also helping increase incomes and create new job opportunities.

### **Box 2.2 From Repairman to Manufacturer, One Day**

Hajdur Vehid from Sarajevo in Bosnia and Herzegovina tells the story of his involvement as an NGO MFI client.

“I have been a craftsman all my life. After the war, I started a repair shop for industrial sewing machines. I did this with a US\$1,500 loan from a local microcredit organization, LOK. By adding some of my own money, I rented a space in the old part of Sarajevo. At first, we got a few discarded sewing machines, repaired them, and put them up for sale. Today, three years later, some of our clients are the largest clothing producers and exporters in the country. And most important, they are reliable suppliers of business. Our other clients are small-scale boutiques.

“Microcredit is the best thing for a small-business entrepreneur. It is just enough money when additional capital is necessary. The capital can be successfully turned over. As a result, the enterprise can grow, and the loan can be repaid.

“I have successfully borrowed and repaid four loans and am slowly expanding my business. I now employ four people. I have plans to expand into the production of clothes and leather goods and hope one day to employ 40 people. There is always room for production, and with a good plan and high quality, one can really be successful, even despite the high taxes. The taxes still force every small-scale entrepreneur in this country to work much, much harder to succeed.”

*Source: Interview with Hajdur Vehid, Sarajevo, January 1999.*

MFIs also help restore economic security by providing credit and financial services to low-income and disadvantaged groups. Microfinance services other than credit, such as savings accounts and insurance, have as much if not more potential to help build social and economic security by helping people build assets and protect themselves against unforeseen crises. Savings and insurance services targeted to a microfinance clientele are likely to see further development as the sector matures.

MFIs also add to their clients' quality of life in other, more subtle ways. Some microfinance models and organisations dramatically increase their clients' sense of self-esteem. This is particularly true of those MFIs that focus on the poorest of the population. Group-lending models, in which group members guarantee each other's loans, appear to have benefits beyond the provision of credit. They give members support, confidence, and ideas for earning income.

A total of fourteen NGO MFIs (nearly 10% of the total surveyed) and one bank also reported providing clients with business support services, including business advice and management training, in addition to business loans.

## **Chapter 2 Summary**

The countries of CEE and NIS are diverse, but they share one major attribute—each is in the transition from socialism and a state-managed economy to democracy and a market-oriented economy.

With this transition has come increased poverty and unemployment. The poor in the region are distinct from the poor in other developing but nontransitional economies in two main respects. First, many are among the “new poor.” Second, many of the poor are literate and well educated.

In the postsocialist era, self-employment and micro and small businesses have replaced state-owned enterprises as important sources of employment and income. However, entrepreneurship and business development are hindered by high tax burdens and excessive government regulation.

During the last 10 years, many countries in the region have undergone major restructuring of their financial sectors. Private banks have sprung up from the privatisation of some of the old, state-owned banks and from foreign and new, local banks entering the market. Nonetheless, many banks still suffer from weak governance, bad lending practices, and undercapitalization. Few have a strategic interest in small-business lending, which is seen as a high-risk, low-profit business.

As a result, microfinance institutions have emerged in the region largely to meet the unfulfilled financing need of micro and small enterprises. The region's MFIs serve a clientele ranging from low-income individuals with no or limited business experience to more established micro and small enterprises. By providing access to capital to these individuals and businesses, MFIs are helping encourage initiative and rebuild entrepreneurship. They are helping develop businesses, increase incomes, and create new job opportunities. In this way, they are making an important contribution to creating wealth and improving the quality of life of low-income people in the region.

## CHAPTER 3

### ORGANISATIONAL MODELS OF MICROFINANCE IN CEE AND NIS

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*Chapter 3 provides background information on the four main microfinance models in Central and Eastern Europe and the New Independent States: credit unions, nongovernmental organizations (NGOs), “downscaling” commercial banks, and microfinance banks. It describes the origins of each model and key features—specifically, their mission, legal and governance structure, capital structure, target clients, and products and services.*

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#### Credit Unions

Credit unions (CUs) have the longest legacy of all MFI types in CEE and NIS. The origin of credit unions dates back over 130 years. The first CU (known then as a “savings and loan cooperative”) was established by F. Wilhelm Raiffeisen in Germany, in 1869. Raiffeisen’s vision was driven by socio-economic motives—to provide financial services to the large segment of society without access to mainstream banks and to empower the lower classes to reinvest their savings in their local communities. The Raiffeisen model of savings and loan cooperatives began to spread by the late 1800s—first to Central and Eastern Europe, then to the remainder of Western Europe, and finally to Africa and the Americas.

Some of the earliest credit unions in the CEE and NIS region were established in Poland and Ukraine. Poland’s first credit union was founded by Dr. Franciszek Stefczyk in 1890. By the end of World War II, Poland had about 1,300 CUs, with an estimated total membership of well over one million people. In Ukraine, the first credit union was founded in the Poltava region, in the late 1800s. Close to 3,300 CUs were opened in central and eastern Ukraine, although none survived past 1919. Early CUs were also established in the Baltic States (Lithuania and Latvia). By the early twentieth century, credit unions were established as small but vital community-based financial institutions in many countries in the region, that provided the only source of credit in their local areas.

Shortly after World War II, credit union development in most Soviet-occupied states, including Poland and Ukraine, diverged from CU development elsewhere. Soviet banking laws were enacted that first centralised and then liquidated CUs in these countries. In many cases, credit unions and similar institutions were allowed to re-emerge as “worker savings and loan cooperatives,” which were very different. They were no longer independent, community-based institutions but were subject to state control, both financially and administratively. Most were operated and, in effect, owned by state-owned companies, which provided operational cost subsidies in various forms (eg, free rent).

Entirely new savings and loan cooperatives were also established in many of the CEE and NIS countries, including Russia. But many of these workers’ cooperatives used members’ savings to make loans to their wealthier members or the politically powerful. Consequently, they were quickly regarded as corrupt.

In some countries, such as Bulgaria and Romania, these financial cooperatives enjoyed restricted independence. However, at this time, they did not offer inflation-adjusted services. Consequently, savers usually lost money, while borrowers got practically interest-free loans.

Since the fall of communism in the early 1990s, independent savings and credit institutions, owned and managed by their members, have re-emerged throughout CEE and NIS. Credit unions are the most advanced in Central and Eastern Europe, particularly in Poland. The first of Poland's postcommunist credit unions was established in June 1992. Since then, they have developed in the workplace—in factories, coal mines, and shipyards—as well as in small communities, where they are often linked to the local church parish.

In September 2001, Polish credit unions combined had 480,000 members and US\$360 million in assets. This is the second-largest concentration of credit unions in all of Europe, behind only Ireland. They offer a sophisticated range of products and services. While the Romanian and Ukrainian credit unions also have large numbers of members, they have not yet reached the levels of sophistication and financial viability of the Polish credit unions.

The revitalisation of the credit union movement in the region is being supported by the World Council of Credit Unions (WOCCU) and Développement International Desjardins (DID). Currently, these organisations sponsor credit union development projects in Latvia, Lithuania, Macedonia, Romania, Poland, and Ukraine. The Asian Development Bank and the World Bank are also playing an important role in supporting the development of credit unions and other membership-based savings and credit associations in Albania, Azerbaijan, Kazakhstan, Moldova, Ukraine, and Uzbekistan, among others.

### Box 3.1 St. Anthony's Parish Credit Union Is Born

"It was on June 12, 1996, that we opened the first Polish parish credit union. First, it was housed in tiny quarters. We had anticipated that it would be adequate because we didn't expect more than 200 members. However, within a month, we had 100 members. After three months, 200 people had joined and deposited their savings with us. When the parishioners learned that our interest rate on loans was less than other financial institutions were charging, they started joining even faster. That's when the explosion came. Soon, we were the first parish credit union with 1,000 members. Now, in June 1998, we have 2,600 members."

Father Bernard Zielinski, priest and founder of St. Anthony's Parish Credit Union

*Source: Adapted from Anna Cora Evans and Dave Richardson, **Polish Credit Union Development: Building a Sustainable Network of Financial Services to Serve Low-Income Masses**, WOCCU Research Monograph Series, No. 17 (Madison, Wisc.: World Council of Credit Unions, Inc., 1999).*

## Mission

The mission of credit unions is to deliver some specific, mutually beneficial service to their members, rather than necessarily to maximise profits.

### ***Legal and Governance Structure***

Credit unions are typically established under special legislation. In many countries in the region, the relevant enabling legislation is poorly developed and has numerous ambiguities or restrictions concerning credit union operations (see Chapter 8).

Credit unions are owned by their members and are accountable to them. Their members are also their customers. Membership in a CU is based on the principle of a common bond—that is, the stipulation that its members must share at least one declared, common characteristic. This common bond ensures a certain level of solidarity and a sense of belonging among the members. On more practical terms, it also has the positive effect of keeping loan delinquency low through peer pressure. The most frequently encountered common bonds are workplace (members are all employees of the same company), professional association (members all pursue the same profession or craft), and geographic location (members all live in the same neighbourhood or community).

The common bond is one of two traits that legally distinguishes CUs from banks. The other is that CUs take deposits only from their members. Banks, on the other hand, do not require its clients to have a common bond and can take deposits from the general public.

CUs' mutual-benefit orientation is further underscored by the mechanism through which they choose their governing and managing bodies. They observe a strict one-member, one-vote principle when electing directors and managers, who frequently must also be drawn from a CU's own membership. (This starkly contrasts with commercial companies, in which the weight of each shareholder's vote, in the selection of directors and managers, is generally proportional to the number or percent of shares owned.)

### ***Capital Structure***

Credit unions are also distinguished from other MFI types in that they are usually "savings-first" organisations—that is, they mobilize savings from their members, and these savings then form the capital base for their on-lending activities. Some credit unions in the region (such as those in Moldova and Poland) are also part of national associations. These associations may operate a central finance facility to manage liquidity among their member CUs and may also borrow externally to provide credit unions with an external source of growth capital.

### ***Clients***

CUs do not generally target "poor clients" specifically, at least not in the sense that many NGO MFIs do. However, low-income people who deposit very small amounts make up, by far, the majority of credit union members. Better-off clients, though, are also important to credit union viability. Larger savers, while constituting a small percentage of the total number of clients, typically contribute the majority of the deposit-base volume. For example, in Polish credit unions, savers with accounts over US\$600 account for only 25% of the total savers but contribute nearly 60% of the deposit base (see Table 3.1). Holding larger and longer-term deposits is seen as a necessary means of building a CU's capital base and ensuring continual and expanding access to loan services for all borrowers.

On the lending side, credit unions are specifically positioned to serve microenterprises and low-income clients in two ways. First, their lending requirements are minimal, application procedures simple, and processing time short. Second, their loan sizes are generally limited and, hence, not attractive to larger borrowers.



**Table 3.1 Savings Structure of a Multi-Branch Polish Credit Union**  
(as of 31 December 2000)

Deposit Range (US\$)	Number of Savings Accounts	% of Total Savings Accounts	Volume (US\$)	% of Total Deposit Volume
\$1–\$600	6,249	74.5	2,784,394	41.0
\$601–\$2000	1,240	14.8	1,797,231	26.5
\$2000–\$3000	904	10.8	2,213,646	32.6
Total	8,393	100%	6,793,271	100

### *Products and Services*

Most credit unions in the region offer both savings and credit services. All offer time deposits, and the majority offer demand deposits (see Table 3.2). On the credit side, all credit unions offer consumer loans. Increasingly, credit unions are entering the business of enterprise lending, which historically was often closed to them by law. Today, such restrictions have been lifted in many of the countries studied. In fact, many recently established credit unions, such as the village credit and savings associations in Albania, are primarily focused on financing businesses, particularly small, private farms and rural enterprises. The most developed and sophisticated credit unions, such as those in Poland, offer a still wider range of services, including automated teller machines (ATMs), electronic payment of monthly bills, credit cards, and life insurance.

**Table 3.2 Products and Services by Institution Type**

Institution Type	Type of Product or Service									
	Working Capital	Investment Loans	Consumer Loans	Housing Loans	Time Deposits	Demand Deposits	Money Transfers	Foreign Currency Exchange	Insurance Products	Leasing
Credit Unions	100%	72%	100%	6%	100%	84%	68%	4%	68%	0%
NGOs	98%	40%	11%	2%	3%	2%	0%	0%	0%	1%
Commercial Banks	100%	100%	71%	35%	88%	88%	76%	82%	29%	47%
Microfinance Banks	100%	100%	20%	10%	80%	90%	90%	70%	0%	10%

## NGO Microfinance Institutions

NGOs (nongovernmental organizations) have developed as important providers of microfinance in CEE and NIS. For the most part, NGOs emerged in the region after the fall of communism. During Communist rule, there was little social impetus to create them, and little political and legal room in which they could function. Those NGOs that did exist were largely “citizen’s associations,” organisations whose members shared interests or hobbies (eg. football or chess).

With the transition to democracy and increased freedom to create social and political organisations, NGOs have multiplied rapidly. Most countries in the region now have hundreds. These NGOs are active in many important social and economic areas, such as advocacy for human rights, conflict resolution, education, health, and community development. Over the past decade, there has been a steady increase in policy-makers’ awareness of NGOs and of the valuable role they can play both in public-service delivery and in society generally. What had been a widespread, markedly inhospitable official attitude toward NGOs has given way, in most countries, to a more neutral posture and, in some cases, even to strong support.

NGOs specializing in microfinance have developed in CEE and NIS as a result of two main factors. First was an awareness among some of the industry’s early leaders, such as Maria Nowak and Rosalind Copisarow, and international NGOs that microfinance could be a powerful tool to help reduce the region’s rising unemployment and poverty. Many foreigners in the region were aware of international microcredit experiences and set out to adapt them to the regional context. Second was strong international donor support for microfinance development.

Early NGO microfinance initiatives in CEE and NIS included:

- **Albanian Development Fund (ADF).** Established in 1992, the ADF initiated a village-lending scheme in the poor rural areas of Albania. The scheme was started with the support of a French NGO and the United Nations Development Programme (UNDP), and was scaled up with World Bank financing. The ADF went on to establish an urban microcredit programme. Both have since been spun off as independent, nongovernmental MFIs. One (the Rural Finance Fund) is a network of village-based credit and savings associations. The other (the Besa Foundation) is a nonprofit foundation specializing in urban microcredit, which the Open Society Institute has invested in.
- **Opportunity International (OI).** OI was created by the Nachala Foundation (later the Nachala Cooperative) in Bulgaria in 1993, with the financial support of USAID. Today, OI provides financial and technical support to a network of nine MFIs in the region—one each in Bulgaria, Poland, Macedonia, Croatia, Romania, Russia, Albania, Montenegro, and Serbia (listed from the earliest to the most recent).
- **Fundusz Mikro.** Fundusz Mikro was founded in Poland in 1994 with the support of the Polish-American Enterprise Fund.<sup>1</sup> Fundusz Mikro’s aim was to adapt international microcredit practices to Eastern Europe and provide Poland’s one million microentrepreneurs with permanent access to capital through a nationwide network of branch offices. With nearly 10,000 clients, Fundusz Mikro has been one of the fastest growing MFIs in the region.

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<sup>1</sup> Fundusz Mikro’s legal structure illustrates the challenges that face NGO microlending in CEE and NIS. Because of an inhospitable tax regime in Poland, Fundusz Mikro was formed as a nonprofit US corporation that, in turn, founded a Polish limited-liability company to carry out its microlending programme.

- **FINCA.** An international NGO specializing in microfinance, FINCA has also played a key role in the development of NGO microfinance. It established FINCA Kyrgyzstan in 1995, which adapted village-banking methods to the region. FINCA Kyrgyzstan is today the largest NGO MFI in the region, with over 20,000 clients. FINCA has since supported the start up of another five NGO MFIs in the region.
- **The Local Initiatives Project (LID).** LID is a national microfinance programme in Bosnia and Herzegovina (BiH), launched by the governments of the Federation of BiH and Republika Srpska in 1996, and is another important early initiative. This ongoing project was designed as part of the post-conflict recovery effort, with the financial and technical support of the World Bank. It aims to build a strong, sustainable, microfinance sector, rather than just one institution. The project consists of three elements: a wholesale microfinance fund that provides performance-based financing for the growth and development of high-performing retail NGO MFIs, intensive capacity-building support, and advice on legal and regulatory reform to create an appropriate legal environment for microfinance.

Other international NGOs also began developing microfinance operations in the region in the mid-1990s. The most active include CARE, Catholic Relief Services (CRS), the International Catholic Migration Commission (ICMC), Mercy Corps International, Oxfam, Save the Children (SCF), and World Vision. They typically began their microfinance activities by incorporating microcredit projects into their larger development programmes. They often had a welfare-driven approach that used low-interest loans and had little focus on ensuring loan repayment. In the beginning, scant attention was paid to sustaining these projects once the initial donor funds ran out. Recently, however, all have increasingly taken an institutional approach and are now aiming to transform their microfinance programmes into independent, locally-owned and -managed, sustainable microfinance institutions, able to offer services to low-income clients over the long term. To do this, the NGOs have had to pay far greater attention to charging cost-covering interest rates and ensuring high repayment.

### ***Mission***

In general, the mission of NGO MFIs in the region is to provide access to credit and other services to the self-employed and to microenterprises. They have chosen to work through financial services as a means to achieve a social purpose, typically that of increasing incomes and creating jobs.

### ***Legal and Governance Structure***

Legally, NGOs are usually formed as either foundations or associations. A foundation (also known as a “fund” in some countries) generally consists of a corpus of property or capital donated by one or more founders who dedicate its use to one or more specific purposes. These purposes are spelled out in the founding documents. Foundations usually have a one-tier governance structure, with a self-perpetuating governing body. An association, by contrast, has a membership of individuals who share a common purpose. It typically has a two-tier governance structure, consisting of a general assembly of all its members and a smaller governing body, chosen by the association’s members from among themselves.

Within the region, there are also a few nonprofit, credit-only MFIs licensed as companies. Examples include Fundusz Mikro in Poland, the Kyrgyz Agricultural Finance Corporation (KAFC) in Kyrgyzstan, World Vision’s Small Enterprise Fund (SEF) in Armenia, and a number of microlending, limited-liability companies sponsored

by international NGOs in Azerbaijan. Given the limited number of private credit-only MFIs, they are grouped and analyzed with NGO MFIs.

### ***Capital Structure***

NGO MFIs in the region are nonprofit organizations that have typically been capitalised by donor grants or concessional loans. However, most of them aim to become financially self-sufficient and earn a positive net income. Any profit is reinvested in their activities, rather than distributed to shareholders.

The income-earning nature of microfinance has created legal ambiguity for NGO MFIs. The assumption that foundations and associations are supported, primarily or exclusively, by grants, individual donations, and other gratuitous transfers is built into the law of some countries in the region. In other countries, where the law is silent or ambiguous on the matter, public officials frequently interpret it to mean that earned income is restricted or prohibited.

However, the importance of “earned income” for NGOs is growing. In fact, most countries surveyed now explicitly permit income-generating activities by both associations and foundations. In some cases, though, the NGO must establish a separate commercial, legal entity to house its income-generating activity, such as microfinance, particularly if the activity is unrelated to the NGO’s declared, socially beneficial purpose.

Another potential source of capital for NGO MFIs is borrowing, whether on a concessional basis from donors or on a commercial basis from banks. In many countries in the region, the legal power for NGOs to borrow is not entirely clear, or there are ambiguities surrounding the permissibility of borrowing funds for on-lending (see Chapter 8 for further discussion).

Because of their legal structure, NGO MFIs cannot accept commercial equity or take deposits. Hence, some have chosen to transform into another legal form, such as a private finance company or a bank, in order to expand their sources of capital. Examples include XAC in Mongolia, which transformed from an NGO to a finance company and then to a microfinance bank; Moznosti in Macedonia, and Microcredit Montenegro, both of which have transformed from NGO MFIs into banks with the help of Opportunity International; and the Aga Khan programme in Tajikistan, which is planning to transform from an NGO operation into a bank.

### ***Clients***

About 60% of the 136 NGO MFIs surveyed reported that they target the economically active poor. The remaining NGO MFIs do not target the poor per se but typically lend to clients engaging in informal-sector activities, and registered microenterprises. These clients often fall in the lower-income segments of society.

The NGO MFIs surveyed are more focused on reaching poor women than are other MFI types. In fact, only among the NGOs in the region are there organisations that target women exclusively. These include the members of the Russian Women’s Microfinance Network, and MI-BOSPO and Women for Women in Bosnia and Herzegovina. Because poor women typically suffer greater financial exclusion than men, microfinance has made them an important target group.

Some NGO MFIs in post-conflict countries explicitly target war-affected groups, particularly displaced persons and returning refugees. One NGO MFI (VAAD in Romania) lends to nonprofit community enterprises (see Box 3.2).

The lending activities of the NGO MFIs in the study are spread fairly evenly across cities, towns, and rural areas. On the other hand, the credit unions operate more in rural areas, and the commercial and microfinance banks operate mainly in urban areas (see Figure 3.1).

### **Box 3.2 Microcredit Helps Teenagers Build a Future**

A Future for Teenagers in Difficulty (VAAD) is a Romanian nonprofit association that processes wood into lumber. Located in Racastie, in the county of Hunedoara, it is one of numerous nonprofits across the country. But its employees are somewhat unique—VAAD hires only young people who grew up in Romania's state-run children's homes. The result is that it often has a young labour force with almost no work experience.

That fact makes VAAD too high a risk in the eyes of commercial banks, which repeatedly turned it down for business loans. "Time after time, the reason we were given for being too much of a risk was that our workers were formerly institutionalised," says Tiberiu Stan, VAAD's general director. "Working with these teenagers is an enormously satisfying challenge, but unfortunately it doesn't exempt us from the same free-market rules as everyone else, certainly not as far as the banks are concerned."

VAAD's luck changed in 1999, when it approached CHF Romania, an NGO MFI, for a loan. "We found CHF to be a flexible and open organization, right when we'd almost lost hope," continues Mr. Stan. "It was just the chance we needed."

With a first loan in October 1999 and a second in November 2000, VAAD was able to begin growing—indeed, dramatically so. It went from a turnover of \$4,000 per month in sales with 8 full-time employees to a current turnover of \$22,000 per month with 69 employees.

The active population of the county of Hunedoara suffers from more than one-third unemployment, making it especially difficult for young people to find jobs—and virtually impossible for the 18-year-olds coming out of children's homes. The 69 jobs provided to teenagers by VAAD, therefore, represents significant assistance. But VAAD is providing its young employees with more than just jobs. They get a home and, perhaps more important, work qualifications that will allow them to compete for future jobs.

Mr. Stan likes to think he and his wife are helping to build a better Romania in which their own son will be able to live.

*Source: Interview with Mr. Tiberiu Stan, General Director, VAAD*

## **Products and Services**

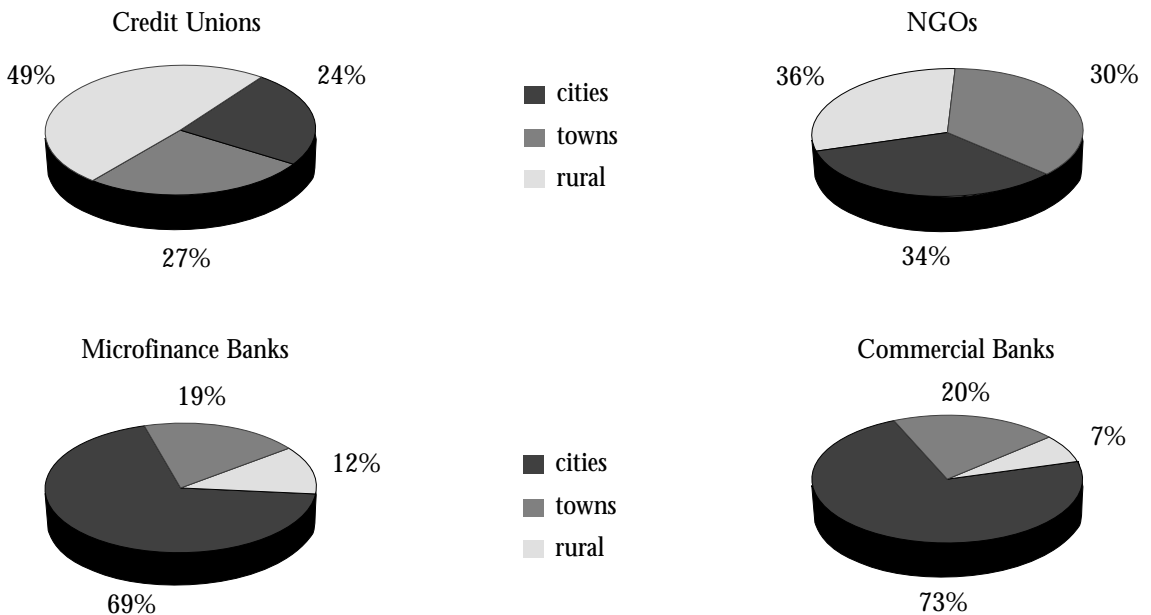
NGO MFIs are nondeposit organisations that usually only provide loans, although some take "forced savings" (savings required as a condition of receiving a loan but that are not on-lent). These institutions have adapted international microlending methodologies to local circumstances. Currently, most offer one or two simple, working-capital loan products, targeted at the self-employed and microenterprises. An initial loan is typically less than US\$1,500, with a term of less than one year and an effective interest rate of 2–3% per month.

Nearly 60% of the NGO MFIs surveyed use solidarity group-lending methods (in which loan liability is shared jointly among a group of typically 4–6 borrowers), either exclusively or combined with individual lending. This distinguishes NGO MFIs from credit unions and banks, which only offer individual loans. Several NGOs, such as CRS and FINCA, specialize in village banking (in which joint liability is shared by a larger group of village residents—typically between 15 and 50—who form a village bank or lending association). The remaining NGOs use individual lending methodologies.

Some NGOs offer a broader range of loan products, including longer-term investment loans (offered by 40% of the NGOs surveyed), which are better suited to growing businesses, agriculture, and production; consumer loans (offered by 11%); and housing-repair loans (offered by 6%). Fundusz Mikro is also experimenting with micro-equity and micro-venture-capital products to meet the demands of growing businesses for longer-term capital. (See Chapter 5 for a description of Fundusz Mikro's "partnership loan" product.)

Although new product development is important, there remains a high, unmet demand for core microcredit products. Hence, many NGOs MFIs are currently focusing on increasing the number of clients for their existing products before diversifying into new ones.

**Figure 3.1 Distribution of Clients by Geographic Location**



### Downscaling Commercial Banks

In the 1980s, during the early days of microfinance development, it was conventional wisdom that mainstream commercial banks would not be willing to engage in microlending because the small size of the loans made such lending prohibitively expensive. NGOs were seen as better placed to address the demands of the microenterprise market.

The commercial-bank downscaling approach challenged this conventional wisdom. The model was initiated by the Inter-American Development Bank (IDB) in the early 1990s, in Latin America. IDB designed programmes that provided credit lines to select commercial banks for the purpose of on-lending to microenterprises. The programme also included technical assistance for each partner bank, which consisted mainly of loan-officer training in microlending techniques and the development of information systems needed to monitor microlending performance.

The partial success of downscaling in Latin America prompted the European Bank for Reconstruction and Development (EBRD) to invest in similar operations in Central and Eastern Europe and the New Independent States, starting in Russia in 1994. At the heart of the downscaling approach are various assumptions that, so far, have failed to deliver microfinance services on the large scale that had been expected. The main assumptions are:

- The use of commercial banks' pre-existing, large branch networks would enable them to reach large numbers of clients at relatively low cost, compared to starting up MFIs or "upscaling" NGOs. Cost savings were expected to be most significant in large countries with widespread populations, such as Russia and Kazakhstan, where far-flung branches would be required to reach a sizeable number of microenterprises.
- The use of commercial banks' infrastructure for transferring funds and handling back-office operations would also produce considerable savings if adopted for microcredit operations.
- The use of commercial banks' know-how and experience with credit operations would allow their microcredit operations to be scaled up quickly, since the most-needed change was thought to be the introduction of a cost-minimizing microlending technology.
- The commercial banks' fuller range of financial services, including deposit facilities and money transfers, would be a clear advantage for the target group, compared to what NGOs could offer.

The downscaling approach further assumed, again incorrectly in most cases to date, that a number of incentives would give commercial banks a business interest in downscaling:

- A reduction in maturity mismatches, which were a significant problem for the banks in CEE and NIS, would result from the credit lines provided by downscaling programmes.
- Microlending would result in increased profits because microenterprises are willing to pay high interest rates to get access to loans. The banks simply had to control the administrative costs and risk associated with the sector.
- Know-how and risk-assessment skills would be transferred to the banks through technical assistance, mostly in the form of a proven credit technology and loan-officer training.
- A lowered "barrier to entry" into the microfinance sector would, in effect, be the result of the programme's initial subsidies. These subsidies, in the form of loan-officer training and other technical assistance and, in some cases, even salaries for a specified period would reduce participating banks' start-up costs.
- Diversification of portfolio risk and strong earnings for the banks, through increased interest and possibly non-interest income, would be potential long-term benefits of the microenterprise sector's expected strong growth.

- A competitive edge in contested banking markets could come from the prestige of participating in an EBRD downscaling programme.

In 1994 in Russia, the EBRD initiated the first of these downscaling programmes through the Russia Small Business Fund, a US\$300-million programme aimed at jump-starting lending to micro and small businesses in this vast country. Similar programmes followed in Kazakhstan, Uzbekistan, Kyrgyzstan, Ukraine, Belarus, Bulgaria, Latvia, and Lithuania. The EBRD's programmes are typically different in two major ways from the IDB's earlier projects in Latin America. The EBRD programmes have avoided using a governmental, intermediary institution to on-lend funds in most cases. Instead, it has engaged in direct bank-to-bank lending. This strategy saves time but exposes the EBRD itself to higher default risk, since there is no sovereign guarantee for bank-to-bank loans.<sup>2</sup> Participating banks are allowed to offer a wide range of loans, up to US\$150,000 in some cases. Microloans are considered to be those under US\$5,000.

Almost every country in the region now has at least one commercial bank that engages in micro- and small-enterprise lending. Not all are EBRD sponsored. Other development banks, such as Germany's Kreditanstalt für Wiederaufbau (KfW), now sponsor similar programmes.

However, so far, most commercial-bank downscaling programmes have failed to reach large numbers of micro-enterprise clients; in fact, most reach fewer than the other MFI types (see Chapter 4). Two key factors seem to have undermined the downscaling commercial banks' performance.

The first has been bad timing. At the beginning of the transition in the early 1990s, major efforts were made to restructure the region's banks from a state-owned to a market-oriented, private banking system (see Chapter 2). It was in the midst of this restructuring and reform, in the mid-1990s, that downscaling was introduced.

This first decade of financial-sector reform was disappointing. Many of the region's banks suffered from severe governance problems, resulting in bad lending practices and a lack of public confidence. Some countries hit major financial crises, as did Russia in 1998. Many of its banks, including some with downscaling programmes, went bankrupt. (Sberbank was an exception—both the bank and its downscaling programme survived.)

Now, in the midst of the region's second wave of bank reform, downscaling is faring better. However, in many countries, bank managers have made the programmes a low priority, relative to the larger task of simply keeping their banks afloat.

The second factor to undermine the downscaling commercial banks' performance has been their lower-than-expected profits. Potential profit margins from microlending now appear relatively small overall—perhaps smaller than initially assumed. Furthermore, the realization of profits from downscaling is slow. Banks must take the time to:

- Shift from traditional asset- and collateral-based lending to cash-flow lending
- Delegate lending decision-making to the branch level

<sup>2</sup> The Kazakhstan Small Business Fund is the exception to the EBRD rule; it does have an intermediary that has been cooperating smoothly with the partner banks and the technical-support team.



- Set up strong monitoring systems
- Increase their level of customer orientation

So far, most bank managers and shareholders have considered both the time and investment required to make these fundamental changes to be unwarranted by the profitability of microlending. This is especially true in the current climate of increasing financial-sector competition. The push for profits has made the development of more mainstream business areas, with higher profit margins, more of a priority. These areas include retail and investment banking, as well as lending to small and medium enterprises.

Despite all of this, some bank managers do see the opportunities of the microenterprise market and have committed to developing their downscaling programmes. This is true at, for example, Sberbank in Russia and some banks in Kazakhstan. But very few banks have gone so far as to invest their own capital in downscaling programmes.

### ***Mission***

It is not clear from the study whether commercial banks with downscaling operations have, in fact, integrated microlending into their overall strategic vision and business plans. Experience suggests that this is not the case for most banks, rather that they operate their microlending operations as independent, donor-supported programmes with the mission of providing micro and small enterprises with access to credit.

### ***Legal and Governance Structure***

The downscaling banks in the region are all fully-licensed commercial banks. They include both private and state-owned banks.

### ***Capital Structure***

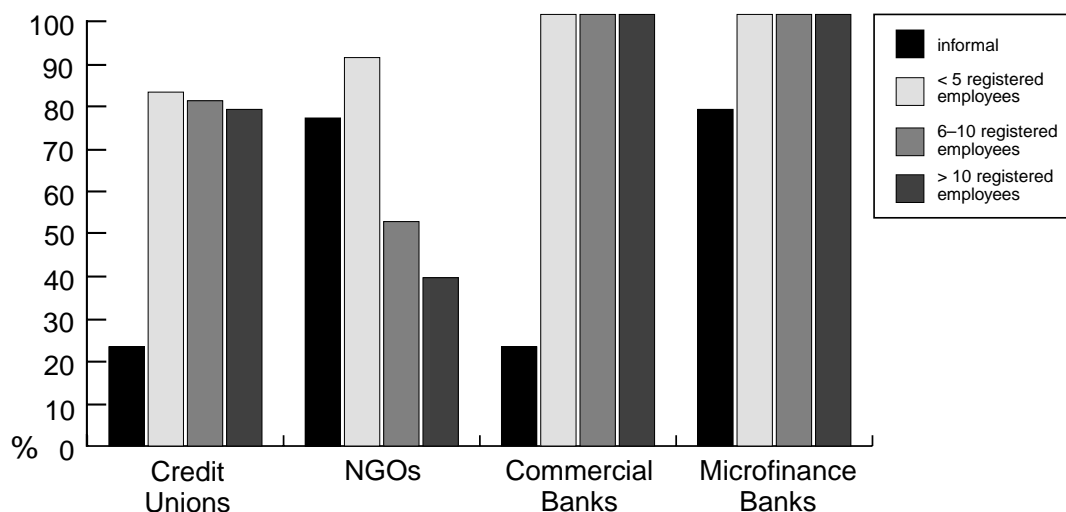
The capital for downscaling programmes, so far, has come from loans from international financial institutions, primarily EBRD and KfW. Ultimately, for these operations to be sustainable, the banks will need to invest their own capital in them.

### ***Clients***

Commercial banks lend to the high end of the micro- and small-enterprise market, providing larger loans to larger businesses than do other MFI types. Their clients are primarily already existing micro and small enterprises with proven business experience and growth potential. The downscaling banks also generally lend only to registered businesses, unlike the NGOs and the microfinance banks, which also lend to informal-sector businesses (see Figure 3.2). The operations of the commercial banks are also very urban focused; 93% of their clients come from cities or towns (see Figure 3.1).

### ***Products and Services***

Commercial banks offer the most extensive range of services of all MFI types (see Table 3.1). Their microlending operations are managed in separate departments that provide loans to micro and small enterprises. Other services, such as deposit accounts and housing loans, are part of these banks' mainstream operations and are likely available only to salaried, higher-income clients. About half of the commercial banks also provide leasing services.

**Figure 3.2 Size of Business Clients Served by MFI Types**

## Microfinance Banks

The newest entrants into the microfinance sector in CEE and NIS are the greenfield microfinance banks. This approach involves the creation, from the start, of banks specialized to serve micro and small businesses. In other words, these banks are licensed to carry out fully-supervised financial intermediation right from the start—unlike NGO MFIs, which start as credit-only institutions. This approach is sometimes referred to as “leapfrogging” because it avoids the step-by-step process of building a microcredit organisation and then transforming it into a full-fledged bank, as has commonly been done in Latin America.

Microfinance banks stand on the principle that success or failure in achieving sustainability and sound institutional development is directly attributable to a bank's owners. Specifically, it rests on their ability to exert an active and professionally competent influence on business policy and to establish efficient organisational structures. Both of these tasks are inescapable for owners committed to lasting, effective institution building. Hence, corporate governance that is conducive to sound microfinance is at the heart of the model.

The microfinance-bank model was developed by Internationale Projekt Consult GmbH (IPC), a German consulting firm. Spearheading the effort in CEE and NIS was IPC's investment subsidiary, IMI AG, which was set up to acquire equity stakes in microfinance banks. Members of IPC's staff are the shareholders of IMI and provide management services to the microfinance banks during their creation and early operation. This incentive structure—having staff members of the parent consulting firm hold equity stakes in (and, therefore, share in the risk and reward of) a subsidiary that invests in microfinance institutions that these same staff members are advising—is a unique feature of the IMI-backed model.

IMI invested in the start up of the prototype microfinance bank in Bosnia and Herzegovina, the Sarajevo-based Micro Enterprise Bank (MEB). Other greenfield banks have since been established by IMI in Albania, Russia, Moldova, Georgia, Romania, Kosovo, Ukraine, Yugoslavia, and Bulgaria, and more are underway.

Opportunity International (OI) has also recently entered the business of creating greenfield microfinance banks. Its first such venture is Opportunity Stedionica (Savings Bank) in Serbia, licensed in July 2002. It is owned 70% by OI and 30% by private investors.

### ***Mission***

Microfinance banks have the dual goal of significant outreach to micro and small enterprises (ie, reaching large numbers of clients) and positive returns on shareholder equity.

### ***Legal and Governance Structure***

Microfinance banks are typically licensed as regular commercial banks under a country's banking legislation and are subject to the regulatory standards and supervision of the bank supervisory agency. However, in some countries, it is hard to establish a microfinance bank because of high minimum capital requirements. For this reason, a special microfinance-bank law has been passed in Macedonia. (See Chapter 8 for a complete discussion of the legal issues surrounding the establishment and regulation of specialized microfinance banks.)

### ***Capital Structure***

In the IMI model, a group of international investors provides the share capital and is active on the bank's supervisory board. These investors usually form a public-private partnership, combining international financial institutions and private-sector institutions.

The founders of microfinance banks usually try to get one or more local financial institutions as members of their partnership. In practice, not all have secured such local buy-in. Nonetheless, it is considered beneficial for three main reasons. First, it builds the local credibility of the banks, which are foreign owned and managed during their start-up phase. Second, it improves the chances of the microfinance bank reaching commercial sustainability by serving local customers. This is because local management typically pushes the bank even further to use local staff and to tailor its operations to local needs and conditions. Third, the local financial institutions that are partners benefit from the financial training and expert knowledge of the foreign investors, which contributes further to developing the local financial sector.

### ***Clients***

The banks' typical loan clients are micro and small businesses. The majority of borrowers also maintain savings accounts, though these are mostly current accounts. Savings accounts are usually opened by salaried employees from both urban and rural areas. Many receive regular transfer payments from abroad. The majority of microfinance bank clients are in cities (70%) and towns (16%). Only 14% of their clients are in rural areas (see Figure 3.1).

### ***Products and Services***

Microfinance banks offer a full range of financial products—not just micro- and small-business loans but also deposit facilities, money transfers, and checking services. These products are designed to support rapid growth of the bank's assets and branch networks.

