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BOSNIA AND HERZEGOVINA

New Law on micro credit organizations in Bosnia and Herzegovina

BY BRACO ERCEG

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Development of the legal framework for micro credit organizations (MCOs) in Bosnia and Herzegovina started under the umbrella of the World Bank Local Initiatives Project I (LIP). The first "Law on micro credit organizations" was adopted in June 2000 in the Federation of Bosnia of Herzegovina (FB&H) and in April 2001 in the Republic of Srpska (RS).

Although the LIP had on the agenda development of more sophisticated legal forms for microfinance institutions -- non profit NGO, microfinance company, savings and credit organization, and specialized microfinance bank -- this has not been achieved for practical reasons (post war recovery of the country and complicated political situation; ambitious agenda of the LIP; slow and complicated process of drafting and adoption of the new Law).

Despite of the intention of the LIP to draft fully harmonized Entity laws in order to create equal legal environment for the micro credit organizations countrywide, some important changes in the two Laws occurred. While MCOs operating in the RS have been supervised by the Ministry of Finance those working in the FB&H were under the control of the Ministry of Social Affairs. More importantly RS-registered MCOs were restricted to disbursement of business loans only while those registered in the FB&H were allowed to disburse loans for consumption and housing, too.

During 2004 all stakeholders, including respective state and entity representatives/Ministries of Finance and Banking Agencies, led by the Central Bank of Bosnia and Herzegovina agreed on drafting the new MCO Law. The process has been again facilitated by the World Bank and its second Local Initiatives Project (LIP II), implemented from 2002-2005. The new Law was necessary for the following reasons:

- Due to important restrictions on loan terms and conditions, the "old Law" became a barrier for further development of individual MCOs and whole sector
- MCOs wanted to enter the financial markets in order to be able to have access to more stable and commercial sources of financing
- Supervision of MCOs was inappropriate because responsible Ministries did not have capacity and qualified staff to supervise and monitor MCOs' operations.

Local and international legal advisers, assisted by Project staff, prepared first draft of the new law, which was handed over to a working group formed by the RS Ministry of Finance specifically to prepare the final draft "Law on micro credit organizations". In addition to the working group, an expert team has been established at the level of the Central Bank of Bosnia and Herzegovina to coordinate the entire process. This consultative team was composed of representatives of the State-level Ministry of Finance and Treasury, the Ministries of Finance from both Entities, the Banking Agencies from both Entities and representatives of microfinance sector.

Finally, the new "Law on micro credit organizations" was adopted in the RS in June 2006 and in FB&H two months later. It is very important that the laws were adopted in both Entities almost simultaneously. The new Law will be applied six months after becoming in force and effect (January/March 2007); during this six months Entity Banking Agencies have to adopt and publish the regulation.

The new law on micro credit organizations introduces some important changes to the sector:

- All existing MCOs will have to transform into nonprofit Micro credit Foundations or for-profit Micro credit Companies with clear ownership structure. Transformation has to be completed by middle July/September 2007 depending on the MCO location (FB&H/RS).
- Similar to MCO laws in countries with a highly developed microfinance sector, the new Law will not introduce any limits on loan terms and conditions. The only limit will be maximum loan size of BAM 10,000 (approximately EUR 5,000) for Micro credit Foundations and BAM 50,000 (approximately EUR 25,000) for Micro credit Companies.
- Supervision and regulation of the microfinance sector will be transferred to the Banking Agencies, which should increase reputation of the whole sector and provide additional confidence to the potential investors/creditors/donors.
- New MCO law does not permit micro credit organizations to capture savings; they will remain credit only institutions.

Over the past ten years, the microfinance sector was one of the fast growing sectors in the entire economy of Bosnia and Herzegovina, and has achieved excellent results in terms of loan disbursement, portfolio growth and quality. At the same time hundreds of thousands of entrepreneurial low-income people had access to financing of their business and benefited from services provided by MCOs.

The new Law on micro credit organizations will create favorable legal environment for further growth and institutional development of the existing MCOs. As a result of the new Law, it is hoped that more intensive consolidation of the microfinance sector in Bosnia and Herzegovina will take place and the sector will become even more competitive than today. Most importantly this will contribute to the creation of better loan terms and conditions for final borrowers.

1 Bosnia and Herzegovina by its constitution comprises two Entities: Federation of Bosnia and Herzegovina and Republic of Srpska. Each Entity has its Parliament and legal power to adopt and execute laws.
2 The working group comprised representatives of the RS Ministry of Finance, RS Banking Agency and microfinance sector

UZBEKISTAN

BY USMON RAKHIMJANOV

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Regulation on taxation of microfinance programs in Uzbekistan

One of the main problems in Uzbekistan for expansion of microcredit operations by local and international NGOs was the absence of tax provisions in the government resolution regulating microfinance operations by non-banking institutions (NGOs). In recognition of this problem, the United Nations Development Program and the Ministry of Finance formed a working group to develop a temporary resolution regulating taxation of microfinance programs implemented by NGOs. The working group worked closely with a group of donor-funded microfinance programs, local NGOs and government institutions to develop temporary Bylaws.

The temporary Bylaws and resolution were signed by Ministry of Finance and submitted to State Tax Committee on 24 August 2006 with a list of international and local NGOs involved in microfinance programs and projects in Uzbekistan. The temporary Bylaws and resolution were signed by State Tax Committee and registered by Ministry of Justice on 31 August 2006 and came in force in 10 September 2006.

At the time the temporary Bylaws were adopted, microfinance programs were operated through representatives offices of international and foreign NGOs providing humanitarian, economic and technical assistance programs. According to the Tax Code of the Republic of Uzbekistan, these NGOs were required to pay tax on income (profit) only as non-resident to the Republic of Uzbekistan. In accordance with resolution of Cabinet of Minister of Uzbekistan No 309 dated 30 August 2002 'On measures for development of microfinance programs in Uzbekistan,' income generated by these NGOs from microfinance activity was exempt from income (profit) tax until January 1, 2006, provided that such income was used to cover operational expenses, to develop the technical asset base and to further microfinance operations.

However, according to Uzbek tax legislation, microfinance organizations were required to pay single social payment, tax on income of physical entities, and insurance fees of citizens to off-budget pension funds from the time of accreditation of their representative offices in the Ministry of Foreign Affairs of the Republic of Uzbekistan.

The temporary Bylaws provide that as of the expiration of the term of the income tax exemption (i.e., January 1, 2006), microfinance organizations must pay following taxes:

1. Income (profit) tax;
2. Tax on municipal improvement and development of social infrastructure;
3. Customs payments;
4. VAT on work and service imported to the territory of Uzbekistan;
5. Obligatory deductions to the state trust funds and off-budget fund of school education;
6. State duties;
7. Duties for buying or temporary import of motor vehicles into the territory of Uzbekistan.

