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BOSNIA AND HERZEGOVINA

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

BY TIMOTHY LYMAN, SENIOR POLICY ADVISOR AT CGAP C/O WORLD BANK

The Microcredit Organizations Law (2000–2001)

Recommendations of the Local Initiatives Project

The begrudging acquiescence of Entity-level policymakers to the use of a hodgepodge of different kinds of NGOs as vehicles for microlending was not an adequate legal basis on which to build a strong start for microfinance in Bosnia. The legal reform component of the Local Initiatives Project (which sought to create the preconditions for a strong microfinance sector at a national level) recommended the development of four new legal forms:

- A form of nonprofit, NGO microcredit organization.
- A form of commercial finance company capable of serving as a vehicle for specialized commercial microlending, but not restricted to this activity.
- A form of member-owned and governed savings and credit association (a feature of the former Yugoslav financial system, although somewhat discredited in the eyes of some who had lost their savings to failed employer-linked savings and credit associations from before the war).

- Possibly a specialized form of microfinance bank (if banking legislation and regulation developed in such a way as to prevent the use of conventional commercial banks for a full range of microfinance services).

Drafting

of the microcredit organizations laws

The legal and regulatory aspirations of the Local Initiatives Project proved grandiose in light of the political realities of early postwar Bosnia. The new draft banking law for the Federation (on which, it was hoped, a new law for the RS would be closely patterned) initially included a provision that would have permitted the four proposed legal forms to be defined under the banking law as nonbank financial institutions (NBFIs) described in normative acts adopted by the Banking Agency. However, the provision permitting such regulatory exceptions for NBFIs was dropped from the version of the law finally adopted. Instead, consultants to the USAID-financed Banking Supervision Project drafted proposed legislative text and amendments to the new banking law aimed at describing the four planned legal forms on Local Initiatives Project's behalf.

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As the project progressed, however, it became clear that only a more limited legislative agenda would have any hope of adoption by both Entity-level parliaments. A choice was therefore made to focus only on legislation to clarify the legality of NGO microcredit of the type already widely in practice throughout the country. Because of the chaotic and ambiguous state of NGO law in the two Entities (and the lack of harmony between the legal forms in question), the draft law called for the introduction of a wholly new form of ownerless nonprofit legal entity set up solely for the purpose of microlending: the microcredit organization ("MCO").

A Federation Ministry of Finance lawyer, who also advised the Local Initiatives Project, together with Local Initiatives Project staff and advisors substantially revised the draft MCO law before it was introduced in the Federation parliament. The goal was a law that could be adopted in substantially identical form in the two Entities, with provisions for reciprocity between the two Entities so that MCOs registered in one Entity could also open offices and operate freely in the other Entity. The goal was also a simple system of registration and minimal ongoing nonprudential regulation of MCOs (which, although they were to be permitted to borrow commercially for onlending, were not to be permitted to mobilize retail deposits). The Ministry of Finance was identified as the most suitable Entity-level regulatory body for the light regulatory responsibilities envisioned.

The MCO laws as adopted

The MCO law passed the Federation parliament in 2000 and the RS parliament in 2001. Unfortunately, during parliamentary debate in the Federation, parliamentarians replaced the Ministry of Finance with the Ministry of Social Affairs as the regulatory body responsible for MCOs – a ministry entirely without any relevant competence or personnel knowledgeable about finance. Also, Ministry of Finance personnel in the RS insisted on certain other features not included in the version that had been adopted in the Federation. In particular, the version adopted in the RS reserved for the Ministry of Finance unspecified supervisory jurisdiction over MCOs operating in that Entity, as well as the power to adopt regulations further defining such important concepts as loan size maximums.

Despite these differences, the two MCO laws jointly accomplished something pioneering for the country at the time: a system of reciprocity that made it possible for a legal entity formed in one Entity to be registered also to carry out business in the other Entity. (This milestone was only

finally reached for banks with the imposition of a new banking law in RS by OHR, when the RS parliament refused to adopt a law granting clear reciprocity to Federation-licensed banks.)

Shortcomings with the MCO laws

Although the reciprocity provisions of the MCO laws made possible the development of a truly national microcredit sector (an important symbolic occurrence in the overall development of Bosnia as a workable "single economic space"), the lack of harmony between the two regulatory regimes caused problems for nationally active MCOs in practice. In the Federation, the Ministry of Social Affairs failed to exercise any form of regulation over the fast-developing sector (permitting, for example, numerous phantom MCOs that had fulfilled the minimal prerequisites for registration to remain on the registration books, even though they never became operational). The sector in the Federation therefore depended exclusively on monitoring and reporting by the Local Initiatives Project as the only source of publicly available benchmarking data (and these data were inadequate, as they did not include several sizeable Federation registered MCOs that did not participate in Local Initiatives Project funding and therefore did not report to the Federation apex). In the RS, the Ministry of Finance involved itself more in the monitoring of MCOs than the MCOs felt appropriate – including in some cases on-site inspections that were not contemplated at the time of the MCO law's passage in RS. Meanwhile, the Ministry of Finance itself complained that its supervisory responsibilities were too vaguely defined (indeed they were not defined at all), that the Ministry lacked the personnel to carry out any meaningful form of supervision, and that the law failed to give them appropriate enforcement powers with respect to problems they did find (such as the phantom MCOs that also existed on the registration rolls in RS).

Developments in the Broader Financial System (2002–2003)

Development of strong Banking Agencies and cleanup of banking sector; privatization of the payment system

The two Banking Agencies developed as strong and independent bodies, with increasingly capable and professional supervisory staff. This development was instrumental in the cleanup of the Bosnian banking sector. It also helped the banks to have entrusted to them the main retail role in the privatization of the payment system, which took place with dismantling of

the former government-controlled sole-source payment services provider in each Entity.

Entry of foreign banks and rapid increase in savings mobilization and liquidity

Along with the strengthening of the banking sector came the first significant wave of new foreign banks receiving licenses to operate in Bosnia. Although formed as domestic Bosnian joint stock companies (in one Entity or the other), as required by the Entity-level banking laws, strong foreign financial services "brands" such as Raiffeisen and Hypo-Alpe-Adria seemed to inspire greater confidence among potential savers than the old Bosnia names that many people still associated with the loss of their savings during the war years. This new confidence led to a sharp upsurge in liquidity in the banking sector as a whole.

Emergence of a credit information services industry

Another development of significance during this period was the launching of a private credit bureau, LRC. Patterned on the U.S. model, where an extremely broad range of data is collected (including not just defaults in payments on bank loans but also positive data such as on-time utility payment and mobile telephone bills), the credit reports offered by LRC have a significant likelihood of being useful to MCOs and their potential clients alike. Although growth in participation by MCOs was slow at first, the system nonetheless offered a potentially workable mechanism to combat serious cross-borrowing and over-indebtedness problems as competition in the microcredit sector became more acute.

Effects of these developments on microfinance

Some strong banks, led by Raiffeisen, began lending to MCOs for onlending¹ – something permitted under the MCO law in both Entities – rather than compete with MCOs for the retail small loan market. (Despite this new source of lending capital, many MCOs also had access to as good or better deals from foreign social investment sources, an illustration of how donor funding can crowd out commercial capital.) Other banks looked with interest at the successful track records of the MCOs with small retail lending and began to use their newfound liquidity to offer competing products. As the retail market became more competitive, MCOs began increasingly to see their bank partners (upon whom they depend for access to the privatized payment system) as competitors, and began to resent the absence of any meaningful protection against

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client poaching by their own banks. (Some would of course argue that this competition is a sign of the success of the microcredit sector, although others might counter that banks' use of their MCO customers' confidential information gives them an unfair competitive advantage.)

However, still no Bosnian bank was successfully focusing on savings services for the poor, although a USAID-sponsored study projected strong demand. Legally prohibited from savings mobilization, some MCOs began to see this restriction – along with lack of legal capacity to participate directly in the payment system – as a significant disadvantage to their legal status.

Maturing of the Market and Consolidation of Financial System Legislation and Regulation at the State Level – Prognosis for the Future (2004 into the Future)

Transformation of MCOs?

By 2004, the last full calendar year of the second Local Initiatives Project, most in the Bosnian microcredit sector agreed on the need for there to be a legally feasible means “transforming” the existing nonprofit MCOs into a commercial legal form². However, given the MCOs' growing success in attracting wholesale debt financing to increase their lending (and their strong balance sheet position to do so given the large equity grants most had received), the reasons for wanting a “transformation” option were not as pressing as in some countries, where dwindling access to funding or doubts about the legal basis for wholesale borrowing for unlicensed onlending have made the need for such “transformations” truly urgent. Moreover, some Bosnian MCOs questioned vocally the “conventional wisdom” that they would need to take on a commercial legal form to survive and prosper long-term. A strong consensus emerged that the MCO laws should be amended to permit MCOs to form commercial microlending affiliates, but that they should also be given the training to make intelligent choices about whether to undertake such a change.

Savings and credit associations: an old idea reborn?

Besides the demand for a commercial microlending vehicle (one of the legal forms originally proposed under the legal reform component of the first Local Initiatives Project), an IFAD project launched in 2003 focused on rural finance and raised again the idea of a legal vehicle for savings and credit associations (another of the legal forms originally contemplated during the first Local

Initiatives Project, and a legal form well-known – if not necessarily widely respected – from the Yugoslav period). However, the IFAD project also apparently underestimated the technical and political challenges of drafting and passing the requisite enabling legislation. Moreover, the response from MCOs (which the IFAD project had contemplated as implementing partners) and the Banking Agencies (who worried about the proliferation of small, difficult-to-supervise depository institutions in the newly cleaned-up financial system) has been skeptical.

