



Policy Monitor

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INTRODUCTION

Greetings Everyone!

The microfinance sector is strengthening its position in our region. Almost every month we hear about a new initiative related to providing financial support to microentrepreneurs. Excellent! Thanks to it, the civil society and the market economy is becoming more mature, while the life condition improves. Unfortunately, almost as often as we hear about successes, we are informed about legal constraints, which jeopardize the development of a strong, microfinance sector. Depending on the country, the legal situation varies significantly, from governmental support of microfinance to the prohibition of lending by all legal entities other than banks (making the development of microfinance extremely difficult). In countries with a legal and regulatory environment adverse to microfinance, the development of strong, sustainable microfinance institutions requires a huge effort, which is possible only in an atmosphere of cooperation of all the parties – policy makers, donors and practitioners.

We see the Policy Monitor as a vehicle for disseminating information and experience in solving policy issues. In order to reach this goal, we intend to present examples from countries that are in the process of creating a microfinance friendly legal environment. At the same time, it must be stressed that countries in our region differ from one to the other and, for that reason, situations that occur in one country (and are presented in the Monitor) might be quite different from what has or would occur in other countries. Nevertheless we hope the discussion that will take place in the Policy Monitor will help the readers to understand the different possibilities and better understand what is happening or may be done in their own countries.

In this first issue of the Monitor, you will find an extremely interesting highlight on the situation in Kazakhstan by Bryan Stirewalt. The author describes the cooperation between the Kazakh national bank and the USAID advisors on the regulatory issues with microlending organizations. In the same section, Marta Bogdanic presents, on behalf of CRS Croatia, the situation in Croatia and the process of working on draft legislation to establish a new type of microlending organization. This issue also contains a short update of the policy efforts in Armenia and Russia, written by Miriam Yesayan and Stephen Macleod, respectively and an excerpt from the "Rush to Regulate" by Robert Peck Christen and Richard Rosenberg on alternative approaches to supervision of MFIs. Finally, in the last section we present the interview with the chairman of the Economic Committee of the Polish parliament, Adam Szejnfeld, who speaks about the government's plan to use microfinance as the tool to fight unemployment.

Let me take also the opportunity to thank Open Society Institute for financial support of the Policy Monitor and all the authors, who contributed to this issue of the Policy Monitor. At the same time, as the best results can be achieved only if all the parties are involved actively in the discussion, we would like to encourage everybody to share their opinions and experience about the legal and regulatory policy process and reform measures. Please send us updates of the regulatory situation and articles describing the policy issues in your countries. We would be more than happy to publish them in the Policy Monitor.

Thank you for all your suggestions and feedback.

Marcin Fijałkowski (marcin@mfc.org.pl)
Legal and Regulatory Program Coordinator

CEE/ NIS NEWS AND VIEWS

RUSSIA

Russia Update

BY STEPHEN MACLEOD,
CHIEF ADVISOR FOR RUSSIAN MICROFINANCE CENTRE

A parliamentary exchange on microfinance between the US Congress and the Russian State Duma was conducted June 8-15 in Washington, DC. The purpose of the visit was to establish a dialogue and information exchange on legislative support for the development of the non-bank finance sector as a source of funding for small business. During the trip, sponsored by FINCA International and USAID/Russia, Russian legislators received information on microfinance operations and methodologies, alternative sources of credit, and the creation of economic opportunities for the smallest, most vulnerable groups of entrepreneurs, even in well-developed countries (including the United States).

An initial meeting of the Policy Steering Committee of the USAID-funded Russia Microfinance Sector Support Program was held in Moscow June 4, 2002. Attendees discussed how best to structure program activities to support legal and regulatory initiatives, research policy issues, and facilitate an exchange of information on program activities.

The framework law "On Credit Cooperatives" was approved in its first reading by the Russia Duma on April 24, 2002. ■

MFC's Monitor does not provide, nor does it attempt to provide, legal advice. The authors of the articles included in this publication present their own point of view, which might differ from the MFC opinions. While MFC may comment on certain statements by the authors, MFC does not take responsibility for the accuracy of the articles or for the legal statements made therein.

If you would like to send an update on any information on new legal initiatives in your country, please contact Marcin Fijałkowski (marcin@mfc.org.pl).

Alternative Approaches to Supervision

BY ROBERT PECK CHRISTEN AND RICHARD ROSENBERG, SENIOR ADVISERS WITH CGAP

If a supervisor has to take on responsibility for new non-bank intermediaries (be they specially chartered MFIs or previously unsupervised credit unions), it is confronted with the gamut of problems. Monitoring, on-site inspection, and messy interventions in problem cases are especially daunting if a large number of small institutions has to be supervised. Several alter-

natives to direct supervision by the banking authority have been suggested.

Self-supervision.

Discussion of self-supervision tends to get confused because people's understanding of this term varies widely. For purposes of this paper, we use "self-supervision" to refer exclusively

to arrangements under which the primary responsibility for monitoring and enforcing prudential norms lies with a body that is controlled by the organizations to be supervised—usually a member-controlled federation of MFIs. Here at last is a point on which experience appears to justify a categorical conclusion. In poor countries, self-supervision financial intermediaries has been tried dozens of times and has repeatedly proven to be ineffective², even in the many cases where donors provided heavy technical assistance. The reason for the failure of the model is not hard to find. Having a watchdog that is controlled by the parties being watched presents an obvious conflict of interest. The immediate benefit to the participating institutions is not great enough to induce them to hold a rigorous line when problems arise. Most of the experience with self-supervision has been in federations of financial cooperatives, but it is hard to see any reason to expect better results from federations of MFIs.