However, the temporary Bylaws provides that a microfinance organizations is not required to pay tax and other obligatory payments on funds received from a donor organization if the funding agreement stipulates that the donated funds and interest income earned on them remains the property of donor organization.

Furthermore, the temporary Bylaws permit those microfinance organizations that have not been paying taxes and other obligatory payments since the expiration of the tax exemption (January 1, 2006) to make such payments without being subject to financial sanctions and penalties applicable under the Code of Administrative Responsibility of the Republic of Uzbekistan.

Since pioneering non-banking microfinance operations in Uzbekistan in 1998, the UNDP Country Office in Uzbekistan continues cross-cutting and empowering already enriched experience in supporting initiatives related to creating a more enabling environment for developing microfinance and small and micro enterprise sector.

BY NADEJDA KIM
ASSOCIATION OF MICROFINANCE ORGANIZATIONS OF UZBEKISTAN (MTA)

To strengthen the microfinance sector of Uzbekistan, the CAMFA project – through the financial support from the United States Agency for International Development (USAID) – initiated the Association of Microfinance Organizations of Uzbekistan (MTA) in September 2005. The MTA mission is to become the coordinating body for strategic development of MFIs and the microfinance sector of Uzbekistan. Currently,MTA brings together 10 members MFIs with a consolidated portfolio about $4.9 million and 34,000 active clients.

MTA played an active role in lobbying the development of temporary Regulation on taxation of non-commercial MFIs described in the above article.

In September 2006, MTA held a workshop for MFI Financial Managers and Accountants, representatives of the Ministry of Finance, Republican and Regional Tax Committees to explain how the new tax regulations would be put into effect.

KYRGYZSTAN

Microfinance Industry in Kyrgyzstan

– Supervision and Regulation Issues

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This essay is part of the Essays on Regulation and Supervision series produced in conjunction with the Microfinance Regulation and Supervision Resource Center, funded by the Consultative Group to Assist the Poor (CGAP) and implemented by the IRIS Center. These essays are intended to provide additional insights and perspectives on the experiences of microfinance institutions, regulators, donors, and others regarding specific microfinance legal and regulatory environments.

Overview of the Microfinance Market

THE MICROFINANCE INDUSTRY in the Kyrgyz Republic was brought into being with the arrival of FINCA in 1995. International institutions provided grants on the basis of international agreements until August 2002, when the government adopted legislation entitled "On Microfinance Organizations in the Kyrgyz Republic." This law took effect in February 2003. As a result, all legal entities conducting microfinance activities must be registered as microfinance institutions, and must obtain appropriate certification or a license from the National Bank of the Kyrgyz Republic.

To date, the National Bank of the Kyrgyz Republic, as the regulatory and supervisory agency, has registered 104 microfinance institutions, of which 26 are microcredit companies and 78 are microcredit agencies. In addition, the sector is represented by 305 credit unions.[1] The Kyrgyz Republic has a law "On Microfinance Organizations" and a law "On Credit Unions."[2] In addition, five commercial banks carry out microcredit programs with the financial support of the European Bank for Reconstruction and Development (EBRD) and constitute serious competition for microfinance institutions (MFIs).

Donors have invested over US$85 million in the development of the microfinance sector, with a large portion of these funds provided in the form of grants and loans for MFIs and commercial banks. Technical training and assistance has also been provided. The major donors are the United States Agency for International Development (USAID), EBRD, the World Bank (WB), the German Agency for Technical Cooperation (GTZ), the Swiss Agency for Development and Cooperation (SDC), the Asian Development Bank (ADB), and the European Commission (EC).

The microfinance sector provides microcredit services to more than 102,000 clients. Individual loans range from US$450 to $1,300, and solidarity loans to members of mutual-assistance groups range from US$50 to $200, depending on the organization. The aforementioned law "On Microfinance Organizations" specifies that the purpose of microfinance institutions is to provide accessible microfinance services to overcome poverty, raise the level of employment, and promote the development of entrepreneurship and social mobilization of the population in the Kyrgyz Republic. Therefore, the concept of microcredit does not depend on the size of the loan, but rather is defined by the loan's purpose.

The microfinance market of Kyrgyzstan has distinctive features. The credit portfolio of FINCA alone is larger than the microfinance credit portfolios of 12 of the 19 commercial banks. In addition, as of 2005, the state joint-stock company Kyrgyz Agricultural Finance Corporation (KAFC) was the country's largest financial and lending institution in terms of its microfinance credit portfolio and number of clients.

Microfinance Development Strategy in the Kyrgyz Republic

Because of the rapidly growing and progressively developing microfinance sector in the Kyrgyz Republic, the National Bank initiated the elaboration of a Medium-Term Strategy for the Development of Microfinance in September 2005.[4] This strategy is expected to help improve the conditions for developing the sector in the Republic by concentrating the efforts of the government, the financial sector, and MFIs. Several years ago, microfinance – widely recognized as an effective tool in overcoming and reducing poverty – became part of the National Poverty Reduction Program. Today, the role of microfinance in the Kyrgyz Republic is limited to microcredit. Currently, there are no savings and deposit services, nor microinsurance

TABLE 1: THE SCOPE OF MICROFINANCE SERVICES[3]

Type of Institution	Number of organizations	Credit portfolio (thousands of US$)	Number of clients	Average loan size (US$)
Kyrgyz Agricultural Finance Corporation (KAFC)	1	Approx. 41,000	37,268	Approx. 1,100
Credit unions	305	10,951	21,650	506
Microcredit programs of commercial banks	5	11,293	8,707	1,297
MFIs (including FINCA)	104	19,146	42,000	456

programs specifically for the poor, despite the recognition that these types of loans and services would benefit the poor most of all.

What are the reasons for such lopsided development of microfinance? It is the author's opinion that several factors are particularly important.

First, there is widespread public distrust of the banking system, due to repeated bankruptcies of local banks. Second, the law "On Microfinance Organizations in the Kyrgyz Republic" (see below), which allows MFCs to provide savings and deposit services, was adopted relatively recently (in 2002, and it took effect in February 2003). Third, only two or three financial and credit institutions in the Kyrgyz market have the institutional capabilities to implement such services. Fourth, even MFCs that are potentially ready for such new operations face certain barriers and obstacles, which will be discussed below.