**Chapter 3 Summary**

The CEE and NIS has seen the development of four dominant microfinance models since the fall of socialist regimes in the mid-1990s. Credit unions have the longest legacy in the region, dating back to the 1800s. Their development was interrupted when socialist governments liquidated or subjected most of them to state control. However, since the mid-1990s, credit unions and similar mutually-owned savings and credit organisations have enjoyed a revival and rapid development in the region. They offer savings and credit services to people who share a common bond.

NGO MFIs—that is, NGOs specializing in the provision of microfinance services—have developed as part of a postsocialist rebirth of civil society in the region. Most focus on providing credit to low-income microentrepreneurs; they typically serve the low end of the micro- and small-enterprise spectrum, including informal-sector businesses.

Commercial-bank downscaling was introduced as a potential means of rapidly scaling-up microfinance in CEE and NIS. The plan relied on using bank networks of retail branches to deliver microcredit. But the downscaling approach has not yet proved that it can reach massive numbers of clients, particularly low-end clients. The development of the downscaling approach in the region has been impeded by timing—the introduction of downscaling coincided with widespread bank restructuring and reform—and lower-than-expected profits. Consequentially, the managers of most banks have not committed to downscaling as yet.

The microfinance-bank model has been the last to develop in the region. Microfinance banks aim to balance both commercial and social goals, applying a commitment to target-group outreach with a profit orientation. Their target clients typically fall between those of the NGO MFIs and commercial banks. These banks offer loans to micro and small enterprises, but, as full-service banks, they also provide savings accounts and other services, such as money transfers and foreign currency exchange.

Together, these four MFI models provide a range of products and services that are starting to meet the diverse financial needs of the region's various microfinance clients.



## CHAPTER 4

### INDUSTRY PROFILE

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*Chapter 4 presents an overview of the current state of the microfinance industry in Central and Eastern Europe and the New Independent States. It includes the study findings on the industry's size and structure, performance, and trends—analysed both by MFI type (credit unions, NGO MFIs, downscaling commercial banks, and microfinance banks) and by subregion (the Balkans, Eastern and Central Europe, the Caucasus, Central Asia, and Russia, Ukraine, and Belarus).*

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The study identified 6,072 organisations engaged in microfinance in 25 of the 28 countries in CEE and NIS. (No MFIs were identified in three countries). The vast majority of these MFIs are credit unions (5,892). The next most numerous are NGO MFIs (136), followed by commercial banks (33), and microfinance banks.<sup>1</sup> We believe this represents nearly the entire microfinance market in the region—an estimated 70–80% of both the existing credit unions and NGOs, and 100% of both the downscaling commercial banks and microfinance banks. The findings are based on a survey conducted in 2001, supplemented with information from public sources. (See Appendix 2 for details of study methodology and data limitations.)

The microfinance industry in the region is very young. On average, all of its MFIs (excluding credit unions) are 3.2 years old, compared to an average age of 8 years for MFIs worldwide.<sup>2</sup> Its credit unions, by contrast, date all the way back to the region's first Raiffeisen savings and loan cooperatives of the late 1800s.

Together, these MFIs served 1.7 million active borrowers and 2.3 million depositors, accounting for a total of nearly US\$800 million in outstanding loans and US\$670 million in deposits, as of 30 September 2001. The total asset base of all these MFIs is estimated to be at least US\$1.2 billion.

This total number of clients represents an estimated market-penetration level of 5% of the potential demand.<sup>3</sup> This market penetration is still limited, but impressive compared to microfinance development in other regions of the world. Elsewhere, levels seldom exceed 5%, even though the microfinance industry is typically 5–10 years older. (An exception is Bangladesh, where the microfinance industry reportedly reaches 20–25% of poor households.) Despite the region's relatively high market penetration, it has no single microfinance giants, as exist elsewhere. Rather, the region is served by a large number of small MFIs, the largest of which reaches 20,000 clients.

Although it is young, the microfinance industry has grown rapidly in CEE and NIS. The number of clients it serves grew at an average of 30% per year in the period 1999–2001, while loan-portfolio values increased by an

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<sup>1</sup> Although 11 microfinance banks were identified (10 IMI-led banks and 1 Opportunity International bank), only 10 (all the IMI banks) were operational at the time of the study. A further 3 NGO MFIs have also transformed into microfinance banks but were not included in this category for analytical reasons.

<sup>2</sup> *MicroBanking Bulletin* 7, November 2001.

<sup>3</sup> Potential demand is assumed to equal 10% of the active labour force, based on the assumption that up to 10% of the labour force are likely to be entrepreneurs or would-be entrepreneurs. These are the levels of entrepreneurship found in OECD countries. It was not possible to compare current client outreach to poor households, given the lack of reliable poverty data in the region.

average of 54% per year.<sup>4</sup> This dramatic growth suggests that there is strong market demand for microcredit in the region, and that people are willing and able to pay relatively high prices to access such loans. Most MFIs charge at or above market interest rates, typically around 1.5–3% per month, for short-term, working-capital loans. The majority of MFIs surveyed expect to see continuing high rates of growth in the short-to-medium term. Based on the estimated current market-penetration level, there is clearly a vast potential for the future growth of microfinance in the region.

## Structure and Performance of the Industry by MFI Type

### *Credit Unions*

Credit unions have by far the most lending and savings activity in the region (see Table 4.1). Together, credit unions had 1.5 million borrowers (85% of the total microfinance borrowers) and 2.2 million depositors (95% of the total) as of 30 September 2001.<sup>5</sup> This accounted for a gross outstanding loan portfolio of US\$408 million and a deposit base of US\$455 million. Despite these numbers, most CUs in CEE and NIS are very small community-based organisations, with an average of 400 members and an average outstanding loan portfolio of less than US\$100,000 each.

**Table 4.1 Lending and Savings Volume by MFI Type**  
(as of 30 September 2001)

MFI Type	Number	Total Gross Outstanding Loan Portfolio (US\$)	% of Total Gross Outstanding Loan Profile	Total Active Borrowers	% of Total Active Borrowers	Total Deposits (US\$)	% of Total Deposits	Total Active Depositors	% of Total Active Depositors
Credit Unions	5,447	408.4 million	51%	1,452,523	85%	455.4 million	68%	2,243,839	95%
NGO MFIs	100	107.9 million	13%	197,069	12%	0.7 million	0%	16,845	1%
Commercial Banks	24	125.1 million	16%	23,308	1%	–	–	–	–
Microfinance Banks	10	158.2 million	20%	41,660	2%	217.6 million	32%	96,082	4%
All MFIs	5,581	799.6 million	100%	1,714,560	100%	673.7 million	100%	2,356,766	100%

Note: Commercial-bank deposits are not included because data are not available and deposit activities are not segregated by microfinance client group.

<sup>4</sup> A sample of 106 institutions was selected to measure the growth rate in the portfolio size and number of borrowers.

<sup>5</sup> All figures for borrowers and depositors throughout this report refer to active (or current) clients.

The countries with the largest credit union networks in the region are Romania (with over 1.5 million credit union members), Poland (with 480,000 members), and Ukraine (with 110,000 members). Cooperative savings and credit institutions also have a strong presence in Russia; however, no reliable data was available on their number and performance.

The strength of the credit unions in the region varies widely. At one extreme are Poland's credit unions, which have established themselves as leading providers of financial services to low-income people. The Polish credit unions offer a sophisticated range of products and services, and together had 480,000 members and US\$360 million in assets as of 30 September 2001. The largest among them achieved an average return on assets of 3% in 1998.<sup>6</sup> The Polish credit union movement also has a strong second-tier level of organisation, the National Association of Cooperative Savings and Credit Unions (NASCU). NASCU has a central finance facility, a stabilisation fund, and an insurance company. It has played an important role in developing the professionalism and financial viability of the Polish credit unions.

At the other extreme are the small, weak credit unions, such as those in Azerbaijan and other countries in Central Asia. They suffer from weak governance and management, limited outreach and service provision, and often operate at a loss—partly due to a reluctance to charge enough interest to cover their costs and to enforce loan repayment. In some of these countries, the perception that credit unions and other financial cooperatives are a remnant of the communist past has prevented them from receiving meaningful public or government support.

### **NGO MFIs**

Among the MFI types, the NGO MFIs reach the second-largest number of clients. Together, NGO MFIs had 200,000 active borrowers and a total gross outstanding loan portfolio of US\$108 million, as of the end of September 2001.

Most of the region's NGO MFIs are still small; on average, each has 1,800 borrowers and a loan portfolio of US\$1 million. However, of all MFI types, the leading NGO MFIs reach the largest number of clients. The largest NGO MFIs are FINCA in Kyrgyzstan with 20,000 clients, Constanta Foundation in Georgia with 16,000 clients, and Fundusz Mikro in Poland with 10,000 clients (see Table 4.2).

NGO MFIs also reach the largest number of poor clients, of the MFIs that focus on enterprise lending (ie, all MFIs except credit unions). Their loan balance relative to per-capita GNP (a recognized indicator of poverty outreach, where the lower the ratio, the greater the poverty outreach) averages 124%, compared to 553% for the microfinance banks, and 648% for the downscaling commercial banks surveyed. (See Chapter 5 for further discussion of poverty outreach.) NGO MFIs in CEE and NIS also reach relatively more women—64% of their clients are women, compared to 47% for credit unions, and 25% for microfinance banks. (No data was available for commercial banks.)

The financial performance of NGO MFIs is quite varied in CEE and NIS, but overall they are performing well compared to worldwide standards. These MFIs have been quick to learn and apply the best practice standards of leading MFIs elsewhere in the world. They generally have a strong focus on maintaining high levels of portfolio quality and efficiency, as well as on progressing toward financial sustainability.

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<sup>6</sup> See Anna Cora Evans and Dave Richardson, *Polish Credit Union Development: Building a Sustainable Network of Financial Services to Serve Low-Income Masses*, WOCCU Research Monograph Series, No. 17 (Madison, Wisc.: World Council of Credit Unions, Inc., 1999).



An estimated 18% of all NGO MFIs surveyed had reached operational self-sufficiency (ie, were able to cover their operating costs from their own revenue) as of the end of September 2001. For the majority, this was within 3–4 years of their start up. This is an impressive achievement, given that the best performing MFIs worldwide have usually taken 5–7 years to reach similar levels of financial sustainability. Furthermore, at least nine of the region's NGO MFIs more than 3 years old reached full financial self-sufficiency, with a positive unadjusted return on assets ranging from 0.4% to 7.0%, in 2001. That makes them among the most profitable MFIs of any type in the region (see Chapter 6).

### ***Commercial Banks***

Commercial-bank downscaling programmes have failed to live up to the initial expectation that they would reach large numbers of clients in a cost-effective manner by leveraging the bank's existing infrastructure of retail branches. (See Chapter 3 for an explanation of the commercial-bank downscaling model.) A sample of 24 downscaling commercial banks (73% of the total identified) reached only 24,000 microenterprise borrowers (1% of the region's total number of borrowers) as of 30 September 2001. On average, each of the commercial banks had fewer than 750 active microenterprise borrowers (ie, those with initial loans less than US\$5,000) and an outstanding loan portfolio of US\$4 million.

Nonetheless, the downscaling commercial banks accounted for a large 16% (US\$125 million) of the total gross loan portfolio of all MFIs surveyed at the end of September 2001. This is primarily because they make larger loans to larger businesses than the other MFI types. The commercial bank downscaling programmes had an average outstanding microloan balance of US\$7,740, compared to US\$211 for credit unions, US\$1,500 for NGO MFIs, and US\$5,123 for microfinance banks.

Russia's Sberbank is the only commercial bank to have developed a downscaling programme of significant scale. Sberbank had nearly 10,000 clients in September 2001 and an outstanding gross loan portfolio of US\$47.5 million. Downscaling also seems to be taking off in Kazakhstan, where several commercial banks are aggressively competing for shares of the microenterprise market.

There is no comprehensive data on the profitability of commercial banks' microlending operations. Anecdotal evidence suggests that their financial performance is mixed. Sberbank Russia, which has by far the largest downscaling programme, has reportedly developed microlending operations that are now profitable at the branch level. However, given the small size of the microloan portfolios of the other commercial banks, it is unlikely that many others have made their microlending operations profitable. This assumption is reinforced by the fact that few banks have yet invested their own capital in microlending.

### ***Microfinance Banks***

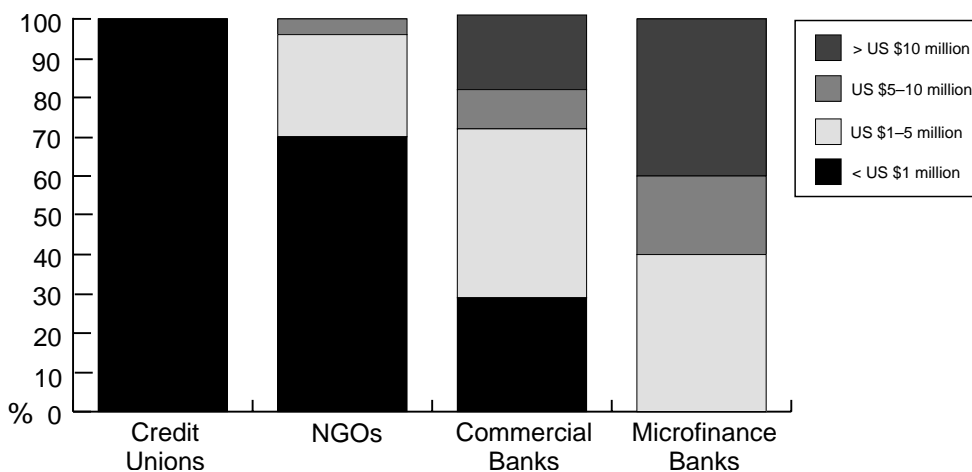
Microfinance banks are the second-largest MFI type in terms of volume of lending and savings activity. Together, the 10 microfinance banks surveyed served nearly 42,000 borrowers and 96,000 depositors as of the end of September 2001. They accounted for US\$160 million (20%) of the total gross loan portfolio of all MFIs surveyed and nearly US\$220 million (32%) of their total deposits.

However, deposit-level data are highly skewed by the Micro Enterprise Bank in Kosovo (MEB Kosovo), which alone had US\$150 million in deposits in 2001. The other nine microfinance banks together only had a total of US\$67 million in deposits. MEB Kosovo posted its exceptional level of deposit mobilization because it was the only licensed bank in Kosovo immediately after the end of the conflict in 1999. This gave it an effective

monopoly on deposit taking for a short period of time, just when many international organisations and Kosovars were looking for safe places to save.

On average, each microfinance bank has 2,700 borrowers and a loan portfolio of US\$10 million, making them the largest MFI type in the region (see Figure 4.1). Among the top performers are the Microfinance Bank in Georgia, which had nearly 16,000 clients and a portfolio of US\$23 million in September 2001, and KMB Russia, which had 7,400 clients and a portfolio of US\$78 million.

**Figure 4.1 MFI Type by Loan Portfolio Size**



With the support of large volumes of up-front investment, the microfinance banks have achieved consistently better financial performance than any other MFI type. Six of the ten IMI-led microfinance banks were profitable after three years in operation, with reported returns on equity ranging from 4% to as high as 47%. However, these returns are not adjusted to take subsidies into account. MEB Kosovo is again an exception, with a return of 96%.

The microfinance banks' high rates of profitability, compared to other MFI types, are partially driven by their larger loan sizes and ability to earn revenue from nonlending services, such as money transfers and foreign exchange. These services can account for up to 40% of their total revenue. (See Chapter 6 for further discussion.)

### Structure and Performance of the Industry by Subregion

The countries of Central and Eastern Europe and the New Independent States comprise a vast and diverse region. It includes the EU accession countries with relatively advanced economies, as well as the countries of the Caucasus and Central Asia, which are among the poorest in the world. The pattern of microfinance development in each of the five subregions defined in the study is fairly distinct, often determined by the levels of foreign donor support and government acceptance of microfinance.

The subregion of Eastern and Central Europe (ECE) has the highest level of microfinance activity overall, due to the long history and the strong presence of credit unions. Other MFIs, however, are fairly undeveloped in this subregion. In the Balkans, microfinance—mainly NGO MFIs and microfinance banks—has developed with high

**Table 4.2 Top 20 MFIs in Region by Number of Active Borrowers**

	MFI Name	Country	MFI Type	Year Operations Began	Number of Borrowers (September 2001)	Loan Portfolio (US\$ million)	Profitability (OSS <sup>1</sup> or *ROA <sup>2</sup> )	Depth Ratio <sup>3</sup> %
1	FINCA	Kyrgyzstan	NGO	1995	20,315	3.3	114	60
2	Microfinance Bank	Georgia	MFB	1999	15,724	23.0	2*	199
3	Constanta Foundation	Georgia	NGO	1997	11,483	1.0	135	15
4	Sberbank	Russia	CB	1994	9,550	47.5	–	300
5	Fundusz Mikro	Poland	NGO	1995	9,405	9.8	109	40
6	Mercy Corps Women's MicroCredit Program	Kyrgyzstan	NGO	1997	8,500	0.7	281	30
7	UMCOR/AREGAK	Armenia	NGO	1997	7,500	1.7	272	43
8	Kyrgyz Agricultural Finance Corporation	Kyrgyzstan	Public Company	1997	7,462	1.5	–	77
9	KMB Bank	Russia	MFB	1998	7,424	78.0	103	633
10	MCO Partner (Mercy Corps affiliate)	Bosnia and Herzegovina	NGO	1997	6,603	5.4	149	65
11	FINCA	Georgia	NGO	1998	6,559	0.6	89	16
12	XAC Bank	Mongolia	MFB	1999	6,542	2.4	7*	94
13	NABWT	Tajikistan	NGO	1999	5,818	0.8	130	80
14	"Kamurj"	Armenia	NGO	2000	5,580	0.9	145	33
15	Rural Finance Fund	Albania	NGO	1992	5,277	3.7	–	63
16	EKI WV (World Vision affiliate)	Bosnia and Herzegovina	NGO	1996	5,042	6.4	–	102
17	FORA	Russia	NGO	2000	4,900	2.9	64	36
18	MI-BOSPO Tuzla	Bosnia and Herzegovina	NGO	1996	4,216	2.2	146	41
19	MIKROFIN Banja Luka (CARE affiliate)	Bosnia and Herzegovina	NGO	1997	4,121	4.2	156	82
20	MEB BiH	Bosnia and Herzegovina	MFB	1997	4,032	14.9	8*	293

Notes: The Aga Khan Foundation's microfinance programme in Tajikistan also serves a large number of borrowers and may deserve to be on the top 20 list. According to a 2001 CGAP microfinance assessment, it granted loans to 20,000 clients in 2001; however, survey data were not available on the number of outstanding borrowers, so the Aga Khan Foundation could not be included in this table.

<sup>1</sup>OSS = Operational self-sufficiency.

<sup>2</sup>ROA = Return on assets.

<sup>3</sup>Depth ratio refers to the average loan balance as a percentage of GNP per capita and is a measure of the depth-of-poverty outreach (see Chapter 5).

levels of donor support, as part of post-conflict reconstruction and recovery programmes. A similar pattern of microfinance development, driven by similar forces, has been seen in the Caucasus, though to a lesser degree. The lowest levels of microfinance activity are observed in subregion of Central Asia, particularly in Uzbekistan. Here, there has been relatively little investment in and government support for microfinance, despite the pervasive poverty and potentially high demand. Russia, Ukraine, and Belarus have seen even less microfinance development (other than commercial-bank downscaling in Russia), in part due to an inhospitable legal environment and lack of government support.

### ***The Balkans—Albania, Bosnia and Herzegovina, Croatia, Macedonia, Serbia and Montenegro, and Slovenia***

The Balkans, made up Albania, Bosnia and Herzegovina, Croatia, Macedonia, Serbia and Montenegro, and Slovenia, have been more affected by political instability and conflict during the last decade than has any other subregion within the CEE and NIS. The Balkans subregion also has the greatest, internal disparity of wealth—ranging from Albania, one of the region's poorest countries (with a per-capita GNP of US\$1,110) to Slovenia, the region's wealthiest country (with a per-capita GNP of nearly US\$10,000).

The Balkans have the region's most developed NGO MFIs and microfinance banks. Their development has been expedited by high levels of donor investment, linked to post-conflict, political efforts to restore peace and stability to the area. The study identified 41 NGO MFIs and 7 microfinance banks, both of which operate in every Balkan country except Slovenia. The performance of these MFIs is generally good, with above average numbers of clients (most MFIs in the Balkans reach more than 2,500 active clients) and financial sustainability.

Credit unions are not well developed in the Balkans, in part due to a lack of enabling legislation. There are no commercial-bank downscaling programmes that specialize in microlending. The subregion's commercial banks provide enterprise loans, typically with donor-supported credit lines. Their focus, however, has been on-lending to small and medium enterprises, not microenterprises.

Bosnia and Herzegovina, home to microfinance investment as early as 1996, today has one of the most competitive microfinance sectors in CEE and NIS. Of the top 20 MFIs in the study by number of clients, 25% are in Bosnia and Herzegovina. Bosnian MFIs have also achieved some of the highest levels of MFI profitability.

Together, all of the MFIs in the Balkans subregion served nearly 85,000 borrowers and 77,000 depositors, accounting for US\$111 million in outstanding loans (14% of the region's total gross outstanding loan portfolio) and US\$205 million in deposits (30% of total), as of the end of September 2001 (see Table 4.3).

### ***Eastern and Central Europe—Bulgaria, Czech Republic, Hungary, Moldova, Poland, Romania, Slovakia***

Eastern and Central Europe, with an annual GNP per capita above US\$3,000, includes some of the wealthiest countries in the region. This subregion also includes countries, such as the Czech Republic, Hungary, and Poland, that are the region's most advanced in terms of economic reform and financial and private-sector development. All but one, Moldova, are European Union accession countries.

Credit unions are strongly represented in ECE, particularly in Poland, Romania, and Moldova (see Figure 4.2). Other types of MFIs are much less developed. The study identified 31 NGO MFIs, but most were very small,

**Table 4.3 Lending and Savings Volume by Subregion**

Subregion	Number of MFIs	Total Gross Loan Portfolio (US\$ million)	% of Total Gross Loan Portfolio	Total Active Borrowers	% of Active Borrowers	Total Deposits (US\$ million)	% of Total Deposits	Total Depositors	% of Total Depositors
Balkans	44	111.1	14%	84,344	5%	204.7	30%	76,735	3%
ECE	4987	414.8	51%	1,373,787	80%	441.8	66%	2,081,714	88%
Caucasus	27	38.7	5%	65,933	4%	5.7	1%	33,417	1%
Central Asia	319	76.5	10%	80,223	5%	2.8	0%	16,702	1%
Russia/Ukr/Belarus	204	158.4	20%	110,272	6%	18.6	3%	148,198	6%
Total	5581	799.5	100%	1,714,560	100%	673.7	100%	2,356,766	100%

with over half serving fewer than 60 active clients each. The exception is Fundusz Mikro in Poland, with nearly 10,000 clients in September 2001. There are also three microfinance banks—ProCredit Bank in Bulgaria, Microenterprise Credit Bank in Moldova, and Microenterprise Credit Bank in Romania—and five commercial-bank downscaling programmes.

Together, the MFIs in ECE served nearly 1.37 million borrowers (80% of the study's total borrowers) and 2.08 million depositors (88% of the total), accounting for US\$415 million in outstanding loans (51% of the study's total gross outstanding loan portfolio) and US\$442 million in deposits (66% of the total), as of the end of September 2001. Its CUs make up the bulk of this activity—nearly half of the subregion's total lending volume, two-thirds of its deposits, and over 80% of all its clients. Due to the outreach of its CUs, overall market penetration in ECE is estimated at 11% of the potential demand, the highest market penetration of any subregion in the study.

### ***The Caucasus—Armenia, Azerbaijan, and Georgia***

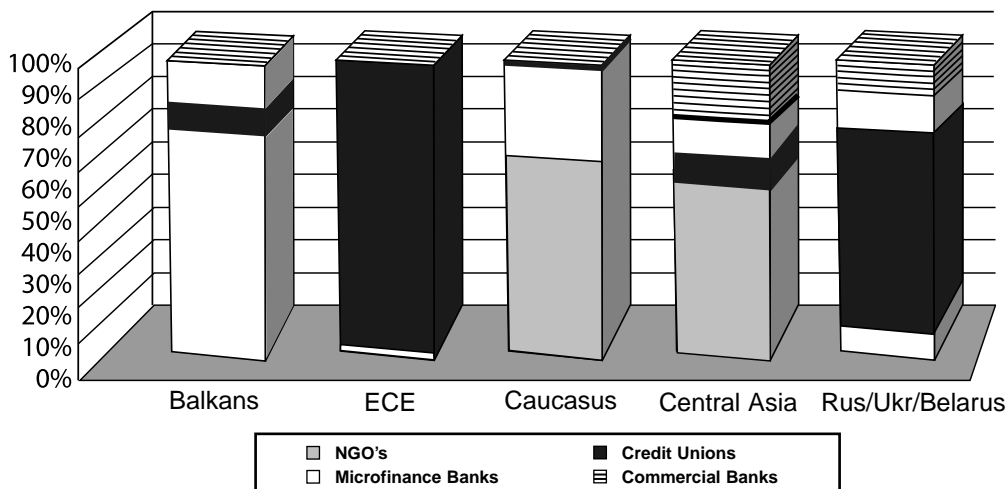
The Caucasus—Armenia, Azerbaijan, and Georgia—is the smallest of the subregions, with a total population of only 17 million. This subregion has suffered from sporadic conflict and is one of the poorest, with an annual GNP per capita of US\$600.

The study identified 30 NGO MFIs operating in the Caucasus. Nearly half of these serve clients that have been affected by conflict—internally displaced persons, refugees, or returnees. These people together constitute 30% of all borrowers from the subregion's NGO MFIs. The Caucasus subregion also has four downscaling commercial banks, all in Armenia, and one microfinance bank, the Microfinance Bank of Georgia. The subregion also has many small credit unions; however, limited data was available on their number and performance.

Overall, the MFIs in the Caucasus reach the fewest clients, 66,000 borrowers and 33,000 depositors, accounting for US\$38.7 million in outstanding loans and US\$5.7 million in deposits.

### ***Central Asia—Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, Uzbekistan, and Mongolia***

Central Asia is the poorest of the study's subregions, with an annual GNP per capita of US\$526. It suffers from particularly widespread rural poverty, consistent with having a larger rural population than any of the other subregions. Over half of Central Asia's population lives in rural areas (compared to one-third in the region overall).

**Figure 4.2 Subregional Distribution of Total Number of Borrowers**

Central Asia's microfinance sector is dominated by NGO MFIs and commercial-bank downscaling programmes. Some of the subregion's NGO MFIs show quite high performance, such as FINCA and Mercy Corps in Kyrgyzstan and KCLF in Kazakhstan, but the majority are small, with limited levels of sustainability. Among the subregion's downscaling commercial banks, those in Kazakhstan are reportedly achieving higher levels of outreach than in other countries.

There is one microfinance bank, XAC Bank in Mongolia. It converted from an NGO, and with over 6,500 clients, is now one of the best-performing MFIs in CEE and NIS. Plus, there are a number of credit unions and an increasing focus by donors on credit union development in Central Asia. Another model of microfinance operations, using the countries' post offices as a delivery mechanism for microfinance services, is being actively discussed and assessed but has not yet been implemented.

As of 30 September 2001, the MFIs identified in Central Asia served a total of 80,000 borrowers and 17,000 depositors, accounting for US\$76.5 million in outstanding loans and US\$2.8 million in deposits.

### ***Russia, Ukraine, and Belarus***

Russia, Ukraine, and Belarus comprise the largest and most populous subregion in CEE and NIS—by far. Together, these countries have a total population of nearly 207 million. The majority of their known microfinance providers are commercial-bank downscaling programmes. Although the potential demand for microfinance here is huge, the known MFIs are estimated to reach less than 0.5% of the potential demand. This statistic, however, does not fully take into account the activities of financial cooperatives and credit unions. These have a strong presence, particularly in Russia and Ukraine, and likely a large outreach, but because little information was available on their operations, they could not be included in the study.

The first commercial-bank downscaling programme in CEE and NIS was Sberbank Russia, supported by the EBRD. Sberbank's programme remains the flagship of the downscaling approach and had nearly 10,000 clients in September 2001. Despite Russia's size, it has only 13 NGO MFIs—fewer than any other CEE and NIS country—and 2 microfinance banks. This is partly due to lack of government support for NGO MFIs (see Chapter 8).

As of 30 September 2001, the MFIs identified in Russia, Ukraine, and Belarus served a total of 110,000 borrowers and 148,000 depositors, accounting for US\$158 million in outstanding loans and US\$18.6 million in deposits. This represents a market penetration of less than 1% of potential demand.

## 2002 Update

The number of microfinance banks operating in CEE and NIS grew to 14 with the opening of Microfinance Bank of Azerbaijan and two Opportunity International banks, Opportunity International Serbia and Opportunity Bank Montenegro. The number of downscaling commercial banks increased to 40 with the launch of EBRD's Micro and Small Lending Project in Kyrgyzstan (four banks) and the extension of the Russia Small Business Fund to three more banks. It is estimated that 160 NGO MFIs were in operation by December 2002, compared to 136 in the initial survey.

At the end of 2002, client numbers and outstanding loan portfolios had significantly increased in MFIs of all institutional types, as compared to 2001. The biggest growth occurred in microfinance banks (see Table 4.1-Update).

**Table 4.1-Update Growth of Loan Portfolio and Number of Active Clients by MFI Type** (31 September 2001–31 December 2002)

MFI Type	Number	Change in Total Gross Loan Portfolio (%)	Change in Number of Active Clients (%)
Credit Unions	1,116	73%	29%
NGOs	69	88%	48%
Commercial Banks	19	22%	50%
Microfinance Banks	10	122%	142%
All MFIs	1,214	77%	40%

The total loan portfolio of the NGO sample nearly doubled (an 88% increase). The biggest growth was observed in Central Asia where the overall portfolio grew nearly three times what was reported in the initial study. The number of active clients grew by 48%, which was slower than the portfolio growth. On average, NGO MFIs increased their average outstanding loan balance by 26%; which was observed in all subregions. As a consequence, the already shallow depth of outreach became even more shallow overall, with some exceptions. It exceeds 100% of per-capita GNP and is much higher than in other regions of the world where, according to the *MicroBanking Bulletin*, the depth of outreach varies between 16% and 60%. However, it is worth noting that 21 NGO MFIs lowered their loan size.

The 10 microfinance banks that participated in the 2001 and 2002 surveys showed a 122% increase in loan portfolio and a 142% gain in number of clients taking out loans. The largest growth occurred in Opportunity International Serbia and Microfinance Bank of Ukraine. Both of these banks were established in early 2001, and by the end of 2002 were in full operation. The increase in the number of clients compared to portfolio indicates a decrease in outstanding loan size. Indeed, seven out of ten banks decreased their average outstanding loan balance, in some cases by as much as 40%.

At the end of 2002, all 14 banks served a total of 110,085 active borrowers with an outstanding loan portfolio of US\$382.7 million. The volume of deposits reached US\$446 million and the number of depositors 246,400. The largest microfinance bank, Microfinance Bank of Georgia had over 29,000 borrowers with a portfolio of US\$34.7 million by the end of 2002. It was closely followed by KMB Russia, which served 21,700 borrowers and had a portfolio of US\$136.3 million. MEB Kosovo still held the largest amount of deposits, with 63% of microfinance-bank deposits in CEE and NIS and 51% of depositors.

Each microfinance bank at the end of 2002 on average served 6,700 borrowers and managed a portfolio of US\$20.5 million. The average loan size was US\$3,600 (down from \$5,100), and the depth of outreach was 360% (down from 550%). The smallest bank loans were given out by XAC Bank Mongolia (US\$440) and by the newly established Microfinance Bank of Azerbaijan (US\$1,070).

In the sample of 19 commercial banks in EBRD downscaling programmes, the loan portfolio increased by 22% by the end of 2002. At the same time, the number of active clients grew by 50%. Thus, the average outstanding loan size decreased, indicating the effect of the downscaling. In six of eight EBRD downscaling programmes, the average loan balance stood below US\$5,000.

A survey of credit unions in Latvia, Lithuania, Bulgaria, Croatia, Romania, Macedonia, Poland, and Russia revealed an almost 40% increase in the number of credit unions. Credit unions were introduced in Uzbekistan in late 2002 when seven credit unions were established through an ADB/WOCCU project. Similar to NGO MFIs, the loan portfolios of credit unions grew more quickly than did the number of clients, which resulted in an increase in average loan sizes.

Lithuania experienced a particularly dynamic growth of credit unions between September 2001 and December 2002. During this period, the number of credit union members almost doubled, and the value of deposits grew by 170%. Loan activities grew equally as robustly.

Unlike the mainstream banking sector in Poland, credit unions increased their volume of savings (45%) and lending (34%) in 2002. They offered higher interest rates on deposits and a range of other services comparable to that of commercial banks. Polish credit unions plan to attract entrepreneurs and increase the percentage of enterprise loans in their loan portfolios to 10–12%. (Currently it is estimated at 5%.)

NGO MFIs continued to dominate the top MFIs with the largest client bases. Microfinance banks, however, continued to grow, which enabled them to move further up the list. Among the largest NGO MFIs, eight of them served low-end clients, with an average outstanding loan balance below 40% GNP per capita.



**Table 4.2-Update Top 20 MFIs in the Region by Number of Active Borrowers**  
(as of 31 December 2002)

	MFI Name	Country	MFI Type	Year Operations Began	Number of Borrowers (December 2002)	Loan Portfolio (US\$ million)	OSS <sup>1</sup> *ROA <sup>2</sup>	Depth Ratio <sup>3</sup> (%)
1	Microfinance Bank	Georgia	MFB	1999	29,815	34.7	1.7*	197
2	KMB Bank	Russia	MFB	1998	21,708	136.3	–	378
3	Kyrgyz Agricultural Finance Corporation	Kyrgyzstan	Public Company	1997	20,000	21.5	–	399
4	FINCA	Kyrgyzstan	NGO	1995	19,789	4.2	139	78
5	Constanta Foundation	Georgia	NGO	1997	16,134	2.9	111	31
6	Mercy Corps Women's MicroCredit Program	Kyrgyzstan	NGO	1997	12,869	1.4	402	40
7	UMCOR/AREGAK	Armenia	NGO	1997	11,841	2.99	142	49
8	XAC Bank	Mongolia	MFB	1999	11,063	4.9	-2.3*	113
9	FORA	Russia	NGO	2000	10,788	6.4	121	36
10	Microfinance Bank of Serbia	Serbia and Montenegro	MFB	2002	9,941	40.1	-2.7*	407
11	Sberbank	Russia	CB	1994	9,802	46.7	–	287
12	World Vision EKI	Bosnia and Herzegovina	NGO	1996	9,292	11.0	102	94
13	FINCA	Georgia	NGO	1998	8,430	1.4	108	28
14	Prizma	Bosnia and Herzegovina	NGO	1997	8,112	3.7	112	36
15	Fundusz Mikro	Poland	NGO	1995	7,535	12.2	–	36
16	Partner	Bosnia and Herzegovina	NGO	1997	7,139	9.5	150	106
17	MEB BiH	Bosnia and Herzegovina	MFB	1997	7,102	33.5	2.3*	374
18	ACTED	Tajikistan	NGO	1998	7,000	0.2	–	17
19	AgroInvest	Russia	NGO	1999	6,722	6.3	145	95
20	FINCA	Azerbaijan	NGO	1998	6,411	0.6	60	16

Notes:

<sup>1</sup>OSS = Operational self-sufficiency

<sup>2</sup>ROA = Return on assets

<sup>3</sup>Depth ratio refers to the average loan balance as a percentage of GNP per capita, and is a measure of the depth-of-poverty outreach (see Chapter 5).

**Chapter 4 Summary**

The microfinance industry in CEE and NIS is very young but growing rapidly. Already, its MFIs serve a total of 1.7 million borrowers and 2.3 million depositors. In client numbers, these MFIs are experiencing an average growth rate of 30% a year, suggesting a strong demand for microcredit in the region. However, market penetration is still very low. Currently, we estimate that only 5% of the potential demand is being met.

Of the region's four MFI models, the credit unions reach the most borrowers (1.5 million, 85% of the total borrowers) and depositors (2.2 million, 95% of the total depositors). The credit unions' dominant scale of operations is particularly apparent in the subregion of Eastern and Central Europe. In Poland, they have been especially successful in establishing themselves as leading financial service providers to low-income people. However, many credit unions in the region are very small organisations—on average they have 400 members and a loan portfolio of US\$100,000.

NGO MFIs have seen rapid development in the region. Together, they reach the second-largest number of borrowers (200,000). However, their performance varies quite widely. On average, each is still small, with 1,800 borrowers and a portfolio of US\$1 million. However, the region has a growing number of high-performing NGO MFIs, each of which reaches over 5,000 low-income clients and is financially self-sufficient.

Commercial-bank downscaling has failed to live up to initial expectations that it would reach large numbers of clients. Most downscaling programmes are still very small, with an average of 750 borrowers each and a loan portfolio of US\$4 million. Only Sberbank in Russia has reached a large scale, with a total of nearly 10,000 borrowers in September 2001.

Microfinance banks have quickly established themselves in the region thanks to a focused and rapid start up, backed by large-scale investment. Of the four MFI types, these banks have built the largest-scale microfinance businesses, each with an average of 2,700 borrowers and a loan portfolio of US\$10 million. In addition, they have relatively high profitability compared to other MFIs, which is driven by their larger loan sizes and ability to earn revenue from nonlending activities, such as money transfers and foreign exchange services.

The state of microfinance development varies quite dramatically across the subregions of CEE and NIS. The highest levels of microfinance activity are in Eastern and Central Europe (dominated by credit unions), the Balkans (dominated by NGO MFIs and microfinance banks), and the Caucasus (dominated by NGO MFIs and downscaling commercial banks). The lowest levels of microfinance activity are observed in Central Asia (particularly in Turkmenistan and Uzbekistan) and in Russia, Ukraine, and Belarus.



## CHAPTER 5

### POVERTY OUTREACH

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*Chapter 5 examines the extent to which MFIs in Central and Eastern Europe and the New Independent States are reaching the poor, both on the regional level and by MFI type. It also describes certain specific methods and products that MFIs are using to increase their poverty outreach.*

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Measuring the poverty levels of clients reached by MFIs is a complex task, given the multi-dimensional nature of poverty. Hence, a proxy indicator is used by microfinance practitioners to measure the extent to which MFIs reach poor clients—that is, to measure what is referred to as their depth of outreach. This indicator is the average loan balance relative to GNP per capita, commonly known as the depth ratio. It serves as a first-order approximation of MFIs' depth of outreach (which assumes that the poor take out loans of smaller size).

Depth of outreach is typically divided into a four-level scale:

- Outreach to very poor or low-end clientele: depth ratio of 20% or less
- Outreach to low-end clientele: depth ratio of 21–40%
- Outreach to broad clientele: depth ratio of 41–150%
- Outreach to high-end clientele: depth ratio of 151% or above

### Key Findings

Overall, the study found that depth of outreach to the region's poor is very shallow, compared to other regions worldwide. Credit unions, with an average depth ratio of 15%, appear to have the deepest poverty outreach of the MFI types in the region. However, this finding must be interpreted with caution for two reasons. First, credit unions primarily make consumer loans, for which the depth ratio is likely not as accurate a proxy indicator as it is for enterprise loans. Second, the sample size of credit unions used to calculate their average depth ratio was quite small (only 211); hence, these results may not be representative of all credit unions in the region.