In both Guatemala and the Dominican Republic, small groups of strong credit unions have formed federations whose task includes monitoring and enforcement of prudential norms. Both these federations bring immense advantages to their task. The credit unions they supervise are all starting out in strong financial condition. The federation's supervisory office need not concern itself with the majority of the country's credit unions that are in poor shape. Accounting and reporting systems are not only good but also uniform. Norms are clearly defined and agreed upon. The supervisory office has strong technical staff. But despite all these advantages, staff in both federations—and many of the member credit unions as well—will admit privately that the "supervisor" is likely to be powerless when a large member gets out of line. They don't believe that a board of directors named by the members being supervised will command credibility or stay the course in an emergency. For this reason and others, both federations have pushed strongly for their members to be subjected to the authority of the bank supervisor.

Federations of MFIs may play some useful roles, such as articulating standards, setting consistent reporting formats, delivering training and technical assistance to members, or even providing central liquidity management. But if the federation is really controlled by its member

CEE / NIS NEWS AND VIEWS

ARMENIA

Current Situation in Armenia

BY MARIAM YESAYAN, DIRECTOR OF UMCOR / AREGAK

The Micro Credit Forum of Armenia, established in 1997, is a consortium of different MFIs. During the past two years, one of the major initiatives of the Forum has been the "Armenia Law on Microfinance" project (funded by the UNDP). The objectives of this initiative were to study the legal and regulatory environment in Armenia and, if necessary, to develop a new law on microfinance. After conducting the study, the national experts recommended drafting a law on microfinance. A draft law on microfinance was presented by the legal subcommittee of the Micro Credit Forum to the following for their review: MFIs, donors and those representatives of the National Assembly of Armenia who were supportive of our initiative. At a later stage foreign lawyers were also involved in the project. These lawyers advised that the Credit Forum's project be integrated with other efforts currently under way in Armenia to develop laws and regulations governing a variety of types of non-bank financial institution.

Currently the Forum has received a No-Cost Project Extension from UNDP and is in the process of preparing the WorkPlan for the final stage of the project. The Credit Forum will need to mobilize additional funds from microfinance practitioners and the donor community to accomplish its program objectives.

Meanwhile, two new financial sector laws of potential relevance to the microfinance sector have been passed in 2002: a Law on Credit Clubs and a Law on Non-Bank Financial Insti-

tutions (NBFIs)¹. There is significant donor interest in further work to harmonize all of these various pieces of legislation (the two new laws and an MFI law) with other relevant Armenian legislation (including the Civil Code, the Tax Code, the Law on Banks and the Law on the National Bank of Armenia). ■

KYRGYZSTAN

New Microfinance Law in Kyrgyzstan

BY JASON MEIKLE, GENERAL DIRECTOR OF FINCA KYRGYZSTAN

The law on Microfinance Institutions (MFI) was passed by the lower and upper chambers of the Kyrgyz parliament in June 2002. It is expected to be signed into law by the president by the end of July. The MFI law is the culmination of three years of work. The initial draft was prepared by FINCA International, Tim Lyman and Kate Lauer with funding from the IFC.

The law provides for a three tiered system: commercial deposit taking MFIs, commercial credit only MFIs and non-commercial credit only MFIs. While the law is a big step for the Microfinance in Kyrgyzstan, it really only provides a legal basis for MFIs. The National Bank now needs to develop the normative acts, which will govern MFIs day to day operations. ■

¹Already one Credit Forum member has indicated its interest in qualifying to operate as a commercial NBF under the new law. A majority of the Credit Forum members would prefer to continue operating as NGOs lending under the provisions of the Civil Code, at least until a more appropriate law governing NGO MFIs is adopted. Alternative Approaches to Supervision is an excerpt of "The Rush to Regulate: Legal Framework for Microfinance" available on http://www.cgap.org/html/p_occasional_papers.html. The authors did not review the abridgment.

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MFI, then asking it to bear the carry the primary responsibility for keeping depositors safe would seem to be a highly imprudent wager.

Delegated supervision.

Under some proposed models, the supervisory agency maintains legal authority over-and responsibility for-the supervised institutions, but delegates regular monitoring and on-site inspections to a third party. This “agent” might be an MFI federation or an independent technical entity. The role of the supervisor lies in (1) periodically testing the reliability of the agent’s monitoring, inspection, and reporting, and (2) intervening in problem situations.