Laws and Regulations governing Microfinance Institutions

Under the Law "On Microfinance Organizations in the Kyrgyz Republic," microcredit may be provided by three levels of microfinance institutions (MFIs):

- Level 1—Microcredit Agency (MCA): a noncommercial institution that has the right to provide loans and financial leasing (on the basis of a National Bank certificate).
- Level 2—Microcredit Company (MCC): a commercial institution that has the right to provide microloans, financial leasing, and factoring (on the basis of a National Bank certificate).
- Level 3—Microfinance Company (MFC):[5] a commercial joint-stock company that has the right (on the basis of a National Bank license) to provide microloans, financial leasing, and factoring, and to accept time deposits.

The National Bank of the Kyrgyz Republic, as the regulatory and supervisory agency, regulates MFIs under the Law "On Microfinance Organizations" and has established special prudential and nonprudential requirements for MFIs.

Prudential regulations (for MFCs only) include requirements for minimum paid-in authorized capital and minimum owner's equity; capital adequacy requirements; risk concentrations; liquidity requirements; limits on connected and insider lending; maximum amount of investments in other financial institutions; and ratio of deposits to net assets (to limit risk of nonrepayment of deposits).

Nonprudential regulations include registration and licensing requirements; qualifications of management; financial reporting; regulatory reporting; external auditing; and public disclosure of reports by microfinance institutions. To date, the National Bank has issued the following laws and regulations for operating MFIs:

- Provisional Statute on the Procedure for Establishing Microcredit Companies and Microcredit Agencies in the Kyrgyz Republic
- Provisional Statute on the Procedure for Establishing Microfinance Companies in the Kyrgyz Republic
- Provisional Regulations Governing the Activities of Microfinance Organizations in the Kyrgyz Republic
- The Provisional Statute "On Minimum Requirements for Conducting an External Audit of Microfinance Companies in the Kyrgyz Republic"
- Provisional Statute on the General Principles of Classifying Assets and Establishing a Reserve for Potential Losses by Microfinance Institutions in the Kyrgyz Republic (for nondeposit- taking MFIs).

Legal and Regulatory Problems and Barriers Related to Providing Services to the Poor

As was mentioned above, to date the development of microfinance in Kyrgyzstan was limited only to the development of microcredit services and has achieved limited results. Services in attracting savings and deposits, microinsurance, and money transfers remain underdeveloped.

Under the current Poverty Reduction Strategy, the Government of Kyrgyzstan has emphasized the importance of MFI activities in reducing poverty. But in practice, the following regulatory weaknesses have limited MFIs' success:

Low Minimum Capital Requirements

Under the law "On Microfinance Organizations," the minimum requirement for offering micro-credit loans consists of proof of authorized capital in the amount of US$2,500. This permits anyone from individuals to legal entities to provide microcredit. In practice, this has resulted in an abundance of MFIs (so far, only MCAs and MCCs) with varying degrees of effectiveness and institutional capabilities. In the future, these companies may provide challenges for the National Bank. Despite the large number of suppliers of microcredit services, the delivery of such services to poorer households, small farmers, and businesspeople living in remote regions is still inadequate.

Onerous Auditing Requirements for Small Organizations

Until recently, the aforementioned law also required that all MFIs – regardless of the amount of capital or the size of the credit portfolio – undergo an independent external audit. This requirement was excessive for MFIs that did not take deposits and therefore did not pose a substantial risk to the financial system. Fortunately, the law was recently revised to relieve nondeposit- taking MFIs of this regulatory burden. Under the revised regulations, MFCs must submit to an external audit and publish financial reports on a quarterly basis, while for MCAs and MCCs, external audits are voluntary.

Lack of Access to the Payment System

BTFF's objective and that of other MFIs is to secure the opportunity to offer our target client groups not only credit products but also savings services, money transfers, etc. Successful MFCs must also be given the opportunity in the near future to become part of the payment system.

Transformation Issues

A microcredit agency (MCA), as a noncommercial organization – specifically, a public foundation – cannot be reorganized into a commercial organization, since this is restricted by the Law "On Noncommercial Organizations." But it is possible to establish a new, commercial microfinance institution, specifically a microcredit company (MCC), a microfinance company (MFC), or a commercial bank. The main reasons for transforming an MCA into an MCC or MFC are to attract capital investments and take deposits. International best practice has demonstrated that it is possible for MFIs to succeed following a transformation. By providing clients with opportunities to save, MFIs can help them to move from survival-oriented loans to saving enough to escape poverty.

However, there are certain barriers to transformation, including the following:

Restrictions on Sources of Capital

The law envisages the possibility of progressive growth for MFIs, specifically the possibility of reorganization from MCCs into MFCs, but with this come a multitude of problems and barriers. The issue of funding is a pressing one, since most MFIs have limited capital, do not attract capital from investors and donors, and are prevented from mobilizing deposits. Since this sector was initially funded by international grants, there is a common assumption that these grants are the source for building a credit portfolio. But in practice, few MFIs receive international grants. Therefore, growth is limited.

Ownership Limitations

Currently, legal entities or affiliates are limited to a 20 percent stake in the capital of a microfi-

nance company. This limitation most likely was established by analogy to the law "On Banks and Banking Activities in the Kyrgyz Republic."

One can understand the decision by the regulatory and supervisory agency and the legislature to seek to diversify risk among different owners and establish a corporate management structure. But if microfinance institutions are supposed to help reduce and overcome poverty, how can MFIs that are legal entities participating in the capital of microfinance companies preserve the social mission without the right to a controlling interest?

The current version of Paragraph 2 of Appendix 1 in the Provisional Statute on the Establishment of Microfinance Institutions lists the international governmental organizations of donor countries for which no such limitations in MFC capital are set. This Statute requires serious analysis and revision, since it allows for a dual interpretation. The aforementioned limitation does not exist for such donor organizations as USAID, WB, ADB, the Islamic Bank of Development, the EC's TACIS program, the Japan International Cooperation Agency (JICA), and the Turkish International Cooperation Agency (TICA). USAID, however, never acts as a Founder of any institutions; it only provides resources for them.

In this connection, one of the largest microfinance institutions in Kyrgyzstan (FINCA) is in the process of reorganizing into an MFC with the right to attract deposits. In this transformation, FINCA is arguing that such ownership limits should not apply to them; however, FINCA is not a government organization of a donor country.

Elimination of this ambiguity (as well as elimination of the limitation itself) is fully within the power of the National Bank, since the aforementioned Statute specifies that the authority to expand the list of institutions that are not subject to limitations lies with the Bank.

If ways to solve this problem are incorporated into the aforementioned Medium-Term Strategy for the Development of Microfinance, MFIs interested in removing this barrier should actively participate in its implementation.

