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

MICROFINANCE Policy Monitor

Published by Microfinance Centre for Central and Eastern Europe and the New Independent States
Publication sponsored by the Open Society Institute

ISSUE NO. 14
SEPTEMBER 2009

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Russian Credit Cooperatives Come Under Legal Regulation

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On the 20 July, 2009 the President of Russian Federation signed a federal law «On credit cooperation». The National Partnership of Microfinance Market Stakeholders (NAMMS) and the Russian Microfinance Center (RMC), during 2008–2009, have both taken very seriously the preparation of the text for the second reading. Both organizations have organized discussions of the draft law provisions with market participants and regulators with the help of CGAP expert support. The introduction of the law is a significant event for thousands of Russian credit cooperatives: from now on, despite their differences, they all come under the same regulation and credit cooperation is recognized by society as a uniform, self-regulating, useful system of an organizational-economic relationship.

For many years Russian credit cooperation legislation had been quite patchy, there were regulations on different types of credit cooperatives, but there was no uniform law on credit cooperation.

Thus, the federal law «On credit consumer cooperatives of citizens» applied to the activities of those cooperative which had only individual (physical persons) membership. This law was adopted in August, 2001. Almost 8 years of experience have shown that the number of provisions have to be changed because they hinder the development of credit consumer cooperatives of citizens. For example; limitation of number of cooperative members (no more than 2000 persons), limitation of lending for business purposes (no more than 50% of total volume of the mutual fund), a very rigid quorum for general meetings (for a meeting to be considered legitimate not less than 70% of cooperative members have to be present) and so on.

The federal law «On agricultural cooperation» regulates the creation and activity of cooperatives, incorporated by agricultural producers or small farmers. Only one article in the law is credit cooperative specific.

The federal law «On consumer cooperation (consumer societies and their unions) in Russian Federation» regulates activities of traditional types of cooperation (for example trade and purchase, sales, supply, procurement). It does not recognize the uniqueness of credit cooperatives as financial institutions. In addition, article 2 of the law states, that it does not cover specialized consumer cooperatives – particularly, credit ones.

The laws resulted in “regulatory arbitrage” – credit cooperatives were able to «move» from one law to another or even completely «get away» under the general provisions of the Civil Code of the Russian Federation (article «Consumer cooperatives») – now as the law has been adopted all credit cooperatives (with the exception of agricultural cooperatives which are regulated separately) despite the formal title will be under the regulation of the new law. So, changing the name or type of cooperative will no longer enable cooperatives to ignore the limitation on financial risks.

The new law «On credit cooperation» defines credit cooperation as a system of cooperatives of different tiers, their unions (associations) and other alliances.

The law underlines the essential difference of credit consumer cooperative activities from banking. In the law, cooperative activity is defined as being an organization of mutual financial assistance of cooperative members through the pooling of their shares, mobilization of cooperative members’ funds and other funds and also investment through lending exclusively to cooperative members. If earlier practitioners avoided banking terminology, so as not to be associated with banks, now the legislator explicitly states mobilization and investment of funds by cooperatives, thus underlining, that the issue is not what to call the transaction but how to the cooperatives operate: cooperative only operate with members’ funds, not with other individuals or companies, and in its activity is guided not by profit maximization but by safety, accessibility and security criteria, following financial legal standard in order to protect the best interests of its members.

The law specifies and expands on the set of principles of credit cooperative activities in compliance with international standards of credit cooperation. In particular the principle of mutual assistance of members is assigned, the voting principle «one person – one vote», disregarding the cooperative member's contribution, equal access of cooperative members to financial assistance and other cooperative services, equal access to information of credit cooperative activities.

Now, that the federal law has been adopted, a new level of discussion will begin in relation to the specificities of income and expenses of credit cooperatives. This is very important when defining an efficient tax policy to support their development and transparency.

The system of measures of cooperative members and protecting their funds is provided for in the new law. The specificities of contracts, limitation of financial risks, formation of special funds, system of cooperative risks insurance are defined in the law. In previous laws special provisions for members and their funds protection were stipulated by separate laws on separate types of cooperatives, and every law had its own specificities. Some cooperatives were not covered by any Federal law with its limitations but now all the cooperatives with such kind of activities have to follow the same financial standards and limitations.

In order to protect interests of regular members and to prevent «leakage» of individual's funds through cooperatives and affiliated structures a definition of affiliated (connected or interdependent) persons has been introduced in the new law.

The law is sensitive to the challenges of new credit cooperatives, for those cooperatives younger than two years old and special softer financial standards have been introduced.

The federal law On consumer in Russian Federation regulates activities of traditional types of cooperation.

General requirements for book-keeping, reporting and document storage of credit cooperatives are defined. Particularly, compulsory audits are required if the annual turnover of assets amount of credit cooperative stipulates a compulsory audit.

The law allows for personal savings of individual members to be maintained. This specific character was stipulated, previously, by only one federal law – «On credit consumer cooperatives of citizens» – and individual's funds in other cooperatives were not protected in the same way. With the new law all individuals whether they are members of «pure» individuals' cooperative or cooperative with legal entities, they will be equally protected by the law.

Previously, cooperatives were able to sign every member with an individual contract (different members require different terms) but now this is a contract of adhesion, for example contract, with conditions pre-defined by one of the parties (cooperative) in inner provisions, adopted by general meeting of cooperative members with uniform terms. Thereby abuse of «uncomfortable» members and favoritism towards «important» persons is excluded.

