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*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).*

INTRODUCTION

## Dear Readers,

This fifth edition of the Policy Monitor marks the second anniversary of this globally unique publication on microfinance-related policy issues. Although much has been done on the legislation side in the region over the past two years to back the efforts of MFIs in expanding their activities and in delivering a better service to economically disadvantaged clients, further advocacy efforts are needed. It is our hope that the Policy Monitor will continue to play a positive role in reforming the legal and regulatory environment for MFIs in the region.

In this issue, you will find the second part of Ricki Tigert Helfer's article on supervising microfinance institutions. The author briefly describes the Core Principles for Effective Banking Supervision developed by the Basle Committee and their application to microfinance. In the same section, Kate Lauer, Monika Harutyunyan and Timothy Lyman, discuss the pros and cons of establishing credit bureaus (including microlending-specific credit bureaus), applicable EU and U.S. legislation and, using the example of Armenia, potential legal issues to be solved before setting up a credit reporting agency. In the section Regional outlook, Tom Jacobs presents the state of microfinance and microfinance-related legal reforms in Central Asia. This issue also contains a description of the Kyrgyz law on Microfinance Organizations and related normative acts by Erkin Jumabaev and Koubanych Abdraimov from the National Bank of the Kyrgyz Republic and an article by Tina Ohmann on microfinance stakeholders' efforts to create a microfinance friendly legislation in Romania.

Finally, the Armenian Micro Enterprise Development Initiative (MEDI) team composed of Chrysanthos Miliaras and Monika Harutyunyan together with Timothy Lyman present the state of microfinance legislation in Armenia and disclose MEDI's strategy to promote a better legal environment for MFIs in Armenia.

Taking this opportunity on behalf of the MFC, I would like to thank the authors for their contribution and the Open Society Institute's Economic & Business Development Program for their financial support of the Policy Monitor.

If you would like to comment or submit an update or article on policy issues in your country, please contact me at marcin@mfc.org.pl.

Enjoy reading!

*Marcin Fijałkowski*
*MFC Legal and Regulatory Program Coordinator*

***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.***

# Increasing Access to Financial Services
## While Balancing Supervisory Interests (part II)

BY RICKI TIGERT HELFER, INDEPENDENT CONSULTANT, FINANCIAL REGULATION AND REFORM INTERNATIONAL AND FORMER CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION OF THE UNITED STATES

This is the second of two articles on regulation of microfinance by Ricki Tigert Helfer, a well-respected independent consultant on financial reform and a former U.S. bank regulator. The first article appeared in the Policy Monitor for December 2003 (available through the MFC website: www.mfc.org.pl/policymonitor). Both articles are based upon her speech to the Second New Independent States Policy Forum on Microfinance Law and Regulation, organized by the Microfinance Centre for CEE and the NIS in Krakow, Poland, June 26 to 28, 2003. The first article focused on the principle of regulation by risk and this second article applies the principle of regulation by risk to microfinance by assessing applicable supervisory standards.

### Introduction to Supervisory Standards for Microfinance

As Chairman of the U.S. Federal Deposit Insurance Corporation (FDIC), I served as a member of the Basle Committee on Banking Supervision (Basle Committee) at the time the Basle Committee developed the Core Principles for Effective Banking Supervision, issued in 1997 (Core Principles) [For a copy go to www.bis.org.] The Core Principles were developed at the insistence of the Group of Seven (G-7), and later the Group of Ten (G-10), Finance Ministers and Central Bank Governors in an effort to provide the tools by which the international financial institutions, such as the World Bank and the International Monetary Fund, could assess the health of the banking system of a country undergoing economic adjustment in the wake of the Asian financial crisis.

The reasons for their development are set out in the introduction to the Core Principles: *"Weaknesses in the banking system of a country, whether developing or developed, can threaten financial stability both within that country and internationally."*

The Core Principles were developed by the Basel Committee in close association with representatives from Chile, China, the Czech Republic, Hong Kong, Mexico, Russia, and Thailand. The Basel Committee also worked closely with representatives from nine other countries: Argentina, Brazil, Hungary, India, Indonesia, Korea, Malaysia, Poland and Singapore. The Core Principles are therefore the product of the work of a broad cross section of bank regulators from transitional, emerging market, and developing economies along with developed country economies as well.