Inability to Fund Capital Requirements with Loan Portfolio

The Provisional Regulations Governing the Activities of Microfinance Companies in the Kyrgyz Republic establish requirements for compliance with prudential regulations. These regulations also define the MFC's equity structure, permitting the following to be counted towards owned capital:

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CROATIA

Microfinance and the related policy issues in Croatia

BY MARTA BOGDANIĆ

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Microfinance industry marks its tenth anniversary in Croatia in 2006. Although the sector has drawn the attention of policy makers to the regulatory constraints on microfinance institutions (MFIs), some of the issues faced by organizations currently operating as MFIs are still unresolved. In particular, no reform measures have been adopted to address the adverse circumstances of donor-funded credit-only organizations, despite efforts of the practitioners to influence policy development through the formation of a legal coordination group that drafted a proposed law on microcredit associations. Croatian financial sector laws are undergoing a thorough review and revision in preparation for accession to the European Union. It is my recommendation that the Croatian Government enact the proposed credit-only NGO legislation. This would ease the circumstances in which donor-funded MFIs operate and hopefully allow for further development of the sector. The level of regulation proposed by the draft law not only corresponds to the needs of the industry, but it is also compatible with the Croatian economic and legal environment and is in line with the EU policies on social inclusion and the building of the inclusive financial sectors.

Changes in Croatia that started in early 1990s – transition, privatization, and war related destruction – resulted in a significant increase in unemployment. Microfinance was one of the tools employed to assist those who turned to self-employment. In 1996, Opportunity International facilitated the founding of NOA savings and loan cooperative (SLC), the first Croatian MFI, to help spark economic revitalization of the Eastern Slavonia region. NOA registered as an SLC, utilizing the only available institutional form for a small scale lending operation. In 1999 and 2000, MikroPlus and Demos microfinance interventions were founded. MikroPlus began as a program of an international NGO (with specific approval from the Croatian Central Bank to engage in the lending operations through an arrangement with a licensed bank); Demos began as a domestic SLC founded by another NGO, this time under an updated SLC legislation permitting SLCs to take grants from international organizations. Currently all three institutions are operating as SLCs, notwithstanding the difficulties of using such legal form to engage in microcredit and the years of effort to improve the legal environment for microfinance, including the drafting of a proposed law that would establish microcredit associations as a new institutional form.

Given the fact that the three existing organizations serve a relatively small number of people (currently roughly 4,000 clients with the portfolio of 5.5 million Euros) while the unemployment level is still rather high (16.2% in September 2006), it is legitimate to ask whether the operating environment is conducive to their growth and development. This article first lays out the legal framework for microfinance service provision in Croatia, and then describes the operating constraints for MikroPlus savings and loan cooperative, which started out as a non-membership credit-only NGO program. As way of background, the

article will also present the efforts so far to influence the policy makers and their position towards microfinance. Finally, the recommendation for the policy solution is made.

> "In some countries there is simply no legal structure under which a socially motivated group can lawfully provide loans to poor clients. Unless such a structure is developed, loans may be legally uncollectable, and micro finance providers may be at risk of prosecution." (Christen, Rosenberg, 2000:3)

The only institutions permitted by law to engage in lending in Croatia are commercial banks and savings and loan cooperatives. There is no other venue for loan distribution, such as the foundations, NGOs, or financial companies found in other countries. Commercial banks do not serve microfinance clients: they are seen as too risky due to their lack of business history, experience, collateral, and geographic location. In addition, the banks do not see the profitability of microlending due to the small size of the loans. (There are no microfinance banks in the country.)

Under Croatian law, SLCs are closed-membership credit unions -- that is, they are institutions of members who join to benefit from the services the organization has to offer. They pool their members' savings deposits to provide capital for loans distributed to members. The members capitalize their organization by contributing savings for the institution's operation; the law therefore presumes that the members will be interested in how the organization is run and actively participate in overseeing the organization's management and institution building. Another incentive for active participation of members in the organization's business is the fact that, in Croatia, the deposits in SLCs (unlike in banks) are not insured by the State. However, member involvement and participation is also a legal requirement under the Croatian SLC Act.

In comparison with banks and other SLCs, all three MFIs in Croatia operate with donor funding (rather than with general public's or members' money as members generally do not contribute savings and focus on providing loans to target clients).

The existing financial sector laws and regulations – which, as stated above, permit only commercial banks and SLCs to engage in lending – do not provide an appropriate venue for quick and efficient delivery of financial services to microentrepreneurs. As discussed further below, in Croatia, the use of a membership-based institution for donor-funded microfinance service delivery is problematic for following reasons, among others: the accounting treatment of donor funds, the treatment of donor funds for purposes of calculating the capital adequacy ratio (which does not include donor funds in the calculation of capital), and the requirement to engage clients in the institution's governance and management.

The first and foremost obstacle for MFIs currently registered as SLCs (such as MikroPlus) is the treatment of donor capital granted for operations. In Croatian donor-funded microfinance accounting, these funds are classified as institutional capital (shown as "statutory reserve"), but members cannot determine the use or the purpose of such capital. Grants are made pursuant to grant agreements that specify the conditions for the use of such funds – usually in terms of target clients and types of allowed and/or preferred activities. MFI management and boards have the obligation to utilize the funding to ensure provision of sustainable financial services to the target groups of clients. Clients that became members by virtue of MikroPlus registration have no say in how these funds are being utilized.

This brings us to the next obstacle: member-based institutions are governed by their members. Croatian SLC legislation also requires clients' participation in the governance and management of the institution. While this is a sound requirement for a membership institution, the practical value of Croatian MFI clients becoming members is very low. In order to comply with the legal requirement, MFI clients have been enrolled as SLC members. At the same time, the clients that contribute no money of their own (i.e., savings) to the institution have no incentive to get interested or involved in the MFI's business. Additionally, although clients are legally required to participate in the governance of the MFI, in reality they have limited ability to influence any decisions, due to the existence of donor conditions on the use of grant funds.

Clients' "virtual" membership also presents a management difficulty for the MFI. Although clients are scattered around the entire country, they have to participate in at least one general assembly meeting annually. SLC is required to cover the cost of transportation and per diem for all members that attend a meeting held outside their place of residence. When an MFI's branch offices exist throughout the country, the cost of such meetings can become a serious financial issue. To overcome this obstacle, MFIs utilize the institution of client representative for quorum purposes. One client can represent a maximum of 100 other clients at the assembly meetings. Clients sign representation authorization papers for another client to act for them at the assembly meetings and to vote on their behalf. MFI ensures compliance with legislation, but clients neither participate nor are meaningfully engaged in the MFI's business.