The new law provides for many practical issues, such as procedures of incorporation, reorganization and liquidation of cooperative, governance and control issues which are redefined.

The law stipulates rigid requirements for the creation and stability guarantees of second tier CCCs, in other words for credit cooperatives, with only credit cooperatives as members. Second tier CCCs must have a minimum RUR 10 million members' capital available within one month and RUR 50 million available within one year. Directions of second tier CCCs funds have been determined. No other tiers – third, fourth etc. are provided for. Second tier cooperatives are allowed to consolidate their funds, incorporating not a cooperative, but a bank. Thereby the uniformity and interaction of different sectors of the financial market is provided for in the new law.

Unlike earlier credit cooperation laws, the system of government regulation of cooperative activity is logically, clearly defined and the functions of the government regulator are identified, for example:

- to keep a register of credit cooperatives and their self-regulating organizations,
- to adopt regulations for CCCs, their unions (associations), self-regulating organizations and other alliances of credit cooperatives,
- to establish additional financial standards for CCCs and investment requirements for a CCC reserve fund,
- to interact with CCC self-regulating organizations,
- to monitor activities of the largest cooperatives – those with over 500 members and also second tier cooperatives,
- to monitor self-regulating organizations activities.

The new law On credit cooperation defines credit cooperation as a system of cooperatives of different tiers, their unions and other alliances.

Both government regulation and the government regulator are important, previously the federal executive body, authorized to regulate credit consumer cooperative activities, was not defined, now the text of article 5 of the new law, explains the general competency of this body and states that the regulation is to be executed by the Ministry of Finance of the Russian Federation.

Previous systems of self-regulation of credit cooperation was spontaneous, and the majority of cooperatives are not members of any association and function, «somehow», according to the new law for all cooperatives, but second tier cooperatives, must be members of Self-Regulating Organizations (SRO).

Within 3 months from the start or termination of membership in other SROs, CCCs (excluding second tier CCCs) must join SRO. It is prohibited to mobilize funds and accept new members for those CCCs, that are not members of SRO or left one SRO and have not yet joined another. In cases of violation the cooperative can be liquidated (by court decision, by authorized body or tax body). The law allows cooperative membership in only one SRO.

SRO acquires its status as it consolidates a minimum 100 CCCs or minimum 5 CCCs, with a total number of members over 100 thousand, as well as meeting other requirements, stipulated by the law.

The law defines functions, rights, duties and responsibilities of SROs.

Unlike the present associations of credit cooperatives, SROs will not only «manage», but will also be responsible by property and reputation for association members. SROs must guarantee the responsibility of cooperatives for their members through the creation of a reserve fund and risk insurance in insurance companies or mutual insurance companies. The amount of reserve fund compensation, according to the new law, should be not less than 0.2% a year from the average assets of a SRO member. The reserve fund compensation for a single SRO member should not be higher than 5% of the reserve fund. Assets are defined for reserve fund's investments and the rules of such investments. If the SRO violates provisions of the law, it can lose its status. If this happens, assets of reserve funds are to be distributed among SRO members according to their contributions into reserve fund and after three years from the moment of exclusion of the organization from SRO register to be repaid to organization members. The basic rules of SRO supervision are defined – routine audits at least once every two years, and extraordinary audits when complaints are filed. The authorized government body is allowed, in the process of SRO audit, to take a decision to audit any SRO member.

The law will be effective ten days after it is officially published. The only exceptions are financial standards of credit consumer cooperatives and the necessary changes in the statute which have to be completed within a year. A separate term of two years is provided for to build a credit cooperation self-regulation system. Within these two years direct government regulation and supervision of CCC activity will be executed.

Thus, the law consolidates best practices of CCC activities, emphasizes savings and individual interests protection, provides for safe activities of CCCs, their stability and transparency, develops interacting and complimentary systems of government regulation of CCCs activities and self-regulation, builds foundation for enhancement of taxation, state support etc.

KYRGIZSTAN

Prospects for developing microfinance in the Kyrgyz Republic

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Significant achievements in microfinance have been achieved as a result of the dedication of the government and the National Bank of the Kyrgyz Republic (NBKR). Government bodies and the regulator represented by the Central Bank are paying particular attention to supporting microfinance and the real success of the sector is way above expectations as the following figures demonstrate:

At the end of 2008 there were 539 Microfinance Institutions (MFIs) and Credit Unions (CUs) with a total loan portfolio of SOM 7.3 billion or USD 170 million, 241 000 borrowers. In comparison the loan portfolio of commercial banks is SOM 25 billion or USD 580 million. Microcredit Agencies (MCAs), Companies (MCC) and Microfinance Companies (MFCs) account for 87% of the total loan portfolio.

Since 2003 the number of MFIs has increased from 72 to 291, their loan portfolio has increased 15 times and the number of borrowers has increased more than 6 times.

According to internationally recognised MFI development indicators for population coverage, the Kyrgyz Republic is the leader of the Central Asia region. During the last three years average annual growth of the total loan portfolio has been 65%, with a comparable growth rate of borrowers.

The Kyrgyz Republic has a strong microfinance market regulatory and legal framework and the supervision of financial markets and banking is developing. **In addition, rapid growth in the microfinance sector has been due to the following:**

- Special laws On microfinance institutions and On credit unions are in place. These laws stipulate legal standards and rules both for the business environment and regulators. Regulators use a flexible approach to mitigate risks and facilitate access to financial services for the poor in remote areas of the Kyrgyz Republic;
- Absence of currency exchange regulation for external investments, favourable investment environment, tax and customs policies;
- Stability of microeconomic indicators for a number of years and particular characteristics for economic development – a predominance of agricultural sector, small and medium sector development and a lack of large industrial enterprises; and
- In 2006, the government and NBKR approved the Middle term microfinance development Strategy for 2006–2010.