The Core Principles comprise twenty-five basic principles of banking supervision in seven areas. Those seven areas are preconditions for effective banking supervision, licensing and structure, prudential regulations and requirements, methods of ongoing banking supervision, information requirements, formal powers of supervisors, and cross-border banking. In addition, the Core Principles set out minimum requirements for banking supervision and in many cases may need to be supplemented by other measures designed to address particular conditions and risks in the financial systems of individual countries. The Core Principles are directed at banks and at the risks that banks present to the financial system. Financial institutions that are not banks and do not present banking-type risks will not necessarily fall within their purview, but the Core Principles can be instructive for bank regulators assessing how to evaluate the risks presented by other kinds of credit-based financial institutions.

The Core Principles make clear that when a financial institution is a "bank" very specific forms of regulation are triggered:

- The financial institution should be licensed as a bank and meet certain pre-established standards related to the proposed structure and financial condition of the institution and the integrity and qualifications of the owners, directors, and management of the bank,
- Banking authorities should have a role in reviewing acquisitions involving the bank in order to determine whether the proposed acquisition will expose the bank to undue risks,
- Minimum capital requirements for banks must be met to establish an adequate cushion for the risks the bank undertakes,
- Bank policies and procedures for granting loans and making investments and for evaluating the quality of assets and the adequacy of loan loss provisions and loan loss reserves must be in place,
- Bank management must have information systems adequate to setting prudential limits on concentrations in portfolios,
- To prevent abuses, banks must comply with rules requiring that credit be extended on an "arm's-length basis," which means that no factors other than the risks attendant to the loan are taken into account in determining whether credit should be extended,
- Banks should have controls in place to identify and mitigate risks, including credit and market risks,
- Bank supervisors should be satisfied that banks have in place a comprehensive risk management process to identify, measure, monitor, and control all other material risks and, as appropriate, to hold capital against those risks,
- Bank supervisors should require that internal controls be in place that are adequate for the nature and scale of a bank's business, and
- Bank supervisors must determine that banks have adequate policies and procedures in place to promote high ethical and professional standards, including "know-your-customer" rules to assure the credibility of the financial system.

### Applying Supervisory Standards to Microfinance

Not all of the supervisory standards set out in the Core Principles apply to microfinance. All

but the first two of those listed above are "prudential" regulatory standards that are included because they assist the regulators in assuring that the safety and soundness of the financial system as well as the bank are protected. While some of these standards are logically applicable to the supervision of financial institutions that are not banks, a number are not. Nevertheless, a few of the standards may be relevant to these non-bank financial institutions because they could prevent bad or incompetent players in a national economy from undermining confidence in the financial system of the country even though the financial system itself is not actually in danger of being threatened.

The rest of this article is devoted to a discussion of the supervisory standards that could be relevant to the regulation of non-bank financial institutions, including microfinance institutions, depending upon the nature of the financial activities they engage in and the risks of such activities.

Some form of registration requirement could be considered for non-bank financial institutions that are not engaged in deposit-taking activity so the government will be aware of the nature of the activity being conducted. An extensive set of pre-licensing requirements would seem to be unnecessary because there are relatively few if any risks to the financial system arising, for example, from the small loans of microfinance institutions. Where risks are limited to small loans to customers or other similar credit related services, then regulation by exception through after-the-fact enforcement actions would seem appropriate rather than regulation by proscription.

Because of the importance of assuring the credibility of the financial system in a transitional economy, any financial institution that accepts deposits of any kind should be asked to give the government – or more specifically the central bank – an opportunity to review the proposed management and board of directors of the financial institution so that any known bad actors can be excluded in advance from positions of responsibility. In bank regulatory parlance this is called the "fit and proper" test. For non-banks it has the same purpose: to protect the financial system from unscrupulous, dishonest people who could undermine the legitimacy of the system by engaging in inappropriate conduct with other people's money. One only need look to Albania to see how the credibility of the financial system was completely destroyed by a pyramid scheme in which a large number of Albanians lost their savings -- so this is not a small issue.

Fairness in a financial system is a value that helps contribute to its legitimacy in the eyes of the participants. Assuring that loans are made on an unbiased, arm's-length basis – that is, on the merits -- can go along way toward assuring fairness. For a financial regulator to decide whether to impose a regulation requiring arm's-length lending on microfinance institutions that are only making small loans requires balancing the benefits of the regulatory protections against the disadvantages of the costs and burden of regulation on financial institutions with limited earnings. It also requires the regulator to ask whether the goals of the potential regulation can be achieved another way.

