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The Role of Government in Microfinance: What is the Optimal Policy Mix?


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Governments recently have shown a growing interest in microfinance and its role in the banking sector. An increasing number of countries are adopting national policies and strategies for microfinance, and governments are funding a plethora of new projects at the retail level. This article explores the optimal roles that government can play to foster permanent financial access for the poor.

What do we mean by government?

Three broad categories of domestic public actors may play a role to promote access to finance:

- Representatives of national and local executive branch (such as financial policy regulators and supervisors, telecommunications regulators, line ministry staff, heads of state-owned financial institutions, provincial governors, and other appointed officials)
- National and local legislative representatives (such as parliamentarians, mayors, and other elected officials)
- Members of unions, political parties, and other socioeconomic political organizations

What roles do governments play in practice?

Our simple, though not perfect framework builds on work done by others on this topic.[1] The framework synthesizes the menu of policy tools for supporting inclusive financial access into three broad and sometimes overlapping government roles (the "3 P's"):

1. **Protector** of clients (e.g., prudential regulations, consumer protection regulations, financial education, judicial and/or administrative recourse mechanisms)
2. **Provider** of financial services (e.g., state banks, targeted credit programs)
3. **Promoter** of increased delivery of financial services (e.g., local wholesale facilities, financial infrastructure, national microfinance strategies, savers incentives)

What is the ideal policy mix?

Since all roles are not equally effective and some tools may actually harm financial inclusion (e.g., by discouraging private-sector delivery of services), governments need to be well informed on the risks and benefits of the specific tools and tailor their use to specific barriers that impede permanent financial services for the poor. While CGAP has identified global trends on the performance of several of these policy tools, the optimal policy mix for a country will depend on its specific situation (e.g., stage of financial sector development, political regime, economic situation, etc.). The capacity of its public institutions and staff is also a key factor.

What about the roles of Protector and Provider?

Based on global analysis, the authors believe that as a rule, the **Protector** role of government is the most essential, since it builds trust and addresses imbalances between customers and financial institutions. A country's regulatory authorities have an important mission of developing appropriate prudential regulations or adapting existing banking regulations to protect the solvency of large institutions that collect deposits from the poor, and ultimately to protect the savings

Conducive regulations in Armenia

Armenia has improved access through solid and up-to-date bank regulation, and tight but generally adequate and supportive regulation for nonbank financial institutions. Recent financial sector policy developments emphasize financial consumer protection issues. New legislation would stipulate additional disclosure requirements for deposit products, consumer loans and mortgages; introduce a standardized EIR/APR (effective interest rate); and create a financial sector ombudsman."[4]

Subsidized credit in Uzbekistan

Mikrokreditbank of Uzbekistan was founded in 2006 with the Uzbek Ministry of Finance as main shareholder. Despite an inflation rate of at least 10 percent p.a., it has been lending at a subsidized rate as low as 5 percent p.a.[6]; to operate sustainably the few struggling private sector microfinance institutions were lending at a rate of over 50 percent p.a. on average.[7]

A more promising case on savings in Russia

Sberbank (with over 60 percent ownership by the Central Bank of the Russian Federation) offers retail customers the lowest minimum demand deposit amount of just US$0.40 and the minimum term deposit amount, at the market deposit rate of interest, of about US$13[8]. Furthermore, Sberbank deposits are guaranteed by the government public deposit insurance system.

of the poor. Regulatory ambitions must be balanced, however, with the capacity available in-country to supervise, especially when determining which organizations should face prudential supervision.[2]

New protection challenges arise with the appearance of new products (e.g., home mortgages, consumer loans), delivery channels (e.g., branchless banking), and players (e.g. non-bank finance companies, telecommunication companies, retailers). Protective regulation must be "proportionate" or appropriately "light touch" if it is to protect consumer against serious abuse while not prematurely impeding access or innovation.[3]

Other examples of effective protection include regulation to increase the transparency of the sector and develop reasonable (i.e., not excessive) anti-money laundering provisions. In Cambodia, requiring MFIs to publish effective interest rates has increased client awareness of credit costs, fostered competition, and encouraged efficiency gains, all of which have contributed to significant drops in interest rates over the past few years.

From a global perspective, while performance of state-owned financial institutions and programs varies, the authors see engagement of government as direct **Provider** of financial services (especially subsidized credit) as the least efficient policy tool for sustainable access. Recent World Bank data shows state-owned banks operating in 73 out of 102 countries and comprising 15% of total banking assets. State-owned retail financial institutions (SORFIs) usually combine financial and policy objectives. While these institutions are typically expected to at least break even, they often do not (due to the challenges of the policy objectives for them), performing relatively better on outreach than profitability. Many have required massive periodic recapitalizations, demanding extensive public funding that could have served other policy purposes (e.g. health or education) or created incentives and support for private institutions to deliver pro-poor finance. A recent CGAP study of 26 SORFIs found that those institutions with stronger outreach often performed better financially[5]. Having the state act as Provider of financial services can also create unfair competition (e.g., by offering subsidized credit) and erode the payment culture (if collections are laxer). While quantitative evidence is scarce, it appears to the authors that state-owned institutions may play a more positive role in providing payment or savings services rather than subsidized credit (see Russia box).

A recent CGAP research highlights the magnitude of government funded programs at the retail level. The results confirmed that governments are a substantial source of funding in microfinance, possibly at levels equal to or much higher than funding from developed countries. Governments fund microfinance programs in over 50 countries mostly through local wholesale facilities, state banks and independent programs. Even though the announcements are often larger than the actual implementation, these programs could detract from sustainable access in their effort to increase outreach.[9]

Should governments play a promotional role and if so, how?

Governments have many options to serve as a **Promoter** of financial inclusion; this role is less well-understood and worthy of further exploration. Indirect promotion tools include policies and investments that benefit the microfinance industry while not focusing exclusively on it (e.g., promoting fair competition, stabilizing the overall macro-economic situation, strengthening the sometimes fragile financial sector as a whole and the national payment system). Governments may also promote the microfinance sector more directly by developing a national microfinance strategy, establishing local wholesale funds that provide MFIs with financial and technical assistance, or supporting so-called "priority-sector lending" as in

Early benefits and challenges of the Kyrgyz national microfinance strategy

Though long-term benefits of the Medium-Term Microfinance Development Strategy in the Kyrgyz Republic for 2006–2010 are yet to be seen, some positive developments are evident. Favorable legislation for various forms of MFIs has become a model adopted by other countries in the region. Communication has improved among various government authorities, funders, and practitioners through joint work on the strategy and its implementation. The strategy also got Kyrgyzstan on record for adopting good practice principles, such as absence of interest rate caps found in other countries of the region, non-prudential regulations for credit-only microfinance institutions, and establishment of micro-depository microfinance institutions which offers a transitional bridge from nonbank institutions to the banking sector. Today, the country's nonbank microfinance sector has one of the deepest outreach indicators in the region – over 8 percent of population below the poverty line (in comparison, the average indicator for the depth of outreach in ECA is about 1 percent).[11] Despite these positive developments, challenges remain. For example, the meso level of the financial sector (e.g., financial infrastructure, training, re-financing), though mentioned in the strategy, is addressed to a much lesser degree due to the lack of funding. Kyrgyzstan is not an exception here – action plans that are hard to fulfill is a typical feature of other national microfinance strategies.