Non-banking finance institutions are regulated by special laws: On licensing, On accounting, On collateral, On cooperatives, On anti-money laundering and combating the financing of terrorism (AML/CBT), On foreign currency transactions.

At the beginning of 2008 the On credit unions has been amended and changed, which will allow:

- The elimination of discrepancies of the current legal framework for credit unions

(as non-commercial organizations) because of their right to distribute profit as dividends among participants with Civil Code provisions;
- The establishment of a legal base for establishing and regulating apex institutions (including central credit institution, stabilization fund, deposit insurance fund), aiming to redistribute resources, liquidity management, deposit insurance and other supplementary services for credit unions.

Development of the microfinance sector has also been helped by legal entities, such as rural enterprises, farms or cooperatives being allowed to become participants of Cus. Additionally, payment services and money transfers with banks or other financial institutions are allowed and legal provision is being developed to transform Credit Unions into other financial institutions. Recently, the provision and procedures of termination of Credit Unions has been amended.

The Kyrgyz Parliament, to further develop the microfinance sector, is amending the law On microfinance institutions. During the drafting process of the law, many MFI representative requests were taken into account, especially those that aim to expand the range of MFI activities. The law stipulates the following changes and amendments:
- Expanding the scope of MFCs activities (loans/leasing in a foreign currency, money transfers, currency exchange, limited guarantees)
- Expanding the scope of MCCs activities (money transfers)
- Cancelling licensing requirements for leasing for MCAs and MCCs
- Legal entities participation in MFCs' equity
- Definition of donor organization and international finance institution
- Requirements for an organisation to call itself an MFI
- Information on pricing of MFI services
- Principles of fair lending
- MCC/MCAs registration procedures according to new edition of the law On legal entities registration
- Origin of the capital requirements in compliance with AML/CFT

Taking into account how the legal framework has developed, the growth in the number of MFIs, how regulation and supervision has been adapted to microfinance, it is the time to develop further the existing Microfinance Development Strategy and develop the new Microfinance Development Strategy for 2010–2015.

Any development is controversial and subject to barriers and limitations. Just because there has been a rapid growth in the number of MFIs, this is not evidence of any quality of the MFIs or their contribution to financial intermediation. It is well known that the majority of microfinance lending is carried out by a dozen large MFIs founded by big microfinance players such as FINCA, MercyCorps, ACDI VOCA and the Aga Khan Foundation. This raises the question of which MFIs have a right to exist, is it only well capitalised companies or all companies who have a minimum capital requirement SOM 50000 / USD 1200 or even MCAs without any capital requirements.

Internal saving has not really increased. Lending in the Kyrgyz Republic is still dependent on external sources: at the end of 2008 71.3% of the loan portfolio of Non Banking Financial Institutions (NBFIs) was funded by international donor organisations. The reasons for this phenomenom need to be explored further.

Despite the growth of microfinance in the Kyrgyz Republic, there are a number of issues of concern:

The current position of the Central Bank to minimize the regulation of non-depositary MFIs and simplify market entry requirements cannot last forever. This is because it not only causes banking risks but also raises issues of transparency, reporting, taxation and trust in the financial system. Questions are being asked about statistics, because the NBKR is not able collect data from MFIs who are not under NBKR supervision.

The regulator is concerned about the development of apex institutions. Credit Unions ban be founded and/or governed by specialized institutions, regulated by the NBKR, including central credit institution, deposit insurance fund and stabilization fund. What and who should boost their emergence and development? Should it be donors, strategic investors, MFIs and Credit Unions with their associations, government and\or special programs?

The new law On credit unions, stipulates the transformation of Finance Lending Institutions (FLIs) from one legal status to another legal status. However, there is an absence of prudential supervision of MFIs, and the termination of Asian Development Bank credit line forces Credit Unions to think about benefits of transformation into MCCs or MFCs. Will it hurt the system of Credit Unions, which has a longer track record and higher dynamics of development than MFIs? Credit Unions operational and lending principles are quite different; each institution has its own niche, its own clientele and its own objectives in the system of commercial banks and FLIs in te Kyrgyz Republic.

The protection of customers, society and government and the integrity of the Kyrgyz financial system from criminal activities needs to be considered. AML and CBT mechanisms have been brought in. According to Kyrgyz Republic law No. 135 dated 31 July 2006 On anti-money laundering and combating the financing of terrorism all MFIs and Credit Unions must take measures on anti-money laundering and combating the financing of terrorism. This law which affects microfinance activities has not been taken into account by the current microfinance strategy.

Anti-crisis measures in microfinance may impact the development of the microfinance sector. There are two scenarios: either an acceleration of the development of the sector due to the lack of commercial bank loans or a decrease in MFIs loan portfolios due to clients being insolvent. As microfinance clients are quite distinct from the corporate sector, microfinance clients may not suffer such high losses as their purely commercial counterparts.

Finally, modern trends are transforming access to greater financial access, such as branchless banking and mobile telephones. Lessons can be learned from developing countries experience in changing cash to e-cash on mobile telephones. What is the future of these services? Will they develop to offer alternative financial services and delivery channels for the unbanked poor in the Kyrgyz Republic? The Central Bank is already working on how to legislate and regulate such new banking products.