Move towards unified and consolidated financial system regulation and supervision

Perhaps the most far-reaching current trend affecting the legal and regulatory treatment of microfinance in Bosnia, however, is not the possibility of new Entity-level legal forms. Rather, it lies in plans to create unified and consolidated mechanisms for oversight of the entire Bosnian financial system under the auspices of the state-level Central Bank, all with the objective of better realizing the goal of uniting the country into a single, workable economic space. To prepare for this evolution, the Banking Agencies have already taken steps to standardize their procedures and coordinate their supervisory activities (particularly with respect to banks operating in both Entities). Ultimately, the plan is to provide some sort of common umbrella over all regulatory aspects of the financial system, including, in addition to banks, insurance and private pensions, leasing companies and the securities market. Given the provisions of the Bosnian Constitution that vest authority for these matters at the Entity level, it is not yet clear exactly how this state-level consolidation of regulatory and supervisory jurisdiction will be implemented. However, the Entities have the power to cede their constitutional authority to the state level, and it might well be that OHR would see fit to encourage them in this direction, if failure to do so impedes Bosnia's continuing development into a unified economic space. However the change is ultimately accomplished, it is also anticipated that it will be accompanied by a migration of some (and maybe most) of the current Entity-level commercial law (such as the banking law) up to the state level.

The new draft MCO law(s)

A broad consensus has emerged to replace the Entity-level MCO laws of five years ago with a new law that will address the disharmony and other shortcomings of the current laws and permit the current MCOs to “transform” into

a commercial legal form or retain their nonprofit form, should they so choose. Owing to legal uncertainty as to whether commercial laws such as the MCO law will have migrated up to the state level, draft Entity-level legislation has been prepared that can be adapted for adoption at the state level if needed. In any event, the contemplation is that the regulatory body for MCOs should be the state-level Central Bank. (The Entity-level Banking Agencies would be the second choice if state-level unification has not progressed, because the Ministries of Finance in both Entities concede freely that they lack the necessary human resources to implement an appropriate transparency-driven monitoring system for MCOs.) The new draft MCO law addresses perceived need for “transformation” options by permitting a class of commercial MCOs, as well as NGO MCOs (relying on the companies laws and foundations laws, respectively, at the Entity level for the creation of the underlying legal entities, as these basic enabling laws are now in relatively good shape in both Entities). The draft also eliminates the various other differences between two current Entity-level MCO laws. Importantly, it is anticipated that any commercial MCO formed as a joint stock company could be licensed as a commercial bank if it can meet the required level of initial minimum capital and other prudential prerequisites for bank licensure. This will permit a smooth legal and regulatory evolution for MCOs from their current nonprofit status ultimately into deposit-taking institutions with power also to offer payment services.

Prognosis for the future

It is likely that some of the larger MCOs will decide to undergo a commercial “transformation” once the legal opportunity to do so is made available. If USAID's consultants are right about unmet demand for savings services among poor Bosnians, eventually one or more will probably also seek to team up with or become a commercial bank. While it is still far from certain whether the IFAD project will succeed in gaining passage of a law on savings and credit associations, it seems likely that all of the other legal options originally envisioned in 1998 for carrying out microfinance in Bosnia will eventually be put in place. ■

¹ Many MCOs, including all of the participants in the Local Initiatives Project, had received sizable equity grants from their sponsors, putting them in a strong balance sheet position as potential borrowers.

² The term “transformation” is used here to refer to a transfer of an MCO's loan portfolio to a commercial legal entity in exchange for shares or other consideration.

ALBANIA

Regulation and Supervision of Albania's Microfinance Industry

BY MICHAEL GANNON, IRISH FRIENDS OF ALBANIA

Introduction

Microfinance in Albania has been a very important part of economic development for the last 15 years. In the early 1990s, MFIs entering Albania functioned as quasi-governmental agencies with no state supervision. Over the past 15 years, the microfinance sector has become a part of the financial market. During this period, Albanian MFIs obtained high levels of loan repayment. It is remarkable that microfinance institutions in Albania retained their base at time of crises in loan repayments that led to downfall of one major state-owned bank. In fact, the good state of Albanian MFIs was the impetus for negotiations with the Bank of Albania (BoA) to obtain regulatory and supervisory system suitable to their needs.

Today, Albania's microfinance industry is shaped by 10 institutions: seven MFIs and three commercial banks with microfinance portfolios. The total number of clients is 34,500; they borrow approximately \$50 million. The microfinance institutions and commercial banks involved in microfinance activity serve 2% of Albania population (6% of the households in more than 80% of the regions of the country).

Development of Microfinance Regulation

The first development in state supervision of microfinance was initiated by the World Bank in 1998. Major cooperation between government of Albania, donors and beneficiaries resulted in the redrafting of the Law for Savings and Credit Associations (SCAs). The new Law for SCAs of 2001 resulted in the delegation of licensing of SCAs to the Bank of Albania, and acknowledgment of the monitoring and financial role of the Union.

In 2003, the Bank of Albania updated its licensing regulation for Non-Banking Financial Institutions (NBFIs). The new regulation permitted NBFIs to offer a broad scope of financial services, including: lending, money transfers, foreign exchange and safe facilities. Each MFI that wants to become an NBFi must meet requirement of minimal capital of approximately \$1 million. This

capital must be in cash and is therefore burdensome for the currently active MFIs. In addition, registering under NBFi regulation brings with it the duty of tax reporting. BoA does not collect taxes but we assume that it would consider non payment of taxes as a serious misbehaviour. Assumption of a tax liability is a major disincentive for MFIs to come under BoA regulation. If MFI are registered as non profit organisations they are tax exempt.

A specific law for other types of MFIs was not enacted as they may not collect deposits. (From the outset, deposit taking and non-deposit taking MFIs were understood to be different and distinct types of institutions.) The main concern of Bank of Albania regarding MFIs is to have them report on their lending activities.

Bank of Albania Capacity to Regulate MFIs

The first step of the BoA to reform microfinance regulation (taken in 1998) was the delegation of two specialists from its Supervisory Department to be interlocutors with the MFIs. The supervision of non-deposit taking MFIs included analysis of the three MFIs with formal status with the BoA. These were 3 MFIs which has permission to operate from the Minister of Finance. The analyzed MFIs showed consistently improving loan repayment rates and have very high levels of capitalization.

The Supervisory Department of the BoA and its consultants accept microfinance regulation and supervision within the overall work program and

staffing structure of the Department (although the BoA does not recover any of the cost of supervision of microfinance)¹. However, the Bank of Albania has been much more involved in drafting regulations for deposit-taking MFIs than for non-deposit taking MFIs. The BoA commenced the internal process of drafting and approving the SCA Licensing and Supervisory Regulations of 2002. To achieve the minimum level of supervision, the BoA involved six other supervisory staff at different times.

Commercial Banks in the Microfinance Market

The Bank of Albania saw the microfinance sector as one with enormous growth potential, which if managed and supervised well, can benefit a large proportion of the population. The banks have entered the microfinance market in Albania and may become the largest actors in this market in the next few years. In fact, the latest development of microfinance in Albania is due to entering commercial banks to the market². ProCredit Bank is a leader of micro-loans. Given the activity of commercial banks, which may become the largest actors in this market in the next few years, the BoA must gain accurate information from commercial banks about their loan activity in order to launch regulations distinguishing microfinance loans, consumer loans, housing loans and other types of loans.

The BoA strategy of developing its supervisory staff is essential taking into consideration the fact that commercial banks are to develop the

GRAPH 1: STRENGTHS AND WEAKNESSES OF CURRENT REGULATORY SYSTEM

Strengths	Weaknesses
<ul style="list-style-type: none"> ■ The representative and financial role which Unions of SCAs have for their members. ■ The Union may also provide some of the key support services which the SCAs need. ■ Capitalization requirements for SCAs are low enough to commence activity "from zero". Minimum capital is zero, and the members dues can be refunded under certain circumstances, e.g. if the member leaves for good. ■ This system encourages grass roots development of SCAs. ■ A minimum capital leverage ratio of 10%, is low enough to allow MFIs to access considerable levels of funding. 	<ul style="list-style-type: none"> ■ The Unions have right to monitor their members SCAs (i.e. they monitor themselves). ■ BoA regulation has allowed SCAs to build 'members capital', this is non-institutional capital that members may withdraw if they leave the SCA. ■ The maximum single loan size permitted is 10% of gross loans, this is high. ■ The high entry threshold for BoA licensing, when there are no entry thresholds for NGOs or legal persons to commence MF activity, results in the continuation of MF under those structures.

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microfinance market. The inspections of BoA in MFIs and commercial banks show differences in the fields of institutional culture, strategy and level of quality of provided services. The BoA ensures that MFIs and commercial banks work within a well supervised and regulated system that makes them efficient.

Development of MFIs in the future

All Albanian MFIs proclaim that they exist to fund the development of micro-business in Albania, and for no other reason. But consumer loans cannot be ignored by MFIs because the same clients who have micro-business will seek consumer loans, and may prefer to use their MFI than the bank. The second reason for offering other types of loan is that it can be economically viable to grant, for instance, education or training loans.

A shift in lending policy and the development of new products among the MFIs is very probable. MFIs define themselves by the level of loan that they lend to the client. Loan limits have stayed under \$30,000 and average loan size has remained a fraction of that. The BoA

has not constrained MFI activity but intends to launch a monitoring system to be aware of the nature of the MFIs' loan portfolios, both in terms of loan size and purpose.