EU accession-related harmonization of financial sector laws and regulations provides an opportunity to look at the third issue: the treatment of grants for purposes of calculating the capital adequacy ratio . At least two groups of experts -- one created within the Ministry of Finance and the other in the Croatian Central Bank -- are reviewing the current SLC legislation. (Both groups seem to believe that current form of microcredit in Croatia can be adequately housed in the SLC form.) The various proposals created so far mainly capital adequacy ratio in line with the one promoted by the World Council of Credit Unions (and also require the change of the SLC name to that of a 'credit union', propose the increase of the seed capital requirement, and introduce the concept of "related persons" to avoid the risk of self-dealing as there is currently no regulation restricting lending to related persons). A capital adequacy ratio of 10% is an example of a sound fiscal discipline requirement in a member-capitalized institution. However, in a donor-funded organization, this ratio translates into a requirement to set aside a substantial amount of the capital base (i.e., that portion funded by donors). Unless donor-funded MFIs are recognized as specific type of institution, the obstacles contained in this otherwise appropriate member institution legislation will continue to accentuate problems for the MFIs.

At the end of 1999, MikroPlus facilitated the formation of a legal coordination group to address the regulatory framework constraints for MikroPlus' operations. The result of the group's work was a draft proposal for credit-only NGO legislation that addressed not only the source of funds for MFI operations, but also the concerns of the government over the approval for existence of another kind of financial sector player. The proposed legislation envisioned the creation of associations (NGOs) with a license to lend donor and investor capital to a target group of clients. These institutions would be non-profit non-deposit taking entities that had the ability

to receive cash collateral from borrowers (provided that the cash was segregated from other funds and would not be used for onlending) and to borrow money from socially oriented investors and commercial banks, which borrowings could be used to finance their further growth.

To ease the concerns of the Ministry of Finance officials regarding the potential that this new type of institution could be used as a tax evasion vehicle, the draft law included a provision that MFI ceasing to operate could not return the funds received for lending to the original funder or repatriate the money; instead, the loan fund could either be passed on to another MFI or another socially minded organization or, in the unlikely event that such entities did not exist, the funds would revert back to the state. Clients had the ability to borrow and receive various kinds of technical assistance from their MFI, but were not required to engage in the governance or management of the institution. The clear division of roles and responsibilities between the institution and its clients, the institution's obligation to make information on its performance publicly available, the protection of clients and truth-in-lending requirements are all indication of the direction in which this proposal intended to orient the MFI sector development. Despite these intentions and the support of international donor community, this legislation never became a reality.

In contact with Croatian government officials, several issues were repeatedly mentioned as the supporting reasons for their lack of enthusiasm to deal with microfinance. While microfinance is viewed as the appropriate type of intervention for the poor countries in Asia, Africa and Latin America, Croatian government officials wrongly view Croatia's need for microcredit as minimal or non-existent. The lack of knowledge about the microfinance movement in Western Europe and the US led to a belief that enactment of credit only legislation would hurt Croatian chances to join the European family of nations, or that this legislation would have to be abolished upon joining the EU. The consideration of country's image and its legislative framework at the time of EU negotiations seemed to be the prevailing reasons behind the dismissal of microfinance discussions. The lack of familiarity with MFI structure and funding sources in Croatia occasionally generate the financial sector stability concern, even though microcredit institutions (and MCAs, as conceived of in the draft law) don't enter into financial intermediation.

In Croatia today, transition and war-related poverty and unemployment remain issues that demand the attention of the policy makers. For those individuals that turn to self-employment or small-scale economic activities, donor-funded MFIs often represent the sole source of finance. Croatian MFIs have shown the ability to diffuse the micro finance models and methodologies to reach the populations not served by the financial sector institutions. There is no doubt that microloans have helped some population groups in Croatia to secure their economic well-being. However, all this is happening despite the requirement placed before donor funded MFIs to operate under an inappropriate institutional form.

Some critics of the legislative proposal emphasize that there is no longer any donor funding of loan capital in Croatia and it is unlikely to reappear if the legal framework for microloan provision improves. This is a short-sighted view of the reality of Croatian MFIs – they were funded with donor capital and that fact alone is not adequately dealt with by any of the existing legal forms. The provision of an improved legal framework would at least enable these MFIs to concentrate on their work with clients and in turn make them more attractive to specialized microfinance funds and investors. The stable operating conditions are certain to improve the overall status of the microcredit sector in the country.

Contrary to the beliefs of some Croatian policy makers, Western European countries also strive to find ways of promoting self employment among the marginalized populations. These efforts differ between the countries and reflect each country's unique circumstances, but in line with the European social model, all have the promotion of social inclusion, employment, equal opportunities for all citizens and inclusive financial sectors as their goal. European microfinance network was created to promote awareness of this kind of work in France, England, Spain, Belgium, The Netherlands, etc. Unlike in these countries, Croatian policy solutions for the microcredit interventions should take into account the reality of donor-funded MFIs to fold this fact into the legislative framework. The proposed credit-only NGO legislation, as the first tier regulation for micro finance institutions, addresses the current constraints and provides a stimulating environment for the further development of the MFIs.

1 The relevant legislative change in 1998 related to the newly introduced possibility for SLCs to take grants from international organizations.

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Microfinance Industry in Kyrgyzstan

– Supervision and Regulation Issues

- Fully paid-in authorized capital
- Capital contributed above the par value
- Reserves for future needs
- Retained earnings (or losses) from previous years
- Current-year losses
- Any investments in other microfinance institutions and banks.

However, an MFI's loan portfolio cannot be counted as a contribution to authorized capital, which creates problems for MFIs that are transforming into MFCs. It would be reasonable to transfer an active loan portfolio on the basis of an agency agreement until the portfolio is gradually repaid and contributed to authorized capital. This requirement hurts an MFC's ability to attract additional resources by limiting its leveraging potential. Under the Law "On Commercial Banks," however, a commercial bank's equity structure also encompasses subordinated debt, which includes loans serviced under an agency agreement as Tier Two capital. Therefore, MFCs and commercial banks are treated differently. Permitting MFCs to count subordinated debt as a contribution to authorized capital would afford transforming MFIs an opportunity to adequately service active loans while still meeting the relevant prudential requirements.

The regulations also prohibit MFCs from counting fixed and other assets as a contribution to authorized capital (with the exception of cash). In the five or more years that they have been operating, certain MFIs have accumulated valuable fixed assets, such as buildings, vehicles, and equipment. These MFIs should be allowed to offer a certain portion of capital (perhaps 20-30 percent) in the form of fixed assets if a transfer from an alreadyoperational MFI is involved.