A variant of this model seems to work in Indonesia, where Bank Rakyat Indonesia has long used its rural branch offices to supervise a large number of tiny municipal banks; however, the relationship between BRI and the municipal banks is much closer than is normally implied by the term “supervision.” In Peru, the bank superintendent has delegated day-to-day oversight to a federation of municipal savings and loan institutions. However, the superintendent keeps a tight hand on the quality and independence of the federation’s work: the norm is that each institution gets an annual on-site supervision visit from the supervisor’s office. We are not familiar with other cases where such a model has been used long enough to draw conclusions about its success. Thus, we would only make some general comments:

- If the agent is a federation of MFIs, then it will probably handle problem cases well only if the supervisor’s oversight of the agent is active enough to give the supervisor a high degree of de facto control over the agent’s operations.
- Though the supervisory agency may be able to delegate its monitoring, the law will usually not permit delegation of its authority and responsibility to intervene when institutions run into trouble or collapse. Thus the supervisor who accepts responsibility for new MFIs with the expectation that the agent is going to do most of the work may later find herself with serious burdens that can’t be delegated.
- If the government accepts responsibility for the soundness of MFIs under a delegated-supervision arrangement, it needs to consider whether it has a viable exit strategy if the delegated supervision doesn’t work.
- To be successful, any agent would probably need to be better at monitoring MFI condition and risk than the typical external audit firm. As we observed earlier, external audits

MFC Policy Program

The Policy Program created within the MFC has a broad goal to foster improvements to the legal and regulatory operating environments for microfinance institutions in the countries of CEE and the NIS. To achieve this goal MFC has engaged in a combination of regional activities. Within the scope of the Policy Program, MFC conducts diagnostic analysis of the existing legal and regulatory environment for microfinance in CEE and the NIS undertaken on a country-by-country basis. We have already completed the diagnostic assessments of Armenia, Georgia, Serbia and Tajikistan. These reports are available on the MFC web site (www.mfc.org.pl/policydiagnostic.php4).

Another important activity conducted within the Policy Program is the clearinghouse project designed to provide a new tool – a database containing legal acts related to microfinance industry in the CEE and NIS. The database will supply reliable updated information to

practitioners, policy makers and the donor community involved in microfinance legal and regulatory reform.

MFC has also developed a 4-hour policy training module aimed at training decision makers on fundamental of microfinance.

Finally, MFC organizes an annual Policy Forum on microfinance law and regulation in CEE and NIS. The purpose of the forum is to:

- Benchmark the progress of countries from the CEE and NIS;
- Increase the awareness of policy makers with regard to policy issues;
- Enhance the benefits of the clearinghouse project;
- Build capacity among consultants and advisors who may become engaged in future reform initiatives.

For more information on the MFC Policy Program, please contact Marcin Fijałkowski (marcin@mfc.org.pl)

of MFIs have so far proved notoriously unreliable in verifying the accuracy of MFI financial statements, in particular the quality of MFI loan portfolios.

Apexes.

In some countries there is an apex institution or national fund that does wholesale lending to local MFIs-typically credit-only MFIs. As an investor, such an apex is by its nature a kind of supervisory agency. If it expects to have its loans repaid, it must evaluate and monitor the soundness of the MFIs it lends to. For MFIs that fail to meet its standards, the sanction is denial of loans.

It is sometimes suggested that apex structures be used to supervise deposit-taking MFIs, usually under a delegated supervision arrangement with the financial authority. Such an arrangement might involve potential conflicts of interest: for instance, would the apex be anxious to close down an MFI that owed it money?

More generally, some apexes have been successful at recovering their loans. But the justification for these apexes often includes an expectation that they will catalyze significant quality improvements in the MFIs they fund. Few have been notably successful at this task. PKSF, the large microfinance apex in Bangladesh, seems to be an exception to the generally disappointing apex experience. But this apex was established after a critical mass of credit-worthy MFIs

had already developed – a situation that prevails in few other countries.

Rating agencies?

Thirteen strong Guatemalan credit unions are setting up a private rating agency that will evaluate and certify their financial soundness³. The credit unions will not control the rating agency. The situation prompting this step is that public confidence in credit unions is so low that they have to pay 2 percent more than the banks they compete with to raise deposits. The country’s financial authorities have refused to take responsibility for supervising credit unions, so this group of strong institutions is trying a private alternative, at least as a temporary measure. The rating agency will have a large advertising budget to build public recognition of the plaque representing the agency’s approval. The principal sanction for a non-complying credit union will be the (well-publicized) revocation of that credit union’s plaque. Additionally, contracts with the participating credit unions will give the rating agency the right to replace their boards or management in the event of non-compliance, although enforcement of these rights would probably take too long to be practical. As the rating agency gains credibility, the participants hope that the government authorities will eventually agree to have the bank superintendency supervise the stronger credit unions, and perhaps use the rating agency in a scheme of delegated supervision. Implementation has not yet begun,

² Just as we did earlier, we are defining prudential supervision as effective” when (a) at least 80 percent of the licensed institutions are in fact solvent, and (b) this situation stays stable over decades. Self-supervision of financial institutions occasionally works in a rich country, but it is hard to find successful cases in poor countries.

³ Only 10 percent of Guatemala’s credit unions are participating, but they account for 85 percent of the country’s credit union savings and loans. Here as in most other countries, one does not have to work with more than a few institutions in order to reach the vast majority of the country’s microfinance clients.

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so nothing can be said yet about the results of this experiment.