It is obvious that MFIs credit policy will depend on level of funds they have at disposal and the sources of these funds. (Although Albanian MFIs are steadily growing, their activity still depends on donors support.) Swift growth of MFIs by developing new products, including large loans, will be plausible only by collection of local deposits. To collect deposits, MFIs must operate with a banking license or become SCAs. The first MFI which transformed to banking status is the Mountain Area Finance Fund. MAFF has plans to transform to a Bank, but central to these plan is the merger of MAFF with other MFIs in order to achieve the scale needed to become a bank.

Regarding the development of SCAs, a series of mergers and acquisitions are already taking place. These mergers have also cultural significance. A few years ago, neighbouring villages would not work with one another to establish one large SCA. The training and experience of SCA development has brought the villages closer together in the past few years and now neighbouring villages merge together.

It must be pointed out that Albania is over-supplied with providers. That is why the BoA intends to implement requirements for entry into the banking and NGO market. The most effective constraint for new banks is increasing the minimum capital requirement. But on the other hand such restrain can plausibly discourage new small MFIs from entering the Albanian market or transforming into a bank.

The Bank of Albania is seeking the compliance of each MFI with its regulations and strongly supports MFIs' inclusion in financial sector reform. In January 2005, the seven MFIs established a national representative organization to pursue issues of common interests such as participation of MFIs in national deposit insurance scheme or founding a Credit Information Bureau in Albania. BoA finds that such initiatives will be a great contribution to the process of creating an inclusive financial sector. ■

1 BoA specialists have been enthusiastic about supervising microfinance, but they wish to continue also their roles of supervising the banking system and do not want to work exclusively with microfinance.

2 Commercial banks tend to classify micro-lending as loans below \$10,000, which is much lower than the maximum loan of the MFIs.

ARMENIA

Armenian Microfinance Legal and Regulatory Update

BY CHRYSANTHOS MILIARAS AND MONICA HARUTYUNYAN¹, CHIEF OF PARTY AT USAID/ ARMENIA MICRO DEVELOPMENT INITIATIVE (MEDI), LEGAL SPECIALIST AT MEDI

For the past two years the USAID/Armenia Micro Enterprise Development Initiative (MEDI) has been actively working towards clarifying and improving the legal and regulatory environment for microfinance in Armenia. Today, we are pleased to report that MEDI is about to achieve this critical goal, the realization of which has enormous positive implications for the future development and expansion of microfinance in Armenia.

Since MEDI last reported on this effort in the May 2004 issue of the Policy Monitor, a great deal has occurred. Specifically, at the time of the last article, the main issue facing MEDI's efforts in this area surrounded who would regulate microfinance, as opposed to how it would be regulated. (The two potential regulators,

the Ministry of Finance and Economy and the Central Bank of Armenia (CBA), both agreed to the general principle that non-depository microfinance in Armenia should be regulated in a non-prudential manner.) In short, this was an issue that the Government of Armenia needed to resolve internally and MEDI went out of its way not to recommend one government body over the other, so long as any new regulations or laws that were developed were based on global best practices as defined by CGAP.

MEDI was able to help break the above deadlock by coordinating closely with the World Bank. This collaboration directly resulted in the World Bank making the improvement of the enabling environment for microfinance a conditional of its \$20 million Poverty Reduc-

tion Support Credit to the Government of Armenia, which was signed in October 2004. This conditionality provided the Armenian government with an incentive to swiftly select a microfinance regulator (it chose the CBA) so that the all-important work of developing the specific regulations could commence with sufficient time for the government to fulfill its obligation to the World Bank.

In early 2005, the CBA appointed MEDI to facilitate a working group comprised of three of Armenia's leading micro credit organizations: MDF-Kamurj, UMCOR Aregak, and World Vision's SEF. In keeping with its role of honest broker, MEDI acted as a conduit between the CBA, the working group, and the World Bank,

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RUSSIAN FEDERATION

Microfinance and Macroregulation

BY ANNA BAITENOVA, LEGAL ADVISOR AT RUSSIAN MICROFINANCE CENTER

The microfinance market in Russia is developing and therefore provides additional incentives for the improvement of the legal framework.

Today there are many legal provisions in Russia regulating the microfinance activity, although the concept of microfinance is not specifically articulated in Russian law.

Traditionally, according to UNDP, microfinance is the provision of a wide spectrum of financial services, such as loans, deposits, settlements, insurance, etc., for household, individual businessmen and microenterprises with low income. Thus, the financial aspect of microfinance is as important as the social aspect.

In present day, Russia microfinance services are being provided both by commercial entities (banks and other credit providers, although the banks are mainly focused on big loans) and non-commercial entities (consumer credit cooperatives, small business support funds, SME mutual insurance societies, non-commercial partnerships)¹. The large number of these organizations reflects both a degree of legal regulation of the organizations and the degree of interest in the development of microfinance activity.

Non-Bank Credit Organizations and Non-Bank Deposit-Credit Organizations

The activity of non-bank credit organizations (i.e., a commercial entity that carries out some but not all banking activities) is regulated by the Law "On banks and banking activities in RF". The formation of non-bank credit organizations providing depositary and credit services as regular financial intermediaries in limited segments of the financial service market was recognized in the joint statement of the Government of the Russian Federation and Bank of Russia dated December 30, 2001 "On development strategy of banking sector in Russian Federation" as one of the strategic directions of banking sector development in Russia that year. However, there are very few of these organizations (a couple of dozens) – the majority are settlement credit

organizations, there are some encashment organizations and only one non-bank deposit-credit organization (NBDCI), the Women Microfinance Network, which was founded on the basis of a non-commercial partnership (notwithstanding the 2001 resolution of the Bank of Russia No 153-P "On prudential regulations of activity of non-bank credit organizations providing depositary and credit services.")

The main feature of NBDCI is its simplified list of permitted activities and transactions (when compared to banks). In addition, the statutory capital and reporting requirements are also less when compared to that applicable to banks. However specific features of microfinance activity were not taken into account in the NBDCI regulation (in particular, the large number of individuals in remote areas who require finance services). Recently the working group on the improvement of legal regulation of NBDCIs was formed by the Interdepartmental Microfinance Council together with the Ministry of Economy and Trade (with the participation of representatives of other ministries and departments and public institutions).

Non-Commercial Organizations Cooperatives

The main players in the Russian microfinance market are non-commercial organizations. The majority of them (over one thousand) are consumer cooperatives. Basic regulations on consumer cooperatives are stipulated by the Civil Code, the main source of civil rights in Russia. Consumer credit cooperatives serve only their own members and are focused as a rule on providing small loans, which corresponds their organizational status and objectives of mutual financial support. For certain consumer cooperatives, additional laws apply. For example, traditional consumer cooperatives (i.e., for procurement, trading, etc.) are regulated by the Law "On consumer cooperation (consumer societies or unions) in Russian Federation." This law allows providing loans and cash advances for

its members and permits deposit-taking from both members and from the public. However, it does not stipulate provisions aimed at protection of this activity, and does not apply to specialized credit cooperatives. Nevertheless, many Russian microfinance organizations are registered under this law as it does not restrict the number of members of cooperative society nor the provision of loans to entrepreneurs and it establishes an acceptable quorum for the general meeting of members (i.e., a simple majority – 50 percent plus one vote).

The federal law "On consumer credit cooperative societies" regulates the formation and activities of consumer credit cooperative societies formed only by individuals. The law provides for a specific kind of activity of cooperative society: mutual financial assistance, meaning accumulating the personal funds of members and granting loans only to members. In addition, the law includes provisions limiting the investment of shareholders funds in order to ensure financial safety of cooperative society and its members. However, certain provisions of the Law are unnecessary in their limitation: the limitation on the number of shareholders (no more than 2000 person), the quorum of general meeting (not less than 70% of all shareholders enlisted should be present physically at the assembly, which constitutes difficulties for large cooperatives), the limitation on loan amounts for enterprise purposes (no more than half of the mutual financial assistance fund). The League of Credit Unions has prepared for submission to the State Duma a draft federal law that includes changes and amendments to the Law "On consumer credit cooperative societies" in order to remove these unreasonable restrictions and to enhance other provisions of the law.

Simultaneously the Union of rural credit cooperative societies is working on amendments to the federal law "On agricultural cooperation." This law, taking into account peculiarities of rural life, permits membership by individuals and legal entities (i.e., agricultural manufacturers), but duplicates provisions from the law "On consumer credit cooperative societies", guarding financial safety and protection of interests of cooperative society shareholders. The work on amendments of the aforementioned Law is under way

The federal law "On agricultural cooperation", even taking into account amendments already introduced dealing with the peculiarities of credit consumer co-operative societies, still not follows these peculiarities in the full extent. In particular, it's stipulated, that only members of agricultural organizations or their employees can

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be members of consumer co-operative societies. Thus the number of the members of co-operative which are not being the agricultural producers, should not exceed 20% from the number of the members of consumer co-operative being the agricultural producers. However there are a lot of people wishing to join credit consumer co-operative society and not residing in rural areas, among them pensioners, teachers, nurses, municipal workers, and also entrepreneurs, engaged in providing various public services and trade, etc. The law enables them to be enrolled as associate members without violating established proportions, however the representation rate of associate members on general meeting is limited by 20% of the number of the members of co-operative and does not depend at all on number of the associate members. Such a mechanism violates basic principles of credit cooperation – principle of equality of all the members of co-operative society in decision making.

The draft of the federal law “On agricultural cooperation” was adopted in the first reading, which is approved conceptually, it was introduced by the group of State Duma of Russian Federation representatives. However draft law not only does not resolve above mentioned problems, but rises new questions. In particular, it stipulates limitation on the use of the words “rural” and “agricultural” in the title of the cooperative, if the co-operative does not meet requirements of the law “On agricultural cooperation”. However the concept “rural” is wider, than the concept “agricultural”, in some regions of Russia the agriculture is not developed, but the region is considered to be rural and organizations operating there are supported by the government, introducing such a limitation will deprive them of this opportunity. There are also other issues.