Although NGO MFIs are often presumed to have a poverty focus, the study found that those in CEE and NIS have a depth ratio of 124% on average, suggesting they reach a broad clientele (see Table 5.1). This reflects the interest of NGO MFIs in enterprise development, with most focused on meeting the financing needs of micro and small enterprises, rather than focusing on targeting the poor per se. It also reflects the fact that microfinance clients in the region are generally able to make use of larger loans than in other regions, such as Africa and Latin America, given the higher rates of economic growth and economic opportunity.

To date, few NGO MFIs in the study have focused on targeting low-end clients—that is, lower-income clients with less business experience and smaller businesses, who require very small loans. In an analysis of the depth

**Table 5.1 Various Indicators of Depth of Outreach**

<b>MFI Type</b>	<b>Average Loan Balance (US\$)</b>	<b>Depth Ratio (%)</b>	<b>Loans &lt; \$1,000 (%)</b>	<b>Loans US\$1,000–5,000 (%)</b>	<b>Loans &gt; US\$5,000 (%)</b>
Credit Unions	211	15	90	6	4
NGO MFIs	1,501	124	64	30	6
Commercial Banks	7,741	648	15	28	55
Microfinance Banks	123	553	35	36	29
All MFIs worldwide	453	46			

ratios of a sample of 100 NGO MFIs from the study, only 28% were found to serve both low-end and very low-end clients, and only 12% exclusively serve very low-end clients.

The majority of the NGO MFIs that serve low-end markets are young institutions, between 2.1 and 5.9 years old, that use a group-lending methodology (see Table 5.2). This lending methodology, in which group members guarantee each other's loans, is seen as better adapted to low-end clients, who generally have limited assets to offer as acceptable collateral. These NGOs are also doing well on reaching large number of clients. On average, they each had 2,700 clients, compared to 1,700 for NGOs serving broad and high-end clients.

The study also found that MFIs do not necessarily have to sacrifice financial sustainability to reach the poor. However, few MFIs have yet achieved this “win-win” result—that is, deep poverty outreach and financial sustainability. The study identified only two NGO MFIs, the Constanta Foundation in Georgia and KCLF in Kazakhstan, that serve the poor (indicated by depth ratios of less than 30%) and have become operationally self-sufficient (see Table 5.2).<sup>1</sup> (For a detailed discussion of the relationship between poverty outreach and sustainability, see Chapter 6.)

The microfinance banks are designed to provide micro and small enterprises with long-term access to a broad spectrum of financial services. They do not specialize in serving the poor. As a consequence of this full-service approach, the range of loans that they can provide is far larger than that of NGO MFIs. Indeed, some microfinance banks in the region offer loans upward of US\$100,000. This is reflected in their average loan size of over US\$5,100 and depth ratio of 550%, indicating they serve a high-end clientele. For the microfinance banks, this wide range of loan sizes has the advantage of attracting many clients and increasing profitability, since it is easier to earn more on larger loans. However, the risk of such an approach is that the microfinance banks could fail to provide low-end clients, such as smaller microenterprises and the informal sector, with the smaller loans they typically need.

The owners and management teams of microfinance banks are aware of this tension. To ensure that their banks do not shift too far up market, they maintain a close watch on their lending patterns and loan-portfolio distribution. So far, they seem to be maintaining a reasonable balance. An analysis of the microfinance banks' cumulative loan portfolio reveals that one-third of their loans are less than US\$1,000 each (see Table 5.1). These are likely to be loans to low-end clients.

<sup>1</sup> It is recognized that other NGO MFIs may consider themselves poverty focused. However, they were not captured in this analysis due to a lack of data or higher depth ratio.

**Table 5.2 Characteristics of the Top 10 MFIs Serving Poor Clients**

Name	Region	Depth Ratio	Total Number of Borrowers	Total Gross Loan Portfolio	OSS	Age Classification <sup>1</sup>	Methodology Used <sup>2</sup>
<b>VOKA-</b> Slovakia	ECE	0.09	62	20,340	NA	Young	Group
<b>Horizonti</b> Macedonia	Balkans	0.10	785	135,088	NA	New	Group, Village bank
<b>Mikroplus</b> Croatia	Balkans	0.10	1,156	542,852	49%	Young	Group
<b>CARE Intl</b> Tajikistan	Central Asia	0.11	635	12,358	NA	Young	Group
<b>FINCA</b> Azerbaijan	Caucasus	0.13	3,342	273,037	71%	Young	Group, Village bank
<b>Constanta</b> Georgia	Caucasus	0.14	11,483	987,256	135%	Mature	Group, Individual
<b>IRC</b> Azerbaijan	Caucasus	0.15	1,440	128,000	NA	Young	Group
<b>FINCA</b> Georgia	Caucasus	0.16	6,559	607,117	89%	Young	Group, Individual
<b>CRS</b> Bulgaria	ECE	0.21	1,396	444,150	34%	Young	Village bank
<b>KCLF</b> Kazakstan	Central Asia	0.21	3,150	788,595	107%	Mature	Individual, Group

Notes: The top 10 MFIs serving poor clients were determined by their depth ratios.

NA: Not available. OSS: Operational self-sufficiency.

<sup>1</sup>Age classifications—New: less than 2 years of operation; Young: between 2.1 and 5.9 years; Mature: more than 6 years.

<sup>2</sup>Methodological classifications are based on number of borrowers required for joint liability. Individual: borrower alone; Solidarity group: 2–10 borrowers; Village bank: more than 11 borrowers.

Some microfinance banks, such as KMB Bank in Russia and the Microfinance Bank in Georgia, are making active efforts to increase their low-end client base. KMB managed to grow its customer base by 3,000 clients in just four months by introducing “express micro loans” of under US\$1,000. The Microfinance Bank of Georgia has introduced “pawn loans” designed to attract poorer clients (see section on new practices and products below).

The challenge for the microfinance banks in CEE and NIS will be to maintain their focus on low-end clients over time as their foreign owners likely begin to sell out and they face increased banking-sector competition.

The commercial banks clearly serve clients at the high end of the spectrum, with a depth ratio of nearly 650% and an average loan size of US\$7,740. These banks’ downscaling programmes provide loans to larger micro and small enterprises. Only 15% of their loans are less than US\$1,000 (see Table 5.1).

Some microfinance practitioners do not consider these downscaling commercial banks to be providing microfinance, given their high-end focus. However, they were included in this study for two reasons. First and foremost, they provide access to finance to micro and small enterprises that require loans smaller than those offered by conventional banks but larger than those provided by other types of MFIs. Indeed, conventional banks rarely provide loans smaller than US\$50,000. Second, downscaling commercial banks use a specialized microlending technology similar to that used by other MFIs—ie, based on character and cashflow, rather than collateral.

## **New Products and Practices to Deepen Poverty Outreach**

Most of the MFIs in the region initially based their operations on practices and products used elsewhere in other developing countries. This has meant that, generally speaking, they have developed their operations around the delivery of a simple, short-term, relatively high-interest, working-capital loan product. The result is that some MFIs in the region, as elsewhere, have been able to develop high-volume, financially sustainable operations. However, many also recognize that these loans are well suited only to a small segment of the potential microfinance market, primarily businesses with high turnover in the trades-and-services sectors.

For this reason, many MFIs worldwide are experimenting with new products, services, and practices suited to a wider range of clients, including both businesses and households. In CEE and NIS, a main focus of product innovation has been on the development of services for the region's new poor. If successful, these experiments could provide the CEE and NIS microfinance community with ways to expand services to poorer clients that are demand responsive and viable.

### ***New Products***

Some MFIs in the region have been changing the terms and conditions of their loan products to better suit poor clients. In some cases (such as for FINCA in Georgia and Fundusz Mikro in Poland), these are marketed by local MFIs as new products; in others, they are marketed as more flexible terms and conditions on existing products. (This is the case with KCLF in Kazakhstan, Prizma in Bosnia and Herzegovina, and Demos in Croatia.)

**Springboard loans from FINCA Georgia.** Many growing MFIs have found client retention to be a problem, in part due to the rigidity of the size, terms, and conditions of their early loan products. So some MFIs have begun to tailor loans to suit a client's particular requirements. However, some poorer clients are still not eligible for these tailored loan products because of their remaining collateral requirements. To retain these low-income clients who require uncollateralised, larger loans, FINCA Georgia has introduced its "springboard" loan.

The springboard loan is a modification of FINCA's solidarity-group loan. Regular solidarity-group loans start at US\$100 and increase with each loan cycle to a maximum of US\$300. The springboard-loan product starts at US\$200 and increases with every loan cycle up to US\$1,000, a significantly larger amount for low-income entrepreneurs. This product is targeted at businesses that have high turnover, primarily in the retail sector. The interest rate is set at a flat 4% per month, similar to that of the regular solidarity-group loan. These springboard loans require slightly more due diligence on the part of the MFI and involve smaller-sized groups than FINCA's traditional solidarity loans.

FINCA reports that the product has proved attractive to poorer clients and has reduced its client dropout rate. Plus, the new loan has been cost efficient due to the high volume of business and the good repayment history it has elicited. Indeed, its demand has been very high—springboard loans accounted for 65% of FINCA Georgia's total loan portfolio in May 2002.

**Partnership loans from Fundusz Mikro, Poland.** Fundusz Mikro has found that the demand for microloans in rural and remote areas is often dampened by potential borrowers' lack of confidence in their ability to make their businesses succeed and, hence, to repay loans on time. These potential borrowers include the new poor, who are venturing into self-employment for the first time with very little business experience. In order to attract such clients, Fundusz Mikro is experimenting with loan designs that take into account the psychological effect of borrowing.

For example, its new "partnership loans" (also called "partnership financing"), introduced in January 2002, are aimed at first-time borrowers in rural areas. This is an equity-like product, based on a profit-sharing principle. The loan is offered only after the borrower produces a reasonable projection of the income stream from his or her business. The borrower agrees to share a portion of the profits with the lender as the charge for the loan. This charge is negotiated and then paid in installments, along with the repayment of loan principal. The average charge works out to be around 31% a year. This is more expensive than the charge for a standard group loan, which costs 21% a year; however, the higher cost is designed to offset the higher risk taken by the MFI. To further cover this risk, Fundusz Mikro also charges a nonrefundable fee, equivalent to the interest return on a bank deposit the size of the loan.

Fundusz Mikro's risks from partnership loans are, in fact, substantial. If, at the end of the contract, the borrower declares that they did not earn adequate profits (and this can be verified by the MFI), the profit-sharing charge is refunded by Fundusz Mikro. (Of course, the principal has to be repaid and the small nonrefundable fee is not refunded.) The MFI takes the risk that the customer may not pay the profit-sharing portion of the charge at all or may pay a smaller amount than would be generated by a regular loan. Also, the product involves more time on the part of the loan officers, although this time and its associated costs are expected to decrease as the staff's experience and efficiency in assessing these loans increases.<sup>2</sup>

It is too early to judge the demand, costs, and financial viability of partnership financing. However, it is reportedly off to a strong start. Fundusz Mikro disbursed 70 partnership loans in the first five months after launching the product in January 2002. They account for 10% of all its loans made in rural areas in January–May 2002. The clients it has attracted are generally poor, first-time borrowers. Fundusz Mikro not only expects partnership financing to increase its depth of outreach in rural areas, but also anticipates using it as a marketing tool to enhance the MFI's image and build borrower confidence.

**Gold pawn loans from the Microfinance Bank of Georgia.** Since 2001, the Microfinance Bank of Georgia (MBG) has offered "gold pawn loans" as a way of deepening its outreach to the poor. These loans allow clients to use jewelry as collateral, rather than conventional collateral. The loans are made as consumer loans—ranging in size from US\$20–\$1,000, for up to three months, at 3% interest per month. The average loan size is US\$250. Often, these loans are taken out for emergency purposes by the new poor.

The bank has found that there is high demand for these loans. The product involves very low transaction costs to both the "pawner" and the "pawn broker"; it has covered its own cost since its launch. By the end of 2001, about 14,800 of these pawn loans, for a total value of nearly US\$3,900,000, were outstanding. This represented 13% of MBG's total outstanding gross loan portfolio.

### ***Modifications to Existing Loan Products***

Several of the MFIs in the study have modified the terms and conditions of their existing products, rather than launch new products, to better serve the needs of poorer clients. KCLF, an NGO MFI in Kazakhstan, for

<sup>2</sup> Fundusz Mikro is also experimenting with a micro-venture-capital product for the higher-end market; this is also a high-risk product.



example, no longer requires that a client's loan size increase with every new loan cycle. Clients may now take out repeat loans that are the same size or even smaller than their initial loan, based on what best suits their needs. Prizma in Bosnia and Herzegovina now accepts a higher, though still manageable, rate of delinquency on quick-access loans, when their low-income clients encounter cash-flow difficulties due to late pensions or remittance payments. Demos in Croatia has introduced grace periods on certain clients' repayment of the principal amount borrowed; this modification is designed particularly to make their loans more attractive to start-up microentrepreneurs, many of whom need time to generate enough income with which they can start loan repayment.

### ***Experimental Delivery Methods***

Expansion into new geographic areas, especially rural areas, requires substantial investment, particularly in building branch networks. It also takes time for branch offices to function at full capacity and break even. This can be especially burdensome to a young MFI with few resources to cover these up-front investment costs.

Several MFIs, such as Prizma in Bosnia and Herzegovina and Constanta in Georgia, are successfully experimenting with new delivery methods to increase their geographic outreach at lower costs. Others are trying partnerships between different MFI types to achieve the same goal, and these are also proving successful.

**Outreach agents working for Prizma.** In 2001, Prizma (an affiliate of International Catholic Migration Committee) in Bosnia restructured its operations to focus more on serving the vulnerable, low-income poor in both urban and rural areas. This strategy includes basing outreach agents in rural communities to disburse loans and collect fees from clients. These outreach agents work out of satellite offices—small, rented rooms—located in or near their clients' towns. To help offset the cost of reaching its new low-end clients, Prizma also plans to hire women living in its target communities to work as part-time, local client coordinators with the outreach agents. Their job is to promote the MFIs' loans and to help maintain portfolio quality. Prizma expects its new strategy will increase both number of clients and depth-of-poverty outreach in an efficient and financially viable manner.

**Part-time, rural outlets (mobile bank branches) used by Constanta.** Since late 2001, Constanta in Georgia has tested four part-time outlets (also called mobile bank branches) in poor, rural areas. These are no more than windows or desks in local commercial banks or in local offices which operate for limited hours and with minimal staff.

These four mobile branches reached operational sustainability in about one-third the time a regular branch typically needs, in part due to their low start-up costs (about US\$25–\$75 per month in rent, compared to US\$500 for a full branch office). This is especially impressive in light of the fact that the mobile branches make smaller loans, and their loan officers have relatively smaller caseloads than those at full branches.

Mobile branches are facilitating Constanta's expansion into the interior areas of Georgia. When a critical mass of clients has built up at one of them, Constanta hopes to be able to replace it with a full-fledged branch that can also cover its own costs.

**Partnership models of the Microfinance Bank of Georgia and others.** Not all types of MFIs can directly serve the poor efficiently. While the majority of NGOs are committed to low-end clients as their primary target, microfinance banks and downscaling commercial banks are not well-placed to specialise in providing services to poorer clients. Ultimately, their profitability and ability to generate a return to their shareholders are dependent

on having a diverse portfolio of smaller and larger loans, as well as other revenue-generating services. Hence, the most attractive clients for them are micro and small enterprises, which have the potential to grow and need a variety of financial services beyond loans. Furthermore, microfinance banks and downscaling commercial banks are subject to prudential regulations and banking supervision; this restricts them from taking risks with uncollateralized loans, typically demanded by poor entrepreneurs.

Recently, different types of MFIs have been experimenting with active cooperation or partnerships to increase their number of clients and deepen their outreach. For example, in Bosnia and Herzegovina, several NGO MFIs—such as Bospo, Mikrofin, and Sunrise—are borrowing from local commercial banks to on-lend to poorer clients. From the MFIs' perspective, borrowing increases the capital they have to on-lend. The commercial banks are motivated to lend to the MFIs for two reasons. First, the MFIs have a track record that demonstrates their creditworthiness as clients. Second, the commercial banks see the potential to attract the MFIs' clients as depositors, and so increase their own customer base and market share. The banks handle the cash-management functions for the MFIs—that is, the MFIs' clients go to the commercial-bank branches to collect and repay their loans. For many this is their first time inside a mainstream bank, which gives the bank an opportunity to market savings accounts and other services to them.

In Georgia, the Constanta Foundation and the Microfinance Bank of Georgia (MBG) have formed a partnership. Constanta, an NGO MFI, transitions its larger clients, who need larger loans than it offers, to MBG, and MBG carries out cash-management functions for Constanta. MBG also has a cooperative arrangement with Western Union. Western Union operates out of MBG in exchange for providing money-transfer services to MBG's clients. By utilizing Western Union's efficiency with wire transfers, MBG has expanded its services at a lower cost than would have otherwise been possible.

### ***Staff Incentives***

Some MFIs, such as Partner and Prizma in Bosnia and Herzegovina and FINCA in Azerbaijan, have introduced staff incentives to encourage greater outreach to low-end clients. Typically, these incentives are linked to the number of loans disbursed to these clients and to the maintenance of high repayment rates. The MFIs expect such incentives to motivate staff members to focus on this targeted clientele. Certain poverty-focused MFIs even supplement staff incentives with sensitisation training for serving poorer clients. Such programmes help loan officers effectively engage poorer clients during outreach and marketing efforts. The goal is to increase the volume of loans successfully issued, these clients' repayment rates, and these clients' experience in dealing with the MFI.

### **Poverty-Outreach Trends**

Currently, poverty outreach in CEE and NIS is relatively limited, but nascent trends establish a positive outlook for microfinance services aimed at poor clients. First, the study found that mature NGO MFIs (those more than six years old) are deepening their outreach to the poor. This is true of both NGOs that already serve low-end clients and those that predominantly serve high-end clients. What this suggests is that the MFIs surveyed do not necessarily suffer from mission drift as they mature, although it is sometimes assumed they do.

Second, the study revealed that the largest increases in reaching the poor have come from MFIs who target very low-end clients and use an individual-lending methodology. Poor clients, therefore, have a demand for individual loans, and MFIs have the opportunity to offer individual loans to meet this clientele's need, in addition to the group-lending methodologies commonly available to this client group. That said, collateral requirements on

individual loans clearly have to be suited to this client group. Those NGO MFIs that provide individual loans to poor clients are usually quite flexible about the type of collateral they will accept. Typical collateral includes equipment, jewelry, or co-guarantees.

Increasing competition between MFIs and mainstream commercial banks, and among MFIs themselves, seems to be a key driving force behind increased poverty outreach. When microfinance emerged in CEE and NIS, the mainstream financial sector was extremely weak. Hence, MFIs experienced a high demand for credit, even from businesses that in more developed economies would be able to get loans from mainstream banks. Many MFIs “cherry picked” clients and lent to the most well-established micro and small businesses.

Commercial banks in CEE and NIS are now beginning to move into business lending. Most are focused on lending to high-growth small and medium enterprises, often with financing from donor-funded credit lines. Some are also beginning to lend to microenterprises. In many cases, a bank's entry into this market is the result of a donor-funded downscaling programme or is spurred on by the example set by a microfinance bank. In countries where banks compete for high-end micro and small enterprise clients, NGO MFIs are increasingly focusing on the low-end of the market or rural areas, where transaction costs make it difficult for commercial banks to operate. It is arguably here at the margins of mainstream finance—where markets fail—that microfinance should be focused.

Such competitive pressures are already playing out in Georgia and Bosnia and Herzegovina, two countries with the most developed microfinance sectors in the region. In Georgia, the Microfinance Bank of Georgia (MBG) has succeeded in making individual loans to the broad-to-high end of micro and small businesses efficient and profitable. This, in turn, has encouraged five major, Georgian commercial banks to begin lending to this clientele. This increased competition between commercial banks and MGB for this loan market has placed a check on NGO MFIs creeping up market to serve this client group. Rather, NGO MFIs are increasingly seeing their market niche as low-end clients. Consequently, Georgia has enjoyed an increasing depth-of-poverty outreach from its NGO MFIs.

Competition within the microfinance sector in Bosnia and Herzegovina has also encouraged some NGO MFIs to move down market. In Bosnia, many of the larger NGO MFIs predominantly serve urban microenterprises in the broad-to-high end of the market and are rapidly increasing their client base among this target group. Given the increasing competition for this client base, some NGO MFIs, such as Mikra (a local affiliate of Catholic Relief Services) and Prizma, have decided to specialize in serving low-end clients in more rural areas.

Although increased competition generally appears to be good for poor clients, there is also a risk that it will lead to over-indebtedness. As financial institutions become more aggressive in marketing their products and pricing becomes more competitive, clients may be encouraged to take out more credit than they can afford to repay. The challenge for MFIs is to remain focused on understanding the needs and debt capacity of their clients, and ensuring that their drive to increase loan disbursements and their own viability does not come at the expense of the client.

Consolidation within the microfinance sector also appears to be good for the long-term provision of financial services to poor clients, although a careful watch needs to be placed on these trends. Ultimately, providing high-quality financial services to low-income people and the smallest businesses depends on the quality, effectiveness, and viability of financial intermediaries. Quite often MFIs operate at such a small-scale, and with such low levels of capitalization, that they cannot maintain their operations over the long-term without ongoing subsidy. Given that such subsidies are rarely available long-term, many microfinance operations cease operating after short

periods of time when donor funds run out. The challenge is to develop MFIs that operate at sufficient scale, with secure access to finance, so that they can operate sustainably and benefit not only their clients but the next generation of clients too.

Consolidation can assist in building the scale and sustainability of small MFIs. For example, in Bosnia and Herzegovina, over 30 NGOs started up microcredit programmes in the mid-to-late 1990s. All were established with donor funding to help people develop entrepreneurial activities and rebuild their livelihoods after the war. However, the majority of these NGOs ran very small-scale operations with limited prospects of either institutional or financial sustainability. In 1999, as part of a World Bank-financed programme through which the majority of donor funding for microfinance was channeled, 17 NGO MFIs underwent an institutional assessment to see which of them had demonstrated the capacity to become strong, sustainable institutions. Only eight NGOs had developed the necessary vision, management capacity, and quality of operations to build viable microfinance operations. As a result, all future funding and technical support under this Local Initiatives Project was invested in these eight institutions with mutually agreed-upon performance targets. The nine partner institutions whose financing was not continued were required to repay the principal amount of the loan capital originally lent to them, which was then reinvested in the better-performing institutions.

These disinvestments forced a series of mergers and acquisitions. The better-performing institutions with secure funding either merged with or took over the weaker organisations. Only one MFI ceased operations altogether. This consolidation has led to the development of larger, more viable NGO MFIs in Bosnia. On average, each has about 5,000 clients and an outstanding loan portfolio of US\$4 million. It has also allowed some MFIs to increase their outreach to the poor and rural areas. For example, LOK, which had operated out of Sarajevo, merged with three other small, local microcredit organisations, which operated in poorer, more rural parts of Bosnia and Herzegovina. Through these mergers, the clientele in this area continued to have access to credit, which would have ceased if the smaller organisations had collapsed (the likely alternative scenario).

Although such consolidation can help strengthen the viability of the microfinance sector and its outreach to the poor, merger and acquisition trends need to be monitored. It would defeat the purpose if consolidation led to larger, national MFIs that become less focused on reaching low-income people and poor communities than local MFIs.

## **Assessing the Impact of Microfinance**

So, what effect has microfinance had on the lives of clients and their families? This study did not set out to measure the impact of microfinance on clients. However, data was collected on the MFIs' impact-assessment practices, and existing impact studies were reviewed to see what evidence of the ultimate impact of microfinance is emerging.

The study found that the MFIs in CEE and NIS that are most focused on evaluating the impact of their operations are the NGO MFIs. A total of 73% of NGO MFIs reported that they attempt to assess impact, compared to 33% of microfinance banks, 30% of downscaling commercial banks, and 17% of credit unions. This is hardly surprising. NGO MFIs, according to their mission, are the most focused on the social results of their work; the most common reason they gave for measuring impact was to determine whether they are fulfilling that mission. Another reason given was to meet donor reporting requirements, for which impact measurement serves to prove satisfactory impact. A third reason is to get feedback on their clients' satisfaction with service provision and product design. In this way, impact measurement helps improve impact—by providing client-level data to guide product design and service improvements.

The most common methods that MFIs reported using to collect information on impact are integrated into their day-to-day operations. Information is collected through questions on loan applications, direct client interviews, and observations by loan officers and other staff members. More scientific methods, such as longitudinal impact studies involving some form of control group, typically only occur if funded by a donor.

MFIs measure a range of impact indicators. The most common (used by 70% of the NGO MFIs surveyed) is the number of jobs created or sustained per loan, followed by clients' business profitability (60%), changes in household income (55%), and increases in business assets (55%). Some MFIs also assess changes at the community level, such as increases in local economic activity and increases in social capital. Other, less quantifiable measures include changes in clients' self-esteem, entrepreneurial skills, and well-being, which MFIs assess in client interviews. Finally, some MFIs also assess the extent to which increased income has led to greater access to health services and education for clients' family members.

This study did not collate the impact data gathered by individual MFIs. However, some national-level statistics are available. For example, in Bosnia and Herzegovina, MFIs funded under the Local Initiatives Project had disbursed 170,000 loans, for a total value of US\$183 million, during the period 1997-2002, creating or sustaining over 250,000 jobs. Measuring the employment impact of microfinance is regarded as particularly important by policymakers and donors, given the high levels of unemployment in much of the region.

To date, there are very few reliable impact studies that measure the impact of microfinance over time. Only one cross-country study has been carried out that provides some findings of relevance to the whole region. Sponsored by USAID, this was a joint project by the MFC and Assessing the Impact of Microenterprise Services (AIMS). It involved individual impact studies conducted by four of the region's NGO MFIs, Inicjatywa Mikro in Poland, Parter (an affiliate of Mercy Corps International) and Project Enterprise (an affiliate of the International Catholic Migration Commission) in Bosnia and Herzegovina, and the FORA Fund in Russia.

The key findings were:

- Access to microcredit had a positive impact on clients' household income, savings, and expenditures, compared with those of a non-client control group.
- Access to microcredit had a positive impact on clients' businesses, in terms of increased sales, profitability, and acquisition of assets, with client businesses performing nearly twice as well as the control group. Data also showed that the business impact was greatest for repeat clients. New clients tended to use additional business income for household expenditures or to build savings, whereas repeat clients, having already satisfied those goals, reinvested a higher percentage of increased earnings into their businesses and so saw greater business impact.
- Client microenterprises also had a greater impact on the local job market than did the microenterprises of the control group. Client businesses generally hired more people, especially full-time workers, and employed fewer unpaid family members than did the control-group businesses. Inicjatywa Mikro found that client businesses employed an average of five people, compared to two in the control group.

Further knowledge about the regional impact of microfinance is likely to emerge from the Imp-Act Project launched in 2001. Understanding the impact they have on the lives of the poor better positions MFIs to improve the products and services they use to make their impact. However, one area yet to be fully explored, even by the Imp-Act project, is the impact of microfinance on the local economies in which MFIs operate—specifically, the

extent to which access to finance helps create sustainable businesses that create jobs and generate and retain wealth in low-income communities. Further work is needed to develop simple measurement tools in this area.

Other than this project, currently there is limited information available about the impact of microfinance on the lives of the clients, their families, or their local communities. The study's findings suggest that there is a vast potential for the region's MFIs to deepen their outreach and serve the poor successfully. In most of these countries, the low-end market is large and still not adequately served. This is a market that demands financial services beyond just loans; it could support much new product development, particularly in savings services, insurance, and affordable consumer loans. But reaching the poor also costs more than reaching other populations; hence, it requires prioritizing social returns over financial returns.

## **2002 Update**

The group of MFIs that reach poorer clients remained very small. Only 26 MFIs had a depth of outreach below 40%, including several of the largest. (See the depth-ratios column in the 2002 update to Chapter 4, Table 4.2-Update.) Nine of these MFIs were operationally self-sustainable, showing that poor clients can be served on a sustainable basis.

In the top 10 MFIs with the deepest outreach (in Table 5.2-Update), it is worth noting that three of the top NGOs are members of the CRS network.

In the beginning of 2003, the SEEP Poverty Assessment Working Group, together with the MFC, surveyed the current methods used by MFIs in CEE and NIS to assess the poverty of microfinance clients. The most striking finding was that a majority of the 41 MFIs responding to the SEEP survey admitted that they did not have a holistic approach to poverty assessment. Furthermore, it is evident that virtually no institution uses proxy poverty indicators that can provide reliable information on their poverty outreach to management, or to external stake-holders as well.

Close to half of the MFIs in the region do attempt to measure the poverty level of their clients in some form. As expected, those which provide a wider range of services are more involved in poverty assessment. Among those which provide credit exclusively to income-generating enterprise projects (which are most of the organizations in the mainstream microfinance movement), almost none measure the poverty level of its clients—except the smallest institutions.

Practitioners can rarely provide detailed classification about the poverty levels of their current clients. The MFIs that measure poverty levels most commonly use economic measures. They expressed a strong need to develop methods based on non-economic measures to be able to report and compare quantitative data on their client poverty level and better understand how they can expand their outreach.

**Table 5.2-Update Characteristics of the Top 10 MFIs Serving Poor Clients**

Name	Region	Depth Ratio	Total Number of Borrowers	Total Gross Loan Portfolio	OSS	Age Classification <sup>1</sup>	Methodology Used <sup>2</sup>
<b>Mikroplus</b> Croatia	Balkans	10%	1,264	565,205	91%	Young	Group
<b>ABW</b> Uzbekistan	Central Asia	10%	975	58,377	NA	New	Group
<b>FINCA</b> Azerbaijan	Caucasus	16%	6,411	638,501	60%	Young	Group, Village bank
<b>Horizonti</b> Macedonia	Balkans	17%	1,592	449,319	86%	New	Group, Village bank
<b>ACTED</b>	Central Asia	17%	7,000	200,000	NA	Young	Group
<b>Atyrau Micro-credit Project</b> Kazakhstan	Central Asia	18%	1,200	260,000	NA	Young	Group
<b>Economic Development Center</b> Romania	ECE	23%	2,115	820,000	42%	Young	Individual
<b>CRS</b> Bulgaria	ECE	25%	2,978	1,142,696	127%	Young	Village bank
<b>Agribusiness Consulting Centre</b> Kazakhstan	Central Asia	25%	100	30,000	NA	NA	NA
<b>KCLF</b> Kazakhstan	Central Asia	26%	4,487	1,403.956	99%	Mature	Individual, Group

Notes:

The top 10 MFIs serving poor clients were determined by their depth ratios.

NA: Not available. OSS: Operational self-sufficiency.

<sup>1</sup>Age classifications—New: less than 2 years of operation; Young: between 2.1 and 5.9 years; Mature: more than 6 years.

<sup>2</sup>Methodological classifications are based on number of borrowers required for joint liability. Individual: borrower alone; Group: 2–10 borrowers; Village bank: more than 11 borrowers.

**Chapter 5 Summary**

Currently, outreach by MFIs to the region's poor is relatively weak compared to that of other regions in the world. Most MFIs have focused on meeting the needs of micro and small enterprises, rather than targeting their operations to low-income households *per se*.

Experience suggests that reaching the poor requires an explicit commitment from an MFI's management (and board) and a focus on developing appropriate products and practices. Several MFIs in the region have made such a commitment, and some are experimenting with new ways of increasing poverty outreach.

- The Microfinance Bank of Georgia has developed "pawn loans," which allow clients to use jewelry as collateral.
- Fundusz Mikro in Poland is offering "partnership loans," equity-type products based on profit-sharing principles.
- Demos in Croatia has introduced loans targeted at start-up microenterprises, that allow a grace period on the principal amount borrowed.
- Other MFIs, such as Prizma in Bosnia and Herzegovina and Constanta in Georgia, are experimenting with new delivery methods that lower the transaction costs involved in increasing outreach to rural areas.

Although poverty outreach is currently limited, these examples reveal positive trends and an improved outlook. Mature MFIs in the study, particularly NGO MFIs, are deepening their poverty outreach—rather than moving upmarket, as is often assumed. A primary driver in these MFIs' growing focus on low-end clients is the competitive pressure from downscaling commercial banks and microfinance banks for the relatively higher-end clients.

To date, there is limited information available about the impact of microfinance on the lives of clients, their families, or their local communities. Findings from one regional impact study suggest that the impact is positive—with client populations enjoying increases in household incomes, business profitability, and employment. However, further study is needed to understand the impact of microfinance on poverty and to ensure the development of products and services that have a positive impact over time.





## CHAPTER 6

### FINANCIAL PERFORMANCE

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*Microfinance institutions are specialized financial institutions that aim to achieve a “double bottom line”—both a social and a financial return. Chapter 6 examines five interrelated areas of financial performance of MFIs: portfolio quality, operating efficiency, productivity, financial self-sufficiency, and funding structure. It also analyses the relationship between depth of outreach (one aspect of social return) and financial sustainability.*

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Analysing financial performance requires high-quality, reliable, and standard information. The survey set out to collect such financial data to allow an analysis and comparison of the financial performance of the MFI types in CEE and NIS. However, the quality and availability of financial data varied widely, limiting the ability to provide a definitive assessment of financial performance.

- For credit unions, data were not readily available. The study draws some conclusions about the financial performance of credit unions based on the limited data available from some of the better-performing CUs and WOCCU. However, because of this, the findings on credit unions should not be taken as necessarily representative of all of them in the region.
- The majority of NGOs provided financial data, but the quality was quite variable. Only one-third of the NGOs provided accurate, reliable financial data that allowed a calculation of all financial ratios. Hence, again, survey findings are not fully representative of all NGOs.
- Commercial banks provided data on portfolio quality and loan-officer caseload. But data on the efficiency and profitability of their microlending operations were not available. Nonetheless, some generalizations can be made on these aspects of their operations based on case studies.
- All microfinance banks provided data on their portfolio quality and productivity, as well as their published financial statements, which were used to calculate operational efficiency and profitability ratios. However, their published data do not provide a complete picture of their operational costs, as some costs are subsidized and treated separately. This made it difficult to calculate their true level of profitability.

This lack of standard and reliable data underlines the need for the region's MFIs to improve the quality and transparency of their financial information, and to adopt standard indicators and ways of measuring financial, as well as social, performance.

#### **Portfolio Quality**

Some delinquency (late or nonpayment of loans) is inevitable in any lending operation. However, high repayment rates generally indicate that loan terms and conditions are in line with the borrower's capacity to repay, that the borrower values the loan, and that the borrower is willing to repay the loan. High repayment rates also indicate the strictness of an MFI's approach to delinquency management.

We use the portfolio-at-risk (PAR) measurement to assess levels of delinquency. As the measure most used by MFIs across the region, PAR is a realistic indicator of the value of a lender's loans that are at risk of not being repaid—that is, likely actual loan losses. Specifically, PAR measures the value of all loans outstanding that have one or more installments overdue (past a specified date), compared to the value of the total loan portfolio.

The study data reveals that the majority of MFIs in CEE and NIS have achieved impressively low levels of delinquency, with an average of only 3.4% portfolio at risk (more than 30 days past due). This demonstrates that MFIs are emphasizing a strict credit culture and have a strong focus on delinquency management. Such portfolio quality is particularly impressive when compared to the region's mainstream banks. Delinquent loans commonly accounted for up to 60% of their assets in the mid-1990s.<sup>1</sup>

**Table 6.1 Portfolio at Risk > 30 Days by Institutional Type**  
(as of September 2001)

Type of MFI	Number	Average PAR	Max PAR	PAR < 5%	% of MFIs with PAR in Different Ranges		
					PAR 5.1–10.0%	PAR 10.1–20.0%	PAR > 20.1%
Credit Unions	511	6.00	16.73	93%	4%	3%	0%
NGOs	58	4.05	54.10	81%	12%	3.5%	3.5%
Commercial Banks	20	0.37	1.44	100%	0%	0%	0%
Microfinance Banks	10	0.69	2.05	100%	0%	0%	0%
Total	599	3.40					

However, there are variations by MFI type. The banks—both commercial and microfinance banks—all report high-quality loan portfolios, with less than 5% PAR. Among the credit unions and NGO MFIs, there is a much greater range in portfolio performance. The vast majority (93%) have high-quality portfolios. However, 7% of the credit unions for which we had data and 19% of the NGO MFIs have a PAR greater than 5% (see Table 6.1).

Among these credit unions and NGO MFIs, several have extremely severe delinquency problems, with PAR measures as high as 17% and 54%, respectively. Such high delinquency levels make it practically impossible for an MFI's operations to be financially viable, as losses have to be covered from interest income if the institutional capital is not to be depleted. When more than half of an MFI's loans are late and at risk of never being repaid, it suggests that the institution does not know how to run a lending operation properly and is operating a welfare, rather than credit, programme.

MFIs with less strict approaches to late repayment of loans can undermine the operations of other MFIs and the overall soundness of the microfinance industry. Clients of the less strict MFIs may begin not taking their repayment obligations to any MFI seriously. As a result, a poor credit culture can ensue throughout the microfinance

<sup>1</sup> Andrew Sheng, ed., *Bank Restructuring: Lessons from the 1980s* (Washington D.C.: World Bank, 1996).

sector. Hence, all MFIs have a responsibility to address delinquency and institute measures to manage and control it to a reasonable level.

## Operating Efficiency

Operating efficiency is commonly thought to be the degree to which the use of resources is maximised to produce the desired impact. The operating cost ratio measures efficiency by comparing all administrative and personnel expenses to the average gross loan portfolio outstanding. Simply put, it measures how many cents an MFI has to spend to lend a dollar. It also shows how much interest would have to be charged on loans to break even if an MFI were relying on interest income alone. Efficiency derives from having well-developed lending methodologies, streamlined procedures, and productive staff.

However, efficiency measures are simplistic and need to be interpreted with care. The operating cost ratio is a crude measure that focuses on cost per loan and does not take into account loan recovery rates or lending outcomes. Furthermore, economies of scale provide the potential for it to be more cost effective to make larger loans or manage a larger loan portfolio. Hence, smaller MFIs or those that provide smaller loans often compare unfavourably with larger MFIs on efficiency ratios even though they may be serving their target market effectively.

On average, the study found that MFIs with larger loan portfolios are more cost efficient. Those with an average portfolio of more than US\$10 million have an operating cost ratio of 16%, compared to 31% for those with a portfolio of less than US\$1 million (Table 6.2).

**Table 6.2 Breakdown of Operating Cost Ratio by Loan-Portfolio Size**

Type of MFI	Number	Average Operating Cost Ratio (2001, annualized)	Minimum Operating Cost Ratio	Maximum Operating Cost Ratio	< US\$1 million	US\$1–10 million	> US\$10 million
All MFIs (except CBs)	121	26%			31%	19%	16%
Credit Unions	70	12%	5%	21%	12%	–	–
NGOs	42	31%	4%	110%	36%	22%	–
MFBs	9	13%	5%	20%	–	10%	13%

However, there are differences in efficiency among MFI types. According to the limited data available, credit unions are small but very cost efficient, managing portfolios of less than US\$1 million with an average operating cost ratio of only 12%. Unlike other MFI types, credit unions are often managed by members who volunteer or accept only nominal payment, which tends to keep their operating costs very low compared to other MFI types.

The microfinance banks have also achieved high levels of cost efficiency, with an average cost ratio of 13%. However, it is not clear that all of the microfinance banks' operating costs are included in their financial statements, hence this level of efficiency might be overstated.