The concept of a private, independent rating agency for MFIs seems to be getting a lot of attention lately. Even though one of the authors of this paper was an enthusiastic proponent of the Guatemala experiment, there are some important reasons why the rating agency model needs to be approached with caution:

- The “market” for the ratings in Guatemala is the depositors, who can use the rating to judge the safety of their deposit. In the case of non-deposit-taking MFIs, the market for ratings consists of investors—mainly donors. In Latin America and South Asia, two companies that provide ratings mainly for credit-only MFIs are finding the demand for their services from donors to be somewhat disappointing.
- The Guatemalan experiment has huge advantages that are unlikely to be present in an MFI rating scheme in most countries. The participating credit unions all agree on the norms to be applied. The credit unions were in compliance with these norms before the rating agency was set up, so there is no need to cajole or strengthen laggards⁴. All the credit unions have the same methodologies, accounting standards, and information system. Their competition

with commercial banks for deposits provides a strong incentive to submit to supervision.

- Even so, it is far from clear that the Guatemala rating agency will work.

Deposit Insurance.

Recently there has been increased discussion of the possibility of deposit insurance for MFIs. Such insurance could be provided by the government as an adjunct to its regulation and supervision; or the insurance could be issued by a non-governmental (and perhaps donor-supported) body as a substitute for official regulation and supervision. The scheme could provide pure deposit insurance, whose only function is to reimburse small depositors in the event of failure of the depository institution, or it might operate a stabilization fund providing emergency liquidity to solvent MFIs, or capital support to MFIs in danger of insolvency who are willing to take corrective measures. In the absence of experience with such arrangements, we can only offer some general observations.

There is a respectable body of opinion that challenges the wisdom of deposit insurance, generally on the grounds that it blunts depositor oversight of institutions, encourages risky behavior on the part of managers, and centralizes risk more than is desirable. But even for those

who see deposit insurance as a good thing, deposit insurance for MFIs presents some special challenges.

A specific national insurance fund for MFIs confronts actuarial problems. Given the relatively small number of MFIs, their unsecured portfolios, and the absence of historical loss experience, how does one determine the fund size that is adequate to provide depositors with the degree of safety that is being advertised? To provide such safety, the fund would certainly have to be a much larger percentage of deposits than would be the case with a country’s commercial banks. This problem is holding up development of a deposit insurance scheme by the Guatemalan credit unions. These credit unions hope that the problem can be solved by re-insuring residual losses offshore, but they have no indication yet as to whether it will be possible to do so.

If MFIs are folded in with the general deposit insurance scheme for banks, the actuarial problem is lessened, but this would imply normal supervision by the government’s financial authorities, rather than providing an alternative to such supervision.

Another way to mitigate the actuarial problem might be to make the insurance fund international, so that it embraces a larger number of MFIs, and can maintain safety standards that might be tighter than what would be practical in a fund limited to a single country. But such an international insurance fund would probably have very high supervision costs.

Bank guarantees.

Building on Burt Ely’s work, J.D. Von Pischke has offered an intriguing proposal that non-bank MFIs be allowed to accept deposits on the condition that all such deposits are guaranteed by a bank that is licensed by the supervisor, and at least 50 percent reinsured offshore⁵. This approach would eliminate additional burdens on the supervisor. The obvious practical question is whether banks willing to write such guarantees, and offshore markets willing to reinsure them, could be found at a price that MFIs can pay. Given the very high administrative costs inherent in microfinance, adding (say) another 3 percent for a guarantee cost might seem a good bargain to an MFI that thereby gained access to large amounts of public funding. Is it possible that a bank would be willing to write a guarantee at that price for an MFI with demonstrably credible books, good internal controls, and strong profitability? Would a donor support experimentation along this line by temporarily covering part of the bank’s risk? Time will answer these questions, if someone is willing to try. ■

EDUCATION CORNER

In most countries, the state regulates and supervises the functioning of financial institutions in order to protect the safety and soundness of the financial system as a whole and to protect depositors from the loss of their deposits. This is referred to as “prudential regulation and supervision.” In microfinance, generally only deposit-taking institutions should be subject to prudential regulation and supervision. Credit-only microfinance institutions might be subject to other forms of non-prudential regulation.

The term “regulation” is often used to refer to both laws (i.e. legislation enacted by a parliament or other legislative bodies) and regulations (i.e. normative acts adopted by an executive or administrative body such as a central bank or a ministry of finance).

“Supervision” of financial institutions consists of monitoring these institutions to determine whether they are complying with the standards set in prudential regulations. In most countries, supervision is conducted by the central bank or a separate banking supervision agency. In some countries credit unions and similar member-owned and governed depository financial institutions are under the supervision of a different agency, such as a ministry of cooperatives.

When a supervisory agency engages in supervision, the goal is to assure that each supervised financial institution is soundly managed, to protect its depositors and to prevent its possible failure from leading to the failure of other depository financial institutions. In this sense, the supervisor is attempting to protect the financial “health” of individual institutions as a means of protecting the “health” of the financial sector as a whole.

The goals of prudential supervision are not generally relevant in the case of non-depository, credit-only financial institutions such as microcredit organizations. Here, there are no depositors to protect, and the failure of an individual institution is unlikely to affect the “health” of the broader financial sector. The state may still have an interest in regulating these types of financial institutions for other reasons, such as to promote transparency and to prevent fraud and financial crimes. However, this is non-prudential regulation, and here the state is not assuming responsibility for the “health” of the institutions it regulates. ■

⁴ Although only the soundest credit unions are participating at the beginning, other credit unions will be welcomed with open arms if they are able to comply with the norms.