All this demonstrates the necessity both to eliminate the oversights of the introduced draft law, and to improve law in terms of development of rural credit cooperation. Rural credit cooperation development fund and Union of rural credit co-operatives are working toward developing appropriate drafts.

Meanwhile there are new types of cooperative societies engaged in the provision of credit consumer which are only regulated by the Civil Code as (i) they are not rural, (ii) their members include both individuals and enterprises and (iii) they are not engaged in any other activities traditional for consumer cooperative societies activity besides lending.

No doubt, it's easy to get away from the regulation of special laws and to submit regulations of

general provisions of the Civil Code of Russian Federation, and it provides certain advantages: it is not necessary to follow all limitations, stipulated by special laws, (on number of shareholders, on allocation of funds invested etc.). However it also creates problems: an extra attention of tax and the law enforcement bodies to such co-operatives (are there any attempts of legalization of the criminal fund, any attempts of creating financial pyramid, any attempts to escape taxes, licensing, any attempts of running business under cover of non-profit activity etc.). Therefore co-operatives should be ready for constant inspections by the appropriate bodies and all problems, following from these inspections, (document arrests, inviting staff over for providing necessary explanations etc.). Besides shareholders and honest managers frequently do not wish to enjoy such freedom: the Civil code stipulates, that if the year resulted in losses, shareholders are obliged to cover them paying additional capital contribution. And they bear joint liability under the debts of co-operative within the limits of the additional capital contribution, not paid in. Therefore shareholders understand, that the special legislation provides certain protection from financial and administrative risks, from unreasonable inflating of organization and its transformation into a pyramid, managers also would like to have well defined frameworks of activity, in order not to be accused for each decision made, and that they did not have any inclination to be involved into risky activities. Besides there are not only limitation, but also definite advantages in special laws: for example, co-operatives operating under the law “On agricultural cooperation”, enjoy definite privileges and state support measures, the concept of personal savings as personal funds of the shareholder, not the co-operative stipulated by the federal law “On consumer credit cooperative societies”, enables to apply personal income taxation, instead of the company profit tax, which almost double in the amount.

Therefore there is a necessity for adapting wide, more general law “On credit cooperation”. The draft law was submitted to the State Duma of Russian Federation in 2001, but so far was approved only in the first reading (i.e., the concept of the law is approved, but there remains substantial work on the text since there are still serious objections of different authorities, public associations, representatives of credit cooperation).

We already mentioned a working group, to enhance the legislation on non-bank deposit-credit organization, but here we are talking about other working group – on refining draft law “On credit cooperation” in order to accelerate its adoption,

it was created with the task to eliminate disagreements of the text of the law.

Business Support Funds

Aside from the credit consumer cooperative societies, there are also approximately 100 small business support funds – both private and governmental (funded by regional budgets) operating in the Russian microfinance market. These business support funds have been adversely affected by recent amendments to the federal law “On state support of small business in Russian Federation” adopted in August 2004. These amendments deleted the provision governing business support funds and their right to provide loans to entrepreneurs. This deletion has been interpreted by some regional governments as a prohibition on such funds engaging in microcredit and, in some cases, as a prohibition on existence of such funds.

The funds have been successful in defending their right to exist, basing their argument on the general provisions of the civil legislation: the Civil Code and the Federal law “On non commercial organizations” which stipulate the procedures of formation and activity of both organizations and funds. Although the cancellation of provision of one law cannot be interpreted as a cancellation of an entire group of legal entities, the issue of whether funds may engage in microcredit is extremely vital but no longer clear. Some of the funds are looking for opportunities of survival without providing loans, on the basis of granting guarantees for loans provided by commercial credit organizations, and for opportunities of transformation into commercial credit organizations or founding those. Fortunately, the drafting of the new federal law on state SME support policy is under way².

Mutual Insurance Societies

There are approximately 60 mutual insurance societies engaged in microfinance. As there is no law specifically governing such societies (a draft law on a mutual insurance has been under examination of State Duma for number of years, but hasn't yet been adopted), they operate under the Civil Code and are registered as non-commercial organizations (either as consumer cooperative societies or non-commercial partnerships, although some are arguing their right to register societies of mutual insurance as an independent legal entity).

The federal law “On non commercial organizations” provides for, among other types of organizations, a non-commercial partnership which is a member-based organization with the

general meeting of members being the supreme governance body. The financial basis of such partnerships is membership fees and the purpose of creation must be to assist the members in achieving their social, charitable and other socially responsible purposes³. The governance is based on democratic/cooperative management principles; in addition, members are not liable for losses of the organization.

Other Relevant Legislation

There are a number of other possible solutions for microfinance institutions in the legislation, but they are not really popular because of the not sufficient clarity if their legal status. There are two federal laws adopted in 2004 that are relevant to the microfinance sector: "On housing funds accumulating cooperatives" and "On credit histories".

The law "On housing funds accumulating cooperatives" allows individuals to accumulate funds in a housing cooperative for purchase of premises but forbids using these funds for loans. In addition, the law prohibits cooperatives from acting as guarantor for its members and stipulates other restrictions on their activities.

The law "On credit histories" (adopted by the State Duma in 2004, but enacted in June 2005) includes a provision⁴ that obliges credit organizations to present all required information on borrowers (provided the borrower has given its consent) to at least one credit information bureau included in the state register of credit information bureaus. Federal law (i) determines concept and structure of a credit history as well as the basis, the order of formation, storage and use of credit histories, (ii) regulates the activities of credit information bureaus, (iii) establishes principles of formation, liquidation and reorganization of credit information bureaus as well as principles of their interaction with sources of credit histories, borrowers, government bodies, institutions of local government and the Bank of Russia. The Russian Microfinance Center took an active part in the discussion of the draft law and made number of comments, which were taken into consideration. In particular, it's no longer prohibited for non-commercial organizations to take part in formation of credit histories and in the activity of credit information. Besides, some non-profit microfinance institution can become shareholders (participants) of credit bureaus, but hardly it's going to be widespread. This principle of participation is strictly prohibited for cooperatives. Main principles of participation are namely those you mentioned in your question.

For the commercial organizations, providing the information on borrowers in a credit infor-

mation bureau is a duty, for non commercial organizations, it is a right.

RMC also took an active part in developing amendments and changes to the provision of the Tax Code regulating the peculiarities of simplified taxation. Application of the simplified taxation system substitutes for profit tax, property tax and uniform social tax by the uniform tax calculated on the base of results of economic activities of organizations during the tax period. Organizations using simplified taxation system may not be subjects of VAT, except for import VAT. The amendments abolished a number of restrictions preventing non-commercial organizations from taking advantage of the simplified taxation system, which introduces an opportunity of economic benefit to many microfinance institutions.

Work on enhancing microfinance-related legislation is underway⁵. There is also an analysis of application of these laws by microfinance institutions and courts. And alongside

the work on legislation, Russian microfinance institutions are actively dealing with development of standards and specifications of microfinance activity.

In this direction the state regulation inevitably goes together with self-regulation of microfinance institutions activity. And one of the major issues of Russian microfinance legislation enhancement is development of uniform standards of state regulation of this kind of activity and definition of its optimum combination with self-regulation. ■

1 There are a number of other possible solutions for microfinance institutions in the Russian legislation, but they are not popular due to the lack of clarity regarding their legal status.

2 Legislators are working on the text and are getting feedback from a target audience (SME and their associations) and experts.

3 A non-commercial partnership is not permitted to distribute profit among its founders or members.

4 This specific provision was in fact enacted in September 2005.

5 A well-balanced government policy of SME support should provide a balance between microfinance institutions of different types – specifically, a differentiated approach to organizations of the same kind conducting different activity (based on character and targeted clientele).

Armenian Microfinance Legal and Regulatory Update

continued from page 5

providing key technical input as well as working to ensure that the needs and concerns of all parties involved were understood and addressed to the extent possible. MEDI applauds the constructive attitude of both the CBA and the MFI working group, as well as the supportive role played by the World Bank which, at a critical point in the process this past summer, hosted a video conference (organized by the MFC) between MEDI, senior representatives from the CBA and CGAP Senior Policy Advisor, Mr. Timothy Lyman.

The way things currently stand is that the CBA has officially notified all Armenian micro credit organizations (there are currently seven operating in Armenia) that they must declare their intention to register with the CBA by 31 December 2005 and to complete this registration process by 1 March 2006. In parallel, CBA regulations governing credit organizations (under which Armenian micro-credit organizations will be regulated) are in the final stages of being modified. These changes have gone through several iterations and the CBA has been extremely cooperative in terms of seeking feedback throughout this process from the MEDI-

facilitated working group. Regulations are due to be finalized before the end of this year.

The practical benefit of having a clearly defined legal and regulatory status for Armenian MFIs is already being felt. On 25 October 2005, MEDI organized a Micro Finance Investors Conference (MFIC), the purpose of which was to help increase capital flow to the Armenian and Georgian microfinance sectors, both of which need to secure commercial sources of debt and equity in order to maintain their high level of growth. (For more information, please go to: www.medi.am/mficonference.) The MFIC attracted five institutional investors from Europe and the United States. All investors stated that a prerequisite for them to invest in Armenian MFIs was the clarification of the legal and regulatory status of microfinance. Toward this end, it sent an extremely positive message to have the CBA chairman announce at the conference that this process was about to be completed. ■

1 Chrysanthos Miliaras and Monica Harutyunyan are the chief of party and legal specialist respectively for the Armenia Micro Enterprise Development Initiative (MEDI). MEDI is being implemented by Chemonics International Inc.

Barriers or Opportunities?