A successful government-initiated LWF:

The Local Initiative Departments (LIDs) in Bosnia and Herzegovina (BiH) avoided many pitfalls common to LWFs, and succeeded in developing a viable microfinance sector in a post-conflict country. In the devastated economy of BiH, the LIDs' goal was to jump-start the microfinance sector and disburse loans to war-affected citizens. The local wholesale institution began in 1997, supporting 17 non-governmental organizations that initially knew little about microfinance. Five years later, there were nine profitable MFIs, with a portfolio of 42,000 outstanding loans valued at more than 50 million euros, and their number was growing. Part of this success is due to the commitment of the lead international donor, to build sustainable MFIs for low-income clients, rather than simply disburse loans.[12]

India and Brazil. The jury is still out on the effectiveness and efficiency of these tools to address different types of access gaps.

Recent CGAP research shows that national microfinance strategies have increased dialogue among key stakeholders, promoted good practices in many cases, and helped assess the situation on access to finance. However, most strategies were found to be based on weak diagnostics that exclude key actors from the financial sector. Many strategies adopt unrealistic action plans and are championed by institutions that may not have the full capacity, mandate, and/or power to coordinate the industry. The National Strategy for the Kyrgyz Republic offers a more positive example among the 29 national strategies reviewed by CGAP.[10]

While governments can play a useful role in financing MFIs, many donors, investors, and practitioners voice concerns that Local Wholesale Facilities (LWFs) can create disincentives for the commercialization of microfinance by continuing to subsidize both strong and weak institutions even after the sector is developed. In some cases, these structures can create disincentives for saving mobilization by providing long-term subsidized loans. While LWFs have boosted the early development of the sector in some countries, their relevance may fade as new investors and commercial banks become willing to provide finance. Bosnia offers a positive example, where good practice principles have prevailed as the sector matured.

Conclusion

International practice highlights the **Protector** role of government as the most consistently useful for developing permanent access to finance. The prerequisites for successful **Provider** roles by government demand deeper analysis, since many governments are seeking to work in this capacity. Unfortunately much experience to date around the world is negative. It would be helpful to identify alternatives that may be more effective (e.g., creating incentives for private providers to fill specific access gaps). Since many governments want to do more, it is useful for all stakeholders to consider further which **Promoter** roles might be useful and effective. They could develop a vision of integrating microfinance into the broader financial sector and articulating complementary between private and public roles in building inclusive access to finance. The vision could explore ways to promote the sector's expanded access to commercial financing. It should be anchored in a solid understanding of the country's stage of financial-sector development and key access gaps and obstacles, so that government can tailor interventions accordingly. A good diagnostic assessment that identifies barriers and institutional capacity should always precede selection of tools from among the range of policy instruments encompassed in the "3 P's."

1 E.g., De la Torre, A., J.C. Gozzi Valdez, and S. Schmukler, 2006. Innovative Experiences in Access to Finance: Market Friendly Roles for the Visible Hand? World Bank, and Michael S Barr work on "Financial Access & Government Regulation", University of Michigan and Brookings Institution.
2 See Guiding Principles on Regulation and Supervision for Microfinance http://www.cgap.org/p/site/c/template.rc/1.9.2787
3 See CGAP focus note on Regulating Transformational Branchless Banking http://www.cgap.org/gm/document-1.9.2583/FocusNote _ 43.pdf
4 Example provided by Monica Harutyunyan,
5 Preliminary Notes from a CGAP paper in progress by Kate Mckee and Carlos E. Cuevas, based on background materials and inputs by J. Buchenau, K. Proschaska, E. Lahaye, and D. Radcliffe
6 Source: www.mikrokreditbank.uz
7 Source: Central Asia Benchmarking Report. MIX, 2008
8 Source: www.sbrf.ru
9 Source : http://microfinancegateway.org/content/article/detail/50629
10 Source: www.cgap.org/gm/document-1.9.4349/Brief _ NatlMicrofinanceStrat.pdf
11 Source: Central Asia Benchmarking Report. MIX, 2008
12 Avoiding Apex Pitfalls: Local Initiatives Departments of Bosnia and Herzegovina, by Ruth Goodwin-Groen. Case Studies in Donor Good Practices, No. 6, April 2003

UZBEKISTAN

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Microfinance market deficit

The microfinance market in Uzbekistan is divided between banks, credit unions and microcredit organizations. While banks are focused on higher value transactions, and credit unions on lower scale transactions, microcredit organizations are about low scale transactions. This market is not large so far and is developing in fast pace, but it is very promising. Microcredit demand is very high, particularly in rural places, the number of clients steadily grows, and the repayment rates stand at the high level of 97%.

The microfinance market seems to be under-served through licensed or registered institutions, which adds to the cycle of informality in financial transactions. According to the World Bank estimates based on credit union membership data from other regions of the world and the lowest per member loan figures, Uzbekistan has a microcredit gap of more than US$40 million when compared to the least served markets, and nearly US$250 million when compared with average membership rates[1].

Microcredits: A growing sector

While banks usually provide loans of over US$2,500 (except loans provided through EBRD credit line and by Mikrokreditbank), the average amount of a microloan provided by credit unions is equivalent to US$1,213. The average loan amount of microfinance organizations in mid- 2006 was equivalent to US$145.

In order to expand the provision of financial services to small and micro en-

Microfinance in the Republic of Uzbekistan

terprises and private farmers as well as to wider groups of population in May 2006 the Government initiated the creation of specialized bank for microcrediting. The 'Mikrokreditbank' with its wide network of branch offices and mini-banks throughout the country has large potential to expand the scale and increase the volume of microfinance services. However, strict collateral requirements added with requirement of 'only-bank' clients continue to constraint its opportunities to expand the access of small and micro enterprises, small farms and individual households to financial services of the bank.

Given that Uzbekistan had only about US$15 million in outstanding loans from credit unions and microfinance organizations in late 2006, equivalent to less than US$1 per capita, with an estimated US$172 million in bank loans to households and small enterprises, the gross loan figure averages to US$7 per capita, or slightly over 1% of 2006 GDP, which allows characterizing the microfinance sector as under-served[2]. Taking into account the low level of financial intermediation and market penetration in general, we can conclude that this market segment has a significant space to grow.

De jure and de facto

According to the law «On credit unions» (amended in 2004), the activity of credit unions in Uzbekistan is subject to licensing and regulation. As of July 1, 2008 there were 63 credit unions with the total number of members exceeding 80,000, demonstrating high growth rates compared to the 50,000 members figure as of the beginning of 2007. The total assets of credit unions are equal to 74 bln Uzbek Sums, or US$55,988,000. (a 2.7 times increase compared to the same period in 2007). Almost 84% of credit unions' assets are funded by members' shares and deposits (savings) which reflects relative independence of credit unions on external funding.