⁵ Guaranteeing Deposits in Microfinance Nonbanks” (unpublished manuscript, 1998).

KAZAKHSTAN

Microlending Organizations in Kazakhstan

Regulation and Supervision Issues

BY: BRYAN D. STIREWALT, USAID BANKING SUPERVISION PROJECT AT THE NATIONAL BANK OF THE REPUBLIC OF KAZAKHSTAN

This article is a brief synopsis of attempts to improve the regulatory environment for microlending organizations in the Republic of Kazakhstan. The United States Agency for International Development (“USAID”) is providing technical assistance to the National Bank of the Republic of Kazakhstan on banking supervision issues.

Beginning in May of 2001, USAID advisors began assisting the NBRK in an important objective of promoting growth of non-bank financial institutions in Kazakhstan. The NBRK particularly emphasized its desire to develop more microfinance institutions in smaller communities that may not have adequate banking services. In an effort to accomplish this goal, the NBRK expressed a desire to develop a specialized microlending law or microlending regulation that would minimize the NBRK interference with microfinance activities. The NBRK initially expressed a desire to license microlending organizations and establish a minimal regulatory backdrop for their activity. The NBRK wished to minimize the level of prudential supervision and overall regulatory burden related to microlending organizations, to the extent possible. The NBRK further wished to establish several “tiers” of financial institutions in Kazakhstan, starting with the largest commercial banks and moving to microlending organizations, with only the largest commercial banking organizations given the privilege of deposit taking activity.

From discussions with several people and various organizations operating in Kazakhstan, many microlending entities seemed to be operating in the informal sector. These entities were specifically not moving to the formal financial sector in order (i) to avoid high levels of documentation requirements in the formal sector, (ii) an elongated and not overly transparent process for banking activity licensing, (iii) a financial regulatory regime that did not adequately distinguish microlending organizations from commercial banks, and (iv) taxation. As the NBRK cannot directly invest or participate in microlending activity, the NBRK objectives were to ease the regulation and

supervision of these entities in order to provide incentives for them to move to the formal sector of the economy. Another valid incentive for microlending organizations to move to the formal sector was an ability to use the legal system to pursue collection of debts. The most salient issues in this effort were the following questions:

- Should the National Bank address microlending organizations through a separate law or through a regulation that falls under the existing banking law?
- What should be the licensing procedure for microlending organizations?
- What prudential norms should apply to the operation of microlending organizations?
- How would microlending organizations be supervised?
- Should interest rate ceilings be applied to microfinance loans?

Early discussions focused initial attention on political risk associated with granting a license in Kazakhstan. Kazakhstan’s Parliament often holds the Chairman of the NBRK responsible if a commercial bank becomes insolvent or illiquid, subsequently losing its license to operate as a banking institution. The fact that these failed commercial banks were private businesses, not government controlled, seems irrelevant to Parliament, as they believe certain responsibility should be associated with the entity that grants a license. This attitude is similar to holding the agency that grants driver’s licenses responsible for automobile accidents, since they gave the license and should be responsible for the drivers. Given this political risk emanating from the Kazakhstan Parliament, the NBRK was hesitant to provide licenses to microlending organizations, as they would possibly be held responsible for the financial condition of many small organizations that are operating in remote regions of the country. Due to these factors, the NBRK decided to draft a microlending organizations law, rather than draft an internal regulation.

Under the terms of the draft microlending organizations law, these entities will be registered with the Ministry of Justice, monitored by the Government Statistics Agency and, in essence,

supervised by the Ministry of State Revenue through tax authorities. The NBRK will not license, regulate or supervise microlending organizations. Since microlending organizations will not be licensed or regulated by any financial sector regulator, prudential requirements for minimum capital, minimum liquidity, foreign currency open positions and large exposure limits will not apply to microlending organizations. This is rather unfortunate, as the managers of microlending organizations may not necessarily be well versed in financial institution management principles; thus they may find use in following similar prudential requirements as commercial banks. The draft law defines a microcredit as 1,000 minimum calculation units (roughly US\$5,300 or more than 3x GDP per capita) and the same definition applies to the minimum capital required to open a microlending organization. Lending above this amount by an entity registered as a microlending organization is prohibited.

USAID advisors are encouraging the NBRK to change the draft law to be more flexible in terms of lending limits, in an effort to allow more microlending organizations to be formed. The suggested lending limit would be as follows: “A microlending organization may not extend credit to one borrower in excess of 15% of its authorized capital, and the average original balance on all loans outstanding at any given time shall not exceed the definition of a microcredit (1,000 minimum calculation units).” This change would allow larger microlending organizations to make larger individual loans, within a prudential limit, while ensuring that all microlending organizations continue to be engaged in microlending as their primary business. The calculation of the average original loan amount for the entire microlending portfolio should not be a complex calculation.

Through lengthy discussions with the NBRK, USAID advisors were successful in removing several items from the microlending organization law that might have been overly intrusive to microlending organizations. The NBRK staff, particularly the attorneys, had difficulty comprehending the level of informality with microlending in general. A site visit to a microlending organization proved helpful in this re-

gard to illustrate some of the basic differences between commercial bank lending operations with large corporate clients and microlending.