Tackling the Three Big Issues Shaping Microfinance Markets in the Region¹

BY KATE MCKEE, DIRECTOR OF OFFICE OF MICROENTERPRISE DEVELOPMENT AT USAID

The annual stocktaking exercise by the Microfinance Center found that practitioners perceived three key barriers to creating more inclusive financial markets:

- Concerns about growing competition.
- The lack of adequate financing for microfinance.
- A policy environment that too often hobbles rather than enables microfinance.

I would like to suggest that while each of these is a potential barrier, it is also an opportunity for effective dialogue and action. I will argue that competition is really only beginning in most markets and is, on balance, a good thing for the MFIs and certainly for their clients. I will suggest that the industry appears on the cusp of financing its growth through more commercial sources. And I will encourage all of us to embrace a broader vision of enabling environment and to redouble our efforts to create the conditions for healthy competition. Product innovation, process re-engineering, a focus on increasing efficiency, broad applications of new technology, and creation of new strategic alliances will all be essential if we are to achieve this vision of financial democracy.

Competition

I'd like to suggest that we use a different lens to examine the nature of the markets we're competing to serve, who our competitors actually are, and how to succeed. The lens I'll suggest we use is that of the "Base of the Pyramid", first proposed by Professor C.K. Prahalad of the University of Michigan in his revolutionary book, *The Fortune at the Bottom of the Pyramid: Eradicating Poverty through Profits*. I will also draw on a small set of case studies by DAI (a development consulting firm) called "Discovering Hidden Assets: Financing at the Base of the Pyramid".

Professor Prahalad's argument is based on the premise that whether you are talking about cell phones, financial services, shampoo, or agricultural exports – the growing markets will be those at the bottom of the global economic pyramid, particularly those of households earning less than \$2000 per capita. There are

4 billion people in the so-called "BOP markets." Meeting their demands for appropriate goods and services will be the driver of future market development and profitability for global corporations and domestic companies alike.

There is increasing evidence that BOP buyers will pay for quality products and services – but those goods and services must be adapted to their needs. The first generation of microfinance models – with their collateral substitutes, use of groups and stepped loans to manage risks and bring down the costs of delivery, and so on – offers an example of radically retooling financial services to make them work – profitably – for poor people. We need to continue applying BOP thinking to microfinance, to figure out the next generation of breakthroughs that will help us serve more and more BOP households and businesses better and better.

And as the level and stability of your clients' incomes grow, what will they want from their financial services provider? And how will you respond to the rapidly-evolving opportunity this presents?

Recently I heard the CEO of Visa, Chris Rodrigues, speak at a conference of big companies interested in tapping BOP markets. He talked about the catalytic role that finance plays in an economy and for individual households. Here's what he said: "Cash is like walking to market. Debit cards and other electronic payment systems are like having a bicycle. Credit cards and related services are like having a bicycle with gears."

As the awareness of the size of the BOP market grows, bigger financial services companies like Visa are noticing your clients and wanting to sell them bikes with gears! They are also starting to notice the good microfinance – microfinance that is relatively high-volume and efficient and yields strong and consistent profitability. At the moment you have an edge – you know how to serve these customers better than your potential big competitors. But you will almost certainly need to innovate and constantly improve your products and processes to keep those customers and attract new ones to sustain your growth.

So in this bigger competition for BOP markets, how can your institution come out as

a survivor with loyal clients and growing market share? Here are a few general principles that have emerged from the very recent experience of tapping BOP markets and seem relevant to microfinance:

1) Keep an eye on your products and how to increase the value proposition.

But it's not just the products that need re-engineering – it's the processes too. I see two key re-engineering challenges for the microfinance industry here and worldwide:

- Tailoring financial services to specific market segments.
- Achieving major break-throughs in efficiency to reduce costs without eroding the value proposition to the client.

2) Develop a product line and aim for total customer profitability.

Not all products were profitable from inception – some are loss leaders that attract customers, open the door to offer them other products and, over time (assuming those customers are retained), contribute nicely to the bottom line.

3) Not every microfinance provider needs to have a full line of service.

In the U.S., there are thousands of banks, many of them specialized or quite local institutions and some of them offering just a small number of products targeted to a niche market. However, if your business model is as a niche player, you need to be very good at it and make sure you can retain that specialty as a profitable line.

4) Explore alternate revenue models.

Fee-based services are the profitability drivers for many U.S. banks. What role might you be able to play in fee-based services such as remittance or payment services?

5) Explore alternate delivery channels and service points.

Multiple services points will be one of the keys to achieving dramatically more inclusive financial markets. This may very well involve forging strategic alliances and partnerships to take advantage of another organization's delivery channels or distribution networks.

6) Seek improved technology applications to offer better products, increase efficiency, and enhance profitability.

I think we're finally poised for some innovations that will stand the test of the market, including remittances, smart cards, credit scoring and others.

7) Use new business alliances aggressively to succeed in your business and extend your reach.

In considering which strategic alliances might be a good fit for your institution, don't just think of financial services and IT companies. What about retailers? distributors of consumer products? hardware and construction material companies serving the low-end home improvement market? Suppliers of agricultural equipment and inputs? It's a two-way street – don't just think of who can help you deliver finance – who needs the finance you might be able to offer, to get their products and services into BOP markets?

Expanding and Diversifying Financing Sources.

A recent CGAP survey identified the issue of financing as the first concern worldwide – over 90% of the 120 MFIs they polled cited it as their biggest worry.

What's the current situation?

- There has been a substantial increase in commercial funding to microfinance institutions from diverse sources².
- This growth in the proportion of funding obtained commercially is especially impressive given the very strong year-on-year growth among the region's MFIs' portfolios.
- There has also been a growth in deposits, but legal/regulatory restrictions are especially problematic in this region.
- There has also been growth in MFI financing through debt, but this source is still substantially non-commercial in nature.
- There has been some equity, but it has been rare, comprised almost entirely of MFI retained earnings and equity investments made in the family of ProCredit Banks.

Here's what I think the picture will look like in the near future:

- The demand for debt to finance growth – whether local or international, commercial or not – is far from peaking among the larger regulated institutions. The unregulated MFIs

often face significant obstacles to competing with them for debt.

- But compete they must – there won't be nearly enough grants and equity available to cover the appetite for expansion capital.
- In terms of international capital, this region will benefit from the pressure that the many microfinance debt and equity funds are feeling to place their capital and to move beyond "the usual suspects," especially in Latin America, to younger microfinance markets.
- There will also be opportunities on the domestic debt front. In the more dynamic economies, new market entrants will be attracted to the space traditionally occupied by domestic banks, motivating some of them in turn to try downscaling into the micro market. But it's hard to imagine that some of them won't find it more attractive to lend to MFIs instead, which share some similarities with the SME market they're also trying to tap.

Marc de Sousa-Shields points out (in the USAID-funded study *Financing MFIs: The Context for the Transition to Private Capital*) that even small, relatively new institutions such as Xac Bank in Mongolia have moved to access private capital rapidly and profitably. He continues with advice for all of us: "A primary and obsessive focus should be to lever domestic capital as quickly as possible, as MFIs prove they can grow the value of their business in their core, low-income market." He sees two important roles for the non-commercial capital providers such as USAID, Blue Orchard, EBRD, OikoCredit or Opportunity Investments. First, we should focus our investments not on the safe bets, but on the next generation of MFIs, and we should do it with the explicit goal of leveraging private domestic capital. And second, we should invest in improving the enabling environment and infrastructure for more inclusive financial markets, the quasi-public goods such as better laws and regulations, credit information bureaus, ratings agencies, support services for pro-poor financial institutions, and microfinance associations. The Enabling Environment for Microfinance.

This region, more than any other in the world, has a pretty urgent policy agenda. My priorities as a donor, interested in encouragement of the whole market rather than any specific retail institution, are likely a bit different than the MFC members'. Here are what I think the priorities for legal and regulatory work should be in this region:

- Ensure that the legality of microfinance by other than banks is settled.

- Remove legal and regulatory barriers to non-depository MFIs borrowing domestically and internationally to finance their growth.
- Creation of clear and fair transformation options.

I think an investment newsletter is a good step in this direction as a clearinghouse of information. We will also need to be proactive on consumer protection, to protect our reputations and distinguish ourselves from unscrupulous or predatory players that may enter the market. (This is one important way to head off policies that we won't like, such as imposition of interest rate caps.) And we need to keep our eye on how anti-money laundering and anti-terrorist financing provisions are being designed and implemented. They could pose huge unintended threats to microfinance operations and institutions. Finally, on the policy front, as an industry, we need to be more proactive on improving the business environment for our clients, not just for our own institutions. In prioritizing what advocacy to undertake together, we need to look beyond very narrow concepts of institutional self-interest, to ensure that the consumers in the BOP market have a chance to develop and benefit from more choices and better economic opportunities.

But work on laws, regulations, policies and administrative practices doesn't go far enough. An enabling environment also includes the infrastructure needed for more inclusive financial sectors to develop – infrastructure such as credit information bureaus, credible ratings agencies, specialized consulting and other support services, and regional and national network associations.

I hope you agree with me that each of these three challenges – competition, financing constraints and inadequate legal and regulatory environments – offers an opportunity as well for us to make big progress in extending access to financial services. To turn the challenges into opportunities, we'll need to work better, we'll need to focus on what's truly important, and we'll need to work together in new ways. ■

¹ Excerpts from the Keynote Address of Kate McKee Director, Office of Microenterprise Development, US Agency for International Development. 8th Annual Conference of the Microfinance Center for Central and Eastern Europe and the New Independent States, Bucharest, Romania, May 26-28, 2005.

² The MFC survey found that from 2003 to 2004, commercial sources rose from 47% of total MFI financing to 59%, and grants declined from 52% to 42% of the total.