The operating efficiency of NGO MFIs ranges widely, from 4% to 110%. The average operating cost ratio is 31%, the highest of all MFI types; however, for NGOs with portfolios greater than US\$1 million, it is a more reasonable 22%.

Cost-efficiency data were not available for a representative sample of the commercial banks. However, two banks in Uzbekistan with loan portfolios of US\$3.7 million and US\$4.7 million, respectively, both reported operating cost ratios of 23%. This is high, given that the commercial banks provide larger loans and have larger portfolios than do other MFIs.

Results suggest that MFIs throughout CEE and NIS improve their efficiency the longer they operate. Mature MFIs (those in operation six or more years) have the lowest operating cost ratios, 17% on average (see Table 6.3). Young NGO MFIs and microfinance banks (between 2.1 and 5.9 years in operation) have higher operating cost ratios than their start-up counterparts. This may be explained by the fact that young MFIs often invest in additional staff and branch infrastructure to support future expansion, which can lead to a temporary drop in efficiency.

However, it may also indicate that the initial start-up subsidies of MFIs in CEE and NIS are not fully reflected in their financial statements. The microfinance banks, in particular, appear to have unrealistically low operating cost ratios at start up given the high level of investment costs of these banks.

**Table 6.3 Operating Cost Ratio by MFI Age**

Type of MFI	Number of MFIs	New (< 2 years)	Young (2.1–5.9 years)	Mature (> 6 years)
All MFIs (except CBs)	121	19%	29%	17%
Credit Unions	70	12%	10%	14%
NGOs	42	27%	32%	21%
MFBS	9	10%	20%	11%
Total	121	21%	4%	110%

The study also found that it costs more to serve the poor. Findings show that, in a sample of 26 NGO MFIs for whom reliable data was available, the operating cost ratio was 20% for those serving a broad clientele, 27% for those serving low-end markets, and 56% for those serving very low-end clients (see Table 6.4).

However, within the same target markets, operationally self-sufficient (OSS) NGO MFIs are more efficient than NGO MFIs that are not operationally self-sufficient (non-OSS). The difference is striking when one compares OSS and non-OSS MFIs serving low-end clients: the OSS MFIs have a 16% operating efficiency, compared to 41% for non-OSS MFIs. Clearly, non-OSS MFIs can do much to control their costs and increase their efficiency levels.

The study also revealed that operationally self-sufficient MFIs have achieved their financial sustainability by charging interest rates that cover their costs. Non-OSS MFIs charge lower interest rates to their low-end clientele, compared to OSS MFIs. This is illustrated by the nominal portfolio yield. For OSS MFIs that target very low-end clients, the average portfolio yield is 68%; for non-OSS MFIs it is 55%. This difference in yield indicates that, while low-end clients are willing to pay higher interest for services, the non-OSS MFIs may be reluctant to utilize the opportunity.

**Table 6.4 Comparison of Operating Cost Ratio by Depth of Outreach**

	High-End and Broad	Low-End	Very Low-End	All
<b>Whole Sample</b>				
Number of MFIs reporting	12	7	4	23
Mean operating cost ratio	20.5%	26.9%	55.8%	28.1%
<b>Operationally Sustainable MFIs</b>				
Number of MFIs reporting	7	4	1	13
Mean operating cost ratio	14.8%	16.2%	53.7%	17.8%
<b>Non-Operationally Sustainable MFIs</b>				
Number of MFIs reporting	4	3	3	10
Mean operating cost ratio	30.4%	41.2%	56.6%	41.5%

## Loan-Officer Productivity

Loan-officer productivity is another common measure of efficiency or productivity. It measures the average client caseload of each loan officer.

**Table 6.5 Loan-Officer Productivity**

Type of MFI	Number	Number of Active Clients per Loan Officer
Credit Unions	54	166
NGOs	63	151
Commercial Banks	18	30
Microfinance Banks	10	54
Total	145	123

When it comes to loan-officer productivity, the credit unions and NGOs beat the banks. The credit unions and NGOs both have loan-officer case loads three times as high as the microfinance banks and five times as high as the commercial banks (see Table 6.5). This suggests that the CUs and NGOs have done a better job of streamlining operations and developing lending methodologies that enable a high loan-officer caseload.

Solidarity-group-lending methodologies, in particular, allow greater loan-officer productivity. (In group lending, many of the loan-appraisal tasks are the responsibility of the group, not the loan officer.) Loan officers at NGO MFIs that do only individual lending have a productivity of only 94 clients per loan officer, compared with 195 at NGOs doing only solidarity group lending, and with 171 at those doing a combination of group and individual lending.

## **Financial Sustainability (Profitability)**

The majority of MFIs in CEE and NIS are strongly focused on becoming financially sustainable. This essentially means going beyond their breakeven point (the point at which revenues cover costs) and becoming profitable. However, the term “financial sustainability” rather than “profitability” is more commonly used, particularly by NGO MFIs. This is because most are nonprofit organisations that do not aim to maximise profit but reinvest any surplus income or profit back into their operations.

There are two levels of financial sustainability:

- Operational self-sufficiency is achieved when the organisation earns sufficient income from its own earned revenue sources to cover all administrative or operational expenses but relies on a wholly or partially subsidised capital base.
- Financial self-sufficiency is achieved when an organisation earns sufficient income to cover all administrative expenses, as well as the costs of inflation, loan losses, and the market cost of funds. At this level of sustainability, an organisation is profitable and can offer a positive financial return on investment.

From an MFI's perspective, a high level of financial sustainability is desirable for several reasons:

- It secures the long-term sustainability of the MFI's operations, so it can serve its clients over the long term.
- It allows an MFI to be independent in its operations and decision making (rather than dependent on donors).
- It allows an MFI's staff to focus on expanding and improving its operations (rather than spending valuable time raising funds to operate).
- It makes an MFI a better credit risk, so enabling it to attract commercial investment to support further growth.

Simply striving for sustainability has its benefits; it can bring a financial discipline to an MFI's operations that ultimately can lead to greater efficiency, productivity, and client focus.

Reaching financial sustainability takes time. How much time depends on many factors, including the MFI's portfolio size, capitalization level, interest rates charged, weighted average cost of capital, average loan size, administrative cost per loan, salary levels, and the extent of non-revenue-generating support services it offers. In analysing and comparing the degrees to which MFIs have reached profitability, therefore, it is important to understand the nature and cost structure of their operations. Those providing very small loans to poor clients are likely to take longer to reach sustainability than those MFIs providing larger loans to micro and small enterprises.

Financial sustainability, although a key area of MFI performance, was the most difficult area to get data from MFIs, particularly from credit unions and commercial banks. Below, we discuss their levels of financial sustainability, after which we discuss that of NGO MFIs and microfinance banks, for both of which more data was available.

Credit union financial performance is mixed. The Polish credit unions are the best performing. The largest of the Polish credit unions achieved financial self-sufficiency after just five years in operation and had a positive

return on assets (ROA), on average, of 3.04% in 1998.<sup>2</sup> In 2000, their average ROA was slightly below zero, largely due to dynamic growth and significant investment in their expansion. (Their number of outlets increased by 33% that year.)

Other than Poland, we do not have good financial data on credit unions. Anecdotal reports suggest that many operate at a loss—they do not charge sufficient interest or fees to cover their costs, including losses. In principle, it should be easier for credit unions to become financially self-sufficient than for other MFI types, given their lower overhead costs. However, although other MFIs have demonstrated that low-income clients are willing to pay relatively high interest rates for quality services, many credit unions are reluctant to charge cost-covering interest rates.

There was no comprehensive data available on the profitability of commercial banks' microlending operations. Profitability studies of Sberbank Russia, the most mature of the region's downscaling commercial banks, suggest that microlending operations in all Sberbank branches are now profitable. However, it must be taken into account that Sberbank is also the largest commercial-bank downscaling programme by far, with a total portfolio of nearly US\$50 million. The other downscaling programmes are far smaller—with an average portfolio of US\$4 million—and are, therefore, unlikely to have profitable microlending operations at this point.

More complete data on financial self-sufficiency were available for 43 NGO MFIs and nine microfinance banks.<sup>3</sup> There is a wide range in the financial sustainability of NGO MFIs. Operational self-sufficiency ratios range from 13% to 281% (see Table 6.6). On average, this sample of NGO MFIs had an average OSS ratio of 109%, equivalent to an unadjusted return on assets of 0.7% in September 2001.

Generally, NGO MFIs are moving towards full financial self-sufficiency over time—with increasing levels of self-sufficiency each year. A total of 24 NGO MFIs (18% of all 136 in the study) were found to be operationally self-sufficient in September 2001 after 3–4 years of operations. This is an extremely impressive achievement, given that the best-performing MFIs worldwide have mostly needed 5–7 years to reach similar levels of financial sustainability. The average age of OSS NGOs was 3 years and 9 months.

The most profitable NGO MFIs are in the Balkans, and the majority of these are in Bosnia and Herzegovina. Their profitability has been spurred on by a consistent emphasis on financial performance, as well as the competition and consolidation among NGO MFIs that has occurred in Bosnia and Herzegovina (see Chapter 5).

Nine NGO MFIs have already achieved true profitability, with a positive adjusted return on assets in 2001, ranging from 0.4% to 7.0%. This makes them as profitable as the microfinance banks and challenges skeptics who believe that the NGO ideology and way of working are incompatible with the efficient, profitable delivery of microfinance services.

<sup>2</sup> Anna Cora Evans and Dave Richardson, *Polish Credit Union Development: Building a Sustainable Network of Financial Services to Serve Low-Income Masses*, WOCCU Research Monograph Series, No. 17 (Madison, Wisc.: World Council of Credit Unions, Inc., 1999).

<sup>3</sup> It was difficult to compare financial performance as NGO MFIs and microfinance banks typically report different financial ratios. NGOs report operational (or financial) self-sufficiency and returns on assets, whereas the microfinance banks report returns on equity. Furthermore, sometimes these are adjusted for subsidies, sometimes not. In order to allow greater comparison, we calculated the OSS ratios for a subset (four) of microfinance banks for whom income and expense data were available. We also calculated unadjusted returns on assets. In the text, we also provide reported figures on adjusted returns on assets and returns on equity where they are available.



**Table 6.6 Comparison of Financial Sustainability by MFI Type**

MFI Type	Number	Average Operational Self-Sufficiency (%)	Minimum Operational Self-Sufficiency	Maximum Operational Self-Sufficiency	Number	Average Unadjusted Return on Assets (%)
NGOs – All	43	109	13	281	41	1%
MFBs – All	4	116	56	138	10	10
NGO (< 3 years)	23	86%	13	244	22	-5%
NGO (3+ years)	20	131%	61	281	19	6%
MFB (< 3 years)	3	95%	56	127	8	0.4%
MFB (3+ years)	1	138%			2	4.5%

Note: Operational self-sufficiency (OSS) = Total operating income divided by total operating expenses (including administrative expenses, interest expenses, and loan-loss provision).

Return on assets (ROA) = Net operating profit (loss) divided by average total assets.

**Table 6.7 Financial Self-Sufficiency (Profitability) Results for Microfinance Banks**

MFI Type	Number of MFIs	Average Unadjusted Return on Assets (%)
MFBs	9	0.3%
MFB (< 3 years)	7	-1.1%
MFB (3+ years)	2	4.5%

On average, microfinance banks show the most consistently positive financial performance of all MFI types. Five out of nine of the microfinance banks have reached operational self-sufficiency within 2–3 years, with an average unadjusted return on assets of 0.3%. The average age of OSS microfinance banks is 3 years and 6 months.

These banks are providing solid financial returns to their shareholders. Four of the OSS banks reported unadjusted returns on equity ranging from 8–47%. The fifth bank, MEB Kosovo, is an exception, with an unadjusted return on equity of 96%. This makes it the region's most profitable microfinance bank by far. In fact, it is reportedly the most profitable bank of any kind in all of Central and Eastern Europe today<sup>4</sup>. However, its profits have derived from the high volumes of savings it captured after the war. In September 2001, only 4%

<sup>4</sup> "Back to Nursery School," *The Economist*, September 14, 2002.

of the bank's assets were invested in its loan portfolio, and it had made only 1,600 loans to micro and small enterprises. Hence, it is questionable whether this level of profitability is a true measure of success from a microfinance perspective.

The microfinance banks' profitability results are not adjusted to take into account subsidies, including grant-funded management and subsidized start-up costs. (See the next section on subsidy dependence.) These are treated as sunk costs by the banks investors, and are typically funded by grants and are not expected to be recouped.

The microfinance banks' ability to reach higher levels of profitability is driven by three main factors—large amounts of up-front investment, a higher average loan size, and a business model that has revenue streams other than just lending. The design of microfinance banks is based on the premise (coming from commercial-banking experience) that it is difficult to reach profitability purely from lending. Hence, microfinance banks provide other financial services, including money transfers and foreign-exchange services, which provide important income streams. Data from three microfinance banks show that as much as 43% of their income comes from non-lending activities (see Table 6.8).

**Table 6.8 Percentage Income from Non-Lending Services for MFBs**

Name of Microfinance Bank	Income from Non-lending Activities as % of Operating Income
MFB Yugoslavia	37%
FEFAD Albania	43%
KMB Russia	4%

### ***Financial Sustainability and Depth of Outreach: Is There a Trade Off?***

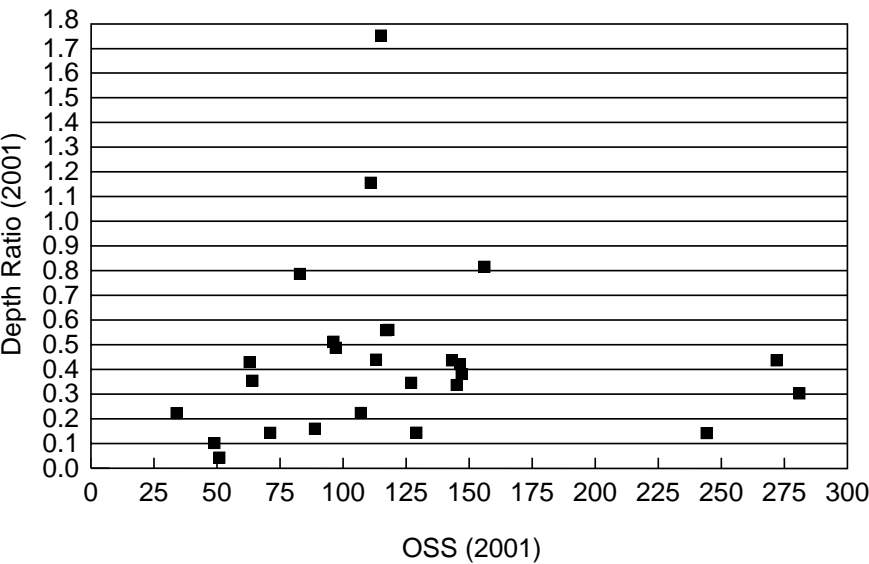
There has been a running debate in the microfinance world over whether there is a trade off between poverty outreach and financial sustainability. A common conclusion is that one may be able to achieve financial sustainability, but it is at the expense of reaching poor clients.

However, MFI data from the region suggest that it is possible to achieve both profitability and depth of outreach to the poor. Among a sample of 10 operationally self-sufficient NGOs, six reported depth ratios lower than 40% (ie, they reach low-end clients), indicating that it is possible for those who reach the poor to become sustainable.

But reaching the poor does cost more, hence a conscious decision has to be made by an MFI to pursue a poverty-outreach strategy. In effect, there is a trade off—poverty outreach is likely to lead to less profitability, but both goals can be achieved if an MFI chooses to and places a strong focus on performance. This is illustrated by the graph below. On the one hand, there are MFIs with an operational self-sufficiency ratio above 250% making small loans. On the other hand, there are also MFIs that are not operationally self-sufficient making large loans.

Given the small transactions and high costs of poverty lending, two factors are key to building a sustainable, poverty-focused operation. One, an MFI needs a large volume of loans. Given the low returns, larger volumes are needed to break even. Constanta and KCLF illustrate this—they have the largest loan portfolios of all the low-end lenders at nearly US\$1 million and US\$0.8 million, respectively (see Table 5.2). Second, an MFI needs

**Figure 6.1    Depth of Outreach versus Operational Self-Sufficiency**



time. If an MFI does not have the capital to build a high-volume operation quickly, it will take longer for it to reach sustainability by providing small loans to poorer clients, compared to providing larger loans to higher-end clients. Again, this is demonstrated by the experience of Constanta and KCLF, which are the oldest institutions in the top 10 low-end lenders; both are more than six years old (see Table 5.2).

The success of microfinance institutions is all too often judged by their level of profitability alone. In a conventional financial analysis, poverty-focused MFIs risk being regarded as suboptimal in terms of resource use, relative to MFIs that do not focus on poverty and can achieve a greater financial return in less time. Any measurement of returns must guard against such a bias. To accomplish this, measures of financial return must be looked at alongside measures of social return, including the demographics and socio-economic profiles of clients and the impact of microfinance services.

**Subsidy Dependence**

As elsewhere in the world, the development of the microfinance industry in CEE and NIS has been heavily dependent on donor funding. The majority of MFIs have relied on donor funding (ie, public subsidies) to cover the costs of starting up and growth of their operations. These subsidies most often come in the form of grants for operational costs and loan capital, technical assistance, in-kind donations (such as computers or vehicles), and credit lines on concessional terms.

Subsidies to microfinance are often considered justified provided the social benefits outweigh the social costs. The primary social benefit is to address a market failure—providing financial services to those who would not otherwise have access to these services via the mainstream private sector. More broadly, the positive social benefits that result include the support of business development, job creation, and wealth creation. The costs are effectively the opportunity costs—the potential lost benefit of putting those funds to alternative public use.

**Table 6.9 Type of Grant Subsidies Received**

Type of MFI	Number	Grants for Operational Expenses	Grants for Loan Capital	Grants for Investment in Property, Equipment, Fixed Assets	In-Kind Donations
NGOs	53	89%	81%	47%	35%
Microfinance Banks	9	100%	0%	22%	33%

Note: In-kind donations are equipment, training, personnel on loan or with salaries covered, etc.

To be cost effective, subsidies should ideally be transparent, effectively targeted, and capped. Furthermore, it is increasingly recognized that subsidies are most effective when used to develop efficient and competitive financial intermediation, rather than directly subsidizing the interest rate paid by the borrower. The experience of MFIs across the world, as well as in the region, shows that microentrepreneurs value access to timely, reliable credit and savings facilities much more than subsidized rates of interest.

It was beyond the scope of this study to analyse, in detail, the level of subsidy dependence of individual MFIs or MFI types.<sup>5</sup> Still, some findings can be drawn from the data available.

Credit unions are the least subsidy dependent of all MFI types. In fact, many locally (rather than donor) driven credit unions have had no subsidies. This is due to the fact that the credit union model is a savings-first model, in which savings are mobilized to form the capital base for on-lending, and staff costs are covered by people initially volunteering their time or accepting nominal payment. However, donors are increasing their support of the start-up and development costs of credit unions and credit and savings associations by providing grants and concessional loans. A small sample of credit unions (186 CUs) in the CEE and NIS reported an average subsidy level of nearly US\$100,000 (see Table 6.10).

Among NGO MFIs, there is a great range in the amounts of subsidy—from as little as US\$50,000 to as high as US\$6 million (see Table 6.10). The most highly subsidized NGO MFIs tend to be international NGOs that get high levels of funding from bilateral donors, usually from their country of origin. For example, FINCA and Opportunity International, both US-based NGOs, have received high levels of funding from USAID, ranging from US\$1.5–\$6 million. Smaller, local NGO MFIs tend to have more difficulty securing high levels of sustained donor funding. The efficiency with which NGO MFIs use subsidy varies quite widely. Subsidy has not always translated into higher financial and social returns for them. Some NGO MFIs with lower levels of subsidy have achieved higher levels of efficiency, financial self-sufficiency, and social returns (in the form of outreach to low-income clients).

Commercial-bank downscaling programmes have received significant subsidy, generally to cover the technical-assistance costs to train loan officers, develop management information systems, provide stipends for loan officers, and sometimes expand their branch networks. Although, the commercial banks did not provide data on the cost of their microlending operations, EBRD reports that the costs of downscaling programmes with local banks are typically higher than for establishing microfinance banks. This would suggest that the average subsidy received is at least US\$2.5 million per bank.

<sup>5</sup> This excludes MEB Kosovo, an exception with a debt-to-equity ratio of 18:1. This ratio results from its extremely high level of deposits.

**Table 6.10 Average Reported Subsidy by Institutional Type**

Type of MFI	Number	Average Value of Subsidy Received (US\$)	Minimum Subsidy Amount (US\$)	Maximum Subsidy Amount (US\$)
Credit Unions	186	99,869	4,400	4,094,864
NGOs	43	1,646,520	52,574	6,200,000
Microfinance Banks	9	1,173,109	818,217	1,528,000

The microfinance banks have also received large amounts of subsidy. They reported an average subsidy level of US\$1.2 million since start up. However, separate data suggest that the average subsidy amount per microfinance bank is more in the range of US\$2–\$2.5 million, if one considers the full cost of international consultants and management, as well as the market value of concessional financing. Such high levels of subsidy have generally been used relatively efficiently, with most of the microfinance banks achieving financial self-sufficiency over time. However, the social return of microfinance banks, in terms of their outreach to low-end microenterprise and poor clients, is less than that of credit unions and NGO MFIs.

Subsidies are most cost effective when used to assist an MFI to achieve financial self-sufficiency over a limited time frame. These conditions help the MFI reduce its dependence on subsidy to zero over time. However, in some cases, the value associated with achieving the social outcomes or public benefit sought by MFIs may justify the *long-term* use of grants and subsidies. For example, there are certain markets that are hard to reach, such as highly dispersed populations or extremely vulnerable groups. Long-term subsidies for the operating costs of MFIs that target these groups may be justified. Also justified may be subsidies to support innovation and new product development aimed at serving these groups, in cases where such costs (and their consequent risks) are prohibitively high for an MFI to cover from its own earnings. Subsidies can also be well spent in helping build the organisational capacity and technical skills of MFIs on a longer-term basis.

The challenge is understanding the cost-benefit structure of MFIs well enough to target subsidies efficiently. If not strategically and carefully targeted, subsidies can do more harm than good. For example, subsidies for capital and day-to-day operating expenses can breed inefficiency, lead to donor dependency, and discourage MFIs from seeking the more expensive commercial money that may be available (see Chapter 8).

A better understanding of the true subsidy dependency and financial viability of MFIs is vital to accurately assess which MFI models and individual institutions have the greatest prospects for long-term sustainability and impact. Again, greater MFI transparency is needed so such assessments can be made. Currently, an MFI's subsidy dependence is not usually clear from its published financial statements or financial results. Better disclosure of information regarding public-subsidy use and subsidy dependence is needed to measure the effectiveness of public funding and to target funding to MFI investments with the greatest social return.

## Funding Structure

Knowledge of the sources and structures of funding of MFIs is important to understanding the MFIs' financial strength and prospects for financial sustainability. To understand their funding structures, we analysed the

**Table 6.11 Structure of Balance Sheet by Type of MFI**

Balance Sheet Liabilities + Equity	NGOs (30)	Credit Unions (288)	Microfinance Banks (10)
Deposits	0	81%	54%
Loans – Commercial	2%	0	16%
Loans – Subsidized	31%	0	17
Capital – Donor grants	34%	0	0
Capital – Private equity	3%	8%	10%

balance sheets of a sample of MFIs (credit unions, NGO MFIs, and microfinance banks), carefully reviewing both their liabilities (what is owed by the organisation to others) and equity (the value or net worth of the organisation). We found major differences in the funding structures of different MFI types (see Table 6.11).

Credit unions rely mainly on local deposit mobilization to create a capital base—unlike other MFI types, CUs put savings, rather than credit, first. In our sample of CUs, 81% of the liabilities and equity were made up of client savings. Credit unions also have small amounts of equity, coming mainly from member fees. Some credit unions, although not any in our sample, also have external borrowing, usually on-lent from a wholesale intermediary. Many national CU movements have established a second-tier wholesale association (eg, the National Association of Savings and Credit Associations in Poland). The credit unions join and pay dues to these national associations, which typically operate a central finance facility that provides liquidity protection to members who must make unanticipated savings withdrawals. For the most part, it is only these national credit union associations that can borrow externally from banks. When it works well, the combination of dependence on savings mobilization and the central finance facility provides a relatively high level of financial strength to credit unions.

In some countries, credit unions have relied virtually entirely on donor credit lines for their capital base and have mobilized very limited savings. For example in Moldova, the World Bank supported the creation of savings and credit associations (SCAs) that borrow capital from a specially-created wholesale intermediary (the Rural Finance Corporation) to on-lend to members. Here, there was limited incentive for the SCAs to mobilize savings, given the provision of capital by the Rural Finance Corporation.

Once a credit union knows how to properly manage savings and loans, external financing can be critical to its growth. However, there are potential dangers in a donor-driven approach to credit union development, particularly if donor funds, rather than deposits, are used to capitalise them. Experience suggests that strong credit unions share three characteristics. One, they are based in locally rooted movements. Two, they have strong, local leaders. Three, their members have a strong common bond and sense of shared financial liability, at least during the start-up phase.

It is possible that the members' sense of their common bond and shared financial liability, which contribute to credit unions' good governance and financial soundness, can be reduced in credit unions that do not focus on savings first. Hence, donors should be very cautious about how they support credit union development. Ultimately, donor subsidies are probably best targeted at first toward strengthening CUs' institutional capacity,

savings mobilization, and financial management capacity, and toward on-lending funds only after the CUs have developed the institutional capacity to manage them effectively. That said, there are exceptions to this approach. In Moldova, strong credit unions have been developed with the support of a donor credit line, with little focus on savings mobilization.

NGOs in the region are still heavily dependent on donors. A total of 65% of NGO MFI funds are either donor grants or subsidized loans (see Table 6.10). Most rely on one or two main donors for funding and have limited amounts of their own capital, built up from reinvesting any net surplus.

Although they have generally been successful, the region's NGO MFIs risk instability and delinquency in the absence of additional, more diverse, and more sustainable funding sources. This is because donor funding cannot be relied upon in the long term. For now, microfinance development is receiving relatively large amounts of donor funding, but such flows could easily diminish as donor attention turns elsewhere.

Currently, few NGO MFIs are leveraging their capital base through commercial borrowing. Most NGO MFIs have a debt-to-equity ratio of 1:1 or less. This suggests that there are clear opportunities for NGO MFIs to increase their commercial borrowing. (The lessons of those that are borrowing commercially are described in Chapter 7.)

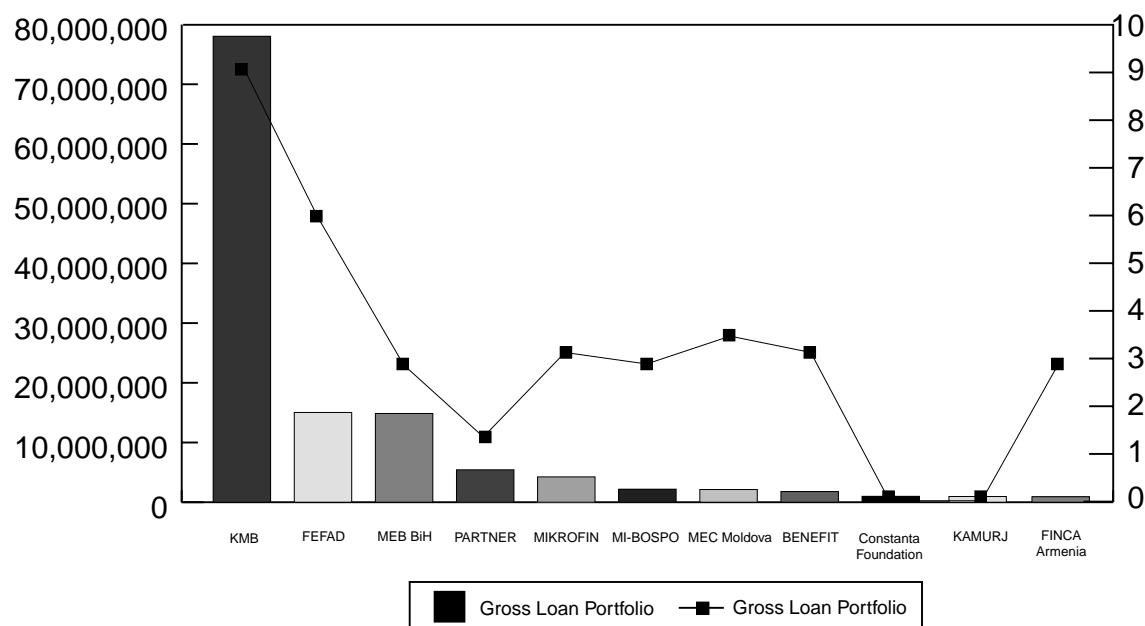
Microfinance banks have the most diverse range of funding sources of the region's MFIs and have been successful at raising large volumes of up-front investment. Their funding sources include deposits (client savings), commercial and subsidized loans, and private equity investment from both international financial institutions and private investors. Commercial investors are more comfortable lending to regulated institutions, like microfinance banks, than unregulated ones, like NGO MFIs. As a result of this perception, the microfinance banks have managed to leverage their equity base far more effectively than have the NGOs. In 2001, the microfinance banks had an average debt-to-equity ratio of 4:1, compared to less than 1:1 for most NGO MFIs.<sup>6</sup>

The IMI-led microfinance banks have been particularly successful at mobilizing investors. Their core investors include EBRD, KfW, and IFC (all development banks), and Commerzbank (a private commercial bank). This group of like-minded investors provides not only the financing needed for the microfinance banks but also banking know-how and political support. Their international reputation and financial standing also gives the microfinance banks credibility—a precondition for mobilizing local deposits.

Although the microfinance banks currently have a sound funding base, their future financial position will depend on two efforts. First, as the region's financial sector strengthens, they will need to attract deposits from the public in the face of increasing competition from other banks. Second, they will need to attract new investors willing to buy out the international investors wishing to exit. One strategy under consideration by IMI is to raise capital through the public stock market by listing itself on the stock exchange.

Balance-sheet data for the downscaling commercial banks was not available, but it is known that their microlending activities have been financed by loans from international financial institutions, notably EBRD and KfW. A true sign of the success of downscaling would be for these commercial banks to put their own capital into their microlending operations. Currently, there are few signs that the majority of downscaling commercial banks are ready to make such a commitment, which does call into question the long-term sustainability of the model.

<sup>6</sup> Jacob Yaron and Mark Schreiner, *Development Finance Institutions: Measuring Their Subsidy* (Washington, D.C.: World Bank, 2001). Yaron and Schreiner have developed a useful way to measure and compare the social cost of subsidized MFIs. However, data were not available to carry out such a subsidy-dependency analysis.

**Figure 6.2 Debt-to-Equity Ratios for Selected MFIs with a Positive Return on Assets**

## 2002 Update

The already low levels of delinquency further improved among the NGO MFIs. Between September 2001 and December 2002, the portfolio-at-risk (PAR) indicator dropped by one-third. In the 2001 survey, eleven NGOs reported a PAR > 30 days of more than 5%. Over a year later, two of them have managed to lower their portfolio at risk to less than 5%.

**Table 6-Update Financial Performance of MFIs**

MFI Type	Number	PAR > 30 days (September 2001)	PAR > 30 days (December 2002)	Number	OSS/ROA (September 2001)	OSS/ROA (December 2002)
NGOs	26	2.5	1.7	33	103	120
Microfinance Banks	10	0.7	0.9	10	-0.1%	0.3%

Notes: PAR: Portfolio at risk.

OSS: Operational self-sufficiency.

ROA: Return on Assets.



Operational sustainability among the NGO MFI sample also improved. Compared to the September 2001 results, 10 more NGO MFIs that previously were not sustainable reached operational sustainability.

NGOs in Central Asia had the highest OSS ratios. This may be attributed to relatively higher interest rates and fees than in the other subregions. Central and Eastern Europe recorded the lowest OSS, where some very small NGOs are not able to earn sufficient revenue from their operations to cover their costs. Hence, they may rely on charitable contributions to continue operating.

In the course of 2002, three more NGO MFIs started to use commercial and other sources of funds. Several other MFIs contracted for ratings by independent rating agencies in order to become more transparent and

### Chapter 6 Summary

There is a wide range in the performance of individual MFIs. However, at an industry level, the region's MFIs have achieved good financial results. The majority of the region's MFIs of all types have impressively low delinquency levels, with an average portfolio at risk (more than 30 days overdue) of only 3.4%. Operating-efficiency levels are generally good, relative to the size, age, and client base of the institutions, with mature MFIs (those more than six years old) having an average operating cost ratio of 17%. However, the study found it costs more to serve the poor.

The profitability of microfinance operations is mixed:

- Among credit unions, those in Poland are high performers and have demonstrated their ability to generate a positive return on assets. Many other credit unions appear reluctant to charge cost-covering interest rates and, so, often operate at a loss.
- There is a wide range in the profitability of NGO MFI operations. Nearly 20% are estimated to have reached over 100% operational self-sufficiency after 3–4 years of operation. Nine have already achieved full financial self-sufficiency or true profitability, with (adjusted) returns on assets of 0.4–7.0%. However, some NGO MFIs have operational self-sufficiency levels as low as 10–20%.
- Limited data were available on the profitability of downscaling commercial banks. Only the downscaling programme at Sberbank Russia is known to have reached profitability. The others in the region likely operate at too small a scale to be profitable.
- The microfinance banks have achieved high levels of financial performance most consistently, relative to the other MFI types. The six oldest microfinance banks all achieved a positive (unadjusted) return on equity of 4–47% after 3–4 years of operations.

attract the attention of investors. In 2002, eight NGO MFIs applied to have their programs rated through the CGAP-IDB Rating Fund, which brought the total number of NGO MFIs that were rated to nine. Rating reports of these institutions are publicly available.

Among the microfinance banks, the rapid growth in the scale of operations came at a cost. The overall financial situation of 10 microfinance banks worsened slightly; the average ROA dropped to -0.3%. Their portfolio at risk > 30 days remained very low, under 1%.

Financial data for downscaling commercial banks were unavailable. However, arrears greater than 30 days grew in 2002, compared to 2001.

Data from the region suggest that it is possible for MFIs to achieve both financial self-sufficiency *and* significant outreach to the poor. However, the greater an MFI's outreach to the poor, the higher its costs—which typically means the longer the time and higher the volume of operations it needs to achieve profitability.

As elsewhere in the world, the development of the microfinance industry in the region has been highly donor dependent. Credit unions are the least subsidy dependent; unlike other MFIs, they rely on deposit mobilisation to create a capital base for on-lending. (Although in recent years, some credit unions are being established with donor funds). NGO MFIs are the most dependent on donor funding for both their operating and capital needs. Few of these NGOs have yet diversified their funding sources or leveraged their capital base through commercial borrowing. Microfinance banks have also depended heavily on donors to cover their up-front investment costs. However, from the start of their operations, the region's microfinance banks have accessed a more diverse range of funding sources than have NGO MFIs; these sources included deposits, commercial and subsidized loans, and private equity investment.

One reason for the difference in funding sources tapped by NGO MFIs and microfinance banks lies in commercial funders' perception of their different legal status; commercial investors are more comfortable lending to regulated financial institutions than to unregulated ones, such as NGO MFIs. Another reason is that microfinance banks have been, from the start of their operations, more proactive in seeking commercial financing.



## CHAPTER 7

### ACCESS TO FINANCE

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*Chapter 7 examines MFIs' demand for finance and the problems they encounter in accessing available funds. It also examines the supply or availability of finance from the region's funders and the problems they face in providing funds. Attention is given to access to commercial-debt finance and socially-motivated private investment as sources of capital for MFI growth. The final section examines the barriers MFIs (especially NGO MFIs) have to accessing commercial loans and how these problems have been overcome by some NGO MFIs in Central and Eastern Europe and the New Independent States.*

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Microfinance development in CEE and NIS, as elsewhere in the world, is heavily donor dependent (see Chapter 6). However, donor funds and concessional finance are limited and not dependable in the long term. There is a general consensus in the microfinance community that if MFIs are to grow enough to reach, on a long-term basis, the millions of people without access to financial services, they need access to more sustainable sources of finance to support their development. These will have to include private sources of debt and equity (both socially-motivated investment and commercial investment) and savings.

The study's findings regarding the supply and demand of finance for microfinance in the region came from two primary sources: responses received to the study's survey and in-depth interviews with 16 MFIs and 10 funders.<sup>1</sup>

### **The MFI Perspective—The View from the Demand Side**

#### ***Demand for Finance***

Lack of funding is regarded as a major constraint to growth by many MFIs. A total of 60% of NGO MFIs and 50% of microfinance banks identified lack of available funding as the factor most likely to stand in the way of realizing their growth and development goals. (Insufficient data was available from credit unions and commercial banks to be representative.)

On average, NGO MFIs stated they needed US\$2.25 million in external funding to meet their goals during the period 2002–2004, while microfinance banks are seeking a far larger US\$65 million, on average. Together, the NGO MFIs and microfinance banks that responded (40% of the total surveyed) estimated their funding requirements will total around US\$500 million through December 2004. Extrapolations of this data suggest that all the NGO MFIs and microfinance banks alone in CEE and NIS could need around US\$1 billion in that period to support their growth and development.

Obviously, these figures are estimates of future need. The MFIs' actual financing needs will depend on the terms and conditions of the funds available and on the MFIs' performance and investment worthiness. Nonetheless,

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<sup>1</sup> Interviews were conducted with the following MFIs and funders: (MFIs) Bospo, Fora Fund, Izvor, Mikra, Mikrofin, Partner, and World Vision Georgia; (funders) Blue Orchard, EBRD, DEG, FMO, IFC, Oikocredit, Raiffaisen Bank, and the Triodos-Doen Foundation.

these numbers do provide some indication of how the MFIs perceive their own financing needs and the volume of funds needed for microfinance development in CEE and NIS.

### ***Constraints to Fund Raising***

Although both NGO MFIs and microfinance banks cited a lack of funds as a major constraint to growth, the nature of their fund-raising challenges differ. NGO MFIs identified availability and affordability of funds as their main constraints to fund raising. The main concerns identified by microfinance banks were the short term of available funds, and the fact that international funders often only make funds available in foreign currency. This can pose difficulties in terms of covering the exchange-rate risk, because loans to clients are made in local currency.

The sources of funds available to an MFI are largely determined by the MFI's legal structure. Microfinance banks, given their legal structure as for-profit, commercial banks, are able to mobilize grants, loans, equity, and deposits from the outset. Most microfinance banks have a more diverse mix of funding sources than do other MFI types (see Table 6.11). However, the mainstream sources of funds available to NGO MFIs are more limited. NGO MFIs are typically registered as foundations or associations. Such organisations do not have a private shareholding structure that allows them to accept private equity investment. They are also not legally licensed to collect deposits. NGOs are assumed to be supported by grants and donations alone, but given their revenue-generation nature, NGO MFIs are also in a position to borrow funds.

To date, however, very few NGO MFIs in CEE and NIS are borrowing—only six NGO MFIs (6% of the total) reported that they were borrowing from commercial sources at the time of the survey in September 2001. Most NGO MFIs have debt-to-equity ratios of 1:1 or less (see Chapter 6). In general, the region's NGO MFIs have far lower levels of commercial-debt financing than those in other regions. According to *MicroBanking Bulletin (MBB)* data, the commercial-funding liabilities ratio (ie, the value of borrowing at commercial rates as a percentage of the value of the average gross loan portfolio) of the 21 NGO MFIs in CEE and NIS that report to the *MBB* is less than 1%. Worldwide, the ratio for MFIs (that report to the *MBB*) is 50%.