In conclusion the issues and questions which need to be addressed when developing the new strategy are much deeper and wider than has been possible to cover in this article. We will only be able to find out what the real issues and questions are if the government, NBKR, MFIs and Credit Unions agree unanimously to adopt a microfinance development strategy for a new five year period.

Changes in microfinance legislation in Kyrgyzstan

– step ahead or crash of microfinance?

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Kyrgizstan

For nearly two years we have been working on changes and additions to the current Law of Kyrgyz Republic On microfinance institutions. The Law On changes and amendments to certain legal acts of Kyrgyz Republic (Laws On microfinance institution, On foreign currency transactions has been submitted to Kyrgyz Parliament.

Despite the fact that certain the most advanced propositions of local Association of Microfinance Institutions (AMFI) has not been approved, these changes is a step ahead and they are very promising for further development of microfinance sector, to increase MFIs transparency, and also facilitate customers protection and market competition.

Thus, the following changes are proposed in the draft law:

- The scope of transactions of microfinance companies is expanded (depository institutions):
  – money transfers (contract with a bank),
  – lending and leasing transactions in foreign currency,
  – providing guarantees, in the amount not exceeding maximum loan per one borrower.
- The scope of microcredit companies' activities is to be expanded (non-depository, commercial organization) with money transfers (contract with a bank), including ones in foreign currency.
- Leasing no longer requires license for microcredit companies and microcredit agencies (non-depository, non-commercial organization).
- In order to protect customers of microfinance services:
  – MFIs are to be required to publish effective interest rate and full cost of the loan;
  – MFIs clients will be allowed to refuse receiving a loan (leasing) without sanctions in the period between signing a contract and actual money disbursement (leasing payment for the assets);
  – It will be stipulated, that repayment of the loan (leasing) before maturity should be economically more advantageous for a client comparing to repayment according to terms stated in the contract.
- Definitions of donor institution and international financial institution are provided.
- The goal of MFI in terms of further development or market relationship and competition is specified.
- Naming MFIs, using names of existing banks or MFIs or those in the process of initiation is prohibited, in order to avoid misuse of names.
- More accurate statements and changes are introduced.

As we can see, new changes in the legislation can positively influence sector development, though not as radically as microfinance institutions would want. However, today microfinance sector is under the clear threat which can hinder its development or even cause the bankruptcy of the industry. This threat is reflected in the initiative of some Parliament representatives to impose interest rate caps for microfinance institutions.

Unfortunately, a question has been raised at the very same moment the draft law was offered to the Parliament, that is very comfortable situations for initiators of interest rate caps and disadvantageous for MFIs. On one hand microfinance community is looking forward for adopting the new law On microfinance institutions, on the other hand it is strictly against imposing interest rate caps. There were even proposals from MFIs to recall the draft law from the Parliament.

Aside from political and other reasons of this problem, we can note a number of negative economic and social consequences of interest rate caps for situation in Kyrgyzstan. Such as outflow of investments, escape of MFIs from certain markets, favorable environment for corruption, etc.

It may sound ironic, that the most dramatic consequence of that alleged government «concern» for MFIs' clients could have the reverse effect. Escape of MFIs from the most unprofitable sectors (especially agriculture), having in mind lack of resources, will make clients use services of informal lenders, who operate in grey area and their interest rates are way higher. Besides, clients of informal markets will be absolutely unprotected. People would have to ask for favors illegal moneylenders, who are working not entirely legally and charge exorbitant interest. This is what those «advocates» can do.

There's one more serious issue, crash or escape to shadow economy of about 80% of existing MFIs. Microfinance sector in the country is diverse in terms of both experiences of MFIs, and portfolio volumes, assets, financial sustainability. From MFIs working in all the regions of the country, to small MFIs working in just one village. As of January 1, 2009 there are 291 MFIs registered in Kyrgyzstan. Of them there are only 3 MFIs with loan portfolio over KGS 1 billion (approximately USD 23 million), 4 MFIs with portfolios from KGS 100 million (USD 2,3 million) to KGS 500 million (USD 11,5 million), about 25 MFIs operate within the range from KGS 10 million (USD 232 thousand) to KGS 100 million (USD 2,3 millions). The rest, almost 260 MFIs are operating with small portfolios and not well enough developed.

In terms of institutional development, financial sustainability, staff and management professionalism, approximately 10-20 MFIs will be able to withstand and somehow survive in case if interest rate caps will be introduced. It's very unlikely, that the rest of MFIs with costly financial resources and high operational costs will be able to operate any longer. They either will be terminated or escape to grey economy.

Starting from year 2002 as the law On microfinance institutions has been adopted which paved the way to MFIs development; we are witnessing a rapid growth of numbers of new MFIs in the country. It's reasonable to ask, why the Government which started pursuing a liberal policy towards MFIs in 2002 after 7 years decided to ruin those MFIs with the help of administrative measures. Is it a prudent Government policy?

Pretentious «concern» about clients of microfinance institutions, may cause reverse effect both for clients and industry as a whole. The only proven way of lowering interest rates is market mechanism – competition and efficiency of MFIs, stable macroeconomic situation in the country.

Access to finance: a paradigm shift in microfinance?

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Access to finance has become an important part of the recent development agenda. Evidence shows that financial development significantly contributes to economic growth and access to finance plays a critical role in this process. Therefore access to finance emerges as a robust paradigm competing with microfinance which dominated the field for the past decades.