The National Bank is also considering adoption of a regulation that would set a maximum amount of interest that can be charged on loans to consumers and small businesses. This is part of a larger effort within the Government of Kazakhstan to lower the cost of credit for small businesses and consumers. USAID advisors have advised the NBRK of the hazards of this type of legislation for microlending, as certain costs associated with lending are fixed regardless of the size of the loan. These fixed costs drastically increase the rate that must be charged in microlending to achieve a reasonable profit. In the end, the NBRK may accomplish a laudable and well-intentioned goal of reducing interest rates to small businesses and consumers, only to find a dearth of lenders due to an inability to achieve a profit at the new, significantly reduced yields.

I would be happy to answer questions associated with this process in Kazakhstan or discuss regulatory issues with microlending organizations in general. I can be reached at bryan@nursat.kz or bstirewalt@kpmg.com. ■

CROATIA

Legal Change and Our Involvement

BY MARTA BOGDANIC, DIRECTOR OF MIKROPLUS CRS CROATIA

One of the main reasons for the slow development of the microfinance sector in Croatia is the lack of an appropriate legal and regulatory environment for this type of activity. Rather than using an existing legal form – none of which, by the way, is appropriate to MF objectives), Catholic Relief Services (CRS) took an innovative approach and began its microfinance program by working within the allowed activities of an international NGO, CRS. To do this, MikroPlus obtained a special permit from the Croatian National Bank. In taking this approach, CRS also had in mind its general strategy for programming in Europe, which is to ensure the lasting impact of CRS' activities by localizing these activities into an appropriate local institution that will continue beyond the horizon of CRS' physical presence. Because of the relatively undeveloped state of the legal and regulatory environment for microfinance in Croatia at the time, in order to "localize" its MF programming, one of the primary needs was to advocate for a change in the law. This article describes the process that CRS went through in order to address the need to operate a microfinance program within a well-defined, secure, and sound legal environment.

Prior to beginning its microfinance program in Croatia, CRS performed an assessment of the legal forms that were then available for such program implementation and concluded that to achieve its objectives, the most appropriate option

was direct program implementation. This model would enable CRS' MikroPlus program to reach sustainable scale quickly, while addressing the financial needs of poor entrepreneurs. As its first step, CRS sought approval from the Croatian National Bank to engage in microlending activity as an international NGO. Because of certain financial and legal conditions,, the loans for MikroPlus clients are actually being disbursed through a local commercial bank. CRS received the permit soon after the request was placed; however, the legal situation remained rather volatile and fragile and could not be ignored if the longer-term goal of institutionalising as an independent local institution was to be realised.

To tackle the subject of the need to draft new legislation that would provide a legal framework for MF activities, in February 2000, CRS formed a legal coordination group to examine the issues facing the future local microfinance institution (MFI) and to consider the possibility of adopting legislation specific to microfinance. The working group that was convened consisted of representatives from the Croatian National Bank, Ministry of Finance, the School of Economics, the Institute for Banking and Insurance, the World Bank Resident Mission in Croatia, the legal firm "Vedriš and Partners", and CRS. Since the World Bank's work on implementing legal reform for MFIs in Bosnia-Herzegovina was largely completed at that time, the working group examined this to familiarize themselves with the options positively considered in the neighbouring country. A basis also for more substantive discussions was a working paper published by the Financial Sector Development Department of the World Bank, entitled, "A Framework for Regulating Microfinance Institutions" (the "World Bank working paper")⁶.

The group agreed to consider various options that would make it possible to transform the

CRS MikroPlus program into a local institution when the program reached a more mature stage. To that end, it focussed on drafting new legislation that would permit micro-lending. Specific consideration was given to the requirements that the new legislation (i) not impose a sizable regulatory cost on the government; and (ii) minimise the potential risks within the operation to the broader financial sector. The decision of the working group was made to provide for a legal type of "credit-only" NGO institution that would permit the receipt of cash collateral for loans (but no true deposit-taking) and that would not be taxed on profits. One idea that was examined was to amend the existing NGO law. This, however, was rejected early in the process due to the complexity involved in properly addressing the special issues that are of particular importance to micro-finance. The group also decided that it would not, at the present time, attempt to establish a range of institutional types, as outlined in the World Bank working paper.)

Following the best practice experiences described in the World Bank's paper, the working group drafted a micro-finance law that provided for the formation of micro-credit associations (MCAs), formed in accordance with the Law on Associations, but requiring authorization from the Ministry of Finance to commence activities. The purpose of such organizations would be to provide micro-loans to target populations. Under the proposal, MCAs could be formed by one or more legal entities or five individual members, would have to operate with only their own funds (donor capital or commercial borrowing), and would be able to take cash deposits as collateral only. Cash received as collateral could not be used for on-lending. The group was very concerned about the need to include provisions that would ensure transparency of micro-credit operations and prevent any conflict of interest in lending. Both of these areas are important in preventing possible abuse of the proposed legal structure. With respect to organisational governance, the initial suggestion was to provide for an assembly, that would be a governing board of some sort, and an appointed executive director. All provisions of the draft law that the working group finalized that were related to the NGO sector relied on the provisions of then draft Law on Associations, which was at that time under Parliamentary review.