Although borrowing levels in the region are currently low, many NGO MFIs are interested in accessing loans—a total of 60% of NGO MFIs stated that they would be interested in borrowing as a source of growth capital. (Given the interest of NGO MFIs in commercial-debt finance and its potential as an important source of capital for microfinance development, see the section on NGO MFIs, accessing commercial debt finance. This presents the barriers that MFIs, particularly NGO MFIs, face in accessing commercial funds, the lessons learned from those who have successfully borrowed, and some practical examples of successful negotiating and financing strategies that have helped MFIs overcome obstacles to borrowing.)

Debt finance is well suited to microfinance because lenders seek low risk and stable returns. Mature, well-performing MFIs typically have high-performing portfolios which generate returns that enable them to afford commercial borrowing rates. Equity finance is another potential form of funding. However, commercial equity investors operate on a high-risk, high-return basis. They aim to maximise profits and expect returns on their investments in the range of 25–30%. Few MFIs in the region will ever be able to offer such high financial returns, particularly those that provide services to the poor. Hence, on the equity front, MFIs typically need to seek out socially-motivated investment.

“Social investment” is investment by private funders (either individuals or institutions), willing to accept a below-market financial return because they support an MFI's mission but recognise the difficulty for it to achieve full commercial returns given the nature of its business. There are already a few social investors active in CEE

and NIS, including Oikocredit and the Triodos-Doen Foundation. More social funders and investment funds are likely to emerge over the coming years, some with the support of donors and international financial institutions. Such financing is vital for the development of the microfinance industry, particularly for expanding products and services aimed at the poor and other markets that cannot generate high financial returns.

Given the limitations of the NGO model in terms of its access to sources of funds, some NGO MFIs are transforming into private finance companies or banks. Three NGO MFIs in CEE and NIS have already transformed into private commercial banks so they would be able to mobilize savings (in turn, providing a valuable service to clients) and access more commercial investment. The first to transform was XAC Bank in Mongolia, which was established in 1999 with the support of UNDP. Its microfinance programme was transformed into a private company and then, in 2001, into a commercial bank with 6,500 borrowers and a portfolio of US\$2.4 million.

Opportunity International has also assisted the transformation of two of its NGO affiliates into banks. Moznosti in Macedonia transformed into a savings bank in 2001, which is currently 100% owned by the Moznosti NGO. Its further transformation into a commercial bank is being considered for 2003; this would allow it to have foreign shareholders. The third transformation was Microcredit Montenegro, an NGO started in 1999. In April 2002, it was licensed as Opportunity Bank Montenegro, owned 75% by OI and 25% by private shareholders.

More NGO MFI transformations are expected in the future, either into private companies or banks. However, a careful cost-benefit analysis should be done before such transformations are considered. Transformation brings added costs, such as profit tax and the investment costs of meeting the security requirements of a bank. In Latin America, where NGO transformations are more advanced, they reportedly have not always led to substantially increased financial flows from either commercial investors or depositors.

## **The Funder Perspective—The View from the Supply Side**

Since the mid-1990s, there has been significant international support for microfinance in CEE and NIS. The study surveyed 21 funders: 12 bilateral donors and international financial institutions and 9 international private funders. We also estimated how much financing has been mobilized from local commercial banks. Together, these funders are estimated to have provided over US\$825 million in financing for microfinance development during the period 1996–2001 (see Table 7.1).

The vast majority (93%) of this funding has been public money—from bilateral donors and international financial institutions. However, as a small but growing number of MFIs have demonstrated their financial viability, private investors (mainly socially-motivated investors) have started to invest in MFIs. Together, they invested nearly US\$33 million (4% of the approximately US\$826 million total), as of September 2001. Five MFIs also reported receiving a total of US\$29 million in loans from *local* commercial banks (3% of the total financing). However, US\$27 million of this was reported by KMB Russia; the remainder was borrowed by four NGO MFIs in Bosnia and Herzegovina.

## **Funders' Goals and Financing Criteria**

Funders have different, although overlapping, goals in supporting microfinance. These goals include poverty alleviation, private-sector development, and financial-sector development. Although their funding goals may be different, most funders—public and private—have similar expectations of the MFIs they fund. They want them

**Table 7.1 List of Funders and Funds Provided (1996–2001)**

Type of Organisation	Name	Total Financing (US\$)	% Total
Bilateral Donors and International Financial Institutions	EBRD Group for Small Business	310,000,000	38%
	World Bank	150,000,000	18%
	USAID	115,000,000	14%
	Kreditanstalt für Wiederaufbau (KfW)	80,000,000	10%
	DEG (now owned by KfW)	52,000,000	6%
	Netherlands Development Finance Company (FMO)	16,000,000	2%
	Open Society Institute (OSI)	14,000,000	2%
	International Finance Corporation (IFC)	8,000,000	1%
	DFID	7,000,000	1%
	UNHCR	4,000,000	0.5%
	Novib	4,000,000	0.5%
	Opportunity International (OI) Microcredit Fund	3,000,000	0.4%
	CGAP	1,203,000	0.1%
	PlaNet Finance	150,000	0%
<b>Subtotal</b>		<b>764,350,000</b>	<b>93%</b>
International Private	Commerzbank AG	20,000,000	2%
Funders and Social Investors	International Micro Investitionen AG (IMI)	7,000,000	1%
	Triodos-Doen Foundation	3,500,000	0.4%
	Oikocredit	1,500,000	0.2%
	Citigroup/Citigroup Foundation	395,000	0%
	Deutsche Bank Microcredit Development Fund	250,000	0%
	Blue Orchard Finance SA	200,000	0%
<b>Subtotal</b>		<b>32,850,000</b>	<b>4%</b>
Local Commercial Banks	Various	<b>29,000,000</b>	<b>6%</b>
<b>Total</b>		<b>826,200,000</b>	<b>100%</b>

to have strong and effective management (including good leadership and a skilled financial manager), good governance, and the potential to reach both high levels of outreach and sustainability.

### ***Types of Finance Available***

Different funders provide different types of finance. Bilateral donors, such as DFID and USAID, usually provide only grants. International financial institutions (IFIs), such as the Asian Development Bank (ADB) and the World Bank, provide concessional loans, often on-lent to MFIs via government intermediaries. Other IFIs, such as EBRD, DEG, and IFC, provide loan or equity finance to MFIs at or near commercial rates. Social investors, such as the Blue Orchard Fund, Oikocredit, and the Triodos-Doen Foundation, provide loans at or near commercial rates and equity below the market rate. Commercial funders, such as Commerzbank and local commercial banks, provide commercial loans at commercial rates of interest.

The table below summarises the types of finance provided by different funders. (See Appendix 6 for details on the region's funders, including their funding goals, financing instruments, and funding criteria.)

**Table 7.2 List of Funders by Type of Finance**

Type of Finance	Funders
Grants	CGAP, Citigroup Foundation, DFID, FMO, IFC, KfW, NOVIB, UNHCR, USAID, World Bank
Concessional Loans	ADB, Cordaid, Deutsche Bank Microcredit Development Fund, KfW, Novib, OI Microcredit Fund, OSI, World Bank
Commercial and Quasi-Commercial Loans	Blue Orchard Finance, Commerzbank, DEG (now part of KfW), EBRD, FMO, IFC, Oikocredit, OSI, Triodos-Doen Foundation
Loan Guarantees	Blue Orchard Finance, Commerzbank, FMO, IFC, KfW, OSI, OI Microcredit Fund, USAID
Socially-Motivated Equity	Commerzbank, DEG, EBRD, FMO, IFC, IMI, OSI, OI Microcredit Fund, Triodos-Doen Foundation

### ***Funding Strategies***

The funding strategies of some of the region's leading funders have been highly influential in shaping the microfinance sector. Specifically, some funders strongly support particular MFI models over others. Below are the funding strategies of the region's most prominent funders.

**The European Bank for Reconstruction and Development (EBRD).** This is the largest funder of microfinance in the region. During 1996–2001, it provided over US\$300 million in microfinance funding. The EBRD focuses on supporting regulated MFIs that can offer commercial returns. The EBRD initiated the commercial-bank downscaling approach in the region in 1994 and has remained the lead investor in this model. It was also an early investor in the microfinance banks. The EBRD has recently shown interest in financing NGO MFIs that have demonstrated profitability and are interested in transforming into regulated financial institutions. However, it is unlikely that the EBRD would become a significant funder of NGO MFIs, given that it is geared toward making large-scale, multi-million-dollar investments, beyond the capacity of many NGO



MFIs to absorb. The only way the EBRD could invest in smaller MFIs would likely be through some form of wholesale lending intermediary or equity fund.

**The World Bank.** Specifically the International Development Association and the International Bank for Reconstruction and Development, the World Bank provides concessional financing to governments for public investment. Including its investments for rural finance, the World Bank is the second-largest funder of microfinance in the region. It has funded different microfinance models in different countries, all with a focus on achieving poverty outreach and sustainability. This has included credit unions in Georgia and Latvia, village-based savings and credit associations in Albania and Moldova, NGO MFIs in Bosnia and Herzegovina, and finance companies specializing in micro and rural finance in Latvia and Kyrgyzstan. The World Bank has also played a role in supporting the development of the legal framework for microfinance in some countries, notably Bosnia and Herzegovina.

**The United States Agency for International Development (USAID).** USAID is the third-largest supporter of microfinance in the region; it has provided a total of US\$115 million in grant funds over the last five years. Its focus is on assisting the poor to become economically self-reliant. The majority of USAID's funds have been targeted toward the development of NGO MFIs with a strong focus on poverty outreach. It mainly funds US NGOs, such as FINCA and Opportunity International. USAID is expected to focus increasingly on supporting NGO transformation. Already, it has played a key role in supporting policy and legal reform to improve the region's operating environment for microfinance. It sees such reform, combined with the growing experience and profitability of NGO MFIs, as likely to propel MFI transformations. USAID is ready to explore both the provision of technical assistance during the transformation period and the use of different financial instruments to increase the amount of loan capital available to MFIs.

**The International Finance Corporation (IFC).** This is the private-sector investment arm of the World Bank Group and has—in keeping with its mandate—taken a more commercial approach to supporting microfinance than has the World Bank proper. The IFC provides market or near-market commercial loans and equity investment and has focused on supporting those microfinance models and institutions with clear potential for commercial viability, similar to the approach of the EBRD. The IFC was an early and committed supporter of the microfinance banks and has played a leading role in their development since the mid-1990s. The IFC is also exploring mechanisms that could increase the flow of commercial funds to smaller MFIs with the potential for commercial viability, including nonbank MFIs. These mechanisms include investment in global equity funds for MFIs and, still under consideration, guarantee schemes.

**Kreditanstalt für Wiederaufbau (KfW).** The German development bank has also been an important funder of the microfinance banks and commercial-bank downscaling. It has invested a total of US\$80 million in them.

**The Open Society Institute (OSI).** Commonly known as the Soros Foundation, OSI is also a key player and has supported innovative microfinance approaches in the region. It supported the transformation of the World Bank-financed urban microcredit programme in Albania into an independent foundation, the Besa Foundation. It has also supported the NOA savings and loan cooperative in Croatia, village savings and credit associations in Moldova, and credit unions in Lithuania, Russia, and Ukraine. Another area toward which the Open Society Institute directs its support is local capacity building (eg, it offers fellowships with which managers can travel to conferences and training courses).

**International Micro Investitionen AG (IMI).** IMI has been a leading advocate and investor in a more commercially-driven approach to microfinance development. IMI was set up as an investment company whose

purpose is to acquire equity stakes in microfinance banks. IMI was founded by the staff of IPC, a consulting firm that has pioneered the microfinance-bank model and provides technical assistance for the start up and development of these banks. IMI has been the lead investor in 10 microfinance banks in the region and has mobilized like-minded investors to support their creation. These other investors include Commerzbank AG, a private German commercial bank, now one of the first commercial banks to invest in MFIs.

**The Triodos-Doen Foundation.** A Dutch foundation, founded in 1994 by the DOEN Foundation and Triodos Bank, it has also been seeking microfinance investment opportunities in the region. Triodos-Doen's microfinance fund is managed by Triodos Bank, one of Europe's leading "social banks." To date, Triodos-Doen has made investments in KMB Bank in Russia and Mikrofin in Bosnia and Herzegovina.

**The Blue Orchard Fund.** This is a Swiss company specializing in the management of investment funds dedicated to the microfinance industry. It has provided loans to Mikrofin in Bosnia and Herzegovina and to KCLF in Kazakhstan. Currently, Blue Orchard is looking for other microfinance investment opportunities in the region but has found very few MFIs that it considers creditworthy or which have a demand for commercial finance given availability of cheaper donor funds.

Although the European Commission (EC) is notably missing from the list of the region's microfinance funders, there are mounting signs that this will change, particularly in the EU accession countries. First, the EC already is a major donor of other activities in these countries, as well as elsewhere in CEE and NIS. Second, once the accession countries join the EC, they will likely be eligible for financing from funds available to EU member states to finance microfinance programmes. Third, the European Investment Bank, an EC-sister organisation, has a microcredit guarantee facility for which the accession countries might become eligible. It is vital for the EC to develop a good understanding of microfinance development in the region, given the large volume of funds it is likely to make available to the effort.

### ***Future Supply of Finance***

According to this study, the level of external financing for microfinance in the region is expected to increase during the period 2002–2005. Both donors and commercial funders reported that they plan either to sustain or increase their levels of financing in that period. This compares favourably with other regions, where funding levels look set to level off or, in some cases, decline (see Table 7.3).

We estimate that a total of up to US\$1 billion could be available for microfinance development in the region through December 2005. This roughly matches the MFIs' estimates of their financing needs over the same period (taking into account only NGO MFIs and microfinance banks).

Commercial borrowing<sup>2</sup> could potentially become an important source of capital for the growth of microfinance over the long term. Currently, however, few MFIs receive financing from commercial sources, although many are interested in doing so.

On the supply side, ironically, every commercial financier that responded to the survey stated that there are not enough MFIs in the region to which they can lend. The conclusion is that the funding problem is not the result

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<sup>2</sup> Commercial financing includes loans and equity that MFIs receive from any commercial financier, such as a commercial bank. Loan guarantees are also considered a commercial-financing instrument. This section focuses on commercial borrowing, including the use of guarantees, which is open to all MFI types.

**Table 7.3 Expected Change in Level of Financing for Microfinance**  
(2002–2005)

Donors and International Financial Institutions	Increase	Decrease	Remain at Current Level
CEE/NIS	87%	0%	13%
Africa	63%	25%	12%
Asia	86%	0%	14%
Latin America	57%	0%	43%

International Private Funders and Social Investors	Increase	Decrease	Remain at Current Level
CEE/NIS	78%	0%	22%
Africa	71%	0%	29%
Asia	57%	0%	43%
Latin America	57%	14%	29%

of a financing gap between demand and supply, as often is assumed. In actuality, the problem seems to result more from a “knowledge gap.”

The study identified four main barriers to MFIs in Central and Eastern Europe and the Newly Independent States, which makes it difficult for them to access commercial funds. These barriers are lack of information about each other, country-specific and microfinance-specific risks, legal frameworks, and donor practices. These findings are based on interviews with NGO MFIs and, therefore, are of most relevance to them specifically. The findings are of some relevance to credit unions. However, access to commercial-debt finance is best considered by credit unions only when they have established a savings base and strong institutional capacity. The findings are of least relevance to microfinance banks, which are established as more commercially-driven organizations and, so, tend to have clear strategies to access commercial-debt finance from the beginning of their operations. This focus gives the region's microfinance banks the smallest knowledge gap regarding commercial funding.

### ***Lack of Information***

NGO MFIs and commercial funders know very little about each other. Most NGO MFIs are unaware of the commercial financing available. Even some of the region's largest, most profitable NGO MFIs do not know many of the sources that exist or do not know how to access their funds. The majority of the NGO MFIs do not understand the importance of commercial financing for long-term institutional sustainability and do not know what is needed to access it, either on the local or international level.

On the supply side, we found that several international financiers and most local commercial financiers are either unaware of how NGO MFIs work or of how to select the most appropriate ones to lend to. This is due to the failure of all stakeholders in the sector to discuss and prepare for the long-term growth of microfinance in the region. Commercial financiers report that, until very recently, most NGO MFIs did not seriously plan for commercial financing. Some NGO MFIs have considered it as a way of diversifying their financing sources but not as a necessary move for future institutional sustainability.

This mindset is, however, changing. MFIs are beginning to realise the importance of commercial financing, even though it will be some time before the youngest become creditworthy. Motivating this change is the recognition by certain MFIs that decreasing donor funding will hamper their growth, and that the few MFIs with commercial funding are growing fast.

### ***Risk Profiles***

Local and international commercial financiers find that investment in many of the region's MFIs (credit unions, NGOs, and microfinance banks), as well as in the countries in which they are located, carry high risk for them. Consequently, they charge these MFIs high interest rates or do not lend to them at all. The primary individual components of the risk involved in lending to the region's MFIs, as categorised by commercial financiers (both local and international) are described below.

#### *Country-Specific Risks (degree varies depending on the country where the MFI is located)*

- **Political risk.** This is a risk that the country in which an MFI is located could experience economic or political crisis. This means international commercial financiers either cannot lend to (invest in) MFIs in these countries at all or lend only with high loan-loss provisions—which drive their costs up and result in their charging high interest rates.
- **Financial-sector risk.** There is a risk that the financial sector of the country in which an MFI is located could collapse. Many countries in CEE and NIS have weak financial sectors, characterised by banks that are undercapitalised; lack standard accounting practices, banking skills, good governance, etc.; and are prone to fraud and corruption.
- **Contract risk.** This risk is that, in the event of an MFI default, the lender or investor might not be able to enforce its loan contract with the MFI because a country's legal system is weak.

#### *Microfinance-Sector Risks (degree is the same for all MFIs worldwide)*

- **Unknown-quantity risk.** There is risk to lending to a very new sector. Many local banks in the region have not yet even heard of microfinance. They suspect various aspects of NGO MFI operations to be illegal or fraudulent, such as their high volume of loans, their high interest rates, or the huge cash flows generated. Specifically, there is the spectre of possible Ponzi or money-laundering schemes behind the business model. The NGO legal structure, in particular, poses problems for commercial funders. First, some see it as ill-adapted to a financial business with large, daily cash flows. In practice, however, the NGO model has proved adaptable to large-scale, successful microfinance. Second, the structure is seen as having no clear, built-in financial accountability, making most commercial lenders wary of lending large amounts to NGOs. Third, the history of NGOs in the CEE and NIS region is short, increasing lenders' fears that the NGO governance at present is weak. This fear has been magnified by NGOs that have set up boards that do not have adequate training in either microfinance or their oversight responsibilities.
- **Collateral risk.** This is the risk of losing all or part of a loan made to an MFI because it lacks full collateral security. MFIs are seen as high-risk customers, in that the principal loan amount from a commercial bank or investor is usually not fully secured by collateral. The major asset for many NGO MFIs is their loan portfolio, which is made up of many, small, usually uncollateralized, loans. Some banks are reluctant to accept an uncollateralized portfolio as security, despite the fact that the MFI has a track record of high repayments.

- **Supervision risk.** There is risk that an MFI could go bankrupt more easily than other financial-industry borrowers because of inadequate supervision by the country's central bank. NGOs are not regulated by central banks at all. Credit unions, microfinance banks, and commercial banks are supervised, but they not be supervised properly if the central banks lack expertise in the specialised area of microlending.
- **Management risk.** If an MFI properly functions because of the presence of just one or a few excellent managers or board members, then the MFI could be at risk, if they were to leave the institution, and could collapse. This is naturally more often the case today at MFIs than at most other potential, commercial borrowers because of the newness of the discipline. Exacerbating the problem is a lack of widespread, formal microfinance training for MFI managers.
- **Competition risk.** The risk here is that, once NGO MFIs have grown, they will compete with local commercial banks (or international banks with local branches) or that MFIs already compete with them. The region's commercial banks often see MFIs—particularly regulated ones, such as finance companies—as competition and, so, see supporting them as counter to their own interests.
- **Currency risk** (only for foreign commercial financiers as lenders). If the local currency devalues, there is a risk that an MFI will not be able to pay back a hard-currency loan.

As a result of all these risks, it is not uncommon for international and local commercial banks to charge 25–30% annual interest rates to the region's MFIs, particularly in high-risk countries.

### ***Legal Framework***

There are three main legal issues that can restrict NGO MFIs' access to commercial borrowing. First, in many countries, there are explicit legal restrictions or ambiguities regarding the permissibility of nonregulated institutions' borrowing and on-lending funds. This can restrict NGO MFIs' borrowing from commercial banks. Second, legislation in CEE and NIS does not usually include clear mechanisms for the transformation of NGOs into for-profit companies or licensed financial institutions. This transformation can be important to NGO MFIs looking for new sources of capital because commercial funds can either be unavailable to NGOs or, at least, more easily available to commercial entities. Third, banks typically require their borrowers to have conventional collateral, such as land or buildings. Few MFIs in CEE and NIS have such collateral. Typically their only significant asset is their loan portfolio. So, unless a bank is willing to accept an MFI's portfolio as collateral, this requirement can restrict the MFI's access to commercial borrowing.

### ***Donor Practices***

Certain donor practices actually block MFIs' access to commercial financing. The requirements that many donors attach to their grants tend to work against strengthening the creditworthiness of NGO MFIs and, hence, ultimately make it harder for them to access commercial financing.

One of the main ways donors can influence the creditworthiness of an MFI is through funding policies that bolster the MFI's organisational development, such as funding for technical services. Technical services are important, covering, for example, the training that most MFIs need to broaden their outreach in a sustainable manner. Yet, many bilateral donors prefer their grants or soft loans to be on-lent to an MFI's clients, from which immediate impact can be seen, rather than spent on building technical capacity. In light of such funding restrictions, MFIs can find it more difficult to become sustainable.

Furthermore, it is often the policy of multilateral donors to fund only short-term, discrete consultancy jobs. This creates a disincentive for qualified consultants to commit to the sector and build expertise in it because the prospect of primarily short-term assignments makes developing a microfinance practice less attractive. Multilateral donors, like the EBRD, that are actually willing to pay for technical services for long-term institution building, are confronted with a shortage of qualified consultants. MFIs themselves face this bottleneck when they need to hire consultants with the know-how to accomplish their goals.

Donor funding that subsidizes MFIs can also undermine the MFIs' progression to true, long-term creditworthiness. Such donor funding essentially competes with commercial funding, especially when donors continue to provide subsidized funds to MFIs that are, in fact, commercially creditworthy. The international commercial financiers that responded to the survey believe that continued donor funding of profitable MFIs gives these MFIs significant disincentives to seek commercial funding. It makes too much cheap money available to them—a one-year loan at Libor plus 5.5% from a bank, for example, can not compete with a cheap loan from a donor of 5–7 years at Libor. This problem is pervasive throughout CEE and NIS. For example, in Bosnia and Herzegovina, now-profitable NGO MFIs have few incentives to seek commercial funds because donors, including KfW, USAID, and the World Bank, are still providing them with below-market-rate loans.

The unhealthy result of providing large amounts of subsidized funding to profitable MFIs, of course, is that these MFIs are not forced to make themselves truly creditworthy in the eyes of commercial funders—they are not pushed toward true, long-term sustainability. As a remedy to this situation, CGAP recommends that donors principally be in the business of identifying and betting on promising, but not yet profitable, MFIs, while leaving the proven winners to commercial investors.

## **An MFI Checklist for Accessing Commercial-Debt Financing**

Some of the NGO MFIs in CEE and NIS have overcome the barriers and successfully accessed commercial borrowing. To negotiate these loans, they found that there were certain items they needed to have in place first. These items form a checklist for MFIs preparing to borrow commercially for the first time. They are the minimum preparation an MFI should undertake before approaching a commercial funder. Although these guidelines were developed based on the experience of NGO MFIs, they are relevant to all MFI types to differing degrees.

### ***1. MFIs need comprehensive, timely audited financial statements prepared by internationally recognised auditors.***

Two or more years of such statements are preferable. Some local commercial institutions accept local auditors' statements, but not all.

Preparation of such financial statements can be very expensive, costing as much as US\$35,000. However, every MFI in this study, that has undertaken such an audit, by auditors familiar with the microfinance sector, believes the benefits far outweigh the cost. The benefits even extend beyond preparing to seek commercial financing. For example, auditors can teach an MFI how to improve its accounting and financial management.

### ***2. MFIs need to demonstrate profitability (preferably with a positive adjusted ROA), supported by their audited financial statements.***

Every commercial financier expects to see that an MFI seeking funding is or has the clear potential to be profitable. The MFI needs to be able to show it can at least cover its operating costs before taking on the additional

cost of a loan. A positive adjusted return on assets (ROA) demonstrates that an MFI's management can manage the MFI well and achieve its stated goals. A low-cost, efficient MFI structure is vital to building large-scale, financially-viable microfinance services, and it gives the MFI more flexibility in managing the interest rates of commercial financing.

**3. *MFIs need a high-quality portfolio, indicated by very low delinquency rates (preferably calculated using the portfolio-at-risk measure).***

An MFI's major asset is its portfolio. A portfolio can be used as collateral if it is of high quality. If an MFI does not have high portfolio quality, financiers will see it as unable to manage its business and consider it too risky to accept the portfolio as collateral.

**4. *MFIs need a robust business plan out to three years, with careful financial projections, including cash flow, in a format and language both the MFI and the financier can understand.***

Financiers value the ability of an MFI to plan for its financial needs, especially during periods of high demand. They will, rightly, consider an MFI that cannot manage the seasonality of its business as a risky client. It is imperative that an MFIs' financial management is—and is seen to be—as rigorous as possible.

**5. *MFIs need a system to track costs, particularly the costs of different loan products, staff time, and money.***

When budgeting, the amount of time required to prepare grant proposals and to report to donors should not be ignored. One MFI, for example, found that the time, and so the cost, of getting a lower-cost loan was so high that it might as well have paid the higher interest rate! Another, Mikrofin in Bosnia and Herzegovina, found it could manage its interest margin by using higher-cost commercial funds for loans that generated a higher effective interest rate.

**6. *MFIs need to understand their rights, powers, and obligations under relevant national and local (ie, regional and municipal) laws, particularly the banking and tax laws.***

For example, several MFIs (such as Constanta in Georgia and the FORA Fund in Russia) discovered that only banks can legally borrow and on-lend money in their countries. If some NGO MFIs, such as Constanta, were to do so, they would lose their charitable status, which currently exempts them from profit tax, and would be taxed like any other business. Also, it may be worthwhile to check funding agreements carefully because some funders have restrictions on the uses of their funds.

**7. *MFIs need to research potential sources of funding to find and approach financiers which share their vision and can meet their long-term financing needs.***

To do this, an MFI must develop a long-term view of the kind of financing relationships it needs. Then, after it identifies one or more appropriate financiers, the MFI should contact them at least a year, if not longer, before it expects to need their financing. It takes time to build a banking relationship, and the MFI could use this year to do so. Also, the better an MFI's financial situation, the more likely it will be to get a loan or line of credit, so it is important that financiers first be approached when the MFI has a healthy financial position, rather than waiting until it needs the financing.

**8. *MFIs need a board and management that are respected and can provide the oversight to ensure that business is conducted efficiently, legitimately, and transparently.***

The makeup of an MFI's board is a main factor on which its reputation is built. Hence, care should be taken in selecting board members to ensure both their credibility and an appropriate mix of skills. A typical mistake made by MFIs is to appoint board members who have reputations that do not enhance the MFIs' credibility and overall reputation, even if they are experts in some relevant area.

**9. *MFIs need to be explicitly transparent about their business operations and performance.***

Specifically, an MFI should be transparent about its social and financial performance, interest rates, board decisions, and other important matters. Commercial funders are skeptical of MFIs that even appear to have anything to hide. Among the best ways to demonstrate the needed transparency are to have audited financial statements and to be willing at any time to share information about business operations.

**10. *MFIs need to learn how to negotiate with financiers and, if necessary, hire the services of a skilled lawyer.***

Many MFIs have found negotiating with commercial funders difficult, especially once they are accustomed to asking donors for financing. The two are very different. Unlike dealing with donors, negotiating with financiers requires:

- Confidence in the belief that the financier will benefit from having the MFI as a client.
- Complete legal information about what the financier and MFI can do, especially regarding collateral and contracts. The MFI is a much more effective negotiator if its representative or legal council has—and can offer the financier—this information.
- The relevant vocabulary likely to be used during the negotiation. The MFI's negotiator will become confused without an understanding of terms, such as “hypothecation,” “leverage,” and “commitment fee.”
- International connections as a way of gaining added credibility in the eyes of a commercial financier. For example, an MFI might be part of a recognized international network.

**11. *MFIs need to build relationships with more than one bank.***

Doing so increases the chances of ultimately winning loans from a willing commercial lender. It could even result in having a choice of lenders. In such a position, an MFI's managers can compare loan terms and choose the best lender for its situation.

Banks with which an MFI develops relationships should ideally include small banks and some foreign-owned banks. Smaller banks tend to be more innovative and flexible than bigger banks and, so, more able to lend to MFIs that do not fit conventional categories. Foreign-owned banks are often new to the market, so are seeking new opportunities missed by established banks. They also tend to be more transparent than the older, more traditional local banks.



There is a wide range of mutually beneficial activities an MFI can arrange with a bank in order to build a relationship. These include:

- Graduating clients (ie, support for the MFI's clients to move from borrowing from it to borrowing from the bank)
- Sharing facilities
- Using the bank's teller capabilities for an agreed fee
- Contracting with the bank to lend to microentrepreneurs
- Cross-selling services
- Selling the MFI's portfolio to the bank

**12. *MFI's need to translate as many documents and reports as possible into English for international financiers***

As a potential client, the MFI needs to make it as easy as possible for potential financiers. Also, practically speaking, it is unlikely that international financiers will have easily available translation capabilities covering the MFI's local language.

**13. *MFI's need to educate prospective financiers about relevant aspects of their operations, before asking for financing***

Specifically these aspects are:

- Showcasing the MFI's outstanding performance (particularly its cash flows)
- Introducing the MFI's manager and board as respected and competent people who can be trusted
- Demonstrating the microfinance industry's strong performance in the country
- Highlighting the strong reputation of at least one of the MFI's major donors

## **Solutions to Obstacles in Commercial Loan Negotiations**

Of course, no amount of preparation can guarantee an MFI that obstacles will not arise when negotiating with commercial financiers. In fact, obstacles will certainly arise. Below is a list of the six major obstacles encountered most often by NGO MFIs throughout CEE and NIS during their negotiations for local and international commercial-debt financing—and the solutions they found effective.

Before looking at specifics, however, it should be noted that one tool is vital for an MFI trying to find a solution to any one of these obstacles: a current understanding of the loan market. Without it, an MFI can not intelligently estimate whether or not the lender actually has room—and how much room—in which to move on whatever point is under negotiation. For example, when negotiating the term of a loan, an MFI should know if current market risk is preventing the potential lender from giving any borrower, even AAA borrowers, a term

longer than one year. In that case, it would likely not be strategic for an MFI to make getting a longer term a deal breaker in the negotiations, unless truly necessary, of course.

### ***Obstacle 1. Rigid Collateral Requirements***

When faced with high, rigid collateral requirements, certain techniques may allow an MFI, nevertheless, to negotiate the collateral down. One way is for the MFI to pledge part of its portfolio to the lender as collateral. In other words, the lender takes a lien on the portfolio. As an asset of “receivables,” the portfolio qualifies under most laws as acceptable collateral, if its quality is high. The MFI and lender must negotiate the value of the portfolio being pledged. For example, the NGO MFI Mikra, in Bosnia, when asked to pledge 200% of the value of a loan, reduced the pledge to 150%, given the high quality of its portfolio. IZVOR in Romania also pledged 150% of the value of a commercial loan in portfolio collateral.

In the case of an MFI borrowing for short-term, liquidity purposes, it is sometimes possible for it to negotiate with its local bank, which can see all of its cash flows, an unsecured (0% collateral), short-term bridge loan or credit line (less than three months). Several MFIs, including FINCA Kyrgyzstan and Partner in Bosnia have succeeded in doing this.

A second approach is for an MFI to negotiate a contingency on the high collateral. It can, for example, negotiate a line of credit, agreeing that collateral will be required once a set amount is drawn down, but not before. In fact, the threshold amount for this common practice is sometimes set by law. Mikrofin in Bosnia has used this technique.

Third, an MFI, in order to reduce the risk to its lender and thus the required collateral, can attempt to get a loan guarantee. There are several institutions in the region that provide guarantees, including Deutsche Bank and OSI. (See the section on use of guarantees below for more details.)

Fourth, an MFI can attempt to reduce the risk a bank feels it assumes when lending to it and, hence, reduce the collateral required by moving its own accounts into the bank. The lender is then able to see the MFI's accounts and cash flows firsthand.

Lastly, some MFIs have found it worthwhile to explore certain equity-like financial instruments, such as subordinated debt and convertible debt. These may be secured without the collateral requirements of a loan, provided the MFI is financially sound and can offer the financier their required level of return.

Even if none of these collateral-reducing techniques are available to an MFI, all is not lost. An MFI that must take out a loan at whatever collateral level is required should establish a good repayment record. In that way, it may find it easier to get improved terms, including the collateral requirement, on its next loan.

### ***Obstacle 2. High Interest Rates on Loans or Credit Lines***

Some investors charge a 30% interest rate to MFIs today, especially those in high-risk countries. Seeking out a more hospitable lender, one that would not require such a high rate, is of course a natural strategy. For example, an MFI could try to find a socially responsible financier (one agreeable to a lower interest or return in exchange for help achieving its own mission of helping the poor). IZVOR in Romania has managed this.

Similarly, an MFI could also apply for lower-cost donor money to reduce its weighted average cost of capital. However, many MFIs reported that the amount of time it takes to complete donor proposals offsets much of the saving from the lower-cost money.

An MFI can negotiate for a lower interest rate by initially accepting a loan or credit line at a rate higher than it would like. As it uses that loan to demonstrate creditworthiness, it will be in a better position to renegotiate better terms on the same loan, as well as on future loans. Not getting a loan when an MFI needs it, or quickly enough, has an opportunity cost. This is a case in which it could be worth paying a high interest rate in order to get a loan quickly to meet cash-flow requirements, and planning on renegotiating later. Both FINCA Kyrgyzstan and Mikrofin in Bosnia have taken this approach.

There are also ways for an MFI to negotiate down the total amount it pays in interest on a loan without actually negotiating the interest rate head on. The possibilities are numerous. Negotiating fewer annual payments reduces an MFI's effective interest rate.<sup>3</sup> Negotiating a revolving line of credit, rather than a fixed-value loan, allows an MFI to pay interest only on the minimum amount it needs at any moment. Partner in Bosnia has such an arrangement with a local bank for a maximum amount of US\$30,000.

An MFI that conducts a high volume of transactions with the same bank can use that as leverage in negotiating. Such an MFI, when negotiating its interest rate on a specific loan, should keep the bank focused on the total amount it earns from all the MFI's transactions. That may make the bank a more flexible lender. FINCA Kyrgyzstan and Mikrofin in Bosnia have taken this position successfully.

Alternatively, a similar MFI—that is, one with a high volume of transactions at one bank—can offset a high interest rate by negotiating lower rates on some of its other transactions with that bank, again using the amount of its business as leverage. Partner in Bosnia has been successful using this strategy.

The argument that an MFI should keep its eye on the total cost of its financial services, rather than only on the amount of interest on a single loan, can be extended further. Of course, what matters is not exclusively its total cost for financial services, but simply its entire costs versus revenue. If an MFI improves its efficiency by increasing productivity and/or reducing its total costs, it would overall be able to afford—or rather offset—a high interest rate if the need arises.

### ***Obstacle 3. Short Terms on Loans or Credit Lines***

One solution an MFI can implement, when offered a shorter term for a loan or credit line than it would like, is basically to accept it—at least at the beginning. The MFI can then renegotiate the term later, as it proves itself creditworthy and gains the financier's trust. Again, FINCA Kyrgyzstan and Mikrofin in Bosnia are followers of this strategy.

A second solution implemented by some the region's NGO MFIs is the negotiation of added elements to the loan that tend to offset the inconvenience of the short term. One is a bullet payment, which allows the MFI to delay payback of the principal until the end of the term. (But an MFI should use this only if it is certain of the ability to manage the cash flow needed to pay back the principal when it comes due or is certain of the arrival of additional funding that it can use to pay the principal back.)

A third solution is for an MFI to negotiate a quick rollover facility, so it can still manage its cash flow. MI-BOSPO in Bosnia and Herzegovina has managed this with Raiffeisen Bank.

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<sup>3</sup> See Richard Rosenberg, *Microcredit Interest Rates*, CGAP Occasional Paper No. 1 (Washington, D.C.: GCAP, reissued January 2003).

A fourth solution is to negotiate a grace period on principal payments, giving the MFI the maximum time for on-lending the principal. Such a grace period may, for example, allow the borrower to delay all payments of principal until the third year of a three-year loan. Mikra in Bosnia has used this strategy.

#### ***Obstacle 4. High Exchange-Rate Risk***

In cases of high exchange-rate risk, some MFIs in the region have negotiated that their lenders take it on, rather than themselves. For example, Oikocredit, in certain situations, has been known to lend in either local or foreign currency.

Alternatively, an MFI can pass the exchange-rate risk onto third parties. One way to do this is simply to buy a third-party guarantee to cover the risk. Another is for the MFI to denominate the loans it makes to its own clients in the foreign currency it is borrowing in, typically either euros or US dollars. But in such cases, it is in the MFI's and the clients' interest for the MFI first to judge whether or not it would be passing on a manageable risk.

Of course, in some instances, an MFI will not be able to avoid taking on high exchange-rate risk itself. In these cases, it is prudent for the MFI to manage its costs and interest rates according to the worst-case scenario regarding its projected exchange-rate losses, based on a careful sensitivity analysis.

#### ***Obstacle 5. Risk of Delays in Fund Disbursements***

Delays of a year are not uncommon in procuring commercial loans. Two common reasons for this are the length of time it takes for an agency to disburse funds, even after an MFI has been approved for funding, and the time taken to draw up and negotiate loan details, especially once lawyers are needed in the process.

An MFI could take such delays into account in a number of ways. For example, it could build substantial amounts of extra time into its estimates of every step of the loan process, and start the process that much earlier. Also, it should calculate and weigh the cost of such potential delays; it may find that it is more cost effective to pay more for a loan disbursed more quickly.

#### ***Obstacle 6. Negative View of NGOs' Financial Accountability***

It is understandable that commercial funders may be skeptical of the low level of financial accountability provided by the NGO ownership structure. If this is the case, an NGO MFI can attempt to increase its accountability in a financier's eyes in various ways. An NGO MFI can simply agree to start with a small loan or line of credit. By using this to establish creditworthiness and the lender's trust, the NGO will be positioned to receive a larger loan or credit line next time.

A second way is for the NGO to pay for an independent credit rating. Although most commercial funders will still do their own due diligence, credit ratings are a useful way of establishing an NGO's seriousness and providing an objective, industry-standard opinion of its creditworthiness. Partner in Bosnia had a rating done by Planet Finance, which has proved very useful because it verified its strong performance and financial soundness to funders.

There are other ways as well. Some NGO MFIs have brought international organisations or member networks to their negotiations for commercial funding. For example, MI-BOSPO in Bosnia had Women's World Banking

closely involved in its negotiations, which proved very successful. An NGO MFI could also try inviting the financier in which it is interested to observe one of its board meetings directly. Finally, changing its legal structure from an NGO to a finance company would increase an MFI's financial accountability—or at least its appearance.