Microfinance and Access to Finance

Microfinance – the provision of mostly small credit services to the self-employed poor – has grown in importance with over 100 millions clients around the world. Despite its many successes in the past 30 years and massive funding support from public and private donors alike, microfinance so far has missed out on its promise to provide access to finance in the broader meaning of the word. Low penetration rates in most countries (with some notable exceptions in Asia), lack of economies of scale and an excessive number of microfinance institutions consuming donor resources raise doubts about the contributions of the movement to financial sector development.

Research reveals that sustained economic growth is associated with the successful development of the banking system that mobilizes savings on a large scale. Traditional lenders and other informal credit institutions including microfinance are necessary in the first stage of development when access to banks is limited by scarce collateral. These institutions pave the way developing new markets and stimulating competition. Over time, with the improved income and accumulation of assets, the role of banks increases and the micro-lending institutions occupy a complementary niche role to cater to clients remaining still outside of the banking system.

What is Access?

It is difficult to define and measure access to finance because it has many dimensions. Broad access to financial services – also sometimes called financial inclusion – implies an absence of price or non-price barriers in the use of financial services. Financial services need to be available when desired, and products need to be tailored to specific needs; the prices for these services need to be affordable, including all non-price costs such as having to travel a long distance to a bank branch. And most importantly, the services must also make business sense resulting in profits for the providers of these services.

Lack of access is not the same as exclusion. While access to financial services relates to the situation where a substantial part of the population cannot use these services because such services do not exist, exclusion occurs where services are generally available but certain groups do not participate on account of their social, ethnic or economic status (e.g. minorities). Although lack of access and exclusion has a similar result – preventing people from participating in the financial system – they may require different strategies and policies to be resolved successfully.

Importance of Access: Emerging Evidence

There is a strong and causal relationship between the depth of the financial system and growth and poverty. Finance allows individuals to smooth income over time and insure against risks lowering vulnerability. By providing access to investment opportunities, it raises income levels helping to improve income distribution and poverty reduction.

Finance matters especially for poor households and smaller firms. Yet in many developing countries the financial system does not cater to the needs of all agents of the society. Banks and other financial institutions (like stock exchanges) serve large enterprises and wealthier individuals. Substantial segments of the enterprise and household sector suffer from lack of access to finance, hindering their growth and welfare.

Measuring Access to Finance

Despite its importance for growth and poverty reduction, access to finance is a difficult concept to operationalize.

Till this date there are no coherent cross country or country specific indicators that measure access to finance. Financial services come in various forms – credit, savings, payments, insurance – each of which has its distinct set of characteristics, risks, costs and methods of delivery. Access may require multiple measures that would reflect this variety of services.

In general conditions conducive to access to financial services can be grouped into the following three categories:

- **Supply of Financial Services**
  Physical (and virtual) presence of outlets (branches, ATMs, POS, etc.) are the backbone of the financial system and are the key ingredient of access to finance. Lack of products will constrain usage of financial services. In addition financial services need to be readily available for consumers in terms affordability, simplicity of application, etc.
- **Demand for Financial Services**
  Despite availability customers may be reluctant to use financial services because they may not trust that their savings will be protected and available when needed. They may also doubt the quality or security of financial transactions.
- **Pro-Access Policies and Regulations**
  Repressive policies and regulation constrain financial development and access to finance.

Other Dimensions of Access to Finance

Credit services are distinctly different from payment and savings services. Payment and savings infrastructure requires substantial investments and therefore need economies of scale, the conditions that do not necessarily exist in many developing countries. Banks may not be willing to locate branches (or close them down) in smaller towns if there is not enough volume of business to be profitable. Credit services, in addition to costs which may be very high in remote and less populated rural areas, face a set of additional constraints due to risks, especially default risk on top of various systemic macroeconomic risks. Lenders have to compromise returns with the costs of providing the services and associated risks.

It is also necessary to distinguish the needs of individuals (households) from the needs of enterprises, in particular micro and small enterprises. Both segments need different financial products and access strategies may be different in each case.

How Much Access: Finance for All?

Lack of use does not automatically imply an access problem. Households and firms may not be using credit because they do not need to borrow or they lack viable investment projects. In such cases promoting credit might lead to imprudent borrowing and may have adverse effects.

Lack of access becomes a problem when the financial system does not support and stimulate economic growth and economic opportunities which drive it.

Universal access (usage) may not be a desired public policy. Broadening access for its own sake too forcefully raises concerns and risks: excessive and imprudent access to credit, often at unfavorable terms, raises indebtedness as poor borrow beyond their repayment capacity leading to their further impoverishment.

Each country has its own 'normal' level of access to financial services which is consistent with their level of overall development, income levels, state of infrastructure in a country, capacity to enforce laws, etc[1]. Extending financial services to a larger segment beyond what is optimal in relation to the current level of development may not be rational: the costs of induced provision may outweigh its benefits.

Broadening access to finance is a long term process. Based on observed financial indicators some researchers[2] have suggested three stages of access to finance development:

- Repressed access: access is limited to the very low percentage of the population,
- Intermediate phase: up top 50% of the population is starting to use financial services to some degree for their daily financial needs
- Full access: at least half of the population is using banking services.

Strategies to improve access in each scenario may be different.