Although the initial draft law was completed by the end of 2000, there were some delays resulting from changes in the Government following the January 2000 elections. This included

⁶ Gallardo, Joselito, Bikki Randhawa and Hennie van Greuning, "A Framework for Regulating Microfinance Institutions," Policy Research Working Paper # 2061, Financial Sector Development Department, The World Bank, February 1999.

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changes in the Ministry of Finance personnel. This created an appreciable delay as, for a nine months period, there was no Ministry of Finance representative participating in the group discussions. As the group was very eager to see concrete steps taken on legal reforms for MFIs in Croatia, nine months was a considerably long time. However, this waiting period coincided with the arrival of the World Bank's Structural Adjustment Loan (SAL) Team in Croatia and provided an opportunity to discuss with them the environment and conditions required to operate a microfinance program in Croatia. The World Bank had its own experts review the group's draft legislation, and, following a favourable opinion from them, they accepted to offer it to the Government for consideration under the SAL agreement. Simultaneously, the World Bank recommended that an international legal expert review the law for content and harmony with other Croatian laws.

Most of the meetings and rewriting of the final draft took place between February and May 2001. Legal counsel provided advice on how to make the law more general and applicable to various different micro-finance methodologies. Le-

gal counsel also made suggestions for improving the provisions pertaining to transparency of an MCA's activities, introduced provisions on the disposition of assets upon the voluntary termination of the activities of an MCA, and changed the proposed governance structure to allow for the formation of so-called "single-tiered" institution, i.e. the institution would have a mandatory assembly of founders and an executive director. This was done to bring it into line with the liberalising trend in civil law countries regarding the legislation governing associations⁷. The revised draft made the formation of other governing bodies optional. The final draft version of this law was produced at the end of May, following consultation with other interested parties, including the Ministry of Small and Medium Enterprises and the Croatian Central Bank.

Parallel with this process, the negotiations between the World Bank and the Government of Croatia on the various conditionalities for the SAL agreement continued. The Government selected the enactment of the micro-finance law as one of the preferred conditions for the loan agreement and decided to include it in the final SAL text. This followed the strong support of-

fered by the Deputy Prime Minister's office as well as the willingness of the Ministry of Finance to improve operating conditions for micro-finance institutions and to assist poorer economically active members of society to continue to have access to micro-loans.

The final draft of the Law on Micro-credit Associations was submitted to the Ministry of Finance on July 12, 2001, and is expected to be enacted in Parliament before the release of the second instalment of the SAL. The second tranche of the SAL is scheduled for release before the end of 2002. A positive development with regard to this law is the adoption in September 2001 by the Croatian Government of the Law on Associations in a form that does not require any additional changes in the proposed Micro-credit Association Law. Although the government's original schedule called for the submission of this law to Parliament before the end of March 2002, the current timetable for the adoption of the law by the Croatian Parliament has now been changed to submission and the first reading in Parliament of the proposed law in the early months of the second half of this calendar year. ■

MEET THE POLICY MAKER

POLAND

Interview with Adam Szejnfeld, Deputy to The Polish Parliament, Chairman of The Economy Committee

• *Do you consider there is a place in Poland for microfinance institutions?*

A.S. There still exists a very large space for microfinance institutions in Poland, despite the fact that this sector of the economy is no longer *carte blanche*. Banking and non-bank institutions are already active on this market. We should consider the following groups: firstly, such non-governmental organizations as Fundusz Mikro and similar institutions, for example Canadian-Polish Enterprise Foundation. The second group consists of Savings & Loans Cooperatives (the so called SKOKs). The third group is made up of cooperative banks. Commercial banks also have special credit facilities for small and medium-sized enterprises (SMEs), it should be said that they are still not sufficiently accessible for a wide range of bor-

rowers. Of course, we should not forget the strictly state-owned institutions such as the Labor Offices or the Agency for the Restructuring and Modernization of Agriculture that focus on supporting enterprise development and the creation of new jobs.

• *Could you describe the above mentioned institutions in more detail?*

A.S. In discussing the earlier mentioned groups of institutions granting small loans, we can say, in considerably simplified terms, that the product offered by such non-governmental organizations as Fundusz Mikro is intended for the smallest enterprises. The Canadian-Polish Enterprise Foundation focuses on small enterprises too, but it also tailors proposals for medium-sized firms. They can offer much larger loans than may be obtained from Fundusz Mi-



kro. As far as the SKOKs are concerned, if the trends that have been observed over the last two or three years

continue, the position of SKOKs on the financial market serving small and medium-sized enterprises is likely to grow. SKOKs are developing satisfactorily. They are going through a transformation in their attitudes and no longer see their role as primarily "savings accounts for the working classes". SKOKs have worked towards an understanding of their situation by Parliament, which has borne fruit in the form of changes to several laws. Thanks to these changes, they already enjoy a quite different sphere of operations. At present, SKOKs are serving not only private individuals who are not conducting economic activities, but also small and medium-sized enterprises. One might say that SKOKs have "come out of the factories onto the street". The cooperative banks, whose reputation deteriorated somewhat at the be-

⁷ Timothy Lyman, Kate Lauer, Cover memo to the Draft Law of the Microcredit Associations to Persons Interested in Microfinance Legal and Regulatory Reform in Croatia, March 5, 2002

ginning of the nineties, are nowadays recovering their lost position. Despite what some may think, cooperative banks no longer lend money only for agricultural or else agriculturally related operations (for example food processing), but also grant loans for the activities of small and medium-sized enterprises located in small municipalities and in the countryside. There are also several examples of cooperative banks operating in large cities and capable of rivaling the branches of the large commercial banks active in the same area. However, state-owned institutions, granting loans or lowering the cost of credit by subsidizing the interest on loans raised for the creation of new firms or jobs, conduct operations that are not only business but also socially orientated.