## **The Use of Guarantees**

Guarantees have the potential to increase significantly the flow of commercial funds, especially bank loans, both to MFIs and directly to micro and small businesses. In the process, these entities also develop relationships with commercial lenders. By reducing lenders' credit risk, they greatly help overcome the skepticism many bankers in the region have about lending to an industry that they still do not understand and consider too risky.

In a guarantee scheme, an external guarantor makes an irrevocable commitment in exchange for a fee to honor the debt (or a portion of the debt) of that borrower in the event that it fails to repay the debt. The intermediary guarantee is used to mitigate the risk to commercial lenders of on-lending to MFIs. The individual guarantee mitigates the risk of commercial lenders making loans directly to micro and small enterprises.

Intermediary guarantees increase the cost of loans to MFIs (in both time and money), but they can be worthwhile for MFIs if there is no other way that they can secure loans from commercial banks. These guarantees enable MFIs to reduce the repayment risk to the lender by:

- Providing sufficient collateral to get a first loan and establish a track record with a bank
- Providing easy collateral to quickly get funds for on-lending
- Reducing the de facto collateral requirements in cases in which government regulation or bank policy has set the required level higher than the MFI is able to meet alone
- Covering the MFI's exchange-rate risk on a hard-currency loan

Experience from MFIs in CEE and NIS and elsewhere that have used guarantees suggests that there are three main conditions under which MFIs can use guarantees effectively:

- The bank actually wants to work with the MFI or its clients but is looking for a guarantee to cover the risk in a market that is perceived to be high.
- The guarantor is credible, efficient, and pays out quickly under well-defined circumstances.
- The level of guarantee coverage for the bank reflects the risks but no more.

There has been much debate in the microfinance literature about the efficacy of guarantees. One of the main arguments against them is that there is little documented evidence that guarantees ensure banks will continue lending when the guarantees are no longer present. At least one guarantee is designed to help ensure that the risk is shared by the bank, borrower, and guarantor. In this structure, the portion of the loan guaranteed declines over time, so that the lending bank assumes an increasing level of the risk. Provided the loan is repaid on time

**Box 7.1 Financial Transparency Precedes Commercial Financing**

The Kazakhstan Community Loan Fund (KCLF), an NGO MFI operating in Kazakhstan, was faced with a dilemma in 2001. Its donor funding was coming to an end right when it had pressing financial needs to meet its expansion plans. The KCLF management reacted by initiating a series of staff meetings to generate ideas about how to meet its financial challenges in the coming years. Out of this process came a host of ideas, including approaching international commercial sources of financing.

In the winter of 2001–2002, KCLF opened a dialogue with the Blue Orchard Fund (a Swiss asset-management company specializing in microfinance investment) about the possibility of receiving a commercial loan from Blue Orchard's banking partner, Dexia Bank. The first steps consisted of an exchange of information including four years of external audits, current financial statements, concise descriptions of KCLF's activities and board members, and annual reports. In addition, Blue Orchard wanted to see an independent credit rating of KCLF.

Finding the money to finance the evaluation for such a credit rating was one of KCLF's largest challenges during this application process. Such evaluations cost US\$10,000–\$20,000. KCLF unfortunately did not have that amount of unrestricted funds, so it approached CGAP for help in financing the rating evaluation. A CGAP grant was approved in late 2001, but it covered only 80% of the cost of the rating. To cover the remainder, KCLF negotiated with HIVOS, a Dutch funding agency, which became a major player in its ongoing grant-application process. HIVOS cofunded the rating but only on the condition that the rating team also establish annual benchmarks for KCLF and continue its monitoring and follow-up activities.

In late January 2002, a team from M-CRIL, a microfinance credit-rating agency based in India, came to Kazakhstan to evaluate KCLF for a credit rating. It assigned the MFI an "A," which proved to be a critical component in finalizing the Blue Orchard negotiations.

Later that summer, Blue Orchard sent a representative to KCLF in order to familiarise itself with its potential borrower's operations. Loan requirements were finalized in these meetings, and in August 2002, KCLF received its first US\$100,000 noncollateralized loan from Dexia Bank. These funds are now playing a critical role in KCLF's expansion strategy, and a parallel loan is being negotiated for 2003.

One of the important lessons that KCLF learned from its commercial-lending experience was the need for financial transparency from day one of its lending operations. This includes having external audits, sound accounting systems that meet international standards, and a legal operating status that allows for commercial debt. In addition, KCLF found that a skilled lawyer can help the negotiation and final loan approval process go more smoothly. According to KCLF, the cost and effort of this transparency are well worth the benefit they can bring.

*Source: KCLF (Interview with Janice Stallard from ACDI/VOCA)*

and in full by the MFI, the bank's risk aversion to it and other MFI clients is likely to shrink. Ultimately, it may be willing to lend to MFIs without the security of a guarantee. This structure was designed to stimulate long-term bank lending to MFIs. But even if that fails to develop, these guarantees are still likely to increase MFIs' or other borrowers' access to commercial funds while they are offered.

There are already a few guarantee schemes operating in the region. As yet, no governments have funded guarantee schemes. All are funded by international agencies. These include the guarantee scheme of Deutsche Bank's Microcredit Development Fund, which provides guarantees to MFIs seeking to borrow from local commercial financial institutions. With the assistance of Women's World Banking (a global network of MFIs that target women clients), members of the Russian Women's Microfinance Network and MI-BOSPO, an NGO MFI in Bosnia and Herzegovina, have taken advantage of these Deutsche Bank guarantees to access commercial loans from local commercial banks.

### **Chapter 7 Summary**

The MFIs in CEE and NIS consider a lack of funding to be a major constraint to their growth. They are concerned overall about the availability and affordability of funds. In the case of loans, they would like to see longer durations offered. They are also concerned that many international funders only make loans in foreign currency, leading to problems for the MFIs in managing exchange-rate risk.

To date, many MFIs, particularly NGO MFIs, have been highly donor dependent. Few borrow commercially. Over the last couple of years, however, NGO MFIs have become increasingly interested in diversifying their funding sources, particularly in increasing their commercial-debt financing and socially-motivated investment (both debt and equity). This is particularly true in countries where donor funding is declining. The fact that most MFIs have debt-to-equity ratios of 1:1 or less suggests a large capacity to leverage their existing capital base and increase the flow of commercial funds into the sector.

On the supply side, a total of over US\$825 million has been invested in the development of microfinance during the period 1996–2001. The vast majority of these funds (93%) comes from bilateral donors and international financial institutions. International private funders and social investors have invested US\$33 million (4%), and local commercial banks have invested less than US\$30 million (3% of total).

Most donors and commercial funders of all types expect to increase their funding of microfinance in the region over the next three years. However, international commercial funders, in particular, find that there are not enough viable MFIs in the region to which they can lend. Hence, it seems that the funding problem in the region amounts not to a financing gap between the demand and supply of funds, but rather to other barriers faced by MFIs when trying to access the funds that are, in fact, available.

The study identified four main problems preventing NGO MFIs from accessing the commercial-debt financing that is available:

The Open Society Institute (OSI) has also set up various guarantee schemes. One example is its scheme in Bulgaria, used to guarantee loans made by the United Bank of Bulgaria (UBB) to microenterprise clients of Microfund, a local NGO MFI. Microfund first identifies eligible clients; the process includes a loan appraisal of each client. The applications of those eligible are submitted to UBB. If UBB's credit committee approves the loan, UBB disburses it at an interest rate of 15% annually on a declining balance. OSI provides a 100% guarantee that automatically pays out to UBB if a loan goes into default. OSI charges a guarantee premium of 1% on the dollar amount to the client and takes the exchange-rate risk. Microfund gets a rebate equal to 7% annually (on the balance) from UBB. UBB's cost of funds is 4.3% and its management fee is 0.5%, so UBB ultimately earns about 3% in profit.

- A lack of understanding of both the importance of commercial financing to long-term institutional sustainability and how to access it
- The high risks that often come with these MFIs from a commercial lender's perspective, resulting in their only lending at very high rates or not at all
- Laws and regulations that make it difficult for NGO MFIs to borrow or to transform into another legal form that can borrow more easily
- Certain donor practices—such as providing MFIs with capital at below-market interest rates—that undermine MFIs' motivation to build long-term, commercial creditworthiness

Some NGO MFIs in the region have overcome these barriers and successfully accessed commercial loans. To do so, they have found it enormously advantageous first to have a number of practices in place and financial targets met. These primarily are ways of ensuring and promoting strong financial performance, good financial management, good governance, and transparency. They have also found certain approaches to the negotiation of favourable loan terms and conditions more useful than others. These MFIs are beneficial role models to those looking to borrow commercially for the first time.

There is a large potential to increase the flow of commercial funds into the microfinance sector, as well as to strengthen, more generally, the relationships between the region's MFIs and commercial banks. However, it is clear that many bankers in the region still do not understand microfinance and are wary of lending to MFIs. Guarantees could potentially play a role in offsetting their risk aversion and, therefore, in increasing MFIs' access to commercial finance.





## CHAPTER 8

### THE LEGAL AND REGULATORY ENVIRONMENT FOR MICROFINANCE

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*Chapter 8 begins with an overview of the legal reform measures currently being pursued in Central and Eastern Europe and the New Independent States. It next provides an overview of the types of regulation relevant to microfinance generally, followed by an analysis of certain problems specific to the regulation of different MFI types, namely credit-only MFIs, member-owned and member-governed organisations, nonbank financial institutions, and banks. Finally, it examines broader issues of relevance to all MFIs, such as tax policy and collateral laws.*

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The legal and regulatory environment for microfinance is not uniform across the countries of Central and Eastern Europe and the New Independent States, nor are the various approaches toward legal and regulatory reform. Although the countries of the NIS started in 1991 with virtually identical legal systems (some CEE countries shared many similarities), each country has taken a different path of development and reform in most areas, including the legislation and regulation of finance and microfinance. However, in most—if not all—countries in the region, the legal and regulatory environment remains challenging for microfinance institutions.

Many of the legal systems of these countries permit a variety of institutional types to engage in microlending and to provide other microfinance services. Nonetheless, most of these legal systems also present ambiguities that trouble existing MFIs and hamper their ability to function in an effective and sustainable way. In part, these ambiguities are due to a particular characteristic common to the legal systems of CEE and the NIS: legal entities are generally interpreted to be permitted to exercise only those powers and engage only in those activities specifically provided for in applicable law and regulations. Thus, a lack of clarity and precision (including silence) regarding microfinance activities and which entities may conduct them causes significant problems for microfinance institutions operating in the region.<sup>1</sup>

#### Overview of Reform Efforts

Reform efforts in the region have generally focused on improving the legal and regulatory environment for credit-only MFIs, given that they face the most ambiguity regarding their legal powers to lend. In general, donors are the driving force behind the legal reform efforts and are currently working to get NGO MFIs and policy makers involved.

Many of the international NGO MFIs and the local partners they support operate with bilateral and multilateral donor funding and have been protected by bilateral agreements between their respective donors and host

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<sup>1</sup> This discussion is intended to give a general sense of the legal and regulatory environment in Central and Eastern Europe and the New Independent States. However, it is not intended, nor should it be taken, as legal advice. In addition, the discussion is a snapshot of the situation in August 2002. Laws and regulations in most countries of the region are frequently amended; thus, specific references to countries' situations are unlikely to remain current long after the publication of this report.

governments.<sup>2</sup> However, these MFIs are aware that such funding (and thus the protection of the agreements) will not last indefinitely. Consequently, they and local MFIs (which are not protected by bilateral agreements) are starting to work with donors to help policy makers understand the needs of MFIs and the difficulties that they face when operating in an unclear or unfavorable legal environment. Specific examples of difficulties commonly encountered by MFIs in the region include:

- A prohibition on lending without a license from the national bank, as is the case in Serbia
- Uncertainty regarding the extent of lending activities that may be conducted without a license from the national bank (due to the lack of clear distinction between the legal concepts of “lending” and “crediting”), as is the case in Russia and Tajikistan, and other countries in the NIS
- Ambiguity regarding whether engaging primarily or exclusively in microfinance activities potentially jeopardizes an NGO’s nonprofit status, such as in Georgia
- Not having access to the same tax deductions as other financial institutions, for example, as in Georgia and Tajikistan

In several countries, practitioners, donors, and policy makers have—either independently or in consultation with one another—begun reviewing the laws and regulations to determine how to make them more amenable to the development of microfinance. Reform advocates have found it strategically efficient to ensure that all parties concerned are involved in the process—the national bank, parliament and relevant parliamentary committees, ministry of finance, ministry of justice (and other appropriate ministries), and the tax authority.

Recently, some reform efforts (such as in Kyrgyzstan) have examined and duplicated the reform efforts of other countries. Before undertaking reform, it is essential that participants clearly understand their own country’s specific legal system and the existing, pertinent legislation and regulations. It is highly inadvisable for a country to adopt legislation or draft legislation from another country wholesale; this inevitably leads to an ambiguous interplay between the adopted and indigenous laws and regulations. Often, a more efficient approach is to see whether obstacles can be addressed through lesser changes—or simply by advocating more favourable interpretations—of already existing laws and regulations.

As noted above, different approaches to reform have been taken in the different countries of the region. Bosnia and Herzegovina, Macedonia, Kazakhstan, and Kyrgyzstan are the only countries to have passed new legislation specifically addressing microfinance. The Bosnian law pertaining to microcredit organisations (passed in both the Federation of Bosnia and Herzegovina and Republika Srpska in 2000 and 2001, respectively) deals only with nonprofit microlending institutions. The Macedonian law (passed in July 2002) provides specifically for the establishment of licensed and prudentially regulated microfinance banks. The Kyrgyz law (also passed in July 2002) covers a range of legal vehicles, from licensed deposit-taking entities to noncommercial microcredit organisations. In at least five countries (Armenia, Croatia, Georgia, Serbia, and Tajikistan), proposed specialized microfinance legislation has been drafted, either by representatives of the microfinance community or by

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<sup>2</sup> If, as is typically the case, a bilateral agreement has treaty status and has been incorporated into national law, the provisions of the agreement take precedence over any conflicting national law. They thereby generally shield the implementing partners (ie, the MFIs operating pursuant to the terms of the agreement) from legal provisions that would otherwise hamper their ability to operate. Such agreements may, depending on their specific terms, also protect the implementing partners from the imposition of certain taxes.

policy makers.<sup>3</sup> In still others, reform efforts are focused on amending existing legislation. And in Azerbaijan, Montenegro, and Uzbekistan, normative acts or executive-branch decrees pertaining to microlending institutions have been adopted.

## Regulation of Microfinance Institutions

In general, there are two broad categories of regulation of financial institutions: prudential regulation and non-prudential (or “conduct of business”) regulations. The two primary concerns of prudential regulation are depositors’ safety and ensuring the safety and soundness of the financial system. Prudential regulation, in which a governmental entity supervises and controls financial institutions that take deposits from the general public,<sup>4</sup> is a complex and time-consuming task. It involves frequent—even daily—reporting and monitoring (through various performance ratios and other objective measurements), risk assessment, and control. Examples of prudential regulation include minimum capital requirements, reserve ratios, and liquidity ratios. Examples of non-prudential regulation include, among many others, truth-in-lending requirements, public registration requirements, and reporting requirements.

As a general proposition, typical non-depository microfinance institutions do not pose a significant risk to the financial system and, therefore, do not require prudential regulation. Although some people do advocate prudential regulation of non-depository microfinance institutions, most agree that this wastes regulators’ limited resources, and probably narrows the market of MFIs. (Many MFIs’ are incapable of meeting prudential norms, including the heavy reporting requirements; those MFIs that could comply would face unnecessary burdens.)

Subjecting non-depository microfinance institutions to non-prudential regulation, which tends generally to be significantly less burdensome than full-scale prudential regulation, is not necessarily ill-advised, especially if the regulation is narrowly tailored to achieve specific objectives (eg, to increase the transparency of microlending institutions by requiring registration in a central registry and periodic, public reporting).<sup>5</sup>

## Issues Affecting Commercial and Noncommercial (or Nonprofit) Credit-Only Organisations

In most of the countries in the region, credit-only organizations must contend with one or more of the following five issues: (i) are they permitted to lend under existing legislation; (ii) may they lend if some of their capital comes from borrowings or will they be deemed to be engaged in financial intermediation (ie, deposit-taking activities); (iii) is it permissible to take cash collateral (also referred to as “forced savings” or “compensating balances”); (iv) does engaging in microfinance activities jeopardize an organisation’s nonprofit status; and (v) does the law require that the assets of a liquidating nonprofit organization go to the state treasury?

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<sup>3</sup> In some countries, such as Armenia and Georgia, several groups are in the process of drafting laws regarding microfinance (or microlending) institutions. The drafting or adoption of laws that specifically govern microfinance—a path taken or being taken by a number of countries—is not necessarily the best, or most advisable, course at present. This is largely due to the relatively undeveloped state of the microfinance industry and the significant work still needed to clarify its general legal situation.

<sup>4</sup> The distinction between deposits and borrowings is not always clear, complicating the issue of when a financial institution that borrows and on-lends should be subject to prudential regulation.

<sup>5</sup> For further discussion, see Robert Peck Christen, Timothy R. Lyman, and Richard Rosenberg, *Microfinance Consensus Guidelines: Guiding Principles on Regulation and Supervision of Microfinance* (Washington, D.C.: CGAP, forthcoming, June 2003).

***Permitted to Lend?***

Although in the majority of countries in the region, the civil code or relevant legislation places no restrictions on who may lend, in many countries there is an ambiguity with respect to legal terminology that places unlicensed lending institutions in an unclear and uncomfortable situation.

In many countries, the banking legislation requires any organisation that extends credit to be licensed by the national bank. While there are minor substantive differences between a loan and credit,<sup>6</sup> in most cases the two activities are distinguished primarily by the type of institution conducting the activity. This leaves unlicensed microlending institutions vulnerable to claims by the authorities (usually the national bank) that they are engaged in offering credit without a license. Thus, there is an effort in several countries to clarify the situation for microlending institutions operating without a license from the national bank.

One option that has been discussed is drafting legislation that defines a microlending institution as an organisation—whether noncommercial, commercial, or both (depending on the situation in the particular country)—that is permitted to engage in lending without a national bank license and without prudential regulation. In Croatia, for example, a draft law provides that an association engaged in microlending must be authorized by the Ministry of Finance. In Kyrgyzstan, the law (or draft law) places the responsibility of authorization on the national bank.<sup>7</sup> In this latter case, there may be a risk that the general public will interpret the authorization or registration of an institution by the national bank as an implicit endorsement of the institution and an assurance that the national bank will monitor and supervise the activities of the institution. This is not desirable from the perspective of most national banks, considering their already heavy supervisory burden with respect to depository financial institutions.<sup>8</sup> The most appropriate government body (whether the national bank, the ministry of finance, the ministry of justice, or another body) will vary from country to country depending on a variety of factors, including the capacities of the different agencies or ministries and the individuals involved.<sup>9</sup>

While the possibility of simply amending the civil code or relevant legislation to clarify the distinction between the terms “loan” and “credit” appeals to some, this option has thus far not attracted much interest from policy makers.

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<sup>6</sup> For instance, in some countries, a credit involves money, whereas a loan may involve either money or other assets.

<sup>7</sup> In Kazakhstan, because its parliament often holds the chairman of the National Bank legally responsible if a commercial bank fails, the National Bank did not want to be involved. Consequently, microlending organisations (commercial and noncommercial) are registered with the Ministry of Justice and monitored by the Government Statistics Agency and by the Ministry of State Revenue through its tax authorities.

<sup>8</sup> There are, however, some national banks that wish to control all financial institutions, including credit-only institutions. There are also national banks that have resisted permitting unregulated entities to lend in an effort to force consolidation of the financial sector and limit the number of regulated institutions. It is possible that they may have resisted out of fear—rightly or wrongly—that unregulated lenders will be exploited for illicit purposes, such as money laundering or as vehicles for pyramid schemes.

<sup>9</sup> In Tajikistan, for example, the National Bank has responsibility for both registering and licensing banks and other credit organisations, while the Ministry of Justice has responsibility for registering all other forms of legal entities. However, because the difference between lending and crediting is not clear, some MFIs are concerned that they may, at some point in the future, be considered credit organisations, which should be registered with the National Bank. Donors, MFIs, and policy makers are working to correct this situation through new legislation, regulations, and amendments to existing legislation.

### ***Borrowing and On-Lending***

In many countries in the region, even if legislation clearly permits an unlicensed MFI to engage in lending activities it remains unclear whether it can legally use borrowed funds to on-lend to third parties.

The civil code often puts no prohibition on which institutions may borrow and which may lend. However, concern is triggered by the fuzzy line dividing borrowing (allowed under the civil code) from deposit taking (which may only be undertaken by licensed financial institutions). In some countries, such as Armenia, current interpretation permits unlicensed microfinance institutions to borrow from commercial sources but not from individuals. In other countries, NGO MFIs and other MFIs operating without a deposit-taking license borrow (and on-lend) at their risk.

Given the importance of enabling MFIs to borrow—in order to raise capital and expand—it is essential that laws be clarified regarding the circumstances under which borrowed funds may be on-lent. Generally, commercial borrowing and borrowing from foreign sources do not pose risks that should concern bank regulators (such as losing the public's savings). Thus far, few countries seem to have explicitly or formally addressed and clarified this issue.

### ***Cash Collateral***

In some countries, the issue of cash collateral presents a problem for regulators if the cash is not segregated from the other assets of an MFI. Many MFIs take cash collateral (often referred to as “forced savings” or “compensating balances”) in order to enforce loan repayment. In many countries, this type of activity raises the concern of bank regulators if there is the potential for the entity taking the collateral to lose it through its lending activities. As with borrowing and on-lending (see above), the bank regulators are concerned with financial intermediation and the possibility that a lending operation (eg, an NGO MFI) would put the public's money at risk.

There are methods of ensuring the safety of the cash collateral. In some countries, legislation or regulations have been proposed that would set forth specific requirements (eg, placing the cash collateral in a segregated bank account or prohibiting access of such funds by the MFI except in the case of a default on the borrower's loan). However, few, if any, countries in the region have yet addressed this issue in legislation or regulations.

### ***Jeopardizing Nonprofit Status?***

In many countries, NGO MFIs face the question of whether they may engage in lending as a primary activity without violating the provisions of the civil code (or relevant law) governing nonprofit or noncommercial organisations. Nonprofit or noncommercial organisations must satisfy certain social goals specified in the relevant law (for instance, humanitarian, educational, or scientific goals). Generally, the relevant law describes these goals broadly enough to encompass microlending for social purposes. However, in some countries, nonprofit or noncommercial organisations are permitted to engage in “commercial” or “entrepreneurial” activity only to the extent that such activities serve the purpose of the organisation (or are conducted through a subsidiary).<sup>10</sup> In such countries, microlending is often viewed by public officials as commercial or

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<sup>10</sup> In Georgia, many public officials interpret microlending to be an entrepreneurial, rather than charitable, activity, even if its purpose is to lend to lower-income people and microbusinesses that cannot access the mainstream financial sector. According to this interpretation, the fact that an NGO MFI's primary activity is microlending could provide an argument for the Ministry of Justice to revoke its registration.

entrepreneurial and does not itself constitute an acceptable purpose for a nonprofit or noncommercial organisation. The NGO MFIs are starting to address this problem either by clarifying their country's interpretive practice (eg, in Russia) or by proposing draft legislation that would specifically define an NGO microlending institution as a new type of nonprofit institution. (This has already been done in Bosnia and Herzegovina.)

### ***Distribution of Assets upon Liquidation***

In several countries, legislation provides that, in the event of the liquidation of an association or foundation, the net property remaining after satisfaction of creditors' claims goes to the state.<sup>11</sup> This would greatly concern founders of NGO MFIs and might dissuade some from establishing an MFI using one of these particular legal forms. In general, there has not been much attention given to this issue by donors, MFIs, or policy makers.

### **Issues Affecting Credit Unions and Other Member-Owned, Member-Governed Organisations**

Credit unions and other member-owned, member-governed legal organisations have been widely used as vehicles for microfinance in many countries in CEE and NIS. In Poland and Ukraine, the credit unions are locally driven organisations that have roots going back over one hundred years. In Albania, Azerbaijan, Georgia, and Uzbekistan, for example, they are being started up with the support of donors, such as the Asian Development Bank and the World Bank.

In many countries, the relevant enabling legislation is poorly developed and contains numerous ambiguities or restrictions concerning credit union operations. Also, numerous differences in terminology in the relevant enabling legislation from country to country raise interpretive questions.

Specific examples of common problems in legislation pertaining to credit unions and other member-owned, member-governed legal forms include:

- Ambiguity as to whether, in the absence of specialized legislation governing credit unions, general legislation on cooperatives permits the formation of financial-service cooperatives (eg, in Georgia)
- Limitations (explicit or implicit) on deposit taking by credit unions, even from their own members (eg, in Kyrgyzstan)
- A lack of clarity regarding the legal relationship between agricultural cooperatives and consumer cooperatives (eg, in Russia)
- Prohibitions on legal entities participating as members (eg, in Croatia and Poland)
- Uncertainty about the legality of borrowing and on-lending (eg, in Russia)
- A lack of clarity regarding the prudential regulation of member-owned, member-governed financial-service providers (eg, in Georgia)

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<sup>11</sup> In some cases, net assets are forfeited to the state only in the case of involuntary liquidation. However, in some countries, the law gives public officials wide latitude to force involuntary liquidations (for instance, by claiming that an organisation has engaged in activities outside those legally permitted for that type of entity).

- Ambiguities regarding the interplay between relevant legislation and other financial-sector legislation, such as the laws governing banks (eg, in Albania)
- A prohibition on the use of credit union loans for business purposes, as distinguished from consumer purposes (eg, in Poland)

## **Issues Affecting Nonbank Financial Institutions**

In some countries in the region, the banking legislation includes a concept of nonbank financial institutions (NBFIs) or specifies the responsible regulating entity. However, often no or few specific institutional types are defined, either in the law or regulations adopted pursuant to the law. At least one country, Armenia, has adopted new NBFIs legislation (passed in May 2002) covering credit unions, savings unions, leasing companies, and factoring organizations (ie, companies that engage in financing through the purchase of invoices or other accounts receivable), as well as a transformation procedure for turning undercapitalized banks into non-depository NBFIs. In other countries, there is ambiguity regarding which institutions fall into the legal category of NBFIs. This puts nonbank lenders in the difficult position of not knowing whether the authorities will deem them to be NBFIs, which must be licensed to operate (see above).

The NBFIs category of financial institution could be useful for microfinance, especially in countries in which it is difficult to get new legislation passed and where the national bank has the ability to adopt regulations defining different legal types of NBFIs. However, there are drawbacks to expanding the number of institutions requiring national bank supervision. First, in most countries, the national bank is already overburdened in its efforts to supervise the existing banks and close down undercapitalized ones. Second, in most countries, the national bank staff has recently undergone, or is currently undergoing, training on risk-based supervision methods and has neither the staff nor the capability to supervise another type of financial institution with different prudential standards.

## **Issues Affecting Commercial Banks and Microfinance Banks**

Commercial banks with downscaling programmes and specialized microfinance banks are important providers of microfinance in the region. In all countries, it is possible—from a purely legal perspective—to conduct microfinance operations as a conventional commercial bank. (Although, in some countries, the national bank may be concerned with the frail state of the financial institutions currently under its supervision and thus hesitant to augment the sector by issuing new licenses.) However, there are financial constraints (such as high minimum-capital requirements and other prudential requirements) that in almost all cases render the commercial-bank option economically infeasible for practitioners engaged solely in microfinance.

An option for establishing a microfinance bank under mainstream bank legislation (which has been suggested to policy makers in a few countries) is to utilize the “specialized commercial bank” category provided for in the banking laws of many NIS countries. Such banking laws contemplate the possibility of establishing new types of specialized banks that engage in specific and limited banking activities (ie, not all of the activities in which the unlimited or “universal” bank would be permitted to engage) and are subject to different regulatory requirements (eg, possibly a lower minimum-capital requirement) from those applicable to the universal bank. (In many NIS countries, the savings bank is a form of specialized commercial bank.) However, creating a new type of banking institution (whether through regulation or through legislation) raises problems of regulatory capacity and possible abuse.



Today, Macedonia is the only country in the region that has legislation defining and creating a bank specifically designed for microfinance.<sup>12</sup> There are discussions underway in at least one other country, Tajikistan, regarding legislation or regulations creating a similar type of institution. However, for the time being, legal reform efforts in the region are primarily focusing on clarifying or solidifying the position of non-depository microfinance institutions.

For countries that are considering adopting new legislation or regulations creating a new form of depository microfinance institution, it is important that they consider carefully the specific prudential requirements (eg, minimum capital requirements, capital adequacy, and liquidity ratios) that will apply and how they should differ from the requirements applicable to commercial banks. Establishing a special legal form for microfinance does present the risk that such a form would be used inappropriately (eg, by existing undercapitalized banks searching for a way around more rigorous prudential standards and supervision applicable to banks).

Another challenge is in crafting appropriate limitations, such as restrictions on loan size and deposit size, client qualifications, or some combination that distinguishes the new institutional form as a true microfinance bank. Finally, the creation of this new type of institution (with different risks and methods of operation) raises issues regarding regulatory capacity. As noted above, regulators have limited resources and are already overwhelmed in many countries by the task of overseeing and regulating the already existing banks and other financial institutions, which are very weak in many cases.

## **Issues of General Concern to Microfinance**

### ***Transformation***

One of the hot topics of discussion in microfinance is transformation—that is, the transformation of a microfinance operation or organisation from one legal form or regulatory category to another. In CEE and NIS, transformation most often involves an international NGO transferring a microfinance programme (that it has been operating through the NGO's local office) to a newly-formed local legal entity (usually some form of NGO or limited-liability company). However, the term may also refer to (i) the exchange by an existing local NGO MFI of its loan portfolio for shares in a newly-formed subsidiary, for-profit company or a licensed financial institution; or (ii) the transformation of an existing company into a licensed financial institution. With donor resources for microfinance beginning to dwindle in some countries in the region, the exchange by a local NGO MFI of its portfolio for shares in a subsidiary company is taking on increasing significance, as NGO MFIs look for new sources of capital that are either unavailable to an NGO or, at least theoretically, more readily available to a commercial form of legal entity.

As is common worldwide, the relevant legislation in the region does not usually include clear mechanisms for the transformation of an NGO into a for-profit company or a licensed financial institution.<sup>13</sup> In addition, often the relevant legislation does not permit the transformation of an operating for-profit company into a bank or

<sup>12</sup> The Law on Microfinancing Banks, passed by Macedonia's legislature in July 2002, has a lower minimum-capital requirement than does its Law on Banks. The minimum-capital requirement for full-fledged banks is EUR 9.0 million; for banks that are not involved in foreign-payment operations and certain other activities, it is EUR 3.5 million; for microfinance banks, it is EUR 4.0 million. However, the Law on Microfinancing Banks also stipulates that microfinance banks must be majority owned by shareholders with track records in microfinance. They also have more stringent supervisory standards imposed on them than do conventional commercial banks.

<sup>13</sup> Often, the legislation does include a mechanism for transforming from one type of company (eg, a limited-liability company) into another type (eg, a joint-stock company).

other regulated institution. Instead, the founders of a bank are required to form a new joint-stock company (eg, in Serbia and Tajikistan), although in some countries, an operating company may transform into a bank (eg, in Armenia).

Transformation mechanisms that are both practical and legally feasible will become increasingly important as more NGO MFIs seek access to new forms of capital, and later on, as more mature non-depository MFIs seek to expand their services to include savings products. The many legal and regulatory issues that will need clarification include:

- The legal rights and obligations of the transferor and transferee with respect to assets in a loan portfolio
- The tax treatment of the transfer of a loan portfolio
- The tax treatment of an asset transfer by an NGO
- The permissibility for an NGO to transfer its assets to a for-profit company

## **Tax**

The tax treatment of NGO MFIs is a controversial issue and involves questions of fiscal policy. In many countries, neither the practitioners nor donors have taken a clear position—for three main reasons. First, in many countries in the region, the NGO MFIs have been shielded from tax liability by the donor-country agreements. Second, thus far, the NGO MFIs have not generated much, if any, profits. Third, if NGO MFIs are generating profits, they have focused on other reform objectives on which it is easier to build consensus.

**Profit-tax exemption for NGOs.** On the issue of profit-tax exemption for NGOs, nonprofit and for-profit MFIs generally take opposing views. Among the different countries in the region, public officials and donors have varying opinions depending on a multitude of factors (eg, the fiscal situation, their particular country's attitude toward nonprofits, other political and legal reforms being undertaken).

Some NGO MFIs argue that they should be accorded the same treatment as other public-benefit NGOs. This argument is put forward by NGO MFIs in countries that, of course, do allow public-benefit NGOs a profit-tax exemption. In the many countries that do not allow this exemption, the NGO MFIs have not engaged on the issue. For-profit MFIs (and those public officials concerned about tax revenues) argue that this special treatment of NGO MFIs would place them in an advantageous position, vis-à-vis for-profit MFIs. This is true, although there is a clear rationale for such a fiscal policy decision: an NGO MFI does not distribute its net revenues; instead, it reinvests such funds into its efforts to carry out its microfinance activities.

**Deductions for bad loans or loan-loss reserves.** With respect to those countries in which NGO MFIs are subject to profit tax, the NGO MFIs have argued that they should be entitled to the same types of deductions granted other lending institutions (eg, deductions for bad loans or for loan-loss reserves). Moreover, they argue, if MFIs generally are provisioning at a higher level than banks and if banks are entitled to deduct their provisioning, then MFIs should be permitted to take a proportionately higher deduction. Often, however, the relevant tax laws and regulations in the region only recognise licensed institutions in describing these types of deductions.

**VAT imposed on loans.** Typically, VAT (value-added tax) is not assessed on financial services, including lending. In some countries (eg, Tajikistan), the definition of financial services includes offering credit but not lending. There is no clear rationale for such a distinction between unlicensed lending institutions and licensed crediting

institutions. At least one country in the region, Russia, has already amended its relevant law to accord lending institutions the same VAT treatment enjoyed by licensed banks.

### ***Collateral***

Typically, there are two broad types of problems associated with laws regarding collateral. The first is the absence of modernised systems for creating and registering interests in collateral. Without a centralised registry, it is difficult, if not impossible, to determine whether there is a pre-existing lien on assets that have been pledged. Moreover, the collateral laws often do not permit the pledge of intangible assets or of an enterprise's assets or inventory (precisely the sort of assets that microfinance clients are likely to have available to pledge).

The second type of problem is one of enforcement and efficiency. Judicial corruption is prevalent and—as is the case in many countries with weak judicial systems—it is often difficult to get a pledge agreement enforced in

### **Chapter 8 Summary**

The legal and regulatory environment in CEE and NIS is particularly challenging for microfinance development. Different types of MFIs face different problems. Credit-only MFIs often face fundamental questions as to whether they are permitted to lend without a license from the national bank. It is also often unclear whether they legally use commercial funds they have borrowed to on-lend to third parties. This can inhibit commercial borrowing by NGO MFIs. NGO MFIs face the additional problem of a lack of clarity regarding whether engaging primarily in lending jeopardizes their nonprofit status.

Credit unions and other member-owned and member-governed organisations also suffer from unclear enabling legislation in many countries. Common problems specific to credit unions include ambiguity whether, in the absence of legislation specifically governing them, the general legislation covering cooperatives allows for their formation; a lack of clarity regarding their prudential regulation; and the legal prohibition on the use of credit union loans for business purposes.

Both commercial and microfinance banks in the region are, without question, allowed by law to engage in microfinance operations. Their challenges relate more to regulatory constraints, which can sometimes make microlending economically infeasible for them. Such constraints include high minimum-capital requirements, provisioning requirements, and other prudential requirements.

There are also certain broader legal issues that plague all types of MFIs. These include:

- The lack of mechanisms by which one type of MFI can transform into another
- Issues regarding the tax treatment of MFIs
- The practical difficulty of registering and enforcing collateral

court. Even if a judgment is rendered, execution may require a court-supervised auction of the collateral, which rarely returns even a significant portion of the value of the pledged property.

These problems merit attention. In most countries in CEE and NIS, they are receiving it from collateral law reform projects sponsored by government ministries and donors with interests broader than microfinance.

### ***Interest-Rate Regulation***

Interest-rate regulation is typically not a problem for MFIs in CEE and NIS. In most of these countries, there is no cap on interest rates. Even in countries where a cap does exist (eg, Georgia), at present, market interest rates for microfinance fall below it. However, government policy in this area should be monitored to ensure restrictive rates are not imposed that would undermine the development of sustainable microfinance, while recognizing the need to protect consumers from extortionate lending practices.

The challenge for reform advocates is twofold. First, reform has occurred more smoothly when those driving it ensure that all relevant parties are involved in the process, including the national bank, relevant parliamentary committees, ministry of finance, ministry of justice, tax authority, and any other relevant ministries. Second, the successful architects of microfinance reform have found it necessary to have a solid understanding beforehand of the applicable laws and regulations. Particular care should be taken when considering the wholesale adoption of foreign laws. This inevitably can lead to an ambiguous interplay between the newly adopted laws and the surrounding, indigenous ones. Often, a better approach has been to address obstacles by advocating less dramatic changes—or even simply more favourable interpretations—of a country's existing laws and regulations.

In some countries, such as Kyrgyzstan, Macedonia, and Tajikistan, consideration has been given to new legislation that create new forms of depository microfinance institutions. The problem with such reforms is largely one of timing. The region's various authorities responsible for bank supervision have limited capacity; they are already overburdened just by the task of overseeing and regulating the banks that currently exist. Hence, in the short term, it may be more practical for reform to focus on removing the barriers currently impeding the growth and development of the nondepository MFIs that already exist, rather than on creating new institutions that would further stretch the capacity of the region's supervisory authorities.



## CHAPTER 9

### A FRAMEWORK FOR ACTION

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*Chapter 9 begins with a description the promise of microfinance—that is, the potential of the sector under ideal circumstances. Next, it describes the outlook we consider most likely, based on our forecasts of the trends shaping the sector in reality. Our outlook includes estimates of the industry's client numbers (market penetration), depth-of-poverty outreach, financial sustainability, and social impact within a timeframe of 5–10 years. The chapter also lists a series of best practices, complete with suggested actions, directed at the microfinance actors in Central and Eastern Europe and the New Independent States—the MFIs themselves, policy makers, donors, commercial funders, social investors, and microfinance support organizations. Our outlook assumes that only the most advanced actors will implement these best practices during the next 5–10 years.*

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#### **The Promise of Microfinance**

The global promise of microfinance is that high-quality, affordable financial services can be made available to all those whom the mainstream financial sector considers not bankable, particularly to low-income households and microenterprises. Indeed, to many, the promise goes farther; it begins with access to financial services but is ultimately the promise of social impact.

But promise, of course, is not reality. Universal access to financial services is an ideal we are unlikely to attain. How close we get will depend on a number of factors. Particularly in CEE and NIS, where microfinance is relatively new, certain broad changes need to occur if the full potential of microfinance is to be realized:

- The governments of the CEE and NIS countries need to accept MFIs as important allies in local economic development.
- The boards and management teams running the MFIs in CEE and NIS must increase their professional effectiveness and client responsiveness.
- The MFIs themselves need to improve their capital-raising abilities to support their growth and development.

These three improvements would integrate the region's microfinance effort into the mainstream financial sector. For the first time, it would have the organizational capacity and access to capital needed to truly scale up and provide financial access to a significantly larger number of those who need it.