Industry Update 2004

BY JUSTYNA PYTKOWSKA, EWA BAŃKOWSKA, MFC Researchers

The microfinance industry in Central and Eastern Europe and the New Independent States continues its development and growth as new institutions enter the market and existing ones increase their outreach and strengthen their financial position. At the same time, the microfinance market remains very diverse as institutions operate under different institutional types, in various economic conditions and cater to a variety of financial needs of microentrepreneurs.

Year to year the MFC conducts a research aiming at mapping current state of the industry. The brief outcomes are presented below.

Microfinance industry growth

At the end of 2004 there were 6,800 microfinance institutions active in the CEE and NIS region, the vast majority of them credit unions. The MFIs of other types were far less numerous with just over 100 non-governmental institutions, almost 50 downscaling commercial banks and 17 microfinance banks.

The total gross loan portfolio utilized by all MFIs amounted to almost 4 billion USD. The largest volume of lending activities was observed among the credit unions. As in the previous years, credit unions remained the dominant MFI type as they managed over one-third of the total volume of portfolio. And credit unions were the fastest growing institutional type – the volume of loans outstanding at the end of the year increased by 68% over 2003.

However, due to the dynamic growth of the other institutional types, particularly banks, their share is gradually decreasing. Credit unions prevail in the CEE countries, like Poland, Romania, Latvia but in the other sub-regions, downscaling commercial banks or microfinance banks hold the majority of the microfinance loan portfolio.

Downscaling commercial banks continued to grow quickly as well. This trend continued from the previous year as more and more commercial banks discovered the potential of micro- and small business sector. Central Asia and Caucasus sub-regions had the largest presence of downscaling banks. After two years of doubling the portfolio microfinance banks have decelerated their growth.

NGO MFIs grow slower each year, indicating that it is becoming more difficult to attract fund-

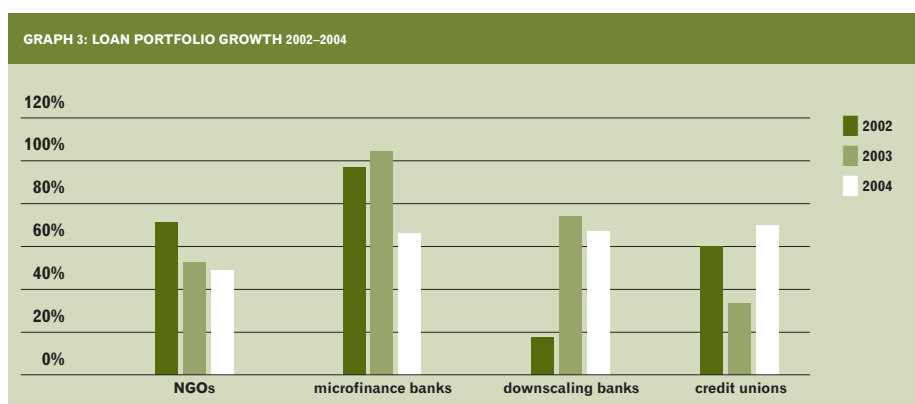
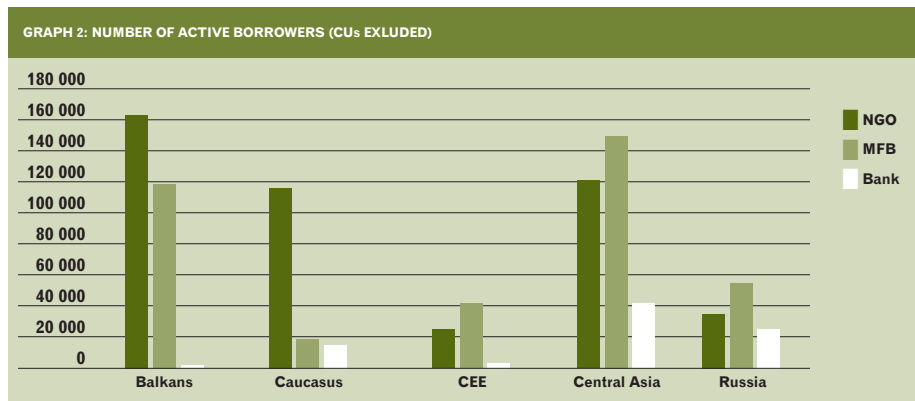
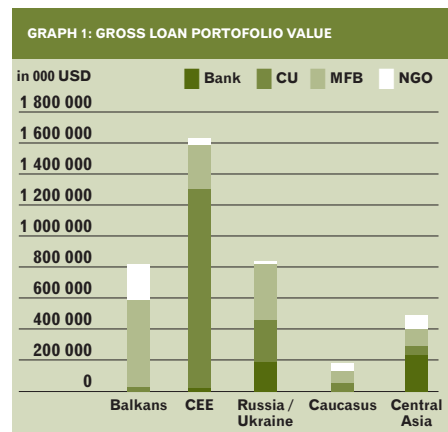
ing to increase the asset base. In many countries, the legal environment prevents the MFIs from using borrowed funds for on-lending and unclear ownership structure deters equity investors.

With the growth of the loan portfolio, more and more people become clients of microfinance services. During the year the number of borrowers increased to 3.2 million people. Half of them were clients of Polish and Romanian credit unions and the remaining clients, mainly in Central Asia and Balkans, were using products of microfinance banks and NGOs.

The dominant clientele of microfinance institutions remain urban borrowers, although the share of rural clients increases every year. Two-thirds of bank clients are located in cities and towns but NGOs serve as many rural as urban borrowers. Balkan and Central Asian NGOs had the biggest outreach in rural areas.

The other significant group of microentrepreneurs were women who outnumbered male borrowers (54% of borrowers are women).

As women usually run smaller enterprises than men, they are served by MFIs that reach deeper. They are more often served by NGOs rather than banks. In the sub-regions, the biggest number of female borrowers was served in Central Asia (one-third of all women clients in ECA). There they also well outnumber male borrowers.



REGIONAL OUTLOOK

Savings

The volume of deposits reached USD 2.9 billion with the largest concentration in Central and Eastern Europe, where the majority of credit unions operate. As in previous years, credit unions remain the biggest savings collectors with over 60 percent of deposits.

Both microfinance banks and credit unions rely on deposit collection to fund their lending activities, as savings constitute over 70 percent of the capital for their loan portfolio.

Depth of outreach

MFI in the region are very diversified in terms of the target clientele. Both commercial and microfinance banks serve microentrepreneurs as well as SMEs with loans starting from a few hundred dollars to 50,000 USD. This has an impact on their average depth of outreach¹ going beyond the threshold of 250% of GNP per capita (which defines the upper limit for microfinance activities according to the MIX). However, for all of these institutions, over 90 percent of clients had loans below 10,000 USD. In that segment the average size of a loan was below 200% GNP per capita.

Commercial and microfinance banks showed the downscaling effect (particularly noticeable among the commercial banks, which have been consistently lowering the average loan size over the years).

Credit Unions remain devoted to low-end clients, however their average loan balance increased by one-third from last year indicating that many of them shifted to provide larger loans.

For NGO MFIs the depth of outreach was rather shallow compared to credit unions. Only 6 NGOs and 3 Credit Unions served truly

TABLE 1: DEPOSITS

	value of deposits USD	%	number of depositors	%
credit unions	1,732,590,817	60%	2,751,447	42%
microfinance banks	1,170,745,060	40%	3,848,919	58%
Total	2,903,335,877	100%	6,600,366	100%

TABLE 2: DEPTH OF OUTREACH

	Avg Loan Balance	Avg depth of outreach	2003-2004 depth of outreach change ²	2002-2003 depth of outreach change
Credit Union	478	32%	35%	-6%
NGO	1144	106%	4%	13%
Microfinance Banks	3884	303%	-1%	2%
Microfinance Banks microloans below <US\$10,000	2038	198%	-0.2%	-10%
Commercial Bank	3869	400%	-17%	-13%

low-end segment having the depth of outreach below 20% GNP p.c. The deepest outreach was observed in Russia and the Caucasus.

As in previous years the average loan balance increased for NGO MFIs (and the depth of outreach became more shallow) however, almost half of the MFIs actually deepened their outreach, most notably the Balkan MFIs where three quarters of the MFIs reached further down to poorer clients.

Financial performance

NGO MFIs continue to improve their financial position. Over 60 MFIs were able to cover their operating expenses. On average, NGO MFIs were more profitable than microfinance banks. The most profitable MFIs were operating in Central Asia in the areas of high demand

for financial services among poor population. Higher ROA was generally achieved in lower income countries with higher inflation and lower deposit rate. As NGO profits are reinvested in the operations high returns allowed the MFI to grow their portfolios.

The other factors that influenced profitability levels were loan-officer productivity and the depth of outreach. MFIs serving poorer clients with smaller loans were able to generate higher revenues and have higher profit margins.

NGO MFIs exhibited the economies of scale – larger MFIs (in terms of the total assets and the size of loan portfolio) were able to run their operations more cost-effectively.

Constraints to growth

The majority of MFIs surveyed in the study perceive the following major constraints to development of their institutions: regulatory environment, competition and access to funding.