During the same period, there were only 22 microcredit organizations with the total assets exceeding 2.5 bln Uzbek Sums, or US$1,900,000. The microcredit market in Uzbekistan emerged in late 1990s, when a number of non-governmental microfinance organizations entered this market with the help of UNDP. World Council of Credit Unions (with funding from USAID) and Asian Development made substantial contribution to the development of credit unions by supporting the elaboration and adoption of legislative and regulatory framework, building capacity of credit unions and their professional Association as well as regulatory and supervisory capacity of Central Bank. The main legislation in recent years applying to MFIs has been Resolution 309 of the Cabinet of Ministers (August 30, 2002) «On measures on microfinance development in the Republic of Uzbekistan». The share of microcredits provided by microfinance organizations comparing to the total amount of loans to small businesses and households was comparatively low. As of July 2006, the total amount of loans disbursed by 10 microfinance organizations operating under this Resolution, including microfinance programs of international organizations, was equivalent to US$35.6 mln, and the number of clients stood at 62,888. The active portfolio as of the end of 2006 almost reached US$5 mln, and the average amount of a microcredit was US$145.

In September, 2006 two laws were adopted: «On microfinance» and «On microcredit organizations». They established the foundation for the microfinance segment of the financial market and introduced an institution of a new type – a microcredit organization, which are also subject to licensing and regulation. According to these laws, the Central Bank of the Republic of Uzbekistan developed a number of resolutions and instructions aimed at supervision and regulation of microcredit organizations' activities.

However, microfinance organizations, established with significant support of donor organizations, are still at the initial stage of their development, having recently re-registered within the framework of the new laws and regulations adopted. Apart from standard limitations of their activity, such as prohibition to mobilize public deposits and disburse cash to legal entities, microfinance organizations for a while were dealing with uncertainty in their legal status because of the requirement to re-register and receive the CBU license. In addition, the temporary absence of detailed regulations and instructions, along with expectations and possibility of regulatory intervention in activities of some microfinance organizations has resulted in stagnation and negative growth dynamics of this market segment.

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Funding sources

The ability of microcredit organizations to provide microloans on affordable terms and conditions (such as group loans) will let them occupy their own niche in the household and small business financing market segment in the medium term.

The cost and sources of funds remain a substantial problem for microcredit organizations. The Central Bank refinancing rates have declined over the years, which have lowered interest rates on domestic commercial funding in general. Under the Civil Code, besides founders' capital and commercial credit sources, microcredit organizations can attract commercial and private loans from legal entities and natural persons, but so far none have managed to do so.

Since both credit unions and microcredit organizations have bank accounts, it opens a way for banks to develop «wholesale» financial products (for example, liquidity facilities) for non-bank credit organizations, which could provide the latter with a liquidity cushion required for certain times or price pressures they experience. For instance, if banks can borrow from the Central Bank at the refinance rate, it's a huge opportunity for on-lending to credit unions and microcredit organizations, taking into account an interest rate spread on loans of those institutions. In addition cooperation between the banks and microfinance organizations (as retail sellers of services) would also assist funding problems as well as provide well developed network of infrastructure that banks have.

Experts admit that for both credit unions and microcredit organizations, one of the most sustainable ways to access non-deposit funding is to demonstrate sound management systems and strong returns, and to obtain international credit ratings to be able to access the syndicated loan market, bond market and other sources of debt and equity in the global capital markets. In Uzbekistan, foreign currency conversion has been a difficult process that adds a highly country-specific risk brought about by existing government policies, making foreign investors very reluctant to enter the Uzbekistan market. On the other hand, there is no regulation of foreign currency operations for non-banking microfinance organizations, which means that they are not allowed for them.

As of 1 January 2008, the total volume of individuals' deposit accounts in commercial banks was equal to 994.6 billion sums, and the total volume of deposits in credit unions for the same period was 34.6 billion sums, or 3.5% of the deposit volume in commercial banks. The further mobilization of members' savings by credit unions was made even more difficult with introduction of new taxation burden for their depositors. Although remedy process underway, unequal tax treatment with respect to the individuals' income from deposits placed in commercial banks versus from those placed with credit unions caused raise of interest rates on loans provided by credit unions.

Existing foundations for market development

According to the Resolution approved by the Cabinet of Ministers "On microfinance development program in the Republic of Uzbekistan through 2010", the government is planning to create economic and organizational prerequisites in order to expand the network of credit unions and microcredit organizations, including improvements in the legal and regulatory framework. Associations of credit unions and microcredit organizations are expected to abide by international best practices in microfinance and more rigid standards, especially in the areas of management and transparency. In accordance with the program regulatory acts on simplified accounting, reporting and cash operations, liquidating credit unions and microcredit organizations have been elaborated and adopted. The other important part of the programs is that increasing the number of credit unions and microcredit organizations in all the regions of the country bringing their number to 159 with the total credit portfolio of 127 bln sums (US$96 mln)[3]. Despite many seminars and workshops aimed at the goal the number and the concentration of microfinance organizations remain unequal and for the favor of more industrialized urban places.

Since both credit unions and microcredit organizations have bank accounts, it opens a way for banks to develop «wholesale» financial products for non-bank credit organizations.

The Microfinance Development Program through 2010 also stipulates attracting and redistribution of grants and loans of international organizations through the state-owned 'Mikrokreditbank'. In January 2008, the Central Bank approved a regulation on competition between credit unions and microcredit organizations for grants and loans for microfinance activities from 'Mikrokreditbank'. Some experts believe that appointing 'Mikrokreditbank' as the main recipient and distributor of funds provided to the Republic by way of microfinance support will interfere with credit unions' and microcredit organizations' activities and can constrain the development of the microfinance sector.

Environmental challenges

While there are some positive environmental factors facilitating microfinance development, there are also challenges.

- Deposit-to-GDP ratios are estimated as very low. A lot of money is still circulating outside of the banking sector. Moreover, the role of the informal sector of economy is still significant.
- High interest rates on loans to microfinance borrowers limit the average amount of loans outstanding and shorten repayment periods, which in turn weakens investment opportunities for the production and service sectors that are the main sources of job creation in microfinance.
- Government-supported subsidized lending programs and tax reimbursements offered to banks implementing them, by way of compensating for the losses incurred due to interest rate gaps, are interventions that cannot provide a basis for sustainable lending. These measures do not facilitate market competition, which in the end will be the only factor ensuring adequate lending conditions and sustainable yet affordable rates for credit-worthy borrowers.
- The mandatory encashment requirements imposed on retailers and small businesses, and a general desire of market players to hide assets and income from tax authorities, continues to hinder broader development of the formal financial system.
- The number of credit unions and microcredit organizations and their geographic distribution remains limited

and varies considerably. While credit unions and microcredit organizations are now permitted to expand their networks, it will take time for them to reach the "critical mass" needed to play more than a peripheral role in financial intermediation. The relatively small scale of credit union operations will likely mean relatively high per unit costs of operations. Microcredit organizations likewise are very small, and even with a more favorable legal framework, this will remain the case until they can access external sources of funding to expand their loan portfolios and increase earnings.

- One of the key elements missing in the financial sector is a credit information and debt collecting infrastructure to facilitate and accelerate loan processing and risk evaluation, as well as the loan recovery process. In this regard coordination through the associations of banks, credit unions, microcredit organizations and government agencies in developing a legislative framework on the activity of credit bureaus and debt recovery agencies might be a good way to move forward. IFC's and UNDP's 'Public Finance Reform' project efforts in facilitating this process are very timely. Developing a comprehensive system involving all micro and trade lenders, and disclosing positive and negative performance information as well as transferring the bad debts to professional agents would be a useful tool to increase access to finance for borrowers, on the one hand, and a way for lenders to determine loan features and price risk accordingly, on the other.