#### **Forces Driving the Future of Microfinance in CEE and NIS**

The actual future of microfinance in the region will be driven by various forces, some within its control and others outside its control. In this section, we identify these internal and external forces, as well as offer our best prediction of the future direction of each.

The timeframe of our predictions is the short-to-medium term—that is, the next 5–10 years. This time period is short enough to make reasonably confident predictions, but long enough to be useful to the region's MFIs in their current planning.

### ***Internal Forces***

Microfinance has experienced rapid growth and development in CEE and NIS, as highlighted in this report. The result is a strong foundation for the sector's future evolution. Of the forces that will steer this evolution, we identify four internal forces that will most affect the future outlook. These are the quality of MFI governance; the level of MFI technical competency; MFI responsiveness to client demands, largely through product innovation; and the supply of funding, including donor funding, commercial finance, and social investment.

**Quality of MFI governance.** Vital to the success of any MFI is the quality of its board, specifically the blend of skills of its members and their ability to guide and oversee the MFI's operations. The governance of local organisations has historically been weak in CEE and NIS. There is little tradition of transparency, and MFIs' board members often have less knowledge and fewer qualifications than its management. However, we believe that the quality of MFI boards will improve in the coming years for two reasons. First, some MFIs have met with success after building serious boards, so now are visible examples to be emulated. Microfinance banks, in particular, have placed corporate governance at the heart of their business model. Their ability to build professional boards with a combination of skilled people and expert knowledge has undoubtedly been a factor in helping them attract strong support and external investment. Second, donors have begun to realize the importance of a strong board to an MFI's success, and some are making that a condition for funding. For example, the Local Initiatives Project in Bosnia and Herzegovina, funded by the World Bank, has made evidence of an active board, with appropriate oversight of key matters, such as risk management, internal audit, and conflict of interest, a condition that must be met by any MFI continuing to receive funding.

**Skills of MFI management and staff.** The skills, know-how, and commitment of an MFI's management and staff are perhaps the single best determinant of its success. The CEE and NIS benefit from populations with high levels of education. Those who have joined the microfinance sector, both from within the region and elsewhere, have typically been well educated, quick to learn, and quick to adapt the best practices of the international microfinance community. In addition, much investment has been made in training the staff of MFIs. This training has helped raise professional microfinance standards in the region. We expect the quality of MFI management and staff to improve as these organisations continue to invest in further training and staff development.

One force that may counter our expectation, is that in countries whose economic growth is creating new job opportunities, it is likely to become increasingly difficult for MFIs to retain qualified staff. Few MFIs, particularly nonbank MFIs, can compete with private-sector salaries, so this will be a difficult trend for them to overcome. However, MFIs' increasing experience and staff training will help them stabilise their level of staff quality, if not their actual staff, in the face of attrition to the private sector.

**MFI responsiveness to market demand.** Currently, the MFIs expect the demand for microfinance products and services in CEE and NIS to remain high. Most forecast continued high rates of growth, with an average annual increase in client numbers of 45% through 2005. In order to maintain these high levels of growth, MFIs will need to ensure that their products and services are truly responsive to clients' needs. Until now, there has been little product innovation in the region. Young MFIs have, understandably, focused on building their capacity around a few simple products, such as working-capital loans for microenterprises. Furthermore, most MFIs have enjoyed high demand for their existing products, so have had little incentive to introduce new ones.

However, as MFIs, mainstream banks, and consumer-lending companies compete more for clients by developing their outreach, product innovation should increase significantly. In the short term, the most likely product innovation will be in credit-based products, such as investment, consumer, and housing loans. This is particularly true for NGO MFIs, which are credit-only organisations. Over the medium-to-long term, savings and insurance products—so vital to building the assets and financial security of low-income households—are likely to receive increased attention, particularly as more deposit-based MFIs develop.

**The supply of donor funding.** According to the survey findings, donors (including bilateral donors and international financial institutions) expect to maintain or increase their levels of funding going to microfinance in CEE and NIS through 2005. However, we expect a change in the distribution of funds across the region as a result of two factors. First, international commitments to focus development efforts on poverty reduction are likely to redirect funding by bilateral donors and international financial institutions, such as the World Bank, away from the more developed economies (eg, those of the accession countries) and toward its poorest countries (eg, those in the Caucasus and Central Asia). Second, financing from the European Commission (EC) will likely increase in the accession countries, as they become members of the European Union.

As a net result, it is likely that the region's poorest countries will see an increase in donor funding for microfinance, as will the accession countries. (The new EC sources will increase their funding more than bilateral donors and IFIs will decrease theirs.) However, the remaining countries—such as Croatia, Serbia and Montenegro, Moldova, Russia, Ukraine, and Belarus—will likely see a decline in or, at best, a continuation of their current levels of donor funding for microfinance.

Beyond 2005, donor funding will probably start to decline in more countries in the region, assuming their economies continue to improve. An additional factor behind this possibility is the risk that microfinance will turn out to be a fad, and donors reduce their funding as their attention turns to other developmental initiatives. Hence, if MFIs are to survive over the long term, they will need to reduce their dependency on donor funding.

**The supply of commercial bank funding.** Because donor funding will remain limited, the access of MFIs to commercial funding is necessary if the region is to see any significant scaling up of its microfinance effort. In fact, the degree to which MFIs can access commercial finance will likely to be a far more important driver behind the long-term scale and sustainability of the sector than will be the availability of donor funding. At present, commercial banks (particularly local ones) are noticeably absent as funders of microfinance in CEE and NIS. It is estimated that, during 1996–2001, commercial banks contributed less than 5% of the sector's total funding. Meanwhile, many local commercial banks have high levels of liquidity and are searching for investment opportunities.

We predict that commercial-bank financing to MFIs in the region will increase significantly in the next 5–10 years. However, MFIs need to make proactive efforts to increase their creditworthiness and pursue this commercial funding. In some countries, this will require removing legal barriers to commercial borrowing. In others, where legal barriers do not exist, there are MFIs already successfully accessing commercial funds. These include microfinance banks, such as KMB Bank in Russia and the Microfinance Bank in Georgia; NGO MFIs, such as Mikrofin in Bosnia and Herzegovina and KCLF in Kazakhstan; and the credit unions in Moldova. The commercial-funding strategies of such MFIs can be used as examples by others.

Significant commercial borrowing by MFIs will place the commercial banks in a new and crucial role within the sector, making them wholesalers of funds to retail MFIs. In addition, we expect new types of mutually beneficial relationships between commercial banks and MFIs to develop in the coming years. These will include sharing



facilities between MFIs and banks, cross-selling each others' services, and client referrals (eg, MFIs referring traditionally creditworthy clients to banks, and banks referring unbankable clients to MFIs).

We also expect direct lending by mainstream banks to MFIs' more bankable clients to increase in the short-to-medium term, financed by the banks' own capital (in other words, for mainstream banks to continue downscaling but with commercial rather than donor funds). This will represent an important deepening of the mainstream financial sector.

**The supply of socially-motivated private investment.** We predict that socially-motivated private equity investment will take on an increasingly important role in the capitalisation of the microfinance sector in the medium-to-long term. Socially-motivated investment is defined as investment by those willing to accept a below-market return for the benefit of supporting a social cause—in this case, an MFI's social mission.

Currently, most MFIs rely on donors for their initial capitalization. However, as donor funding declines, such capitalization will be increasingly hard to secure. Many MFIs will need to find a substitute if they are to survive. One possibility is commercial investment. Very few MFIs, however, will ever likely be able to provide the 25–30% return on equity that is typically sought, even today, by venture capitalists and other commercial investors. Another possible source of capital, for banks and credit unions, is the mobilization of deposits.

For MFIs that do not take deposits—particularly poverty-focused ones unlikely to achieve financial returns beyond 3–5%—neither commercial investment nor deposit mobilization is, of course, a possibility. If they are to grow beyond that allowed by the capital they retain as earnings, they will need more socially-motivated investment to replace declining donor funding. Already, a few foreign, private social investors support microfinance in the region. At least two of them—Oikocredit and Triodos-Doen, both from the Netherlands—plan to increase their levels of investment. It is also possible that local, social investors in microfinance will develop in the region. For example, the local affiliates of the Open Society Institute could be possible candidates to take on such a role.

### ***External Forces***

So far, the microfinance sector in many of the CEE and NIS countries has been somewhat marginalized. In these countries, it has enjoyed little serious support from the government and little integration into the mainstream financial system. Donors have both funded and, in a sense, incubated the development of the sector.

Over the medium term, as donor involvement in the sector declines, external forces will increasingly drive the outlook for microfinance in the region. The three predominant external forces are considered to be government policy regarding microfinance, private-sector development, and the development of commercial lending.

**Government policy.** Government policy can either nurture or undermine the development of microfinance; it is rarely neutral. Currently, the governments in CEE and NIS approach microfinance from widely different perspectives. In some countries, such as Bosnia and Herzegovina, the government has been very supportive of microfinance development—and is creating a legal and regulatory framework that will allow for a range of MFI forms. In other countries, such as Serbia and Montenegro and Ukraine, however, the government has been much less open to the sector, particularly to nonbank, unregulated service providers, and has intentionally restricted its development.

We expect government support to continue to vary from country to country in the short term. At this point, we consider the largest driver pushing governmental policy to loosen toward microfinance to be the sector itself. The stronger the sector (including its funders), the more effectively it can lobby the government on its own

behalf, and the more clearly it will demonstrate the benefits it offers the country's economy. For this reason, we expect the countries in which microfinance is already the most developed (eg, Bosnia and Herzegovina and Georgia) to be the ones in which governmental policy continues to evolve in its favor. Indeed, fueled by this positive feedback loop, governmental support of microfinance in these countries should increasingly outpace that in countries with less-developed microfinance today.

The disparities of government policy toward microfinance in CEE and NIS are expected to diminish over the medium term, with the trend moving in favor of microfinance. For most of the last decade, some governments in the region (including those of the Czech Republic, Estonia, Hungary, Poland, and Slovenia) have already favored market-oriented reform. At the same time, others (including those of Romania, Azerbaijan, Belarus, Ukraine, Turkmenistan, and Uzbekistan) have resisted it but are now opening to the prospect. Recently, even they have loosened their policy toward financial-sector reform and small business. In the wake of this broader trend, we expect governmental policy toward microfinance also to improve across all the countries in CEE and NIS—provided that the microfinance sector ties its own development more closely to that of the overall financial sector and small-business development.

**Development of the private sector.** The client base of MFIs and the pattern of demand for their products and services are likely to change as the private sector develops in CEE and NIS. This is particularly true in the accession countries, whose economies are developing the fastest. Existing microentrepreneurs, such as market vendors and the owners of small retail stores, are likely to be squeezed out of business by increasing competition from large retail firms (as has happened in western Europe). Also, as the region's economies develop, new job opportunities will arise, and those who are self-employed out of necessity will likely find wage jobs. We expect the net result to be a decline in the overall demand for microenterprise credit.

At the same time, however, existing and new microcredit clients will likely generate demand for new microfinance products and services, such as new types of loan products, savings accounts, and insurance products, for example. To survive, MFIs will need to adjust by developing products that meet this demand.

**Development of commercial lending.** MFIs in the more advanced economies of CEE and NIS also need to monitor the development of commercial lending. In these countries, commercial consumer-credit companies are emerging which often target the same low-income, unbankable clients served by MFIs. Although loans from these commercial lenders typically do not come cheaply (they often cost in excess of 500% APR), they are marketed aggressively. In this way, such companies often rapidly capture a share of the loan market. Such has been the case in western Europe.

The expansion of commercial lending in CEE and NIS has two primary implications for MFIs in the countries concerned. First, it represents increased competition. As a result, MFIs operating in competitive lending markets will likely face increasing problems of client retention, unless they can demonstrate their comparative advantage. Second, it presents the opportunity for a new role for MFIs interested in having a positive social impact. Such commercial-lending practices can result in poor people becoming overindebted. A useful service in such environments would be for MFIs to focus on raising their clients' awareness of the importance of savings and financial literacy. MFIs can also market their own products as better tailored to the real debt capacity of clients.

## **The Outlook for Microfinance in CEE and NIS**

Having examined the primary forces that will shape the future of microfinance, we now present the key features of our outlook. Ultimately, forecasts of the number of MFIs that will exist, how they will perform against one

another, or even how any MFI model will perform against the region's other models are not important to the target microfinance clients. What is important are these questions:

- How close will microfinance and the financial sector as a whole come to meeting the ideal scenario of providing universal access to affordable financial services, particularly for the poor?
- How close will microfinance and the financial sector as a whole come to developing a lasting, durable solution to the issue of financial access, capable of increasingly meeting the demands of its target clients on a multigenerational basis?
- Will this access to financial services translate into sufficient quality-of-life improvements for the poor to justify the public subsidy of microfinance?

In an attempt to answer these questions, our outlook for the short-to-medium term (5–10 years from now) includes predictions for the four parameters of microfinance generally considered most important: the number of clients served (that is, the level of market penetration), the depth-of-poverty outreach, the sustainability of service, and the overall social impact.

### ***Market Penetration***

MFIs in CEE and NIS already provide nearly two million people with credit and savings services. However, these MFIs are far from fulfilling the ideal of financial access for all. These institutions are young by global standards (less than four years old on average) and are still relatively small, reaching at most tens of thousands of clients each. We estimate that, together, they currently reach no more than 5% of the demand for credit from microentrepreneurs. Undoubtedly, they fulfill far less of the demand for other services, such as savings, insurance, and other loan products.

We forecast that, as a whole, existing microfinance providers will continue to grow, but at declining rates over the next 10 years. Based on an extrapolation of the MFIs' own growth-rate forecasts, we estimate that they could be serving at least 12 million clients by 2013. This would represent an estimated 20% of the demand (for credit only) at the time.

While we consider this the most likely scenario for the sector, it would still be a challenge to achieve. The MFIs would have to develop the organizational capacity to manage fast rates of growth (a 45% average annual increase in client numbers over the next three years). It would also require funders to make the funding to support such growth (at least US\$1 billion over the next three years) available. In general, the determinant forces are moving in the right directions to meet these requirements, but the situation varies from country to country.

In order to push our expected scenario closer to the ideal—that is, to bring our predicted 20% market penetration in 10 years closer to 100%—a fundamental shift would have to occur in the forces driving the way microfinance is scaling up in the region. In our view, the necessary shift has to take place in the mainstream financial sector's drive to maximise profits. The market would have to be willing to accept lower financial returns than are currently considered competitive. This, in turn, would ensure greater mainstream-sector interest in serving low-income households and greater financial flows into microfinance.

### ***Depth-of-Poverty Outreach***

Currently, poverty outreach in CEE and NIS is relatively weak. Our outlook calls for some, but not dramatic, deepening of this outreach, especially by the region's NGO MFIs. Most commercial-bank downscaling programmes and microfinance banks currently reach only the higher end of the micro- and small-enterprise market. We expect them to remain focused on this market, where the prospect of returns and demand for their other banking services are highest. Credit unions and NGO MFIs have demonstrated a greater ability to reach the poor than have the banks. But even the majority of CUs and NGO MFIs are not focused on poverty. Only 12% of NGO MFIs serve a very low-end clientele. (Comparable data was not available for credit unions.)

Our outlook calls for some improvement in poverty outreach in the region. We estimate that 30% of its MFIs will become focused on low-income clients in the next 5–10 years. Our findings reveal that some of the region's mature MFIs, particularly NGO MFIs, have deepened their poverty outreach since their founding—contrary to the frequent assumption that MFIs move up market as they mature. One reason for these MFIs' growing focus on low-end clients is the competitive pressure from banks (including mainstream banks, downscaling commercial banks, and microfinance banks). As banks increasingly compete for high-end micro and small enterprises, NGO MFIs are pushed into targeting the low-end of the market, including poor and rural clients.

However, competitive pressures alone will not be enough to guarantee a significant improvement in poverty outreach. For MFIs to focus their efforts on reaching the poor would, in our view, require a stronger commitment to poverty alleviation in CEE and NIS. To date, the development of the microfinance industry has been driven largely by an enterprise development, rather than a poverty-alleviation agenda. All MFIs, globally, claim to strive for a double bottom line—that is, both financial and social returns. However, many of those in the region base measurements of their success on financial returns alone. This is in direct opposition to deepening outreach to the poor, since—as this study shows—it is more expensive to provide financial services to the region's poor than to other segments of the target market. Consequently, doing so slows an MFI's progress toward profitability. Greater commitment to the poor would require MFIs to rebalance the double bottom line still farther in favor of social returns and away from profits.

### ***Financial Sustainability***

The main factors that determine whether or not an MFI reaches full financial self-sufficiency (ie, reaches the position at which it can operate without any subsidy) are its scale of operations and cost structure. Currently, most MFIs in the region are small; nearly 60% of all the NGO MFIs, downscaling commercial banks, and microfinance banks and 90% of the credit unions have less than 2,000 clients and an outstanding gross loan portfolio of less than US\$1 million. On such a small scale, it is difficult to be financially self-sufficient. Because an MFI's scale of operations and cost structure are so closely linked to its business model, the outlook for financial self-sustainability is examined separately for each MFI type.

**Credit unions.** History suggests that the credit union model is a robust one; some credit unions have already demonstrated the capacity to sustain their operations for many decades. However, credit unions often operate on a very small scale; those surveyed had an average of 400 members and less than US\$100,000 in outstanding loans. These operations are often partly sustained financially by the willingness of credit union personnel to volunteer their time (this helps keep credit union operating costs very low compared to other MFI types) and

the willingness of members to accept somewhat lower returns on savings. Such mutualism is a strong factor in the credit union model.

However, mutualism alone is unlikely to secure the growth and long-term financial sustainability of credit unions. Relying on the personal commitment of credit union members can restrict their development. Many credit unions identified a lack of professional staff as their major barrier to developing their operations further. Yet, they earn insufficient income to pay the salaries expected by suitably qualified people. Hence, increasing their membership and the income earned from their services is a necessity for their long-term development.

Overall, we approximate that less than one-third of all credit unions existing today will be financially self-sufficient over the next 5–10 years, but expect at least three-quarters to survive during that period on the strength of their mutualism.

**NGO MFIs.** The NGO MFI sector in CEE and NIS has an increasingly strong understanding of what it takes to reach financial self-sufficiency. Toward that goal, many NGO MFIs are now placing a strong focus on increasing their scale of operations and operating-cost efficiency. However, to date, only the minority of NGO MFIs is financially self-sufficient. In September 2001, nearly 20% of the 136 NGO MFIs surveyed were operationally self-sufficient (ie, were earning sufficient own-source revenue to cover their operating expenses), but less than 10% had reached full financial self-sufficiency (ie, were earning sufficient own-source revenue to cover all operating expenses, as well as loan losses, inflation, and the market cost of funds), and even fewer had sustained their financial self-sufficiency for over a year.

We estimate that, 10 years from now, the portion of NGO MFIs that is financially self-sufficient will have grown to roughly one-third, with only 10–15% of them having been self-sufficient for more than five years. Within this group, some will have transformed into other legal entities (eg, specialized microfinance banks or finance companies). Our outlook also calls for approximately one-third of today's NGO MFIs to survive but to remain dependent on some kind of subsidy—whether from donors, the government, or social investors. We expect these NGO MFIs to operate on a smaller scale than those that are financially self-sufficient. Finally, we expect roughly one-third of today's NGO MFIs not to survive the 10-year mark. They may go out of business entirely, merge with other MFIs, or be taken over by other MFIs.

**Microfinance banks.** The robustness of the microfinance-bank model bodes well for its future financial self-sufficiency. The model has a mixed capital base, diverse products and services, and revenue stream. By September 2001, six of the ten microfinance banks in the region had achieved financial self-sufficiency. However, the microfinance banks are costly to set up (about US\$2 million per bank in initial investment and technical-assistance costs). Hence, to date, they are dependent on donor subsidy to start up. Once established, however, the microfinance banks have achieved good levels of operating efficiency, with average operating cost ratios ranging from 10–20%.

We believe that it is in economies with the least-developed banking sector, such as Albania and Kosovo, that microfinance banks have the best chance of achieving financial self-sufficiency and surviving over the long term. This is because, absent a strong banking sector, microfinance banks will be able to carve out a significant market share of both borrowers and depositors.

On the other hand, in countries with a stronger banking sector, such as Bosnia and Herzegovina, the microfinance banks will be competing with more established and publicly-recognized mainstream banks and other

nonbank MFIs. This means their competition for clients will be fiercer. As a result, their deposit base will be smaller, making their profitability largely dependent on the continued commitment of their foreign investors, their ability to innovate to meet client needs, and the ability of IMI and other microfinance-bank sponsors to raise financing. It is likely that some of the microfinance banks in these countries will be taken over by larger banks, or possibly they themselves could take over high-performing MFIs to increase their market share.

**Downscaling commercial banks.** Currently, very few downscaling programmes are operating on a scale that enables them to be financially self-sufficient. As of September 2001, each downscaling bank in the region had an average of 750 borrowers and a portfolio of US\$4 million, and most still had high cost structures. We are aware of only one, Sberbank Russia, that had developed profitable operations by that time. Our expectation is that only those downscaling commercial banks that can radically scale up their operations will achieve profitability. Such scaling up appears to be occurring in Russia and Central Asia. Elsewhere, the downscaling programmes are likely to cease once donor funding dries up. At that point, the only clients they will be able to serve will be those at the high end of the market to whom lending is clearly profitable.

**Social Impact.** The ultimate goal of microfinance is social change—the increased well-being of the poor. Of course, microfinance is not a panacea; poverty alleviation also depends on the poor having access to education, health services, market opportunities, and more. But access to credit and savings can contribute to poverty reduction by increasing income-earning opportunities and helping people build assets. Impact studies in the region already provide evidence that microfinance can increase household income, increase business profitability, and support job creation.

We expect the social impact of microfinance to increase in CEE and NIS, as MFIs provide more services to more people. That said, the impact of microfinance on the poor is inextricably linked to the depth, not merely breadth, of outreach. If the poorest are to benefit from the growth of microfinance in the region, the sector will need to focus more attention on poverty outreach.

## **A Framework of Best Practices**

The study's findings identify the region's MFIs by type and by subregion, their relatively weak financial performance or outreach, and the financing and legal barriers they face. In doing so, the study has revealed where the microfinance industry's best practices are and are not being sufficiently applied by the relevant actors in the region. These microfinance actors are the MFIs, policy makers, donors, commercial funders, and social investors.

From our findings, we have identified which best practices, we believe, if applied more broadly, would most efficiently increase the scale, poverty outreach, financial self-sufficiency, and social impact of the sector. Our microfinance outlook for the region over the next 5–10 years incorporates our expectation that these practices will be implemented, within that timeframe, only by some of the region's microfinance, institutional actors—specifically, the most developed MFIs and microfinance-support organisations and the most progressive policy makers, donors, commercial funders, and social investors.

Needless to say, if more did so, our outlook would be surpassed within 5–10 years; unfortunately, the opposite is also true. Certainly, we consider it a reasonable hope that, beyond our timeframe, more of the region's microfinance actors would, in fact, implement best practices, and so our outlook would be surpassed then.

The best practices that we have identified—that is, those that would have the largest payoff if applied more widely today—fall into four functional categories:

- Creating a supportive legal and regulatory framework for microfinance
- Building MFIs with strong performance
- Ensuring the region's MFIs' access to finance
- Improving MFIs' public transparency and the exchange of information between them

To help implement these best practices—whether within the timeframe of our outlook or later—we have listed them below, along with specific actions that the region's microfinance actors could take for each. These best practices are grouped by the four functional categories listed above.

Each best practice is not, of course, equally applicable at this time across the region, considering that the different countries' microfinance sectors are at different stages of development. Similarly, each specific action we suggest is not equally applicable to each institutional actor. Some institutions are already implementing some steps. Others will find certain steps beyond their capabilities, mandates, or resources. In the end, each institution must judge which best practices and suggested actions it finds realistic—or can make realistic by modifying according to individual circumstances.

## Getting the Policy Framework Right

### ***Best Practice #1. Reduce the bureaucracy and tax burden placed on micro and small businesses***

In many countries in the region, micro and small businesses are subjected to too much red tape and to taxes and fees that are too high. These have become major barriers to the development and growth of these businesses and to entrepreneurship in CEE and NIS. Actions are required to simplify, streamline, and make affordable the conducting of small-business operations, if micro and small enterprises are to fulfill their potential to help increase the number of jobs and create wealth in the region.

#### *Action for MFIs and microfinance support organisations*

- Advocate policy reforms in favour of low-income and microenterprise clients, including the informal sector.

#### *Actions for policy makers (at national and local levels)*

- Introduce reforms to reduce the bureaucracy and tax burden on micro and small businesses. Reforms urgently needed in CEE and NIS include the simplification, streamlining, and cost reduction of business registration and operation, as well as tax breaks for start-up and early-growth businesses.
- Increase the transparency and efficiency of local officials' implementation of existing regulations.

#### *Action for donors*

- Ensure that the needs of micro and small businesses (including those in the informal sector) are taken into account in donor-supported efforts to analyse and present recommendations to the government on improving the business environment. To do this, confer with various micro and small businesses and MFIs that are familiar with their clients' situations, as part of research and policy development efforts.

## ***Best Practice #2. Improve the legal and regulatory environment for microfinance.***

Few governments have yet integrated microfinance development into their own broad economic and development strategies, despite the priority often given specifically to financial-sector reform. (In part, we in microfinance must blame ourselves—we have historically argued that ours is a highly specialized sector, separate from the mainstream financial sector. Now, however, it is increasingly apparent that large-scale sustainable microfinance can be achieved only if financial services for the financially excluded are integrated into the overall financial system.) In many countries, this is demonstrated through legal ambiguities and constraints that still hamper the ability of established and start-up MFIs to function, as well as prevent their greater integration into the financial system. Actions are needed to change the governments' view of microfinance and remove the legal and regulatory constraints it faces.

### *Actions for MFIs and microfinance support organisations*

- Demonstrate the contribution MFIs make to supporting enterprise growth and poverty alleviation in the region. Techniques include publicizing MFI results and developing relationships with policy makers.
- Continue to lobby for and engage in legal-reform efforts, ideally in coordination with other MFIs.

### *Action for policy makers*

- Integrate microfinance development into the country's economic-development and poverty-reduction strategies. One step in doing this would be to make the legal and regulatory reform of microfinance part of the overall financial-sector reform. (Nonetheless, some distinct characteristics of microfinance and how it differs from mainstream banking must continue to be recognized by financial regulations.)

### *Actions for donors*

- Better coordinate the joint support of legal and regulatory reform with other donors.
- Focus on developing donor strategies that allow the development of a diversity of MFI models.
- Fully understand the specifics of a country's legal system and its microfinance-relevant laws and regulations before selecting specific legal reforms to advocate. Particularly dangerous is the adoption by one country of legislation or regulations based on those of another country; before advocating such a strategy, thoroughly study how what is adopted would interact with the indigenous, surrounding laws of the host country.

## **Building Strong Institutions and Delivery Mechanisms**

### ***Best Practice #3. Target subsidies toward institution building***

Microfinance bridges a market gap by providing financial services to those not considered bankable by the mainstream financial sector. The major resultant social benefits include enterprise development and poverty alleviation. To most people, this mission and the ensuing social benefits justify the microfinance sector's receipt of subsidies. But to do the most good, these subsidies should be targeted toward investments that meet two criteria—they should achieve the greatest social impact and should support the growth of financially viable MFIs. Instead, too often, donor's subsidies encourage a culture of subsidy dependence among MFIs. Reversing this trend is an industry priority.

### *Action for MFIs*

- Adopt CGAP financial-reporting standards, which require an MFI to disclose the degree to which its operations are subsidised when reporting its financial returns on investment.



*Actions for donors*

- Rigorously direct grant (subsidy) financing at these specific MFI costs: start-up expenses; institution building, including technical support services and systems development; initial capitalisation; and the costs of innovation and product development. Subsidising these expenses, as opposed to interest rate subsidies, typically prevents an MFI from developing long-term subsidy dependence.
- Ensure subsidies are time limited and linked to performance indicators that benchmark an MFI's progress toward key, mutually agreed-upon performance standards, such as outreach levels, portfolio quality, efficiency, and financial sustainability.

***Best Practice #4. Provide incentives to encourage greater focus and innovation in the development of financial services for the poor.***

Certain MFIs that specifically serve the poor have shown that it can be done in a financially self-sufficient manner. However, because it does cost more to reach the poor, it requires more time and clients to make a poverty-focused microfinance operation financially sustainable, versus one that is not. Ensuring that microfinance does benefit the poor in CEE and NIS will require the concerted action of all actors.

*Actions for MFIs (specifically those interested in increasing their poverty outreach)*

- Provide staff and board members with training and sensitisation programmes aimed at reaching low-income clients.
- Design incentive schemes that encourage loan officers to reach out to low-income clients. An example is the introduction of performance bonuses based on the number of loans to low-income clients that yield high repayment rates.
- Develop partnerships with business-service providers to offer low-income clients who have limited business experience the training they need to develop business ideas and business management skills.
- Develop new products and services that take into account the specific situations and characteristics of the poor in CEE and NIS. For example, while most do not have adequate, traditional collateral, they often can provide household or personal possessions, such as jewelry, as collateral or can borrow on a group basis.

*Action for funders (specifically those interested in funding poverty-focused MFIs)*

- During funding appraisals, assess MFIs' poverty outreach. This can be done with, for example, CGAP's poverty assessment tool. Follow up by giving poverty-focused MFIs funding terms and conditions that take into account their need for more time and/or greater capitalisation to reach financial sustainability, in light of the fact that reaching low-income clients likely incurs higher costs, including subsidies to cover the costs of developing new products and methods aimed at reaching the poor.

*Actions for microfinance support organisations*

- Facilitate the networking and exchange of relevant information between MFIs interested in increasing their poverty outreach.
- Develop training based on the practical experiences of MFIs in the region—specifically, on their policies, practices, and products— that already reach low-income clients.

***Best Practice #5. Increase cooperation and partnership, both among all types of microfinance providers and between them and mainstream banks, to increase financial service provision to the poor.***

Each type of microfinance provider and mainstream banks has different organisational strengths. By developing microfinance-service delivery as partners and building on the relative organisational advantages of each, there is an increased chance of widening the access of the poor to financial services. Much can be done to seek out and encourage such partnering.

#### *Action for MFIs*

- Recognise the comparative advantages that different MFIs have. For example, credit unions and NGO MFIs have demonstrated a greater capacity to reach poor clients than microfinance banks and commercial-bank downscaling programmes. Keeping these differences in mind, explore various, potential partnerships or operational relationships with other MFI types, commercial banks, and even other retail institutions (such as post offices) to increase outreach to underserved markets.

#### *Action for policy makers*

- Enact regulatory and supervisory safeguards against collusion in the financial sector and exploitation of the poor—eg, legislation against predatory lending.

#### *Action for funders*

- Design MFI funding strategies that encourage partnerships between different MFI types, as well as between MFIs and other financial institutions, such as mainstream banks and retail businesses.

## **Ensuring Access to Funding**

### ***Best Practice #6. Capitalise MFIs through the innovative use of grants and equity-type products***

Capitalisation is the key to building the financial viability of MFIs. It is also vital for attracting higher volumes of commercial funding because MFIs need sufficient uncommitted capital in order to borrow. The more done to capitalise MFIs, the easier they will find it to secure long-term viability.

#### *Actions for MFIs*

- Clarify the status of existing grants or concessional loans—specifically, whether or not they are counted as equity or quasi-equity—with donors.
- Consider raising socially-motivated private equity financing. This may require an MFI to transform into a finance company or other shareholder-based organisation that is legally allowed to raise equity finance.

#### *Actions for policy makers*

- Ensure that laws and regulations allow MFIs to transform into alternative legal forms.

#### *Actions for funders*

- Clearly indicate that MFIs whose performance merits capitalisation can and should capitalise existing grants as equity on their balance sheets. Too often, the nature of donor grants is unclear—sometimes treated as equity, sometimes as loans, because they are potentially returnable or come with attached conditions.
- Develop more term loans and new types of equity products, such as subordinated loans and mezzanine financing (loans with equity features). An MFI's use of such financing can help build its capital base and lower its overall cost of funds.

### ***Best Practice #7. Increase commercial-bank finance coming into the microfinance sector.***

The study revealed two problems restraining the flow of commercial financing into the sector; these problems particularly impede NGO MFIs. First, many MFIs have not seriously considered including commercial financing in their growth strategy. Second, from a commercial-lending perspective, nonbank MFIs are often perceived as weak, highly risky institutions by many commercial funders. In actuality, however, nonbank MFIs often have exceptional growth rates and high-quality portfolios. Consequently, any steps taken to increase the commercial financing of microfinance would benefit both MFIs and commercial banks.

#### *Action for MFIs*

- Begin preparing to secure commercial-debt financing as part of long-term strategy for growth and sustainability. Specifically, follow the preparation steps recommended in this report (see Chapter 7).

#### *Actions for policy makers*

- Encourage mainstream banks to increase their direct lending to micro and small enterprises. Supporting guarantee schemes is one way of accomplishing this.

#### *Actions for donors*

- Help MFIs that receive donor, but not commercial, funds to develop banking relationships. This can help MFIs leverage private capital and thus increase the impact of donor funds. Women's World Banking, for example, has brokered banking relationships for its members.
- Expand existing guarantee schemes that have proven effective. This would help MFIs (and their clients) meet bank lending requirements and, therefore, increase commercial lending into the sector.

#### *Action for private funders (particularly local commercial banks, including local microfinance banks)*

- Lend to nonbank MFIs that have demonstrated creditworthiness. There are many reasons this is sensible. First, these MFIs are reliable loan clients. Second, they can serve as an entrée into this new client market, thus allowing commercial banks to take the first step toward downscaling. Third, these clients might be interested in other big banking services down the road, such as savings accounts and money transfers.

### ***Best Practice #8. Increase private social investment in the microfinance sector.***

Ultimately, microfinance is development finance, aimed at improving the lives of low-income people and the communities in which they live. The nature of the microfinance business limits its prospects for high financial returns. Hence, the long-term growth of the sector is heavily dependent on social investors willing to sacrifice competitive returns to a degree in order to support an MFI's social mission.

#### *Action for MFIs*

- Explore opportunities to raise social investment, both from international and local sources. Some specific routes are to contact the social investors discussed in this report and to raise funding from local community members or businesses.

#### *Action for social investors*

- Increase knowledge and understanding of microfinance in CEE and NIS. As a first step, use this report as a source of information about the current state of microfinance in the region and the investment opportunities it offers.

## Improving Transparency and Information Flows

### ***Best Practice #9. Improve the transparency of MFIs***

MFIs aim to achieve a double bottom line—both financial and social returns. The microfinance actors most familiar with the microfinance operations agree that improving both parts of this double bottom line will require greater transparency about MFIs' financial performance and social impact. In turn, this would raise potential investors' confidence and, thus, is a means of increasing the inflow of financing. Virtually all the serious actors within the industry can play a role in influencing MFIs to increase their standards of transparency.

#### *Actions for MFIs*

- Have an annual, external financial audit that is compliant with International Accounting Standards (IAS). This action is aimed specifically at nonbank institutions. Banks are already required to have audits by law. The study found that 80% of NGO MFIs in the region have regular external audits, but not all of these are IAS compliant.
- Have an external evaluation or credit rating conducted as an independent assessment of performance. Financial support for this can be sought through the CGAP-IDB Rating Fund.
- Become one of the MFIs that reports to the *MicroBanking Bulletin (MBB)*, an internationally recognised publication of MFI performance data worldwide.
- Pay more attention to collecting and analysing client information on client demographics and impact, as a way of understanding social impact and collecting data with which products and services can be made more effective.

#### *Actions for policy makers*

- Require all MFIs, including NGO MFIs, to be subject to nonprudential regulation—ie, require that they register and report their financial and social performance on a regular basis. Such reporting could be required once credit-only MFIs reach a certain portfolio size.

#### *Actions for donors*

- Make IAS-compliant financial statements and audits a funding requirement for MFIs.
- Cover the cost of external credit ratings for MFIs.
- Support the development and application of impact-measurement tools.
- Demand greater information disclosure from MFIs about their subsidy dependency, financial viability, levels of outreach, and social impact.

#### *Actions for MFI support organisations*

- Expand MFI training in financial management, performance measurement, and impact assessment.
- Collect performance data and publish performance analysis and benchmarking of MFIs.

### ***Best Practice #10. Improve the exchange of information between MFIs and funders***

The efficient financing of the region's microfinance development requires a better exchange of information by both MFIs and funders. MFIs should have current information about the available supply and sources of funding, and funders should understand the demand for financing from MFIs, individually and as a group. Currently, many MFIs are unaware of the funding that is already available, partly because funders are not always

adept at marketing the financing they offer. Similarly, funders do not have sufficient knowledge of the performance and investment worthiness of the MFIs. In fact, often they are not even aware of the MFIs out there. This “knowledge gap” is perhaps the largest factor impeding more commercial financing of the sector, but also limits donor funding.

#### *Actions for MFIs*

- Become more proactive in seeking new sources of funding. Use the information on various funders provided in this report as a starting point (see Appendix 6).
- Become a participant in Market Information eXchange (MIX), a new program that uses the exchange of information between MFIs and funders to increase standardized reporting by MFIs, to improve and stimulate MFI transparency, and to boost public and private investment in microfinance (See the MIX web site at [www.themix.org](http://www.themix.org).)

#### *Actions for all funders*

- Improve marketing of funding and guarantee schemes to MFIs in CEE and NIS.
- Participate in the Market Information eXchange program (see above).
- Explore the possibility of developing partnerships with other funders to support MFI development in a manner that uses public financing to leverage in private capital.

#### *Action for microfinance support organisations*

- Facilitate and host networking meetings of funders and MFIs. Brokering such relationships can reduce the transaction costs of funders looking for new investment opportunities.

## **APPENDIX 1**

### **THE MICROFINANCE CENTRE FOR CENTRAL & EASTERN EUROPE AND THE NEW INDEPENDENT STATES**

#### **Background**

The Microfinance Centre for Central & Eastern Europe and the New Independent States, launched in Warsaw in September 1997, is a network of 69 microfinance institutions. Its mission is to promote the development of a strong and sustainable microfinance sector in the region, in order to increase access to financial services for low-income people, particularly microentrepreneurs. The MFC fulfills this mission by providing training and consulting services, opportunities to share information and experiences, and research. It also is an active advocate and provider of legal and policy development services for legal and policy reform that benefits the region's MFIs.

#### **Services**

##### ***Training and Consulting Services***

The MFC has established itself as a leading provider of training and consulting services for MFIs in the region. As a regional partner of CGAP, it is accredited to deliver CGAP courses. Since 1998, the MFC has organized 60 training courses and consulting events of different types for a total of 1,176 participants from 245 microfinance-related institutions.

##### ***Opportunities to Share Information and Experiences***

The MFC organizes the Annual Microfinance Conference for microfinance practitioners as well as donors, investors, and policy makers from the region. On average, over 200 representatives participate each year. The MFC also produces various publications aimed at disseminating information throughout its network. Regular publications include the semiannual newsletter in which members brief one another on their activities and microfinance experts discuss topics of regional interest. The "Policy Monitor" specifically focused on solutions to policy and legal issues faced by MFIs in the region.

##### ***Research***

Currently, the MFC has two core research projects. The first is the Imp-Act project, funded by the Ford Foundation. Its goal is to improve the methods used to assess MFIs' ultimate impact on poverty—specifically, the impact on economic recovery and community development of MFIs, particularly those operating in post-conflict areas.