Access to Finance in Transitional Economies of CEE/NIS

In the past countries in Eastern Europe and Eurasia experienced relatively high access to finance: individuals and enterprises had bank accounts and used them on a regular basis even though the financial products were limited and the overall system lacked sophistication. Savings and payment facilities were practically universally accessible for all.

Transition to the market economy changed the situation dramatically: bank privatization, bank crisis, hyperinflation and overall financial instability undermined the trust in the banking system in the 1990's which left many people see their lifetime savings disappear. Both the financial infrastructure and the public confidence in the system were undermined from which access to finance has to be rebuilt.

Yet this process has taken various paths with Central Europe achieving higher levels of access and the NIS countries lagging behind. These outcomes are in line with the general observation that financial deepening have materialized only where the institutional environment was sufficiently favorable, in particular reforms strengthening the private property and contract enforcement.

Transitional economies face both access and exclusion problems, although to a varying degree in different countries. Countries moving towards full access to finance (such as Poland, Czech Republic or Estonia) experience more exclusion than general access problems. The situation in other countries especially in the NIS region (such as Kyrgyzstan or Tajikistan) is the opposite: creating opportunities for wider and deeper access for the majority of the population is still the main challenge.

How to Increase Access to Finance?

Access to finance is not a straightforward issue. It requires concerted efforts to understand the problems and seek appropriate solutions to be able to expand access to finance and reduce exclusion in a meaningful way. While existence of financial institutions and products is very important, it is only a necessary and not a sufficient condition for broadening and deepening access to finance.

Here are a few suggestions as to how one can design the process of developing access policies on a country level.

1. **Create an Interest Group:** Access to finance is not a typical policy issue and requires engagement of various institutions and stakeholders. Close inter-agency cooperation is very important.
2. **Capture the Big Picture:** Assess the level of access to finance implied by the level of economic and social development of the country.
3. **Develop Measures of Access:** Create a set of measures that best suit your policy goals and adequately describe the use of and access to financial services.
4. **Identify Available Data:** Use locally available data and enhance them by surveys.
5. **Understand the Nature of Access to Finance and Exclusion Problem:** Problems may originate from the supply side, demand side or the public policy.
6. **Develop an Access to Finance Strategy:** Prioritize your actions based on the nature and scale of the problem.
7. **Implement Specific Actions:** Launch appropriate actions to address the most pressing issues as developed in the strategic plan.
8. **Monitor Progress on an on-going Basis:** Developing access to finance is a long term evolutionary process. Revise the strategy as needed.

Conclusions

Microfinance despite its advances is but one component to create conditions for broad access to finance. Development strategies may have to be revised to include a stronger role for banks and other institutions to collect savings and create efficient national payment systems to facilitate financial transactions.

Access to finance is intimately related to the overall economic condition of a country. Expanding access to finance should go hand in hand with the other aspects of development like job creation, basic infrastructure, education, health and social participation.

1 Beck and de la Torre call it 'access possibilities frontier'. See: T. Beck, A. de la Torre, The Basic Analytics of Access to Financial Services. World Bank Policy Research Working Paper 4026, October 2006.
2 S. Peachey, A. Roe, Access to Finance: A Study for the World Savings Banks Institute. Oxford Policy Management, October 2004.

Creating the Campaign for Client Protection in Microfinance

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The Campaign for Client Protection in Microfinance (www.campaignforclientprotection.org) was born out of the recognition that by providing financial services to low-income people, microfinance providers have a special obligation to serve them fairly and respectfully. Competition, the desire to achieve profitability, and internal-sales incentives may all play a role in pushing financial institutions into practices that do not coincide with pro-consumer ideals. At the same time, inherent risks in the delivery of financial services not only affect clients negatively but also the MFI's bottom line. These risks – such as client over-indebtedness, inflated interest rates and lack of transparency, unethical lending and collections practices, and loss of client data – can damage their business and their clients, but they also lay the industry open to political interference and reputational damage. The time to do something about these risks is right, especially given the sub-prime crisis in the United States, and increasing focus on interest rates and transparency in microfinance.

The Campaign for Client Protection in Microfinance seeks to unite microfinance providers worldwide to develop and implement standards for the appropriate treatment of low-income clients based on six principles (see box). It is being led by the Center for Financial Inclusion at ACCION International (CFI) which is working with MFIs, associations and networks, in partnership with CGAP, which is working with investors, donors and regulators. A 28-member international Steering Committee provides guidance and advice to the Campaign staff which is housed at the CFI.

The overall objective of the Campaign is for the six principles to become embedded within the fabric of the microfinance community and for microfinance to be recognized as a strongly pro-consumer industry.

The Campaign structure serves as the vehicle for world-wide industry collaboration and will support the microfinance industry as a whole to incorporate 'best practices' in consumer protection and transparency. As of mid-July 2009, over 650 MFIs, networks, associations, investors, donors and individuals have endorsed the Campaign.

The Campaign is not just about ethics. There is a strong business case for MFIs to incorporate client protection into their operations – stronger, longer lasting relationships with clients, greater staff satisfaction, increased client recruitment and retention, and reduced financial risk. And, the Campaign does not claim to have all the answers, the tools or training modules. To be successful we need the help of all industry stakeholders because together we can discover how best to advance this agenda and integrate good consumer protection practices more fully into all institutions that work in microfinance.

Working with CGAP, more than 80 MF investment funds and most major donors have endorsed the Campaign and are beginning to incorporate the client protection principles into their due diligence activities. Investors are working together to identify more practical ways of incorporating the Client Protection Principles into their screening, audits, funding agreements, monitoring, reporting and governance roles.