What to strive for?

Most of the recipes to strengthen a microcredit market are based on wider-scale reforms of banking and financial sectors. The following institutional measures are among priority actions already initiated and requiring further implementation by Government:

1. **Enhancement of the legal and regulatory framework and implementation of efficient supervisory system for credit unions and microcredit organizations (the macro level):**

- Streamlining registration of credit unions' and microcredit organizations' branches;
- Simplifying accounting requirements for microcredit organizations;
- Allowing for portfolio classification and maintenance of loan loss reserves on non-performing loans in microcredit organizations;
- Improving the reporting system for credit unions and microcredit organizations, including development of remote supervision systems and surveillance mechanisms;
- Developing technical support and capacity building programs for government bodies responsible for credit unions and microcredit organizations;
- Developing and implementing transparent policies for government's corrective and disciplinary measures with respect to credit unions and microcredit organizations;
- Allowing hard currency operations and access to external borrowings to credit unions and microcredit organizations;
- Improving the legislative environment for organization and expansion of activity of credit information institutions and activities of debt collecting agencies.

2. **Encourage development of the market infrastructure for the microfinance sector (the meso level):**

- Strengthening institutional capacity of the association of microcredit organizations, establishing information and resource centers on the basis of the association, and developing educational programs to disseminate best national and international experience in microfinance;
- Offering a level playing field with respect to tax treatment of income from financial institutions, including banks, credit unions and microcredit organizations,
- Facilitating adoption of automated information systems to manage credit procedures and portfolios, book-keeping and financial reporting by small credit unions and microcredit organizations;
- Supporting the capacity building of consulting, audit and rating agencies and companies;
- Expanding the roles of credit information institutions (credit bureaus) and consolidating credit information from different segments, with access to information available for all credit institutions;
- Introducing and strengthening the role of new institutions undertaking loan collection operations;
- Strengthening the role of institutional investors to build a large-scale capital market.

Most of the recipes to strengthen a microcredit market are based on wider-scale reforms of banking and financial sectors.

3. **Establishment of a sustainable system of microcredit organizations (the micro level):**

- Developing an operations manual for microcredit organizations detailing the process of establishment and activities of microcredit organizations, including legal and regulatory acts, instructions and resolutions, templates of statutes, and internal policies and procedures;
- Capacity building of microcredit organizations through specialized training programs, increasing efficiency of operational activity, enhancement of accounting and financial management, development of techniques for risk management, credit assessment and corporate management;
- Increasing capitalization of microcredit organizations to widen their financial capacity;
- Facilitating capacity building and support provision to microcredit organizations in accessing domestic and international lines of credit, commercial funding sources from domestic or international capital markets;
- Supporting innovations in efficiency, procedures, and implementation of new technologies.

1 Microfinance development in Uzbekistan. World Bank technical note. March, 2007.
2 Microfinance development in Uzbekistan. World Bank technical note. March, 2007.
3 Central Bank exchange rate as of September 2, 2008 (US$ 1 = 1,322.80 sum).

KOSOVO

Towards establishment of a favourable operating environment

of the microfinance sector in Kosovo – 2007/2008 events

Blerta Qerimi
Manager, Association of Microfinance Institutions of Kosovo (AMIK)

Two recent events organised by the Association of Microfinance Institutions of Kosovo (AMIK) will help to advance a favourable operating environment for microfinance in Kosovo.

Roundtable on Microfinance in Kosovo

AMIK organised a Roundtable on Microfinance in Kosovo entitled "Microfinance and sustainable economic development: Challenges of Transformation." This event took place in Prishtina on 6 December 2007 and was sponsored by the European Fund for Southeast Europe (EFSE).

The roundtable was attended by 48 participants representing: microfinance institutions operating in Kosovo; donors, investors and government authorities with relevance to the microfinance sector; and economic development experts.

Information on developments and the current status of the microfinance sector. First, a presentation on the current status of the microfinance sector in Kosovo was made by Blerta Qerimi, AMIK. The key points of the presentation included: the number of microfinance institutions supervised by the Central Banking Authority of Kosovo, CBAK (14); the number of AMIK members (10); the number of enterprises supported by them in 2007 (around 14,098); and the number of jobs created in 2007 (approx. 14,317). All microfinance institutions of Kosovo comprise 8% of the total loan amount in the Kosovo financial sector and 23% in terms of number of loans, showing a large number of loans are issued in small amounts. The active loan portfolio of all MFIs in Kosovo is EUR 70.5 million. The number of clients is 42,573.

1st Session: Transition and values of the upcoming microfinance regulation. Mr. Edward Nolan, the Advisor to CBAK, offered his detailed insights into the new legislation regarding supervision of transformed institutions. He reported on the long process of getting approval for this legislation, stressing that it has the support of all involved entities but that it still needed official approval by government authorities. Once the microfinance regulation has been passed, CBAK will issue a new Rule and remain as the governor for non-bank institutions. CBAK will also issue new licensing procedures for both those who meet the criteria and as well as for those who do not meet criteria. Entering into commercial registration is an institutional decision, and those who feel comfortable transforming can choose to do so.

2nd Session: Challenges of Transformation discussion. The 2nd session of this Roundtable focused on the regulatory challenges in the microfinance sector. Currently there seems to be inconsistencies on the opinions of the NGO Office, Kosovo Tax Administration (TAK) and microfinance institutions in Kosovo related to transformation into deposit taking institutions. Therefore AMIK will continue to develop a dialogue with the NGO Office, TAK and CBAK in order to manage a successful transformation of

The active loan portfolio of all MFIs in Kosovo is EUR 70.5 million. The number of clients is 42,573.

microfinance institutions into licensed deposit taking institutions.

Workshop: "Prospects of Microfinance NGOs in Kosovo"

The Roundtable was followed by a Workshop: "Prospects of Microfinance NGOs in Kosovo" that was held on 7 March 2008. The workshop was the continuation of joint efforts of AMIK and EFSE towards establishment of a favourable operating environment of the microfinance sector in Kosovo.

This event was attended by 33 participants representing: CBAK, Ministry of Trade and Industry, TAK, United Nations Mission in Kosovo (UNMIK) Pillar IV, EFSE, microfinance institutions and donors.

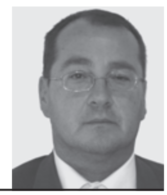
This was the third workshop organized with the purpose of overcoming the legal and regulatory barriers to transformation of NGO microfinance institutions in Kosovo. At this workshop TAK showed their readiness for facilitating the process by suggesting to create a Task Group composed of their consultants and microfinance institutions for further coordination.

The Roundtable and Workshop provide a good foundation for AMIK to continue to work with TAK, CBAK and the NGO Registration Department in order to set the grounds for an enabling regulatory environment for microfinance sector in Kosovo.