1 This paper does not discuss the system of credit unions, since it is governed by a separate law, "On Credit Unions."
2 The Kyrgyz Republic has two specialized financial and lending institutions: the KAFC (Kyrgyz Agricultural Finance Corporation) and the FKPRKS (Finance Company for the Support and Development of Credit Unions). The former is a state joint-stock company, funded by the World Bank with government guarantees; the latter is a wholesale state institution for the financing of credit unions with the support of the Asian Development Bank.
3 National Bank data as of July 1, 2005.
4 The elaboration of the Medium-Term Strategy was initiated by the National Bank and carried out with the financial support of the FIRST Initiative and the technical assistance of a group of consultants from FACET (Holland).
5 At present, there are no MFCs in the Kyrgyz Republic.

Regulation and Supervision of Cooperative Financial Institutions

– The Debate over Delegated and Auxiliary Supervision

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Cooperative financial institutions (CFIs), albeit highly pervasive in most countries, are among the poorly understood entities that comprise the existing institutional base for financial intermediation. CFIs include diverse member-owned financial intermediaries referred to as credit unions, savings and credit cooperatives, cooperative banks, and other terms that differ across regions of the world.[1] Their institutional structure and governance, legal and regulatory status, and scale and services portfolio also vary widely across regions and especially between industrialized countries and developing economies. a most basic common denominator is that they collect deposits and do business often solely with members.[2] Existing literature already supports the notion that CFIs serve many poor people, even though middle-income clients are also among their membership, a feature that in fact allows CFIs to reach poor segments of the population without necessarily compromising their sustainability. In many cases CFIs serve larger numbers of poor people than specialized ("targeted-to-the-poor") microfinance institutions, without relying on donor support as the latter do.

Lack of knowledge of CFI governance, regulation and supervision has been a recurrent obstacle in development finance, resulting in widespread neglect of the CFI sector in spite of its pervasiveness and potential. In addition, there are topics related to organization, governance, legislation, regulation and supervision of cooperative financial institutions over which there is no agreement but over which one is needed if we are to facilitate the growth of these institutions and realize their potential for serving the poor. The issues refer to fundamental questions such as: what are the main strengths and weaknesses of CFIs, what is the role of integration (in networks), how much of it is good and should it be encouraged, what is the role of the legal framework in doing this, should the legal framework be a specialized one covering uniformly all CFIs or should the system be tiered, should CFIs fall under banking authority supervision –most agree that yes, it should—but then how: direct, delegated or auxiliary supervision. And what are the differences –if any—between these schema, and the effects they have on performance of CFIs. Of these many issues, this note focuses solely on the debate associated with indirect supervision, i.e., delegated and auxiliary supervision mechanisms.[3]

The debate over delegated and auxiliary supervision

Delegated monitoring (or a translation of a Spanish expression that expresses the idea more exactly, "auxiliary supervision") is probably the hottest point of the debate and disagreements on regulation and supervision (R&S) of CFIs. It has been consistently supported as a viable concept by some and sharply rejected by others.[4] If delegated/auxiliary monitoring (or simply indirect supervision) is the subject of public debate, then the concept of auto-control has been dismissed as a recipe for disaster. Unfortunately very little exchange has occurred on the strength and shortcoming of both concepts. Such a debate is due, for at least two reasons:

- Supervisors, international agencies, donors and consultants often face the decision of whether to insist on adopting a direct supervision approach –which sometimes is near impossible for a variety of circumstances--or to consider an auxiliary/delegated monitoring approach or even auto-control. Even the most fervent opponents have on occasions had to adopt, forced by circumstances, the least desirable of the option, autocontrol, and may be pushed into accepting some kind of indirect supervision approach as a second best.
- An agreement over the true value of the approach would likely pave the way for a much larger convergence of points of view about what is an appropriate regulatory framework for CFIs. A unified voice would, in turn, have definitive beneficial impact in convincing many governments and banking supervisors to move swiftly in the direction of the consensus.

This is a relatively difficult topic. There is no theoretical or empirical work from which we can draw clear guidelines. The little theoretical work that touches tangentially on the subject provides only arguments why these kinds of arrangements might work. On the empirical side, although there is vast experience out there of the successes and failures of systems that work with and without delegated/auxiliary monitoring, this information has not been processed in an orderly fashion allowing drawing inference. We are reduced to the fact that there are systems of CFIs that employ the approach and work well. The same can be said of systems operating under direct supervision. To complicate matters auxiliary/delegated monitoring seems to be an arrangement that is unique to mutual (not only cooperative) organizations.[5]

The way to settle this debate, we submit, is through more rigorous research that systematically tests the hypotheses that exist. Whether positions will converge is another question altogether.

Delegated/auxiliary supervision

Indirect supervision is a regulatory regime that is unique to CFIs. In this regime an agent (the delegated or auxiliary supervisor) performs certain tasks associated to the supervisory function on behalf of the state authority (the principal supervisor). The agent may be (and usually is) a body specially setup by the network of CFI, but could potentially be any other independent party like an auditing firm or a rating agency. The ultimate responsibility of the functioning of the regime rests squarely with the principal supervisor, and no indirect supervision regime should be expected to work without a commitment of the later to make it work.

Some make a distinction between delegated and auxiliary supervision. In the former case, in addition to the execution of function of data collection, processing and information/ recommendation production, the delegated supervisor is endowed with powers to enforce corrective actions, cease and desist, or, rarely, intervention and or liquidation orders.

Historically this regime grows from the experiences in Germany (and then Europe), starting in the second half of the XIX century, throughout modern times, where it is still the dominant supervision regime.

Why auxiliary/delegated monitoring might work

There are two arguments why indirect supervision might work. One is based on the transaction costs economics (TCE) argument and the other on the analysis of the dominating agency conflicts within a CFI. First, the TCE argument. Networks of CFI (federations, leagues, unions, etc.) are in fact input pooling alliances designed to consolidate across CFI the procurement of inputs required to perform the intermediation function. The purpose of the alliances is to limit risk and exploit economies of scale in the procurement of inputs. The pertinence and complexity of the pooling alliance increases with the range of financial products CFIs offer.[6] As in any alliance of business enterprises control mechanisms that insure contracting parties' compliance with the terms of the agreement (often called "private ordering mechanisms") are necessary to prevent opportunism and insure minimum standards of performance by all parties. The types of ordering mechanisms vary. The more complex the alliance, the more advanced and effective must the private ordering mechanisms be. CFI movements –starting with W. Raiffeisen--have chosen an ordering mechanism that over time proved to serve the movement well: private regulation. Investor-owned banks do not engage in such alliances or in private ordering arrangements. Their solution to the problems of economies of scale and scope and control of uncertainty in input procurement is mergers—with all the built-in disciplining tools that the relational contract provides-- not alliances. There is no need in the banking sector for an ordering mechanism that controls participants in the industry. But such a mechanism is essential whenever inter-CFI alliances exist, unless the State takes over and the public ordering mechanism is adequate to support the respect of the terms of the alliance.