• **Do you believe that in such a case there is still a place for new microfinance institutions?**

A.S. Despite the existence of the above mentioned institutions on the financial market, the state of development of small enterprise and most importantly, the possibilities for obtaining external financial funds for the creation of a firm or the further development of an enterprise and the possibility of the establishment of institutions providing external financing, is still practically limitless.

The government and the parliamentary majority plan to bring about the establishment of another group that will offer enterprises external financial support. But the success of this plan will depend on the government's financial possibilities and determination. A good idea is not enough without financial resources for its implementation. Money is needed not only for the establishment of this type of institution, but also for the development of already existing institutions. Because we already have a dozen or so guarantee funds and several loan funds in Poland, though these are weak in terms of capital and have to be invested in, in order to ensure the development of local and regional enterprise.

• **Are we to understand, that the State should engage itself in the development of microfinance institutions?**

A.S. Of course the less the state interferes in the economy the better and similarly, the less the State engages in finance the better. However, in the situation Poland finds itself, where there exists a need for the development of small firms in a manner more revolutionary than evolutionary, which cannot be achieved without the creation of suitable foundations, the State should certainly commit its resources. The question however is in what way and in what

forms. I haven't the slightest doubt that the best role for the State is to engage itself in this indirectly, for example through the creation of good laws. More troublesome is its direct engagement. As far as the microfinance market is concerned, in my opinion the State should not so much create as assist in the creation of this type of institution. I am promoting a program for support of loan microfinance institutions, but not their creation. This should be the domain of municipal economic organizations and even businessmen themselves. Before the State subsidizes such an institution, its organizer should invest part of the capital for the institution and fulfill predefined conditions, regarding for example the expertise of his staff. A good way would be the application also of the venture capital principle. Another form of state engagement could be the provision of counter-guarantees through the creation of a counter-guarantee system for guarantee funds. The most convincing form for creating microfinance institutions would be as joint stock companies operating as non profit enterprises and not as foundations or associations, because this would help increase their economic effectiveness.

The issue of the choice of support for microfinance institutions, based on their operations being jointly financed by the State as opposed to a 100% financing, has for all practical purposes already been resolved. Of course, there remains the question of whether the government, with the gaps in its budget, will find the money needed to subsidize the new system.

An interesting solution could also be larger enterprises co-financing microfinance institutions. There are already examples of this type of fund in Poland.

• **Taking into consideration the Polish state's budget problems, can we count on any financial support from the European Union's budget?**

A.S. In my opinion, such funds will be involved. But these are difficult issues, because they are connected with public assistance problems. This means that any attempt to use EU funds for subsidizing microfinance institutions will require extensive checking to ensure that EU rules relating to the permissibility of public assistance are not infringed. For example, one would have to determine to what extent the financing of microfinance institutions that operate in the form of joint stock companies may be recognized as public assistance. However I don't believe that these obstacles cannot be overcome.

• **In the event of microfinance enterprises developing in Poland, could this be used to**

advantage in Poland's possible accession to the EU?

A.S. Yes, of course, but on condition that the system of microfinance institutions in Poland does actually develop. At present, the microfinance industry exists in Poland, but the system is inefficient. It embraces only a percentage of small firms and is not seen as an authentic and measurable system of support for enterprise. However if a strong, self-sufficient system of support for enterprise is developed in Poland, then we will most definitely serve as an example for both developing and fully developed states.

• **How do you see the importance of microfinance enterprises as tools for combating unemployment?**

A.S. Their importance in this respect cannot be overestimated. When we look at the research concerning barriers to the development of enterprise and we put to one side the generally known obstacles to this development, such as taxes and levies akin to taxes that are too high, the high labor costs, bureaucratic barriers and the vagueness and lack of cohesion in the legal system, there always remains the one most important barrier to development of small firms, which is the lack of access to external financing. This means that even after eliminating the above mentioned barriers, small firms will still not be able to create new jobs if they do not have the money to invest in this expensive and risky undertaking.

In other words, whatever we do in other areas that may affect the development of enterprise, if we don't facilitate access to external financing, then the small businessman will not develop and therefore will not create new jobs. It ensues from this that there is a clear connection between the degree of development of the microfinance sector and the unemployment level. Creation of new jobs requires access to capital and this is still lacking in the Polish economy.

• **Thank-you very much for this interview.** ■

THE INTERVIEW WAS CONDUCTED BY AGATA SZOSTEK
AND MARCIN FIJAŁKOWSKI



Microfinance Centre for CEE and the NIS

ul. Koszykowa 60/62 m. 52

00-673 Warsaw, Poland

tel: (48-22) 622 34 65, fax: (48-22) 622 34 85

e-mail: microfinance@mfc.org.pl

<http://www.mfc.org.pl>