Networks such as the Microfinance Centre play important leadership and implementation roles in the campaign plan by educating their members about the competitive advantages of providing transparent, respectful and prudent financial services, and supporting member MFIs with assessments, tools and the training they need to deliver those services to all clients.

In development during a year-long pre-launch phase, The Campaign for Client Protection in Microfinance will formally launch in September 2009 with a new name and logo, website and three-year plan. To reflect is global nature, the Campaign website and all resource materials will be available in five languages: English, Spanish, French, Russian and Arabic. A comprehensive campaign plan is being finalized as this article goes to print. It will be available to the industry at www.campaignforclientprotection.org/strategy.

The primary objectives of the Campaign are to:

- Raise awareness throughout the microfinance industry regarding client protection.
- Unite and collaborate with microfinance providers worldwide to develop and implement standards for the appropriate treatment by microfinance institutions (MFI's) of low-income clients based on the six principles of client protection.
- Create a website community to unite financial service providers, microfinance professionals and supporting organizations and enable dialogue and continued collaboration around client protection.
- Provide microfinance practitioners with tools and resources to facilitate their implementation of pro-client standards, utilizing the website to offer continued support and communication.
- Work towards certification standards that set apart those institutions which have fully implemented pro-consumer practices.

First step: Endorse the Campaign

While just a first step, endorsement of the Campaign and six principles signals the intention of MFIs, networks and associations to put consumer protection initiatives at the core of its operational plans and institutional values. Endorsers commit to 1) a process of energetic implementation of the principles in their own organizations and 2) promotion and support of the Campaign. For MFIs, endorsement begins with 1) an examination of each Institution's own policies and practices to identify areas for improvement and 2) completion of a Campaign Action Plan, and 3) active promotion of the principles among staff. Individuals endorsing the Campaign are signaling their intention to honor the principles personally and to work within their own organizations to implement them.

For networks and associations, endorsement is a commitment to engage with their affiliated organizations to promote and support the Campaign and the implementation of the principles.

It is important to note that the Campaign itself is not an enforcement mechanism. It seeks to develop mutual accountability across the microfinance sector. For those institutions signing on to the Campaign, self-assessments and reporting along guidelines established by the Campaign will be required. At the same time, we recognize that self-reporting is not enough. Although the Campaign will not become a certifying body, it will work to facilitate the development of certification processes that can be used by other organizations, such as rating agencies, investors, and national associations. Among these may be a "stamp of approval" that is globally recognized (though locally adapted).

And what about the clients of microfinance? Recognizing the immense challenges of reaching millions of microfinance clients, the Campaign is not directly reaching out to them. However, clients remain the center of the Campaign's goals. They are actually the Campaign's "bottom line." As we move into Campaign implementation in the spring of 2010, field research will be conducted with microfinance clients to understand their attitudes and experiences around client protection issues. In addition, the Campaign will work to partner with leaders in the area of financial literacy and consumer education to help MFIs ensure they are helping their clients become more informed consumers and understand the implications of their financial decisions.

How can I get involved now?

- Go to the campaign website (www.campaignforclientprotection.org) to learn more, endorse, and subscribe to the Campaign eUpdates.
- Download the Assessment Questionnaire, complete it and share key findings with the Campaign.
- Become a Campaign advocate by sending a link to the webpage to your microfinance colleagues, encouraging them to also sign on and endorse the Campaign.
- Send the Campaign team updates on activities that your MFI is taking to promote client protection issues or initiatives internally, in your country or region by writing to the Campaign Director at rratcliffe@accion.org.

The Six Principles of Client Protection

1. **Avoidance of over-indebtedness**
2. **Transparent pricing**
3. **Appropriate collections practices**
4. **Ethical staff behavior**
5. **Mechanisms for redress of grievances**
6. **Privacy of client data**

Financial Services Authority (FSA)

Shaun Mundy

A consultant, specialising in financial capability and financial services regulation. Until September 2007, he was Head of Financial Capability at the UK's Financial Services Authority, where his responsibilities included leading the development and implementation of the UK's national strategy on financial capability.

The legislation which established the UK's **Financial Services Authority (FSA)** set down four objective for the FSA. One of these is to promote public understanding of the financial system.

If financial services markets are to operate effectively, financial services firms need to be financially sound and responsibly managed; they need to treat their customers fairly; and consumers need to have the competence and confidence to manage their money well. Regulators generally focus on the first two of these. However, unless consumers are capable of managing their money well, regulatory interventions are likely to have only limited impact.

For example, the effectiveness of information and advice provided to a customer depends not only on the quality of the information or advice, but also on the customer's ability to understand it and on his or her confidence to go on to purchase products or services which are suitable for them.

It was for these reasons that the FSA announced in 2003 that it would lead the development and implementation of a national strategy for financial capability. Before deciding to do so, the FSA had held discussions with a range of stakeholders and potential partners. They had all agreed that there was a lack of a strategy to improve people's financial capability, that this gap should be filled and that the FSA should take on the leadership role.

Before 2003, the FSA had undertaken a number of public awareness initiatives. For example, it had developed a consumer website and had published a number of leaflets; and it had worked with partners on, among other things, financial education initiatives in schools. However, the FSA, together with its partners, recognised that much more needed to be done in order to bring about a step change in the UK population's ability to manage their personal finances.

> The early priorities of the National Strategy for Financial Capability included financial education in schools, financial capability initiatives targeted at young people, workplace financial capability seminars, a parent's guide to money aimed at new and expectant parents, the development of a website aimed at consumers and the development of on-line tools (a financial health check and a debt test).