While there is agreement in the literature of organizations research that alliances require private ordering mechanisms, stretching the use of these mechanisms to serve the regulatory objectives of the State is an unusual innovation. It is thus not surprising that many regulators are sceptical about its functioning. However, in many countries, helped by a favourable historical experience, authorities have come to trust those mechanisms, modifying them just to suit their own special demands for information and control. The higher the level of integration the more often authorities appear to rely on the movement's own monitoring arrangements.

Regulators face the challenge of creating a regulatory framework that minimizes both the administrative costs (to taxpayers) of performing the function and social costs (to users of the system) that may result from failures. Unfortunately, despite some advances in using principles of TCE to analyze regulation, the tremendous difficulty of estimating these costs makes results unreliable. Rather, the recommended approach in the literature is to focus on transactions (in our case the contracts behind the main agency conflicts that beset the CFI); consider the possible institutional structures that are able to govern the relationship (hazard mitigation) and their capacity to adapt to changing environments; and then assess those alternatives that have the potential to reduce total costs of performing the regulation function.[7] Consideration should be given to alternatives such as private ordering mechanisms –created for the purpose of managing the alliance—and public mechanisms. Were the social costs associated with the inefficiency in preventing failures more important than the administrative cost gained from adopting an indirect regime, there should have been a gradual reduction in the use of the regulator approach. Observations, however, suggest the contrary. Thus, if we assume that governments have been acting as transaction costs economizers—both social and administrative-- an assumption that may or may not be valid, then we would be forced to conclude that more governments perceive indirect supervision as likely to minimize the transaction costs of the regulation function.

Second, the agency conflict argument. In contrast to the investor-owned bank, in a CFI sector there is no fundamental conflict of interests between member-shareholders and regulators, a fact with significant consequences to our problem. In the case of the investor-owned banks, regulators protect the interests of depositors against the incentives of shareholders to expropriate them. Thus, regulators are continuously confronting shareholders seeking to control their incentives to take risks beyond prudence through ever new risk-taking strategies. Shareholders thus have built-in incentive to deceive regulators. Incentive aligning compensation schemes insure that the managers' incentives are aligned with those of shareholders. The shareholderdepositor agency conflict vanishes in CFIs because they are one and the same. By extension there is no conflict of interest between regulators and shareholders. Regulators do not need to protect depositors from shareholders. In fact, from the perspective of CFI members, the regulator is the best allied in its own effort to control managers expense preferences (or member-manager agency conflict), a primary source of CFI failures. If there is a conflict of interest between stakeholders of a CFI and regulators, it is between managers and regulators and not between shareholders and regulators. The result is that CFI shareholders, by definition, have a build-in incentive to cooperate with regulators. Thus, private ordering mechanisms built into CFI networks will favour collaboration with regulators. This mechanism is, of course, weakened if the CFI network is corrupt and controlled by entrenched bureaucrats. This is likely to be the case in CFI systems that have been manipulated by governments for social or political reasons or built in a top-down approach.

It is likely that whether a delegated/auxiliary monitoring system is successful or not may depend on a set of characteristics that are inherent in the configuration of the network.

Other things equal, the higher the level of integration achieved and the higher the dependence of member CFIs from services and products provided by the alliance, the higher will be the chance that a delegated/auxiliary monitoring schema will work correctly. This is so because the private ordering mechanisms the alliance will have put in place are likely to be more efficient. Similarly. it is unconceivable that a delegated/auxiliary monitoring system will work efficiently without a strong commitment of the supervisory authority to make it work.

Why auxiliary/delegated monitoring might not work

The main arguments stacked against indirect supervision are strongly influenced by the investorowned bank supervision tradition. As noted, in investor-owned banks shareholders have a vested interest to deceive the regulator. This vision of regulation is transposed to the context of the CFI. Under this perspective the lack of independence of a regulatory body that is under control of the governance bodies representing those that are being supervised cannot be a reliable mechanism. For the reasons presented above, this risk will be particularly serious in networks with weak governance and entrenched management or a strong borrower-bias induced by intense subsidized government financing.[8] In networks where the weakest CFI, from the point of view of solvency is also the largest CFI in the network or one of the largest, there is considerable risk that the private ordering mechanism may simply lack the power to discipline the aberrant behavior of the oversized member of the alliance. These are also the CFIs that display the highest failure risk. To complicate matters, the federations typically also have the role of advocacy and promotion. These activities are inconsistent with that of supervision. There is a fundamental contradiction between promoting a rapid expansion of the sector and, at the same time, ensuring that the expansion is achieved under the strictest standards of safety and prudence.

Auto-control is the extreme case where supervision is performed and controlled by the integration bodies (typically federation) without any intervention by banking authorities. The absence of any independent party to control the quality of the process makes it completely unreliable. This is a plausible argument, particularly when the system is facing a system-wide crisis.

Does it work?

The debate is made difficult by the absence of documented evidence. Thus, the next best thing is to observe the extent to which the schema is employed in the world and to which extent we have clear evidence of failure in those countries in which it is being employed. Even the strongest critic is likely to admit that there are more than just a few systems of CFI—in both industrialized and developing countries, but mostly in the first group-- that function under a system of auxiliary/delegated monitoring.[9] In fact, in Germany it has already been in place for nearly 130 years. Interestingly, between 1889 and the late 1920's two schemes of indirect supervision existed in parallel: (i) for CFIs affiliated to a federation, the federation performed the supervision of the member CFI (auto-control); and (ii) those not belonging to a federation were supervised by an independent "freelance" auditing firm. After a wave of failures in the group of CFIs subject to "freelance" auditing the German government reformed the law forcing all CFIs to become members of a federation and eliminated the second schema leaving auto-control as the only allowed schema but increasing the power of the auditing federations. That was changed later into "delegated supervision" when banking authorities expanded the banking powers of the CFI and put them under their indirect control.[10]