A basic problem regarding legal environment is that in many countries there are no regulations specifying microfinance activities, which leaves NGO MFIs with unclear legal status. In such conditions it is very difficult for the institution to design a long-term development strategy. In many cases the existing microfinance law is overly prohibitive limiting the scope of operations as well as imposing the caps on revenue generated from lending activities. Legal difficulties are often topped by changing fiscal regulations as well as po-

GRAPH 4: NGO DEPTH OF OUTREACH

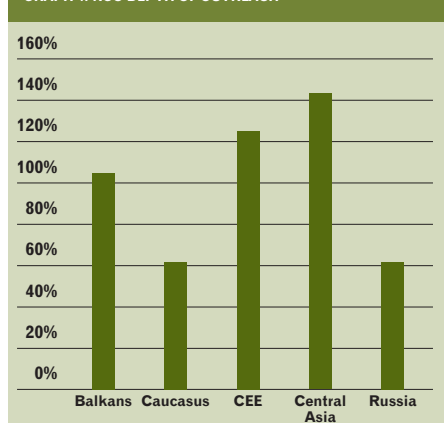


TABLE 3: PROFITABILITY BY INSTITUTIONAL TYPE

	Avg. ROA	Avg. OSS
MFB	-0.61%	112%
NGO MFI	1.76%	133%

TABLE 4: PROFITABILITY OF NGO MFIS

	Avg. ROA	Avg. OSS
Balkans	6.03%	142%
Caucasus	-1.32%	126%
CEE	-6.21%	111%
Central Asia	14.26%	167%
Russia	-2.52%	126%

REGIONAL OUTLOOK

litical instability which adds to the perception of uncertainty that stifles institutional development.

Problems with funding are most acute to NGO MFIs, which are still very much donor-dependent. However, as grants become more scarce in the region, the MFIs must look for other sources. Although the use of commercial sources of funding as well as own resources (net profit) gradually increases, the MFIs have difficulties in attracting the required level of funds because of the cost as well as their lack of experience in building relations with investors. Many NGO MFIs often lack skills for effective fundraising especially among international funders. In addition, unclear ownership structure prevents the equity investors from long-term engagement in NGO MFIs.

With the growth of the MFIs and increase of the outreach, competition for best clients intensifies. As many NGOs offer similar loan products, they often serve the same client group. The strongest competition was observed in the Caucasus – almost all NGOs felt quite strong competitive pressure from other NGOs. There, the majority of NGOs work with urban clients in major cities and compete through price rather than other loan conditions or increase product range.

In the Balkans, a similar situation exists but the MFIs recognize the need to diversify product terms and types of services, not just reduce the price.

In only one sub-region was there significant competition from other institutional types – in Russia and Ukraine, banks were perceived as competitors as they started to offer SME products and access MFI clients through a wide a network bank outlets.

In most cases all over the ECA region MFIs undertook various measures to beat the competition, usually by improving the services and product terms (shorter processing time, longer loan period), introducing new products (consumer loans, agricultural loans), adopting client-oriented approach, bringing services closer to clients and intensifying marketing activities.

Sources of funding

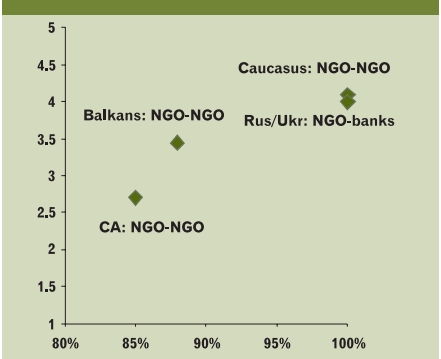
Microfinance banks, as regulated financial institutions with clear ownership structure, have much higher potential to access a variety of funding sources, thus they can better leverage their own resources. For an average microfinance bank, the level the debt (including deposits) to equity exceeded 7, indicating that they attracted 7 times as much external funds as their equity base. Half of their external funding constituted client deposits.

NGO MFIs, on the other hand relied chiefly on equity. Grants are still the main funding source but their share has decreased over the past year by 10%. For half of the NGOs, liabilities constituted less than half of equity. However, the use of borrowed funds increased (especially commercial funds, the share of which almost doubled).

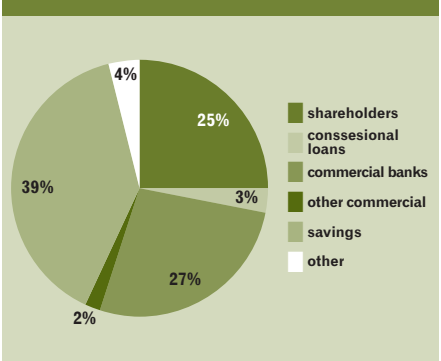
Conclusions

Credit unions are a dominant form of a microfinance institution in the CEE and NIS in terms of portfolio size as well as the number of clients served. Over the last year it was the most dynamically growing institutional type. Microfinance banks were leading organizations in Balkans and CEE sub-regions, while

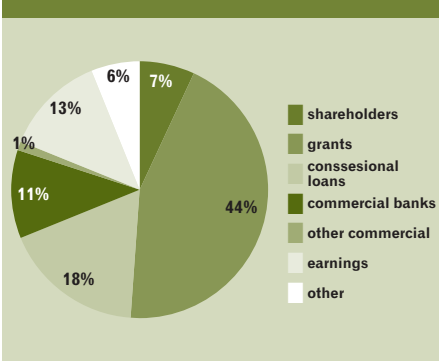
GRAPH 6: COMPETITION



GRAPH 7: AV. MFB SOURCES OF FUNDING



GRAPH 8: AV. NGO MFI SOURCES OF FUNDING



GRAPH 5: MAIN MFI'S CONSTRAINS OF PERFORMANCE



commercial banks developed intensively in the Caucasus and Central Asia.

Along with the portfolio growth, banking institutions consistently deepen their outreach. Although they do not yet reach as deep as NGOs they start offering competitive products.

1 Depth of outreach is calculated as avg. loan balance per borrower divided by GNP per capita. This measure normalizes the loan size for different levels of country income making cross-country comparisons possible. Lower values of the ratio mean smaller loans which are associated with deeper outreach to the poor. Higher values mean that the outreach is more shallow as the institution serves clients with larger businesses. Deepening the outreach happens through the decrease of the depth of outreach ratio, therefore the downscaling effect is observed among the MFIs that their depth of outreach change was negative during the year.

Does Europe need a CRA?

BY PETER RAMSDEN, DIRECTOR FREISS LTD.

This article is the first in a series that aims to answer the question: does Europe need a Community Reinvestment Act and more specifically what could we in Europe learn from the US experience in the implementation of such legislation. This article looks at the American experience and is based on published materials and a field visit by the UK based Community Development Finance Association in 2004. The second article will look at the issues for Europe in adopting such an approach.

The CRA was passed into law by the United States Congress in 1977. It built on the 1975 Home Mortgage Disclosure Act, which created a source of data against which the lending of banks for home lending and enterprise could be assessed in communities. The purpose of the act was to make illegal the practice of discrimination by banks on a neighbourhood or geographic basis.

“The Community Reinvestment Act” is intended to encourage depository institutions to help meet the credit needs of the communities in which they operate, including low- and moderate-income neighbourhoods, consistent with safe and sound banking operations.

The driver for both acts had been mortgage “red lining” whereby banks or other lenders literally drew a red line around areas on the map that were seen as risky for home mortgage loans. Any application from within the area was normally refused. In practice these redlined areas were low income neighbourhoods containing high proportions of Black and Hispanic residents. CRA was responding to a well researched and documented problem of under-investment by banks in minority neighbourhoods.

In its initial format the CRA was something of a paper tiger. Although well-meaning, it lacked teeth. In particular the data on lending by individual banks in specific areas remained confidential within the banking sector and was not available to outside researchers or activists. It took the reform in 1994 by the newly-elected Clinton presidency to open up the debate by requiring public disclosure of bank lending by each bank. This article will focus on the post 1995 period when the act has been more effective.

The CRA requires the periodic evaluation of each insured depository institution’s record in

helping meet the credit needs of its entire community. The evaluation is carried out every two to three years by one of the federal agencies¹ that are responsible for supervising deposit-taking institutions. The evaluation is taken into account in considering an institution’s application for deposit facilities, including mergers and acquisitions. Banks therefore have something to lose by scoring badly in their examinations. A merger or takeover could be delayed or even prevented.

Since 1994 there have been three performance tests for lending, investment and services for large banks (defined as those with assets of over \$250 million).

Smaller banks (defined as those with assets less than \$250million) are evaluated under a streamlined procedure and in particular they do not need to report on the number and extent of loans that they make in the defined areas.

For the lending test the examiners consider:

- The number and dollar amount of loans made in and outside the assessment area.
- The geographic distribution and dispersion between neighbourhood.
- The characteristics of the borrower.
- Community Development Lending – Innovative and flexible lending practices.

For the service test examiners consider:

- The history of opening and closing branches – whether accessibility has been improved for lower and moderate-income neighbourhoods.
- Overall effectiveness of the retail delivery systems.

- Extent and innovativeness of Community Development Services – e.g. counseling.
- Range of services, whether are they tailored to the needs of the neighbourhood.
- Alternative methods for delivery of services – micro-enterprises, CDFIs, etc.

For the investment test examiners consider:

- Investment or grant related to Community Development.
- Deposits in community development banks (used to make additional loans or investments to support a qualified development activity).

Performance against each of the three tests is evaluated on a four point scale from Outstanding, through Satisfactory and “Needs to Improve” to “substantial non-compliance”.

These findings together with the evidence and argument to support the findings are published. An example of a summary report on the Far East National Bank is contained in box 1 below.

For the purposes of the CRA, community development is defined as:

- Affordable housing (including multifamily rental housing) for low- and moderate-income individuals.
- Community services targeted to low- and moderate-income individuals.
- Activities that promote economic development by financing small businesses and farms.
- Activities that revitalize or stabilize low- or moderate-income geographies.