BOSNIA & HERZEGOVINA

New Legal Framework

for microcredit organizations (MCOs) in Bosnia & Herzegovina



Fuad Šehović
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The need to change the legal framework regulating the operations of MCOs has been seriously discussed in Bosnia and Herzegovina since 2003. The Law on Microcredit Organizations that was adopted in 2000 in the Federation of Bosnia and Herzegovina and in 2001 in Republic of Srpska was slowly but undoubtedly becoming a limiting factor for further development of this sector. A certain number of MCOs developed to such an extent that they became larger players in the finance sector of Bosnia and Herzegovina in general and legal regulations and control of their operations became fully inadequate. Although more or less all MCOs applied the world's best practices in their operations and many of them also obtained recognition for their professionalism and transparency in their performance, the need for the entry into the formal financial sector was becoming increasingly pronounced. This means that MCOs will be under strict supervision of governmental regulatory bodies, i.e. the Banking Agency, which was not the case before. Government institutions recognized the potential of this sector and its impact on the financial services market and they decided to introduce a considerably stricter legal framework and supervision of MCOs' operations.

The new Law on Microcredit Organizations was first adopted in the Republic of Srpska in July 2006 and after that in the Federation of Bosnia and Herzegovina in October 2006. The two laws were harmonized to the largest extent. However, there is a crucial difference between them: MCOs in the Federation of Bosnia and Herzegovina were obliged to first transform into microcredit foundations, whereas MCOs in the Republic of Srpska could transform directly into microcredit companies. In other words, MCOs in the Federation had to first transform into non-for-profit organizations – foundations, whereas MCOs in the Republic of Srpska could transform directly into microcredit companies – for-profit organizations, with a clearly defined ownership structure. The two laws provide for two types of microcredit companies: a limited liability

> **The two laws were harmonized to the largest extent, however, there is a crucial difference between them.**

company (LLC) and a joint stock company (JSC).

Under the new laws, the regulatory and supervisory bodies of MCOs are the banking agencies of the two entities, which are also responsible for the supervision of the banking sector in Bosnia and Herzegovina. Banking agencies are independent, non-forprofit institutions and their officials are appointed by the parliaments of the entities based on proposals of the governments of the entities. These agencies provide for the adoption of bylaws that regulate the operations of banks and MCOs. Some of their most important responsibilities are the following ones: issuance and withdrawal of operating licenses, approval of boards of directors and management members of banks and MCOs, approval of statutes and other founding agreements of MCOs, approval of external audit firms, and control of business operations. As regards control, the agencies are authorized to control: the compliance of MCOs' business operations with law, the work of MCOs' bodies (management, supervisory boards), portfolio quality, conflict of interest at MCOs, application of the Anti-Money Laundering Law and application of internal procedures at MCOs.

Based on the authorizations granted under the Law on Microcredit Organizations, the banking agencies adopted a set of regulations based on which it was possible to initiate a transformation process of MCOs, first in the Republic of Srpska, in January 2007, and then in the Federation of Bosnia and Herzegovina, in April 2007. It should be emphasized that MCOs, through their association, the Association of Microfinance Institutions (AMFI), were continuously able to make suggestions relating to regulations that were prepared and to establish a contact with the banking agencies even before they were formally authorized to supervise the operations of MCOs.

The two laws provide for two types of microcredit companies: a limited liability company (LLC) and a joint stock company (JSC).

New legal framework does constitute a very good basis for further development of the sector, irrespective of the fact that MCOs will continue providing exclusively credit services.

The first step involved an application for an operating license for microcredit activities to a banking agency. At the very beginning of this process it became fully clear that the establishment and conduct of business operations of MCOs would have to comply with very strict rules and be subject to a much more comprehensive supervision. Most MCOs completed this process without any significant complications, since the contact with the banking agencies had been established even prior to the initiation of the transformation process, so that most sector practitioners knew what they were expected to do and they had sufficient time to prepare themselves for this process.

The issuance of operating licenses was followed by the process of entry into the relevant registers. However, due to a lack of harmonization between provisions regulating the entry into the Register of Foundations and the Law on Microcredit Organizations, MCOs in the Federation of Bosnia and Herzegovina, which had to transform into microcredit foundations first, were not able to complete this process. It was only in February 2008, when the relevant procedures were adopted, that it became possible to initiate this process. For that reason, most MCOs have not yet been entered into the register. After the entry into the register, microcredit foundations will obtain legal subjectivity and continue operating as microcredit foundations. It should be emphasized that under the Law on Microcredit Organizations, microcredit foundations or microcredit companies are legal successors of MCOs from which they resulted, with all rights and obligations resulting from that status, which ensures absolute safety of all parties that entered into a business agreement with these MCOs.

Upon the entry into the relevant register, microcredit foundations or companies will be obliged to report to the banking agencies. Documents of the agencies clearly define the requirements that these reports must meet, both in terms of their content and the deadline for their submission. They represent one of the basic ,'tools'' that will be used by the agencies for the control of business operations of MCOs.

Based on all the above mentioned, it may be concluded that the new legal framework does constitute a very good basis for further development of the sector, irrespective of the fact that MCOs will continue providing exclusively credit services. The possibility of establishing credit companies is a basis for attracting foreign investors and opening up new possibilities for the whole sector. In addition, the experience accumulated by the banking agencies in the regulation and control of the banking sector will certainly be useful for further improvement of MCOs' business operations, taking the sector to a higher level. These are, of course, our presumptions and it is still to be seen what experiences will be gathered after a certain period of conduct of business operations based on new regulations and under the supervision of the agencies. A very significant fact for the future is the fact that agencies, as regulatory bodies, can react very quickly in case of need to introduce new regulations and solutions, which will result in a faster adoption of business environment to the needs of both MCOs and the market as a whole.

Note: Bosnia and Herzegovina consists of two entities: Federation of Bosnia and Herzegovina and Republic of Srpska. The new laws on microcredit organizations were enacted by the entity parliaments. The banking agencies were also established at the level of entities. The relevant registers of entry of MCOs upon issuance of operating licenses were also established at the entity level, both for microcredit foundations and microcredit companies.

Excerpts from CGAP Focus Note 43: "Regulating Transformational Branchless Banking: Mobile Phones and Other Technology to Increase Access to Finance"

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When a cover story last year in The Economist forecast the end of the cash era, readers living in developing and transition countries may have thought "not us." Surely these high-tech "e-money" substitutes for cash that have taken countries like Japan by storm would take a while to reach poorer countries.

And yet, the transformation from cash to electronic value, stored and conveyed by mobile phones, is hitting developing countries, too. In Kenya, the M-PESA mobile wallet service offered by Safaricom attracted 1 million registered users in 10 months (in a country where fewer than 4 million people have bank accounts). And in the Philippines, the country's two mobile network operators offer the functional equivalent of small-scale transaction banking to an estimated 5.5 million customers.

In a fast increasing number, policymakers and regulators in other developing and transition countries are embracing "transformational branchless banking"[1] – the use of information and communication technologies (ICTs) and nonbank retail channels to reduce costs of delivering financial services to clients beyond the reach of traditional banking.

Much of the current buzz is around mobile phones. But other branchless banking approaches are gaining traction as well. In Brazil, banks have established more than 95,000 banking "correspondents" – local merchants, post offices, and lottery dealers equipped with card-swipe and barcode-reading point-of-sale (POS) terminals. These correspondents provide access to financial services in the 1,600 Brazilian municipalities (one quarter) that lacked any financial service outlets seven years ago.