Improving people's ability to manage their money (which the FSA refers to as people's "financial capability") goes hand-in-hand with good regulation. It should not be seen instead as a substitute for effective regulation.

The FSA was clear from the outset that bringing about an improvement in the population's financial capability was a major challenge and that it would take several years to make a significant impact. On the other hand, the sooner a start was made, the sooner improvements would come about.

The FSA was also clear from the outset that neither it, nor any other organisation, could bring about the necessary improvements acting alone. The FSA has instead worked in partnership with a wide range of other organisations. These are, in the main, organisations which are more likely to achieve their objectives if the people with whom they deal are financially capable.

The FSA set up a Steering Group, comprising senior representatives from its core partners, to oversee the development and implementation of the strategy. Although the Steering Group has included members from a wide spectrum of interests (including the Government, the financial services industry, education, consumer organisations, the not-for-profit sector, employers, trades unions and the media), its membership has been kept to around twelve people, in order to facilitate effective decision-making. The Steering Group is chaired by the FSA.

It is unusual for a regulator to establish a steering group to oversee one of the regulator's key responsibilities. However, the FSA's Financial Capability Steering Group has proved invaluable, not only as a source of experience and expertise, but also in showing to the many organisations with whom the FSA was keen to work that the FSA was serious about working in partnership with them.

One of the main early tasks of the Steering Group was to decide on priorities. There is a wide range of initiatives which could be taken to improve people's financial capability. However, it is important to decide on priorities – which means deciding not to do some things which could well prove effective – since otherwise there is a risk of spreading the available resources too thinly, with the result that nothing gets done properly.

The FSA commissioned a financial capability survey, both to highlight areas where financial capability was particularly weak and to establish a baseline against which future changes (and hence the success, or otherwise, of financial capability initiatives) could be measured when the survey is repeated every four or five years. The survey indicated, among other things, that the young were less financial capable than their elders. This survey proved very useful in setting priorities. But another consideration in setting priorities was the opportunities which were available for reaching large numbers of people cost-effectively. For example, whilst those in employment are, on average, more financially capable than the unemployed, it is possible to reach significant numbers of employed people through workplace seminars, but there are no opportunities to reach large numbers of the unemployed collectively: this is why one of the chosen priorities is workplace ("Making the Most of Your money") seminars.

The FSA has developed a website, Money Made Clear (http://www.moneymadeclear.fsa.gov.uk/) which includes a range of guides, tools and calculators to help people manage their finances. The website also includes news and warnings (for example, news about the implications for consumers of regulatory developments; or warnings about unauthorised overseas investment firms which have been calling people in the UK attempting to sell them shares). As a regulator, the FSA is uniquely well-placed to develop, and to send out, these sorts of messages through its consumer website.

The FSA has learned from experience that, if messages for consumers are to be understood and acted upon, they must be clear and simple; and that they must be delivered at times and in ways which meet consumers' needs. Information overload can be a barrier to effective communication. The FSA often arranges focus group discussions, and undertakes pilot studies, to help it to develop communications which offer the best prospect of achieving their intended purpose.

The FSA's Financial Capability Division is a useful resource for regulatory staff within the FSA. Regulatory staff can seek advice from staff in the Financial Capability Division on communications plans for regulatory issues or developments, in order to ensure that messages are delivered to consumers in ways which are clear and accessible to them. Regulatory staff can also build on relationships which Financial Capability Division staff have established with a wide range of organisations, for example NGOs.

One of the challenges for a regulator in undertaking work in this area is that the skills required are different from those which are needed to regulate firms. Over time, the FSA has brought in staff from educational, consumer, marketing and communications backgrounds – as well as staff from a more conventional financial services regulatory background, who were willing and able to adapt to the different approaches and skills that were required.

One of the skills which is required is the ability to persuade others (not all of whom may appreciate that their organisation would be more likely to achieve its core objectives if its clients – or others with whom it deals – were more financially capable) to work with the regulator, to a common agenda, in order to bring about improvements in people's financial capability. The FSA is not able to impose requirements on firms which it regulates – or on any other organisation – to undertake financial capability initiatives. Financial services firms, together with other organisations, will only participate in financial capability initiatives where they are convinced that this would help them achieve their core objectives and where they are satisfied that the initiative in question is well planned and is otherwise likely to be effective.

There is a risk that financial capability work could be marginalised within a regulator, the vast majority of whose staff are engaged in conventional regulatory activities. It is important that a clear signal is sent from the most senior levels in the regulator about the importance of this activity.

In the case of the FSA, it was widely known – both within the FSA and among stakeholders – that the decision in 2003 to lead the development and implementation of a national strategy was driven by the newly appointed Chief Executive, John Tiner. John Tiner chaired the Financial Capability Steering Group; and his successor, Hector Sants, took over the chairmanship on his appointment as FSA Chief Executive. All of this has helped to embed financial capability within the FSA's mainstream activities.

Many organisations have an interest in developing people's financial capability. In order to make progress, it is helpful for a single organisation to take the lead in coordinating, and driving forward, the work of those which are, or which could potentially be, involved. This need not be a regulator: there are examples in other countries of the lead being taken by a Government Department, a Government-funded agency or the Central Bank. However, the FSA model shows that there can be a number of benefits in leadership of a national strategy, or programme, on financial capability being undertaken by a financial service regulator.

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