For my own part, and absent a specific problem, I would suggest that regulators consider letting the market regulate this issue for now. An illustration of how this might work may be helpful. If an institution develops a reputation for being unfair in its lending decisions because it is playing favorites among potential borrowers and not choosing customers on the basis of which present the fewest risks, then either (a) it will lose customers among those not favored, or (b) it will lose money or (c) both will occur. Any one of these possibilities should lead a financial institution that is sensitive to market forces to change its ways. If, on the other hand, a financial institution accepts deposits from the general public, to protect the financial system from significant failures, an arm's-length lending requirement should be imposed and compliance with the requirement should be checked through examinations.

If a microfinance institution expands the nature of its business to increase the number and level of risks in which it engages, then there are important prudential standards that it should be required to meet. First and foremost, capital is a necessary cushion against many of the risks that financial institutions undertake as part of their normal business activity. There are circumstances in which a capital requirement is relevant for a microfinance institution. If, for example, the institution begins to retain and hold compensating balances as security for loans or accepts deposits from a group of people with a common bond, such as in the case of a cooperative, then imposing some kind of capital requirement would protect the funds of depositors from the insolvency of the institution. If no other financial activity is being conducted by the institution other than extending small denomination loans that individually are much less than 5 to 10 percent of the capital of the institution, then capital standards could be relatively small.

The principle is: the greater the risks undertaken by the institution, the greater the capital levels. If deposits are accepted from the general public, then capital levels should meet the minimum capital requirements of 8 percent established in the first Capital Accord of the Basel Committee on Banking Supervision. If more risky activities are engaged in, then the capital level needs to be higher. Very large internationally active banks typically have capital levels of 11 to 12 percent and higher. Traditionally in the United States, well-run smaller banks have often had higher capital levels than the bigger banks. Essentially all banks in the United States today are considered "well capitalized."

We have also found in the United States that a bank is at greatest risk of failure in its first three years of operation. For that reason requiring initial capital levels to be higher to safeguard against the start-up risks could help protect the financial system from the effects of bank failures and depositors from significant losses, particularly in countries with no deposit insurance systems. Financial institutions that accept deposits from the general public should have controls in place to identify and mitigate material risks and to assure that "know your customers" rules are met. The purpose of these rules is to prevent the financial system from being used for illegal purposes (such as money laundering). Successful microfinance institutions may well know their customers better than more traditional banks AFTER the credit relationship is established. On the other hand, prior to that time, because of the very nature of the poor customers that microfinance institutions serve, microfinance institutions generally will not have the same kinds of detailed identifying information on their potential customers, such as past business history, tax returns, and other detailed records, as larger banks would have for their customers. The critical issue for a regulator is whether the microfinance institution has put in place procedures for learning about their customers in other ways than a paper record so that they can meet the spirit of the "know your customer" rule.

If deposits are accepted from the general public, in addition to the standards discussed above, the institutions should have in place policies and procedures for making loans, assessing asset quality on a regular basis, and establishing and maintaining the adequacy of reserves for loan losses.

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Finally, diversification is a major principle of sound financial practice. Regulators should require financial institutions that accept deposits from the general public to monitor the kinds and level of concentrations in their portfolios and develop measures to mitigate risks if concentrations appear.

When I was Chairman of the FDIC, I commissioned a study by the FDIC staff on the causes of the U.S. banking crises of the 1980s and early 1990s. The results of that study were published in 1997 in History of the Eighties Lessons for the Future. That study showed a geographic pattern to some of the bank failures. Of the 1,617 banks that failed or stayed open with FDIC assistance between 1980 and 1994, 60 percent were in five states: California, Kansas, Louisiana, Oklahoma, and Texas. Of all the banks that failed during that period, 59 percent of the assets in the calendar quarter before failure were accounted for by three states: Illinois, New York, and Texas. [FDIC, History of the Eighties Lessons for the Future, Volume I, pp. 15-16 (1997)] These data illustrate how concentrations – in this case geographic – can have a decidedly deleterious effect on the health of a banking system.