From Afghanistan to Zambia, policy makers and regulators find themselves facing the question of how to approach regulating this new and fast-developing space at the convergence of ICT and financial services. Regulation will go far in determining not only whether branchless banking is legally permitted, but also which models of branchless banking are economically feasible and how far they will go in reaching previously unserved or underserved poor people.[2]

The questions surrounding regulation of branchless banking specifically targeting the unbanked poor have only recently begun to receive comprehensive and systematic attention.[3] CGAP's research on branchless banking regulation seeks to expand our evidentiary base. To this end, during the first half of 2007, we visited seven countries where policy makers and regulators find themselves on the frontlines of policy making about regulation of branchless banking targeted at the unbanked poor: in Africa, South Africa and Kenya; in Asia, the Philippines, India, and Pakistan; in Europe/Central Asia, Russia; and in Latin America, Brazil.[4]

Despite the many obvious dissimilarities among these countries and their situations, policy makers and regulators in the countries studied share a common challenge: how to formulate proportionate regulatory policy that gives space for innovation and permits branchless banking to scale up safely. This Focus Note offers guidance and recommendations based on analysis of the varied experiences of policy makers and regulators in these countries.

Key Topics and Recommendations on Regulating Transformational Branchless Banking

Among the countries studied, a surprising consensus surrounds the short list of most critical topics policy makers and regulators should address to formulate proportionate regulatory policy for transformational branchless banking.

We classify two topics as "necessary but not sufficient" preconditions:

- Authorization to use retail agents equipped with ICTs as the "cash-in/cash-out" point and principal customer interface
- Development of risk-based anti-money laundering (AML) rules and rules for combating financing of terrorism (CFT), adapted to the realities of remote transactions conducted through agents.

We classify four topics as "next generation" policy and regulatory topics. Though they may not prevent branchless banking from getting a start in a given country, they will figure in its success and sustainability as a means of getting financial services to the unbanked poor:

- Appropriate regulatory space for the issuance of emoney and other stored-value instruments (particularly when issued by parties other than fully prudentially licensed and supervised banks)
- Effective consumer protection (on a variety of fronts)
- Inclusive payment system regulation and effective payment system oversight as branchless banking reaches scale
- Policies governing competition among providers (which balance incentives for pioneers to get into the branchless banking business against the risk of establishing or reinforcing customer-unfriendly monopolies and which promote interoperability)

So what are our recommendations? Despite the difficulty of making strong normative statements in such a dynamic environment, our research leads us to make both process-related recommendations and content-related recommendations. The core content-related recommendations can be summarized as follows:

- Permit nonbank retail outlets to serve as agents – and consider carefully any restrictions on the range of permissible agents and types of relationships permitted.
- Evolve a risk-based AML/CFT approach adapted to the realities of small, remote transactions conducted through agents.
- Clarify the legal boundaries between retail payments, e-money, and other stored-value instruments and bank deposits.
- Create a regulatory category for electronically stored value that allows nonbank participation on defined terms.
- Create robust but simple mechanisms for consumer protection, covering problems with retail agents, redress of grievances, price transparency, and consumer data privacy.
- Consider the likely longer range competitive landscape today and how to reach the goal of interoperability.

Above all, our core recommendation for policy makers and regulators is to use proportionality as a guiding principle.

This excerpt is derived solely from CGAP Focus Note 43, the product of a collaboration between CGAP and the UK's Department for International Development (DFID), in partnership with the GSM Association, the global trade association for over 700 mobile phone operators. The authors also benefited from conducting three of seven diagnostic missions with the World Bank's Financial Markets Integrity Unit.

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When is Branchless Banking Regulation "Proportionate"?

The U.K. FSA offers these insights on proportionality and innovation in a recently released statement of principles:

"Proportionality: The restrictions we impose on the industry must be proportionate to the benefits that are expected to result from those restrictions. In making judgments in this area, we take into account the costs to firms and consumers. One of the main techniques we use is cost benefit analysis of proposed regulatory requirements. This approach is shown, in particular, in the different regulatory requirements we apply to wholesale and retail markets.

Innovation: The desirability of facilitating innovation in connection with regulated activities. This involves, for example, allowing scope for different means of compliance so as not to unduly restrict market participants from launching new financial products and services."[5]

A complementary lens for looking at proportionality in regulation of branchless banking, one that factors in the possibility of competing regulatory objectives, appears in "General Principles for International Remittance Services," jointly developed by the World Bank and the Committee on Payment and Settlement Systems of the Bank for International Settlements in Basel:

"…[P]roportionate means that the legal and regulatory framework…should not be overly restrictive and burdensome relative to the possible issues it is designed to tackle or the number and value of [transactions] involved…. In considering this, it is important to realize that the public policy objectives may not always point in the same direction…. Proportionality means that any such inconsistencies are recognized and resolved in a way that, in light of the country's overall priorities, achieves an appropriate balance." (Committee on Payment and Settlement Systems and the World Bank 2007).

**To read CGAP Focus Note 43 (available in English, Russian, Spanish and Arabic) go to http://www.cgap.org/p/site/c/template.rc/1.9.2583
Related publications may be found on CGAP's Technology page at http://www.cgap.org/p/site/c/tech/**

1 The term "banking" is used in this Focus Note in the sense of the full range of financial services that customers typically get from a banking relationship, even though, in many cases, the financial services in question do not directly involve a bank or constitute "banking activity" under domestic regulation.

2 In addition to regulation, two other interrelated issues will determine how rapidly branchless banking scales up and pushes the frontier of financial access in a significant way: (i) development of successful business models that show how to serve low-income people with financial services profitably using technology and (ii) understanding of factors that affect customer adoption among the unbanked poor. This Focus Note is about regulation, although the impact of regulation on business models and customer adoption is also part of this picture.

3 DFID's "The Enabling Environment for Mobile Banking in Africa" (Porteous 2006) (hereafter DFID 2006) and CGAP's "Use of Agents in Branchless Banking for the Poor: Rewards, Risks, and Regulation" (Lyman, Ivatury, and Staschen 2006) (hereafter CGAP 2006) each tackled, for the first time, big parts of the branchless banking regulatory landscape. More recently, several chapters in the Vodafone Policy Paper "Transformational Potential of MTransactions" (Vodafone Group Plc. 2007) picked up and expanded on some of the same themes.

4 This includes the pioneering countries that DFID 2006 and CGAP 2006 addressed, plus Russia (a middle-income transition country where elements of branchless banking are developing fast, notwithstanding the general absence of regulatory adaptations) and Pakistan (a country distinguished by the readiness of critical policy makers to undertake reforms to enable branchless banking to develop). This Focus Note contains information on the legal and regulatory positions in these countries that we believe to be accurate as of September 2007.

5 FSA, "Principles of Good Regulation" accessed September 25, 2007, at http://www.fsa.gov.uk/Pages/about/aims/principles/index.shtml

NGO MFI Transformations: Various Ownership Issues

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More and more nonprofit microfinance institutions (NGO MFIs) are transforming into for-profit companies, including regulated financial institutions. Transformations are typically driven by one or more of the following factors: an MFI's need for capital, its desire to offer services that may be limited to regulated financial institutions (such as savings), and new legislation or regulation requiring or permitting transformation.