Table 1 below presents the most common R&S arrangements in the world with examples for each. While the table provides a richer set of information than we use here, our focus is on the use of either direct or indirect supervision. The reader may recall that there are also non-CFI networks of mutuals that also employ indirect supervision. A rapid perusal of the last column shows that of the systems under banking authority supervision there are more CFI systems under indirect than under direct supervision. And of the developing countries under direct supervision, some are actually networks that have officially merged but keep an internal network structure with local "branches" having their own governance structures (Argentina, Uruguay) and thus, for any practical purpose, they employ indirect supervision. To our best understanding none of the systems listed in the row of indirect supervision (delegated or auxiliary) suffered a crisis during the period in which the system was in use. While several did suffer crises, these happened before the system was introduced. Further, several of the systems under direct supervision (Argentina, Colombia, and Peru) underwent serious crises under this supervision regime. In the case of Peru this happened before the introduction of the indirect supervision regime. In Colombia and Peru, the worst failures happened precisely in the institutions that were under banking authority supervision (BankCoop and UCONAL in Colombia and BCC in Peru).[11]

Synthesis of pros and cons

The main critiques note the following:

1. There is a fundamental lack of independence in a regulatory body that is under control of the governance bodies representing those that are being supervised.
2. The federations typically have also the role of advocacy and promotion, activities that are inconsistent with that of supervision.
3. A mechanism of auto-control is the extreme case where supervision is performed and controlled by the integration bodies (typically federation) without any intervention by 7 banking authorities. The absence of any independent party to control the quality of the process makes it completely unreliable.

However, the concept is much less far-fetched than its critics argue for the following reasons:

1. It is a logical extension –and likely a transactions-cost minimizing one—of a private ordering mechanism, a natural arrangement that exists in every inter-organizational alliance.
2. Both auto-control and delegated monitoring have an illustrious history of over a century of achieving stability and reduced performance variances in CFI systems in many places in the world, starting with the Raiffeisen's auditing federations. The indirect mechanism has historically been and is currently widely used by CFI movements in many countries.
3. The active intervention of regulators is in the best interest of member-shareholders who see in the regulators a means to reinforce the control of management—constraining their expense preferences-- and of potentially aberrant members of the alliance.

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TABLE 1: CLASSIFICATION OF REGULATION AND SUPERVISION APPROACHES

		Cooperative	CFI Specialized	Banking
Direct		IC: New Zealand, UK DC, Argentina, Bangladesh, Benin, Botswana, Bolivia, Colombia, Costa Rica, Ecuador, Ghana, India, Malaysia, Nigeria, Panama, Paraguay, Philippines, Thailand	IC: Ontario (Ca)§, Saskatchewan (Ca)§, United States, DC: Belize(¤)	IC: Italy (B. Popolari), Switzerland DC: Argentina*, Bolivia, Colombia, Costa Rica, Ecuador, Jamaica, Uruguay*
Indirect(2)	Auxiliary	IC: DC:	IC: DC:	IC: Australia, Austria, British Columbia (Ca), Finland, France, Germany, Ireland, Italy (BCC), Netherlands, DC: Albania, Benin, Brazil, Korea, Lithuania, Mali, Madagascar, Mexico, Senegal
	Delegated	IC: DC:	IC: DC:	IC: Quebec (Ca), DC: Peru
Auto-control (2)		IC: DC: Colombia, Sri Lanka		

Source: Authors' compilation. While we are confident in the correctness of the classification, there might be small errors in it. Many other countries were not listed due to difficulties in inferring the regulatory regime from the patchy documentation available.

Notes: IC: industrialized countries; DC: developing countries.

(1) Countries that are mentioned twice are under a split regime under which some CFIs are under banking authority supervision and others (smaller or "close") are under cooperative authority supervision. This is the case of Argentina, Bolivia, Colombia, etc.

(2) Empty cells are those in which information available does not allow to pinpoint examples unambiguously. They tend to be the odd cases

(*) Argentina and Uruguay can be considered under direct banking authority supervision if one considers the BCC and COFAC as consolidated structure. If they are regarded as networks that were forced to merger by the regulators, then they would fall under the "delegated" category. Directives of both institutions often insist that in reality they are federations with a consolidated balance sheet.

(§) The Deposit Insurance Corporation performs the supervision on behalf of the state.

(¤) The "authority" is the registrar of credit unions. Insufficient information to assert whether it can be considered a specialized CFI supervisory authority in the sense of the United States' NCUA.

1 For example, Savings and Credit Cooperatives (SACCOs) in East Africa; "Caisses populaires" or "Caisses d'épargne et de crédit" in West and Central Africa; "Cooperativas de ahorro y crédito" or "cajas de ahorro y crédito" in Latin America; credit unions in the UK, USA and parts of Canada.

2 Although in some cases they also serve non-member users; the distinction between members and non-members is often a small share purchase.

3 Interested readers are encouraged to see the Working Paper for a comprehensive review of the other issues.

4 Supporters and detractors tend to be aligned, respectively, with the continental European and Anglo-Saxon (credit union) backgrounds of cooperative systems. However, indirect supervision is practiced in a wide range of countries including some squarely aligned in the credit-union tradition (e.g., British Columbia, Canada and Ireland).

5 Auxiliary/delegated monitoring is also employed in other networks such as those of savings and loans banks (German, Scandinavian countries, and Spain for many years before switching to a direct supervision schema), insurance (Quebec) and health insurance (France, Belgium). It is likely that there are many more systems out there employing the approach of which we do not know.

6 This aspect of CFI systems is explored in more detail in the Working Paper.

7 This is also the approach advocated by Kane (1997)

8 Borrower-bias is a term used in situations where the equilibrium between borrowers and savers (suppliers and demanders of funds) becomes distorted by (usually) external factors, such as excessive external financing, particularly if this is subsidized, and controlled rates that depress both savings and lending rates.

9 See Access Finance Number 7 (September 2005) for a description of a World Bank supported program in Albania.

10 The process was described by Seibel [2003]. Guinnane [2001] provides an interesting analysis of the factors that played a role in those years and what can be learned from that experience. This particular experience contradicts the often argued intuition that, if indirect supervision will be used, the delegated monitor should be an independent party.

11 In all cases mentioned, they were apex organizations that operated as primary banks, partly encouraged by the banking authority. Their failure led to massive crisis in the networks to which they belonged.

MFC SUPPORTERS

- United States Agency for International Development
- Open Society Institute
- Consultative Group to Assist the Poorest (CGAP)
- The Ford Foundation
- Microfinance Opportunites/ Citigroup Foundation
- The Interchurch Organisation for Development Co-operation (ICCO)
- International Fund for Agricultural Development (IFAD)

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