The MFC's second core research project at present is development of regional and industry benchmarks, in cooperation with the *MicroBanking Bulletin*. Periodically, financial data is collected from the MFC's member MFIs. Data of the best-performing ones are then regularly included in the *MicroBanking Bulletin*, a semiannual publication that reports on the performance of MFIs around the world. Presently, 13 of its member MFIs regularly report data to the MBB via MFC.

**APPENDIX 1** *continued****Legal and Policy Advocacy***

The MFC carries out country-specific analyses of the legal and regulatory environment for microfinance based on demand from in-country stakeholders (MFIs, donors, national governments, etc.). Initially, it conducts a diagnostic analysis of the specific legal and regulatory environment for microfinance in a selected country. From this analysis, country-specific obstacles to microfinance development are identified. Finally, based on this research, a summary and analysis of the current legal and regulatory environment is developed for the country, together with targeted recommendations for overcoming the identified legal and regulatory obstacles. The MFC distributes and discusses these analyses and recommendations, when completed, to the country's MFIs, the national bank, relevant government ministries, and donors. So far, recommendations have been developed for Armenia, Croatia, Georgia, Kyrgyzstan, Serbia, and Tajikistan.

## APPENDIX 2

### STUDY RESEARCH METHODOLOGY AND DATA LIMITATIONS

#### Research Methodology

The research for this study was conducted in two phases. Phase I was September 2001 to April 2002, and Phase II from April to September 2002. In Phase I, MFC surveyed both MFIs and funders in the region. The MFI survey collected data on MFIs' institutional characteristics: products and services, key performance indicators, governance and accountability, impact measurement, demand for finance, future plans, and barriers to growth. The funder survey collected data on funders' institutional characteristics, such as their financing objectives, criteria, and terms and conditions; current and future supply of finance; and perceived barriers to microfinance development.

In Phase II, MFC analysed the survey data and commissioned further research on three themes:

- **Poverty outreach of MFIs.** Additional research and data analysis was conducted by Geetha Nagarajan. Research involved a field trip to Georgia as well as semi-structured, in-depth interviews with eight MFIs.
- **Commercial financing of MFIs.** Research was conducted by Ruth Goodwin-Groen and included semi-structured, in-depth interviews with 16 MFIs and 10 funders.
- **Legal and regulatory environment for microfinance.** This research was conducted by Kate Lauer based on her consulting experience in the region, with contributions from Timothy Lyman.

#### Data Collection

Mapping a newly emerging industry across 28 countries is an ambitious task. It required seeking out the microfinance players in these countries and encouraging them to respond to the survey. In total, the MFI survey was sent to 250 organisations in 25 countries in three different languages (English, Russian, and Serbian/Croatian/Bosnian). In addition, the research team collected data from public sources and experts in the region.

In some countries, MFC had good knowledge of the MFIs operating; in others, it was necessary to use other parties to seek out the players. We believe we identified the majority of organisations that provide microfinance services. However, there can be no doubt that we missed some. If we missed your organisation, or if you know of one not included, please contact us. We would like to include it in our future research.

#### Data Sample and Limitations

The study identified 5,892 credit unions, 136 NGOs, 33 commercial banks, and 11 microfinance banks (including one in start-up phase that was not operational at the time of the study) that provide microfinance services in 25 out of the region's 28 countries. The study also identified 34 funders.

Out of these, 15% of the credit unions, 43% of the NGOs, 38% of the commercial banks, 67% of the microfinance banks, and 71% of the funders responded to the survey. Appendices 4 and 5 provide lists of the MFIs and funders identified in the region, indicating which ones responded to the survey.



**APPENDIX 2** *continued*

In addition to the survey, data were gathered from publicly available sources, such as organisational web sites and annual reports, and from supporting organisations, such as the World Council of Credit Unions. The study's final data coverage was 95% of the credit unions identified in the region, 74% of the NGOs, 100% of the micro-finance banks, and 73% of the commercial banks (see Table A-1).

**Table A-1 Calculation of Study's MFI Coverage**

Type of MFI	Total Number of MFIs Identified	% Responding to Survey	Number of MFIs with Information Collected (including public sources)	% of Coverage (based on survey and public data)
Credit Unions and Savings and Credit Cooperatives	5,892	15%	5,617	95%
NGOs (Microcredit organisations, foundations, and private companies)	136	43%	100	74%
Commercial Banks	33	38%	24	73%
Microfinance Banks <sup>1</sup>	10	67%	10	100%

<sup>1</sup> One other microfinance bank existed but was not operational at the time of the study.

The final coverage for the survey was fairly consistent across regions. Coverage was the highest in the Balkans, with 89%, and lowest in Eastern and Central Europe, at 61% (see Table A-2).

**Table A-2 Coverage Rated by Subregion\***

Subregion	Number of MFIs Identified	Number of Survey Responses	Coverage
Balkans	45	40	89%
ECE	38	23	61%
Caucasus	37	27	73%
Central Asia + Mongolia	34	27	79%
Russia/Ukraine/Belarus	25	17	68%
Total	179	135	75%

\* Does not include credit unions

Although the final coverage is high, secondary sources could not provide answers to all the survey questions. This was particularly the case with credit unions. Hence, the sample size differs for different survey questions, and thus aspects of the data analysis.

Data on the overall size and outreach of the industry is based on a large, fairly representative sample. Smaller sample sizes are available for analysis of other aspects of performance, such as operational efficiency and financial sustainability. Sample sizes are noted throughout the text.

The MFC did not verify the quality or accuracy of the data provided. All data are self-reported, and no checks were done against independent assessments or audited financial statements. However, 100% of microfinance and commercial banks, 83% of NGOs, and 79% of credit unions reported that they have regular external financial audits, suggesting that the accuracy of the majority of the financial data collected in the study was subject to external verification and can be considered reliable.

The data presented in this report provide a good indication of the size and performance of the region's microfinance industry. However, given the data limitations, they should not be taken as completely accurate or representative of the entire sector.



## APPENDIX 3

### DATA TABLES

#### Industry Characteristics

MFI Type		Number	Age (years) Years functioning as an MFI	Total Assets (US\$) Total assets
<b>Credit Unions</b>	N value	5,892	– –	5,360 538,544,849
<b>NGO MFIs</b>	N value	136	99 3 y 3 mth	55 115,572,497
<b>Microfinance Banks</b>	N value	13	10 2 y 4 mth	10 423,565,148
<b>Commercial Banks</b>	N value	33	24 2 y 10 mth	– –
<b>All MFI's</b>	<b>N value</b>	<b>6,071</b>	<b>130 3 y 2mth</b>	<b>5,425 1,077,682,495</b>

#### Outreach Indicators

MFI Type		Total Gross Loan Portfolio Outstanding (US\$)	Total Number of Active Borrowers (with loans outstanding)	Total Deposits (US\$)	Total Deposit- ors	Average Loan Balance (US\$) [Total gross loan portfo- lio/ number of active borrowers]	Depth (%) [Average loan balance/ GNP per capita]	Percent of Women Borrowers (%)	Loans < \$1,000 (%)	Loans \$1,000- \$5,000 (%)	Loans > \$5,000 (%)
Credit Unions	N value	5447 408,373,978	5361 1,451,253	5523 455,410,652	5523 2,243,839	5361 545	5361 36	4601 47	225 90	225 6	225 4
NGO MFIs	N value	100 107,873,565	5361 197,069	7 727,280	7 16,845	100 1,501	100 124	66 53	57 64	57 30	57 6
Microfinance Banks	N value	10 158,180,210	5361 41,660	7 217,591,264	7 96,082	10 5,123	10 6	5 27	6 35	6 36	6 29
Commercial Banks	N value	24 125,130,565	5361 23,308	– –	– –	24 7,741	24 6	– –	9 15	9 28	9 55
<b>All MFI's</b>	<b>N value</b>	<b>5581 799,558,317</b>	<b>5361 1,713,290</b>	<b>55337 673,729,196</b>	<b>5537 2,356,766</b>	<b>5495 2,526.5</b>	<b>5495 212</b>	<b>4692 51</b>	<b>5546 82</b>	<b>5546 12</b>	<b>5546 6</b>

**APPENDIX 3** *continued***Financial Performance Indicators**

<b>Peer Group</b>		<b>Portfolio At Risk &gt; 30 Days (%)</b> [Outstanding balance of loans overdue > 30 days / total gross loan portfolio]	<b>Operating Cost Ratio (%)</b> [Operating expense / average gross loan portfolio]	<b>Loan Officer Productivity</b> [Number of active borrowers / number of loan officers]	<b>Operational Self-Sufficiency (OSS) (%)</b> [Operating income / operating expense]	<b>Commercial Funding Liabilities Ratio (%)</b> [Borrowing at commercial rates / average gross loan portfolio]
<b>Credit Unions</b>	N	511	70	54	36	33
	avg	6.0	12	166	166	1
<b>NGO MFI's</b>	N	58	42	63	43	6
	avg	4.1	31	151	110	16
<b>Microfinance Banks</b>	N	58	9	10	4	9
	avg	4.1	13	54	106	80
<b>Commercial Banks</b>	N	20	–	18	–	–
	avg	0.4	–	30	–	–
<b>All MFI's</b>	N	599	123	145	84	48
	avg	3.4	26.0	123	115	45

## APPENDIX 4

### MICROFINANCE INSTITUTIONS IDENTIFIED IN THE STUDY

The MFIs are listed by country and subregion as categorized in the survey. Names in bold are organisations that responded to the survey. Credit unions are listed in a separate table below.

#### The Balkans

Country	NGOs	Microfinance Banks	Private Commercial Banks	Credit Unions and Cooperatives
Albania	<b>BESA Foundation</b>	<b>FEFAD Bank</b>		
	For the Future Foundation			
	<b>Mountain Areas Finance Fund</b>			
	<b>Partneri Shqiptar ne Mikrokredi (PSHM)</b>			
	<b>Rural Finance Fund</b>			
	<b>World Vision Albania</b>	<b>MEB BiH</b>		
Bosnia and Herzegovina	<b>Benefit</b>			
	<b>MIKROFIN</b>			
	EKI – Economic Credit Institution			
	<b>IRC / Zdravo da ste</b>			
	<b>LOK</b>			
	<b>MELAHA</b>			
	<b>MI-BOSPO</b>			
	Mikro AMK			
	<b>Sunrise</b>			
	<b>MIKRA</b>			
	<b>Mikro ALDI</b>			
	MKO BosVita			
	<b>SINERGJA</b>			
	<b>PARTNER</b>			
	PRIZMA			

**The Balkans** *continued*

<b>Country</b>	<b>NGOs</b>	<b>Microfinance Banks</b>	<b>Private Commercial Banks</b>	<b>Credit Unions and Cooperatives</b>
Bosnia and Herzegovina <i>cont.</i>	<b>Bossel</b>			
	<b>Women for Women International</b>			
Croatia	<b>Catholic Relief Services</b>			<b>ICMC-DEMOS Savings and Loan Cooperative</b>
	Center for Entrepreneurship Osijek			<b>NOA Savings and Loan Cooperative</b>
	International Rescue Committee–Croatia			Association of Croatian Credit Unions
Kosovo	<b>ADIE International</b>			
	Beselidhja/Zavet MicroFinance			
	ICMC–Kosovo Enterprise Program (KEP)			
	Danish Refugee Council Kosovo	MEB Kosovo		
	<b>FINCA Kosovo</b>			
	<b>Mercy Corps International-Agency for Finance in Kosovo</b>			
Macedonia	Horizonti CRS–Microfinance	Moznosti Savings Bank		<b>MOZNOSTI</b>
				<b>FULM House</b>
Serbia and Montenegro	<b>AGROINVEST Fondacija</b>	<b>Microfinance Bank Yugoslavia</b>		
	<b>Danish Refugee Council-Micro Development Fund</b>	<b>Stedionica Opportunity International</b>		
	Micro Business Fund			
	MicroFinS			
	<b>Alter Modus</b>			
	<b>Microcredit Montenegro</b> (transforming into Opportunity Bank Montenegro)	Opportunity Bank Montenegro		
	Remorker			
	The Development Fund of the Republic of Montenegro			

## Eastern and Central Europe

Country	NGOs	Microfinance Banks	Private Commercial Banks	Credit Unions and Cooperatives
Bulgaria	Association "Integra Future"	<b>ProCredit Bank</b>	Hebrosbank	<b>Nachala Cooperative</b>
	<b>Catholic Relief Services–Bulgaria</b>		Union Bank	<b>Popular Kasas Bulgaria</b>
	Microfond Kardjali			
	Mikrofond Silistra			
	Mikrofond Sliven			
	Mikrofond Vratsa			
Estonia			Eesti Ühispank	
Hungary	Autonomia Alapitvány Hungarian Foundation for Self-Reliance			National Federation of Savings Cooperatives
	Business Basic Foundation			
	SEED Foundation/H WWB			
Lithuania			Stauliu Bankas	<b>Association of Lithuanian Credit Unions</b>
Latvia			Unibanka	Latvian Cooperative Credit Union Association
Moldova		<b>MEC Modova</b>		<b>Moldovan Microfinance Alliance</b>
				Rural Development Center
Poland	Foundation for the Development of Polish Agriculture (FDPA)			<b>SKOK</b>
	Fundacja Pomocy Wzajemnej BARKA			
	<b>Fundusz Mikro Sp. z o.o.</b>			
	Fundusz Współpracy-Agrolinia 2000			
	Inicjatywa Mikro Sp. z o.o.			
	Rural Development Foundation			
	Slaska Fundacja Wspierania Przedsiębiorczosci			



**Eastern and Central Europe** *continued*

Country	NGOs	Microfinance Banks	Private Commercial Banks	Credit Unions and Cooperatives
Romania	<b>Asociatia IZVOR-OMRO</b>	Microenterprise Credit Romania		<b>Caselor de Ajutor Reciproc (CAR)</b>
	Cooperative Housing Foundation -CHF/Romania			
	<b>Economic Development Center</b>			
	Foundation for Local Development Buzau			
	HIRO-Asociatia Help Integra Romania			
	Local Women Organisation			
Slovakia	BIC Spisska Nova Ves			
	Fond Mikropozicek			
	Regional Advisory and Information Center (RAIC), Presov			
	Regional Advisory and Information Centre, Komarno			
	Regional Advisory and Information Centre, Povazska Bystrica			
	Regional Micro-Loan Fund Zvolen			
	Seed Capital Company, s.r.o.			
	<b>The Integra Foundation</b>			
	<b>VOKA Slovakia-Rural Organisation for Community Activities</b>			

**The Caucasus**

Country	NGOs	Microfinance Banks	Private Commercial Banks	Credit Unions and Cooperatives
Armenia	<b>Ecumenical Church Loan Fund (ECLOF), Armenian Branch</b>		ACBA	
	<b>FINCA Armenia</b>		Armagrobank	
	<b>Microenterprise Development Fund "KAMURJ"</b>		Anelik Bank	
	Oxfam GB Armenian Branch		Armencombank	
	Shen NGO			
	Small Enterprise Fund International (SEF International)			

**The Caucasus** *continued*

Country	NGOs	Microfinance Banks	Private Commercial Banks	Credit Unions and Cooperatives
Armenia <i>cont.</i>	<b>United Methodist Committee on Relief UMCOR/AREGAK, Microcredit Program</b>			
	World Council of Churches, Armenia Round Table			
Azerbaijan	ACDI/VOCA-CredAgro			
	<b>ADRA Azerbaijan</b>			
	<b>Danish Refugee Council</b>			
	<b>FINCA Azerbaijan</b>			
	<b>International Organization for Migration IOM, Community Development and Microcredit Project</b>			
	International Rescue Committee-Azerbaijan			
	Norwegian Humanitarian Enterprise (NHE)			
	<b>NRC (Norwegian Refugee Council)</b>			
	Oxfam GB			
	Relief International (RI)			
	Save the Children-Azerbaijan			
	Shore Overseas Azerbaijan			
	World Vision Azerbaijan			
Georgia	ACDI/ VOCA Georgia	Microfinance Bank Georgia		Credit Union Development Center
	<b>Charity Humanitarian Center "Abkhazeti" (CHCA)</b>			
	<b>Constanta Foundation</b>			
	<b>Danish Refugee Council-Kutaisi</b>			
	<b>FINCA Georgia</b>			
	International Rescue Committee-Tbilisi			
	Oxfam GB Georgia			
	Save the Children-Georgia			
	<b>World Vision International (Georgian Entrepreneur's Fund)</b>			

## Central Asia

Country	NGOs	Microfinance Banks	Private Commercial Banks	Credit Unions and Cooperatives
Kazakhstan	Agribusiness Consulting Centre (ACC)		<b>OJSC Halyk Savings Bank of Kazakhstan</b>	
	<b>Asian Credit Fund</b>		Almaty Merchant Bank	
	Atyrau Pilot Microcredit Centre, UNDP		<b>OJSC Bank Center Credit</b>	
	<b>Kazakhstan Community Loan Fund, Almaty Office</b>		Tsesna Bank	
			OJSC Kazkommertsbank	
			<b>OJSC Bank TuranAlem</b>	
			<b>OJSC Temirbank</b>	
Kyrgyzstan	Civil Fund of Microcredits			
	Counterpart Consortium			
	Financial Credit Company "Kyrgyzaltrust"			
	Financial Fund "Bay-Tushum"			
	<b>FINCA Kyrgyzstan</b>			
	Kyrgyz Agricultural Finance Corporation			
	<b>Mercy Corps Kyrgyzstan</b>			
	Talas Farmers Union			
Mongolia		<b>XAC Bank</b>	Agricultural Bank of Mongolia	Mongolian Credit Unions
			Anod Bank	
			Golomt Bank	
Tajikistan	Agency for Technical Cooperation and Development (ACTED)			
	Association of Scientific and Technical Intelligentsia (ASTI)			
	Farming and Entrepreneurship Supporting Fund "DEVELOPMENT"			
	<b>CARE International</b>			
	<b>Mercy Corps/National Association of Business Women of Tajikistan</b>			
	ESF and MSDSP (Projects of Aga Khan Foundation)			

**Central Asia** *continued*

Country	NGOs	Microfinance Banks	Private Commercial Banks	Credit Unions and Cooperatives
Tajikistan <i>cont.</i>	NGO "Sitorai Najot"			
	NGO "Womens for Progress" / Central Asian Development Agency (CADA) Khujand Office			
Uzbekistan	<b>Business Women Association/ UNDP Uzbekistan</b>		<b>Joint-Stock Innovation-Commercial Bank Ipak Yuli</b>	
			<b>OAKB Hamkorbank</b>	

**Russia, Belarus, Ukraine**

Country	NGOs	Microfinance Banks	Private Commercial Banks	Credit Unions and Cooperatives
Russia	<b>Counterpart Enterprise Fund</b>	<b>KMB Bank</b>	Sberbank	<b>Raduga (Rainbow) Consumer Cooperative of Mutual Assistance</b>
	<b>FINCA Samara</b>		Far East Bank	<b>Credit Union Sodejstvije</b>
	<b>FORA-Fund for Support of Small Entrepreneurship</b>		NBD Bank	Russian Credit Union League
	NGO VOZMOZHNOST			
	Sakhalin Regional Micro-Credit Program			
	The Russian Women's Microfinance Network			
Belarus	Belarusian Fund for Financial Support of Entrepreneurs (BFFSE)		<b>PriorBank JSK</b>	
			<b>Belorussian-Russian Belgazprombank Joint Stock</b>	
Ukraine Association	Counterpart Meta Center	<b>Microfinance Bank Ukraine</b>	AVAL Bank	National of Ukrainian Credit Unions
	CREDO Association for Entrepreneurship and Development		Privat Bank	<b>CU Kasa Vzaimopomogy</b>
	<b>INTRON</b>		VA-Bank	<b>CU Women Mutual Help</b>
	<b>Local Fund of Small Entrepreneurship Support "Hope for Ukraine"</b>		Forum Bank	
	<b>SBEDIF Business Center</b>		Agiobank	
	Ukrainian Fund for Financial Development of Agriculture			

**Credit Unions** (data as of September 30, 2001)

<b>Country</b>	<b>Number of Credit Unions</b>	<b>Number of CU Members</b>
Bulgaria	13	11,067
Croatia	119	–
Georgia	79	8,956
Kyrgyzstan	206	12,544
Latvia	19	10,567
Lithuania	34	10,783
Macedonia	2	–
Moldova	206	20,968
Mongolia	86	2,116
Poland	640	481,800
Romania	4,304	1,570,424
Russia	62	26,080
Ukraine	122	111,493

## APPENDIX 5

### FUNDERS IDENTIFIED IN THE STUDY

Names of funders in bold are organizations that participated in the study.

1	Asian Development Bank (ADB)
2	<b>Blue Orchard Finance SA</b>
3	CARITAS
4	<b>CGAP, Consultative Group to Assist the Poor</b>
5	<b>Citigroup/Citigroup Foundation</b>
6	<b>Commerzbank AG</b>
7	Catholic Organisation for Relief and Development (CORDAID)
8	<b>Deutsche Investitions und Entwicklungsgesellschaft (DEG)</b>
9	<b>Department for International Development–UK (DFID)</b>
10	<b>Deutsche Bank Microcredit Development Fund</b>
11	<b>European Bank for Reconstruction and Development (EBRD)</b>
12	European Commission (EC)
13	<b>FMO-Netherlands Development Finance Company</b>
14	International Fund for Agricultural Development (IFAD)
15	<b>International Micro Investitionen AG (IMI)</b>
16	International Finance Corporation (IFC)
17	<b>Italian Government</b>
18	<b>Kreditanstalt für Wiederaufbau(KfW)</b>
19	<b>Norwegian Agency for Development Cooperation (NORAD)</b>
20	<b>Novib</b>
21	<b>Oikocredit</b>
22	<b>Opportunity Microcredit Fund-Eastern Europe</b>
23	<b>Open Society Institute (OSI)</b>
24	<b>PlaNet Finance</b>
25	Swedish International Development Agency (SIDA)
26	Swiss Agency for Development and Cooperation (SADC)
27	<b>Triodos Bank</b>
28	<b>United Nations High Commissioner for Refugees (UNHCR)</b>
29	United Nations Development Programme (UNDP)
30	<b>US Agency for International Development (USAID)</b>
31	US Bureau of Population, Refugees and Migration (BPRM)
32	US Department of Agriculture (USDA)
33	<b>World Bank</b>
34	World Vision



## APPENDIX 6

### FUNDER INFORMATION

NAME	CONTACT DETAILS	FUNDING INSTRUMENTS				TYPES OF MFIs FUNDED
		Loans	Grants	Equity	Guarantees	
<b>Blue Orchard Finance S.A.</b>	72, blvd St. Georges 1205 Geneva, Switzerland Tel: +41 22 781 6667 Fax: +41 22 781 6669 Jean-Philippe De Schrevel, Cédric Lombard cedric@blueorchard.ch http:// www.blueorchard.ch	<ul style="list-style-type: none"> <li>• Loan term: up to 3 years</li> <li>• Initial loan for 6-18 months in USD, no rollover facility, unsecured</li> <li>• Possible to sequence loans</li> <li>• Possibility of "bullet" payment at maturity</li> <li>• Interest rate: Libor 6M 4.5-9+% on US\$</li> </ul>			<ul style="list-style-type: none"> <li>• Loan as guarantee for local currency loan from local commercial bank</li> </ul>	<ul style="list-style-type: none"> <li>• NGOs</li> <li>• Non-bank financial institutions</li> <li>• Cooperatives</li> <li>• Banks</li> </ul>
<b>CGAP</b>	1818 H Street, NW, Washington, DC 20433 USA Tel: (1 202) 473 9594 Fax (1 202) 522 3744 Douglas Pearce dpearce1@worldbank.org www.cgap.org		<ul style="list-style-type: none"> <li>• CGAP now seeks to facilitate funding from its member donors, instead of acting as a sole funder. Grants to MFIs and networks are linked to performance criteria and in some cases are for TA.</li> <li>• CGAP-IFAD Pro-Poor Innovation Challenge: grants up to \$50,000 for pro-poor innovations. Minimal reporting but emphasis on lesson-learning for wider microfinance industry</li> </ul>			<ul style="list-style-type: none"> <li>• NGOs</li> <li>• Cooperatives</li> <li>• Microfinance banks</li> <li>• Non-bank financial institutions</li> </ul>
<b>Citigroup, Citigroup Foundation</b>	Citigroup, Inc. Center 850 Third Avenue, 13th Floor New York, NY 10022 USA Phone: (212) 559-1532 Fax: (212) 793-5944 Janet Thompson janet.thompson@citicorp.com www.citigroup.com		<ul style="list-style-type: none"> <li>• Operating expenses</li> <li>• Technical assistance</li> </ul>			NGOs



NAME	CONTACT DETAILS	FUNDING INSTRUMENTS				TYPES OF MFIs FUNDED
		Loans	Grants	Equity	Guarantees	
<b>Commerzbank AG</b>	Kaiserplatz D-60261 Frankfurt, Germany Tel (49 69) 136 20 Fax (49 69) 285 389 info@commerzbank.com www.commerzbank.de	<ul style="list-style-type: none"> <li>• Loan term: short term only</li> <li>• Interest: 15% in Euros after tax</li> </ul>	<ul style="list-style-type: none"> <li>• Restricted grants for training</li> </ul>	<ul style="list-style-type: none"> <li>• Minimum investment: 1 million Euros (in addition to managing international payments of these banks and their clients)</li> <li>• Max. shareholding: 20%</li> <li>• Investment period: indefinite</li> <li>• Expected return: 15% on Euros after tax</li> <li>• Strategic partnership (involvement in governance and institution building)</li> </ul>		<ul style="list-style-type: none"> <li>• Microfinance banks, preferably with known investors</li> </ul>
<b>Cordaid</b>	Cordaid Finance Business Unit P.O. Box 16440 2500 BK The Hague, The Netherlands Tel: 00 31 70 3136362 Fax: 00 31 70 3136301 cordaid@cordaid.nl www.cordaid.nl	<ul style="list-style-type: none"> <li>• Grace period: 18 months on principal payment</li> <li>• Interest: 7–8%</li> <li>• Payments: biannual</li> <li>• Collateral: lien on loan portfolio at 150% of the loan</li> </ul>				
<b>Deutsche Bank Microcredit Development Fund</b>	31 W 52 Street New York, NY 10019, USA Asad Mahmood asad.mahmood@db.com www.db.com/community	<ul style="list-style-type: none"> <li>• Loan serves as collateral to leverage loan capital from local commercial financial institutions</li> <li>• Cannot be used as working capital or on-lent</li> <li>• Interest: subsidized, 1–3% paid quarterly in arrears</li> <li>• Loan term: 3–8 years</li> <li>• Loan amount: US\$ 25,000–\$150,000</li> <li>• Principal payments deferred until maturity</li> </ul>				<ul style="list-style-type: none"> <li>• Finance companies</li> <li>• Credit cooperatives</li> <li>• Microfinance banks</li> <li>• Commercial banks</li> <li>• Investment funds</li> </ul>

NAME	CONTACT DETAILS	FUNDING INSTRUMENTS				TYPES OF MFIs FUNDED
		Loans	Grants	Equity	Guarantees	
<b>German Investment and Development Company (DEG)</b>	Business Relations Belvederstrasse 40 D-50933 Köln (Cologne) Postfach 45 03 40 D-50878 Köln (Cologne), Germany Tel: +49 2 21 49 86-0 Fax: +49 2 21 49 86-2 90 BusinessRelations@deginvest.de www.deginvest.de	<ul style="list-style-type: none"> <li>• Full-cost hard-currency loans</li> <li>• No subsidy (even for country risk)</li> </ul>		<ul style="list-style-type: none"> <li>• Max. shareholding: 25%</li> <li>• Investment period: 6–8 years</li> <li>• Expected return: 10–15% IRR</li> <li>• Exit strategy</li> <li>• Active involvement in governance)</li> </ul>		<ul style="list-style-type: none"> <li>• For-profit finance companies/non-bank financial institutions</li> <li>• Microfinance banks</li> <li>• Investment funds</li> <li>• NGOs on track to transform into formal financial institutions</li> </ul>
<b>Department for International Development (DFID)</b>	1 Palace Street London SW1E 5HE, United Kingdom Tel: +44 (0) 20 7023 0000 Fax: +44 (0) 20 7023 0019 Adrian Stone a-stone@dfid.gov.uk www.dfid.gov.uk		<ul style="list-style-type: none"> <li>• Operating expenses (until operational sustainability reached)</li> <li>• Technical assistance and training</li> <li>• Investment/fixed assets</li> <li>• Loan capital in start-up phases</li> </ul>			<ul style="list-style-type: none"> <li>• NGOs</li> <li>• Commercial banks</li> </ul>
<b>European Bank for Reconstruction and Development (EBRD) Group for Small Business)</b>	One Exchange Square London EC2A 2JN United Kingdom Tel: +44 20 7338 6000 Fax: +44 20 7338 6100 EBRD country offices on web site : www.ebrd.com	<ul style="list-style-type: none"> <li>• Loan term: 5–10 years</li> <li>• Interest: margin over market benchmark (eg, Libor)</li> </ul>	Technical assistance funding is available to EBRD from its shareholders to support project implementation	<ul style="list-style-type: none"> <li>• Max. shareholding: 35%</li> <li>• Investment period: 5–8 years</li> <li>• Expected return: risk adequate IRR</li> </ul>		<ul style="list-style-type: none"> <li>• MSE lending projects with local partner banks</li> <li>• Regulated microfinance institutions in formal banking sector</li> </ul>
<b>Netherlands Development Finance Company (FMO)</b>	PO Box 93060 2509 AB, The Hague, The Netherlands Tel: +31 70-314 96 96 Fax +31 70-324 61 87 info@fmo.nl www.fmo.nl	<ul style="list-style-type: none"> <li>• Loans in local currency or Euros or USD</li> <li>• Unsecured</li> <li>• Loan term: 5–7 years</li> <li>• Grace period: 12 months</li> <li>• Interest: market rates</li> </ul>	Restricted grants for technical assistance and training	<ul style="list-style-type: none"> <li>• Max. shareholding: 25%</li> <li>• Investment period: limited to 5–7 years with required exit strategy</li> <li>• Expected return: 10% on hard currency</li> <li>• Strategic partnership (involvement in governance and institution building)</li> </ul>	For local commercial banks	<ul style="list-style-type: none"> <li>• Supervised by central bank:</li> <li>• Non-bank financial institutions</li> <li>• Investment funds</li> <li>• Microfinance banks</li> <li>• Private commercial banks</li> </ul>

APPENDIX 6 *continued*

NAME	CONTACT DETAILS	FUNDING INSTRUMENTS				TYPES OF MFIs FUNDED
		Loans	Grants	Equity	Guarantees	
<b>Hivos-Triodos Fund</b>	Utrechtseweg 60 Postbus 55 3700 AB Zeist, The Netherlands Tel: 030 693 65 00, 030 693 65 90 Fax: 030 693 65 66 Bas Rekvelt Bas.Rekvelt@triodos.nl microfinance@triodos.nl www.triodos.com	<ul style="list-style-type: none"> <li>Loans in any currency</li> <li>Interest rates: include currency risk (10% in higher risk countries)</li> </ul>		<ul style="list-style-type: none"> <li>Max. shareholding: 5–10%</li> <li>Investment period: 5–7 years</li> <li>Expected return: 15% IRR (in EUR)</li> <li>Active involvement in governance</li> </ul>		<ul style="list-style-type: none"> <li>Microfinance banks</li> <li>Private commercial banks</li> </ul>
<b>International Finance Corporation (IFC)</b>	IFC regional office addresses on web site: <a href="http://www.ifc.org">www.ifc.org</a>	Interest: commercial rates	technical assistance	Each investment tailored to the needs of client and particular country context	Borrowing from commercial banks	<ul style="list-style-type: none"> <li>Specialised microfinance banks</li> <li>Commercial bank downscaling</li> <li>Transformation of NGOs</li> </ul>
<b>International Micro Investitionen AG (IMI)</b>	Am Eisernen Schlag 31 60431 Frankfurt am Main, Germany Tel: +49 69 95 14 37 0 Fax: +49 69 95 14 37 68 <a href="mailto:imi_ag@compuserve.com">imi_ag@compuserve.com</a> <a href="http://www.imi-ag.com">www.imi-ag.com</a>			<ul style="list-style-type: none"> <li>Investment period: unrestricted</li> <li>Expected return: 10–15% ROE after tax</li> <li>Strategic partnership, involvement in governance</li> </ul>		<ul style="list-style-type: none"> <li>For-profit finance companies</li> <li>Microfinance banks</li> </ul>
<b>Kreditanstalt f. r Wiederaufbau (KfW Group)</b>	Palmengartenstrasse 5-9 60325 Frankfurt am Main, Germany Tel: +49 0 69 74 31-0 Fax: +49 0 69 74 31 29 44 Arlina Tarigan-Sibero <a href="mailto:Arlina.Tarigan@kfw.de">Arlina.Tarigan@kfw.de</a>	<ul style="list-style-type: none"> <li>Loan term: concessionary to the government which on-lends on near market terms to partner banks</li> <li>Direct loans to partner banks-initially subsidized or at near market rates</li> <li>Gradual increase of loan conditions to market rates</li> </ul>	<ul style="list-style-type: none"> <li>Consulting services</li> </ul>		When local banks borrow from foreign commercial banks	<ul style="list-style-type: none"> <li>NGOs</li> <li>Microfinance banks (where KfW holds equity stakes on behalf of various donors)</li> <li>Private commercial banks</li> </ul>
<b>Novib</b>	Mauritskade 9, P.O.Box 30919, The Haag, The Netherlands Vincent Pinkster <a href="mailto:vincent.pinkster@novib.nl">vincent.pinkster@novib.nl</a>	<ul style="list-style-type: none"> <li>Interest: subsidized and near market rates</li> </ul>	<ul style="list-style-type: none"> <li>Operating expenses</li> <li>Technical assistance and training</li> <li>Investment</li> <li>Loan capital</li> </ul>		Borrowing from foreign commercial banks	<ul style="list-style-type: none"> <li>NGOs</li> <li>Credit cooperatives</li> </ul>

NAME	CONTACT DETAILS	FUNDING INSTRUMENTS				TYPES OF MFIs FUNDED
		Loans	Grants	Equity	Guarantees	
<b>Opportunity Microcredit Fund–Eastern Europe</b>	Opportunity International Eastern Europe Dapontegasse 2 Vienna, Austria Tel: (43 1) 715 2589 Fax: (43 1) 715 2588 Ken Vander Weele 100746.3540@compuserve.com	• Interest: near market rates		<ul style="list-style-type: none"> <li>• Max. shareholding: 100%</li> <li>• Investment period: 10+ years</li> <li>• Expected return: 10-20% annually</li> </ul>	Borrowing from foreign commercial banks	<ul style="list-style-type: none"> <li>• OI partners</li> <li>• For-profit finance companies</li> <li>• Non-bank financial institutions</li> <li>• Credit cooperatives</li> </ul>
<b>Oikocredit (Ecumenical Development Cooperative Society UA)</b>	Oikocredit International Support Office Tesselschadeaan 4 3818 WD Amersfoort The Netherlands Tel.: +31 33 422 40 40 Fax: +31 33 465 03 36 office.eu@oikocredit.org www.oikocredit.org	<ul style="list-style-type: none"> <li>• Loan size: 50,000–2 million Euros</li> <li>• Interest: 9% on Euro</li> <li>• Loan term: 5–7 years</li> <li>• Grace period: 2–3 years on principal payments</li> <li>• Collateral requirements: tailored</li> </ul>				<ul style="list-style-type: none"> <li>• Credit cooperatives</li> <li>• NGOs</li> <li>• MFI 1 bank</li> </ul>
<b>Open Society Institute (OSI)</b>	Open Society Institute 400 West 59th Street New York, NY 10019 USA Tel: +212 548 0600 Fax: +212 548 4651 Neal Delaurentis ndelaurentis@sorosny.org www.soros.org/osi	• Interest: near and market rates		<ul style="list-style-type: none"> <li>• Max. shareholding: below 50%</li> <li>• Investment period: 5 years</li> <li>• Strategic partner, active in governance</li> </ul>	Borrowing from local and foreign commercial banks	<ul style="list-style-type: none"> <li>• NGOs</li> <li>• For-profit finance companies</li> <li>• Credit cooperatives</li> <li>• Microfinance banks</li> <li>• Private commercial banks</li> <li>• Investment funds</li> <li>• Specialized SME banks</li> </ul>
<b>PlaNet Finance</b>	76 rue du Faubourg Saint Denis 75 010 Paris, France Tel : +33 1 53 24 31 31 Fax : +33 1 53 24 11 57 Arnaud Ventura aventura@planetfinance.org www.planetfinance.org	• Interest: near market rates				<ul style="list-style-type: none"> <li>• Small MFIs needing credit funds through the Revolving Credit Fund</li> </ul>

NAME	CONTACT DETAILS	FUNDING INSTRUMENTS				TYPES OF MFIs FUNDED
		Loans	Grants	Equity	Guarantees	
<b>Triodos-Doen Foundation</b>	Utrechtseweg 60 Postbus 55 3700 AB Zeist, The Netherlands Tel: 030 693 65 00, 030 693 65 90 Fax: 030 693 65 66 Bas Rekveld Bas.Rekveld@triodos.nl microfinance@triodos.nl www.triodos.com	<ul style="list-style-type: none"> <li>Loans in any currency</li> <li>Interest rates include currency risk (10% in higher risk countries)</li> </ul>		<ul style="list-style-type: none"> <li>Max. shareholding: 5–10%</li> <li>Investment period: 5–7 years</li> <li>Expected return: 15% IRR (in EUR)</li> <li>Active involvement in governance</li> </ul>		<ul style="list-style-type: none"> <li>Microfinance banks</li> <li>Private commercial banks</li> </ul>
<b>United Nations High Commissioner for Refugees (UNHCR)</b>	Krunska 58 Belgrade, Yugoslavia tel: (381 11) 444 1196 fax: (381 11) 459 165 Milos Terzan terzan@unhcr.ch		<ul style="list-style-type: none"> <li>Operating expenses</li> <li>Technical assistance and training</li> <li>Investment</li> <li>Loan capital</li> <li>Targeted geographic location</li> <li>Target population</li> </ul>			<ul style="list-style-type: none"> <li>NGOs</li> </ul>
<b>United States Agency for International Development (USAID)</b>	Office of Microenterprise Development 1300 Pennsylvania Ave, NW Washington, DC 20523 USA Tel: +01 202 712 0030 Fax: +01 202 216 3228 Elizabeth Hunt ehunt@usaid.gov www.mip.org		<ul style="list-style-type: none"> <li>Individual grants may emphasize specific purposes</li> <li>Unrestricted at overall level of planning</li> </ul>		Borrowing from local and foreign commercial banks	<ul style="list-style-type: none"> <li>NGOs</li> <li>Non-bank financial institutions</li> <li>Credit cooperatives</li> <li>specialized Microfinance banks</li> <li>Private commercial banks</li> <li>Investment funds</li> </ul>
<b>World Bank</b>	Country and regional office addresses on web site: www.worldbank.org	<ul style="list-style-type: none"> <li>Interest: near market rates</li> <li>Subsidized (&lt;Libor)</li> </ul>	<ul style="list-style-type: none"> <li>Operating expenses</li> <li>Technical assistance and training</li> <li>Investment/fixd assets</li> <li>Target population group</li> </ul>			<ul style="list-style-type: none"> <li>NGOs</li> <li>For-profit finance companies</li> <li>Non-bank financial institutions</li> <li>Credit cooperatives</li> <li>Private commercial banks</li> <li>Investment funds</li> </ul>

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