Transformations raise a host of issues that NGOs and their founders and funders need to address. The complicated issues involved in switching from an ownerless entity to an entity with owners often are not well understood before the transformation process is initiated. This brief reviews seven areas in which those embarking on a transformation should research and seek legal counsel's advice. These areas and others are discussed in depth in Lauer (2008).

1. Factors that may interfere with an NGO retaining control over the transformed institution.

Legal requirements may leave an NGO with less ownership and control than it wants. The law may prescribe a maximum percentage of ownership. Significant owners (e.g., those owning 10 percent or more of the voting shares) may be subject to prior approval by the financial regulator. There may be restrictions on foreign ownership of companies. The initial minimum capital requirement may be too high for the NGO to meet. In addition, minority shareholders may have statutory rights to veto or influence voting on specific issues.

2. Restrictions on an NGO's capital contribution of loan portfolio and other assets.

Local law may prohibit an NGO from selling its loan portfolio or exchanging it for shares. Even if the loan portfolio may be contributed as capital, regulations may not recognize it as "tier 1" capital for capital adequacy purposes. And finally, other assets – such as employee contracts and intangibles – may be difficult to transfer or value.

3. Transferring liabilities.

An asset transfer by an NGO to the transformed institution may be subject to the NGO's pre-existing debt agreements or other contractual obligations.

An NGO MFI that has outstanding borrowings must review whether these liabilities will be assigned to and assumed by the new company or stay with the NGO. Although typically debt may stay with the NGO if the lenders agree, few lenders will want to be in the position in which they can look only to the NGO for repayment after it has transferred its loan portfolio – the principal source and guarantee of repayment – to another entity.

4. NGO-related parties as owners.

Many transforming NGOs as well as outside investors have expressed an interest in providing management, employees, and occasionally board members and trustees with an opportunity to be owners in the transformed institution. Insiders may purchase shares (either at the general offer price or at a discount) or receive shares without having to pay for the shares themselves in one of the following ways: the NGO may grant shares to individuals; the NGO may negotiate a grant from a donor to fund the individuals' purchase of shares in the transformed institution; a third party investing in the transformed entity may fund the issuance of shares to the individuals, typically in order to retain those in key management positions.

The granting by the NGO of shares to individuals raises ethical and sometimes legal questions as to whether public-purpose donations are providing private gains. Whether management, a board member, or a trustee is purchasing or being granted shares, entering into such an arrangement presents a clear conflict of interest issue that the NGO must address: that is, the individual being awarded shares is on both sides of the transaction.

The complicated issues involved in switching from an ownerless entity to an entity with owners often are not well understood before the transformation process is initiated.

5. Corporate governance.

The main difference between NGO governance and company governance is that a company is controlled by owners who have an incentive to protect their private financial interests, while an NGO has no owners and depends on the social motivation of its governing body. The Board of Directors has an important role to play in determining how the new for-profit institution will grow, be profitable, and manage its risk while preserving its vision. The board structure is key to ensuring the right balance between holding management accountable and enabling management to retain its independence and flexibility.

Aside from relying on the board, it is possible to have an agreement among shareholders that includes a statement on the mission of the company and also addresses issues regarding general operations. However, shareholder agreements are not enforceable in all countries.

6. Use of grant funds.

In general, grant funding for NGO MFIs is meant to benefit poor and low-income people by supporting the development of institutions that offer formal financial services to such people. Until recently, most donors did not contemplate the possibility of an NGO transforming into a for-profit company, so their policies and grant agreements did not address a situation in which the grantee would transfer its assets to a company with private owners. Today, most donors support the position that the primary purpose of the grant funds is to increase the poor's access to financial services and that if the funds are used to create a sustainable institution (i.e., the transformed institution) that is able to serve more of them by mobilizing savings and other capital, then the funds have accomplished their purpose. This is not to imply that donors are in favor of uncompensated transfer of assets from the NGO to private parties; rather, in most donor-approved transformations, the NGO receives shares or other value in exchange for its transfer of assets to the new institution. Careful attention must be paid to the pricing of those shares, to avoid unfair transfer of the NGO's assets, including grant funds, to private parties.

7. The long term: Ownership and mission.

Will anyone ensure that the original mission is pursued once the NGO no longer has control over the new entity? Will there be remaining shareholders with an equally strong interest in pursuing the original mission? These are significant and difficult questions, the answers to which will depend on the composition of shareholders and how that composition is permitted or not permitted to change.

Resource

Lauer, Kate. 2008. "Transforming NGO MFIs: Critical Ownership Issues to Consider." Occasional Paper 13. Washington, D.C.: CGAP, May.

Microleasing:

Two cases from Africa

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As microfinance reaches an increasingly mature status, many new products are becoming available, such as special savings accounts, rural finance, trade finance, insurance products, and microleasing. This article will describe the advantages and challenges of microleasing, including a description of two microleasing programs: a rural microleasing program run by K-Rep Development Agency in the Rift Valley in Kenya, and the other a more urban microleasing approach by Uganda Microfinance Limited.

Leasing is a form of asset finance in which the asset is bought by a financial institution (the lessor). The user of the asset (lessee) pays a periodic instalment, consisting of some form of rent and interest, to have the right to possess and use the asset. Unlike traditional loan finance, leasing focuses more on the capability of the lessee to pay the lease from the additional cash flow the asset generates. It is an interesting method of finance for clients without a credit history or collateral. The term "micro" in microleasing denotes leasing services to micro, small and medium entrepreneurs (MSME's) that have no access to commercial finance. In this article leasing and microleasing are used interchangeably where the general characteristics are the same for both.

Basically there are two types of leases: financial lease and operational lease. The difference between the two has mostly to do with the intention the lessee with respect to the asset. In the case of a financial lease, the lessee intends to own the asset after the lease has ended. The period and instalments will be structured so that after the leasing period is over, there remains just the process to transfer ownership of the asset once the lessee has paid the last instalment or a symbolic amount. The financial institution will be the owner of the asset until the end of the leasing period. The cases described in this article are examples of financial leases.

In the case of an operational lease, the lessee assumes the use of the asset more as a rental arrangement; the lessee does not want to become the owner of the asset. This type of lease may be more attractive where an asset becomes obsolete very quickly (IT or cars).

Unlike some forms of loan finance which are repayable on demand or subject to annual review, microleases cannot be curtailed or withdrawn in the event of a credit squeeze or a change in economic conditions. The lessee is therefore assured of access to credit and the asset throughout the lease term, except in the event of default at which time the contract can be terminated.

Leasing is sometimes regarded as more expensive than traditional lending, but it is inaccurate to compare traditional lending and leasing based on the interest rate only. To calculate the true cost of the lease the following aspects are to be taken into account: value of the asset at the moment of purchase and at the end of the lease term, interest rate, length of the lease term, creditworthiness of the lessee, and the option to buy or to return the asset. If the value of the asset is clearly determined, the interest rate may be lower than in traditional lending. Leasing also may be more valuable to the lessee when it reserves savings (that would have served as collateral) to be used as working capital, as leasing is usually up to 100% financing of the asset, whereas in traditional lending this would be between 60-80%. In general, the lessee has to pay for the insurance on the asset, which is true whether it is a financial and operational leases. From a development viewpoint this is positive as it makes lessees less vulnerable to damage to income-generating assets.