The type of lending activity that has been generated under “Community Development”

BOX 1

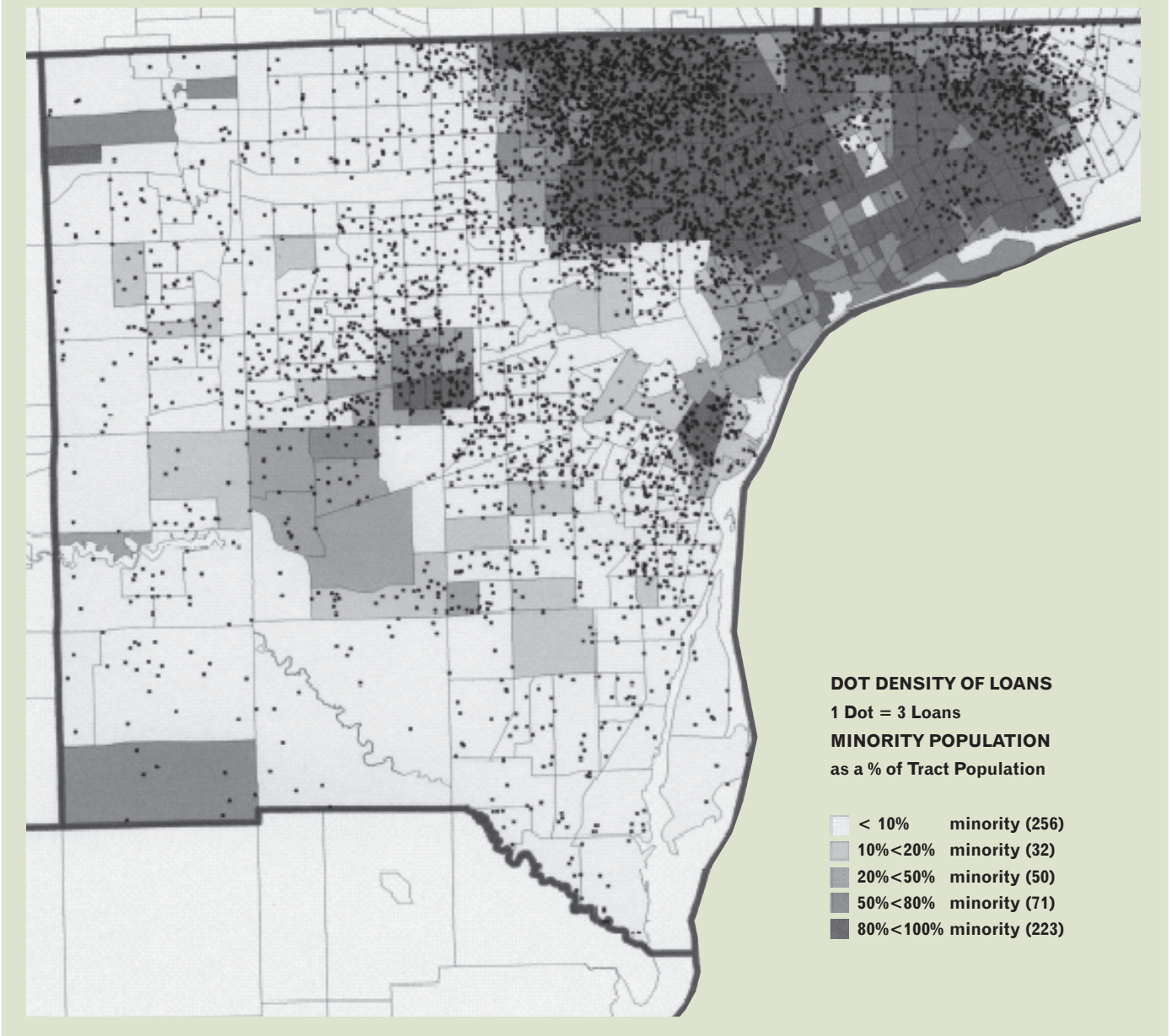
FAR EAST National BANK CRA Rating: This institution is rated Needs to Improve.

Performance Levels:

- **Lending Test:** “Needs to Improve” An inadequate lending volume.
- **Investment Test:** “Low Satisfactory” An adequate volume of investments, grants, and donations that meet a variety of needs, primarily in the Los Angeles assessment area, but no direct investments in other assessment areas.
- **Service Test:** “Low Satisfactory” Delivery systems distribute an adequate level of banking and community development services to the assessment areas.

NATIONAL COMMUNITY REINVESTMENT COALITION

Subprime Refinance Loans by Minority Level of Census Tract in Detroit 2002
 NCRC Analysis, December 2005



includes: loans for affordable housing rehabilitation and construction aimed at low and moderate income people and loans to not-for-profit organizations serving primarily low and moderate income housing or other community development needs.

What the act does not cover?

Although to European eyes the act is an extraordinary piece of legislation, it does not cover large parts of the credit industry, many of which have become more important since

the CRA was enacted. Because the act only covers deposit-taking banks it has no remit to regulate non bank financial operations including credit cards, doorstep lending, insurance, hire purchase etc.

The way that the act focuses on geographic “fairness” has meant that relatively little attention is paid to the performance of the banks in lending to specific groups that may face problems in obtaining credit. Recent research has indicated that women pay more for mortgages than men and may have greater difficulties to

obtain a loan. The act does not require ethnic monitoring or examine the lending performance to other special groups such as people with disabilities, ex-offenders or young people.

Despite these weaknesses the strength of the act is in the disclosure of data. This empowerment factor – combined with the level of detail within the data set has made it possible to examine spatial biases within the lending operation. There are two key aspects of the data collected. First is the small size of census tract districts that are used to report the bank

data and enable the spatial lending performance to be compared with socio-economic variables available at the same spatial scale. If larger spatial units are used the averaging effect makes the data less useful. Secondly the data on individual banks allows comparative performance to be measured.

The map below shows lending in Detroit by Census tract. In the map the dots show the loans while the depth of colour indicates the concentration of minority populations. It appears from the map that some minority districts have high levels of sub-prime lending while others do not. The point is that it is possible to gain an instant impression of the spatial distribution of lending activity in Detroit without knowing anything about the city. No equivalent map of bank lending activity for any city in Western Europe has ever been produced.

CRA results and impacts

The impact of the CRA is in two main areas. First, there has been a dramatic increase in lending to low and moderate income borrowers that probably would not have occurred without CRA. This dimension is the most important result of the act. Home mortgage lending to black and ethnic minority groups has risen considerably in ten years of CRA activity. Over the decade Hispanic loans went up by 195.8% and black loans by 79.5%. In contrast, loans to white borrowers only increased by 29.6%. Similarly, lending to low and moderate income households went up at nearly double the rate (90.6%) of loans to middle income households (50.4%). The impact of these loans has been impressive. Minority home ownership rates have risen by 200% in the past decade.

Secondly the CRA has encouraged an extraordinary level of collaboration between community groups (NGOs) and banks across the US. This collaboration is institutionalized through CRA agreements. These are pledges signed by a community organization(s) and a bank outlining a multi-year program of lending, investments, and/or services. The amount of cash benefit agreed by the banks under CRA agreements has increased by a factor of ten since 1991 and now stands at \$1.1 billion. The credit needs covered by CRA agreements include: housing, economic development, consumer loans, farm loans, building community capacity, outreach and marketing in the community, financial support for NGOs and branch and banking services.

Housing loans make up nearly 46% of CRA agreement activity. Community development (33%) and small business (16%) loans make up the bulk of other activity. As a result of CRA agreements, the number of NGOs funded by banks to serve low wealth populations has grown exponentially.

Indeed many traditionally poor neighbourhoods have seen such rapid recovery that in some instances they have attracted unwanted gentrification.

Most importantly, lending to low and moderate income people encouraged by the CRA has proven to be safe, sound and profitable. CRA has succeeded in directing banks towards an activity that they would have been engaged in anyway if the market mechanisms had been working better.

In 2004 members of the UK's Community Development Finance Association visited Chicago and had the opportunity to meet and interview officials from banks, the federal regulators and from communities. The results were surprising. The banks and the regulators were enthusiastic supporters of the CRA. They emphasised that the level of public and private partnership that we had seen did not happen before the CRA reform of a decade earlier. This new partnership between people on the ground in the communities and the banks had been creative and useful to the banks in helping them to understand new underserved markets. The profit margins on this work may not be as good as corporate finance but it is steady business and surprisingly safe.

Conclusion

The United States is widely regarded by Europeans as having an ultra-capitalistic economic and social model, red in tooth and claw. There is a paradox about the way that a social innovation in this capitalistic system has led to so much private sector innovation at the interface between banks and the communities which they serve and from which they take deposits. The key to this innovation was the way that public disclosure of bank lending data empowered communities. They have won the argument with new tools often using geographic information systems and sophisticated data analysis.

It is worth noting that the changed behaviour of the banks is not driven by direct market pressures. Customers do not choose their bank on the basis of its CRA performance. Instead it is the banks' fear of bad reputation and their

need to have high ratings so that they engage in mergers and acquisitions that drives their behaviour.

The most important revelation was that underserved markets were profitable. CRA would not have been so successful if the banks had not been able to invest in the communities according to sound and safe banking principles.

The next article will explore whether the model of bank regulation that CRA exemplifies is transferable to a European context. Is there a problem that needs addressing? Do we need to ask banks in Europe to disclose their bank lending? Is such an approach relevant in social Europe? And should regulation be pursued at the European or the National level? ■

1 Federal Reserve Bank System (FRB): Each federal reserve bank has responsibility for the banks within its geographic area. Office Of The Comptroller Of The Currency (OCC): Regulates nationally chartered banks. Office Of Thrift Supervision (OTS): Regulates savings and loan associations and savings banks (thrifts). Federal Deposit Insurance Corporation (FDIC): Primary federal regulator of non-member Federal reserve state chartered banks (and back-up supervisor for remaining insured banks and thrift institutions).

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

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