As to the legal aspects, one difficulty in leasing is that the user of the asset is not the owner. The user should have all opportunities to use the asset in return for a monthly instalment, but what if the lessee is past due? Or, what if the service provided by the supplier of the asset is not compliant to the expectations of the lessee? Who bears the risk for theft, damage, or death (in case of animals leased)? These are some of the important aspects to be clearly arranged in the lease contract.

Some countries have a Leasing Act in which obligations and rights are described, as well as tax issues. However, in Kenya and Uganda there is no Leasing Act. In Kenya it is not even allowed for a financial institution to be involved in trade. Leasing may be assumed as trade as the financial institution buys and owns the asset for other than its own use. This is the one of the reasons for K-Rep to call its program Asset Finance.

Leasing is a very specific form of finance that can only be used to buy the specific asset, avoiding misuse of a loan.

K-Rep Development Agency case study

The K-Rep Group was established in 1984 to support NGOs in micro and small enterprise development with financial, management and technical capacity needs. From 1992 K-Rep launched its own direct lending program. Today K-Rep is a conglomeration of for-profit and not-for-profit companies, with K-Rep branches covering all regions in Kenya via its banking network.

K-Rep is regarded as an innovative MFI as evidenced by Development Agency (DA), in which the microleasing product has been developed. The main objective of K-Rep DA is to develop effective methods of delivery of viable demand-led financial services to low-income people. After an experimental phase the more successful products are institutionalized. In the future the microleasing program will be hosted from a new, separate commercial division in the K-Rep Group.

Since 2005 K-Rep DA has piloted the financial leasing of income-generating assets in the Trans Nzoia and Lugari districts. This was a new type of financial product for Kenya's rural MSME's and smallholder farmers in the agriculture sector. Lessees can get finance for different types of assets, like beehives, irrigation equipment, poultry and dairy animals. After the lease term the lessee automatically becomes the owner of the asset after the payment of the last lease installment. In the meantime the asset has been generating additional income.

In the lease contract the client chooses an asset to be used for an agreed period of time. K-Rep DA pays the supplier directly or through the client and encourages customers to get goods with some form of guarantee, i.e. 6 months or one year. In exchange for the use of the asset, the client pays K-Rep DA fixed instalments and takes full responsibility for all the risks of ownership, including required maintenance services and insurance.

K-Rep started this type of financing to fulfill the need of smallholders to get specific assets financed for which they traditionally never received loans. The reason is that the targeted group of lessees had not the required collateral or reliable track record to get a traditional loan approved. Big advantages of leasing are that the loan is automatically covered by the asset financed, the financial institution is sure that the funds are used for the investment in an income-generating asset, and the asset is generating income to the farmer although the farmer does not possess the asset yet formally. Further, the program is comparatively simple and easy to understand for staff.

The leasing project focuses on clients with an average income of KSh 1500 (Euro 15) per month, who have little or no business experience and own cultivated land of half an acre or more. The majority are within the 56% of Kenya's population living below the poverty line. Their lack of assets, formal business and income-generating activities has traditionally excluded them from accessing financial services.

In the three years from 2005–2007 K-Rep DA has disbursed almost KSh 160 million (Euro 1,632,000) with which 5227 assets have been financed. The average size of the lease is KSh 30,610 (Euro 312). In 2007 55% of the leases were for the dairy sector, financing more than 100 cows that year.

K-Rep DA has plans to improve the microleasing product in two ways. First, because microleasing focuses specifically on rural agricultural clients, K-Rep intends to pilot an index-based insurance product to mitigate related risks. K-Rep will also seek technical partnerships for rural development, like training on animal husbandry and irrigation.

Uganda Microfinance Limited (UML) Case study

Uganda Microfinance Limited (UML) was formed in 1997 as an NGO, Uganda Microfinance Union (UMU), but was later transformed into a limited liability company and in 2005 was licensed as a Microfinance Deposit taking Institution (MDI) by the central bank. It has grown from one branch in Busiika to 27 branches countrywide.

In July 2006 UML introduced a new product, microleasing, that aims at helping people acquire productive assets. Initially UML focused the leasing product more on urban lessees. Assets that are financed by UML under this microleasing arrangement are: equipment (e.g. solar equipment for domestic or business purposes), (agro) machinery and motor vehicles. Under this arrangement clients acquire an asset without much collateral or a track-record. At the moment, 66% of the new applications are agriculture related projects or in the value chain for agriculture.

UML advises which parties are accredited suppliers for particular equipment, and the client chooses his/her own supplier. The lessor (UML) is responsible for purchase of the equipment thus eliminating any possibility of diverting the funds to other uses. Lessees are asked to deposit 20% of the asset value and the equipment purchased serves as the collateral. At the end of the leasing period the client pays a 2% option-to-purchase fee in return for title to the asset. All services regarding the asset during the term of the lease is a matter between the lessee and supplier.

UML regards microleasing as an extension of the range of methods of financing equipment. It allows lessees to adopt a mixed financing strategy using microleasing as one of several facilities that can be employed simultaneously to finance capital investment. Microleasing thus preserves the lessees' debt-raising capacity for working capital or other financing requirements. Lease rentals are tailored to match the income generating potential of the asset thus making the investment 'self-funding' with payment periods broadly matching the economic life of the asset. Microleasing is also an efficient means of financing due to the speed and ease of processing transactions, with turnaround time of five working days.

The microleasing portfolio of UML at the end of December 2007 (i.e. 18 months of operation) was approximately Euro 750,000 among 252 clients for an average lease size of Euro 3000. Maximum lease terms are greater than those by K-Rep, in amounts up to USh 40 million (Euro 25,000) and period of six to 24 months.

The product is currently being handled as a separate unit in UML; however, there are plans to roll it out to the other 27 branches in the country. This will entail a comprehensive programme of training the staff in leasing to enable them handle the product from their respective areas.

UML's microleasing programme faces a number of challenges:.

- There is a need for funding sources that allow leases to be done at fairly low rates so that the product remains affordable to the (rural) poor, and on longer terms (18-24 months) than traditional loans (3-6 months).
- Many of the small and micro enterprises that UML deals with are based in the rural areas. This adds risk as many cannot easily access repair centres and shops in case there is a problem with the equipment. Spare parts are not readily available in rural areas therefore the entrepreneurs are forced to take their equipment to towns for repair and servicing.
- Monitoring and repossession costs for the institution can be high when microleasing clients are dispersed across the whole country. UML plans to overcome this problem by rolling out the product to other branches, serving microleasing clients locally.
- Another big challenge is taxation. VAT is applied on leasing transactions in Uganda except for items that are exempted or zero rated. However many microleasing clients fall below the threshold and are not registered for VAT. This makes the product expensive to them as they cannot claim back the VAT. For now there is no solution for this problem.
- Finally, lack of awareness is limiting how fast the product can be taken up by clients and therefore there is need for a massive campaign to sensitize people about the product. A number of UML's partners such as ASPS Danida and GTZ have expressed interest in funding these programmes both on radio and in other media.

Conclusion

So far in the African context leasing has been a great success and an interesting and informative example of an alternative way of microfinance for MFIs in ECA. It overcomes the problem of borrowing for an income-generating asset that would not be financed by a traditional loan due to lack of collateral and credit history. It is also a very specific form of finance that can only be used to buy the specific asset, avoiding misuse of a loan.

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