Of course there are other kinds of concentrations besides geographic that can cause problems. Concentrations by types of borrower or industries, concentrations by types of credit, and concentrations by types of risk would be others. In the U.S. banking crises there were very significant losses in loans to three industries in particular: agriculture, oil and gas and real estate. In addition, there were significant losses related to sovereign lending.

Diversification requirements can be put in place and regulated by exception rather than through the full examination authority of the regulator where the safety and soundness of the banking system is not at risk. Thus, if the non-bank financial institution has significant losses and it is discovered that it failed to put in place adequate controls to monitor and mitigate concentrations of risk, then it could be subject to enforcement actions, which could include fines and closure if the problems are serious enough. If the financial institution has full banking authority, then the management of the bank needs to satisfy regulators that it has in place systems and controls for monitoring and mitigating risks. This is true for all of the prudential standards that apply to banks.

In the United States we have a system for rating banking institutions in examinations called "CAMELS," the letters of which stand for the areas considered in an examination: capital, assets, management, earnings, liquidity and sensitivity to market risk. Without question, the most important of these is "management" because without a strong management the bank is at risk in the other areas. Therefore one of the principal jobs of a regulator is assessing the strength of the management of a regulated financial institution. The greater the risk the financial institution presents to the financial system of a country, the stronger the management of the institution must be and the more sophisticated its systems of internal controls, risk assessment and risk mitigation must be.

Management by risk is the modern approach to managing a financial institution and regulation by risk is the approach described in the this article, and in the previous one, as most likely to result in an appropriate balancing of the costs and benefits of supervision. This discussion is intended to demonstrate the process of balancing that financial regulators might want to consider in the course of deciding what institutions to regulate and how much regulation is necessary. Too much regulation presents costs to the individual financial institution in the form of out-of-pocket expenses to meet the regulatory requirements and in the form of lost energy and focus that discourage more innovative approaches. Too much regulation may produce a financial system with fewer losses, but it can lead the financial system to under perform and can discourage new entrants to the system, especially among those seeking to provide services to the poor and other under-served populations. Thus, there can be fewer economic opportunities for residents of a country if entrepreneurs are stifled by the level of regulation.

This balancing of the costs and benefits of regulation is not easy, but it is worth undertaking at every opportunity that new, and old, regulations are considered. In the United States we have laws, such as the Paperwork Reduction Act and others, that require regulators to determine whether the benefits of new regulations outweigh the costs to those being regulated. Some statutes also require regulators to re-evaluate regulations periodically to determine whether the benefits of the existing regulations continue to outweigh the costs. If they do not, they are required to be rewritten or eliminated. Financial regulators in other parts of the world may want to consider their own approaches to evaluating new and ongoing regulations so their financial systems do not become encrusted with the barnacles of out-dated or over-inclusive regulations, which fail to offer the intended benefits for the financial system. ■

# A Brief Discussion on Credit Bureaus

BY KATE LAUER, INDEPENDENT CONSULTANT,
WITH ASSISTANCE FROM MONIKA HARUTYUNYAN, LEGAL ADVISOR, MEDI
AND TIMOTHY LYMAN, PRESIDENT, DAY BERRY & HOWARD FOUNDATION[1]

The topic of credit bureaus is becoming one of increasing importance across the globe[2]. Although there is some disagreement among various groups – participants in the credit information market, policymakers, social activists – regarding the benefits and disadvantages of private credit bureaus, today it is widely believed that credit bureaus (also known as "credit reporting agencies" or "CRAs"), when well-operated, facilitate the efficiency and profitability of credit assessments and thus generally increase the availability of credit. This article briefly addresses the pros and cons of credit bureaus[3], describes the credit information markets in the United States and the EU as well as the respective legal frameworks – focusing on credit information markets with respect to individuals as opposed to businesses[4] – and then considers the development of a credit information market in an NIS country (Armenia).

## Credit Bureaus – Cons and Pros

There are specific risks involved in credit information markets. First, the processing and disclosure of credit information can be harmful to both borrowers and lenders if the information is inaccurate or if access to the information is not properly monitored and restricted. Second, the availability of such information in various developed markets has led to the problem of identity theft as well as the explosion of the direct marketing business. (In the United States and Europe, legislation has been passed to try to address

these concerns by protecting the consumer and placing obligations on the processors and users of credit information.) Third, a credit bureau (and credit information market generally) cannot function effectively unless lenders and others share their information. Notwithstanding these concerns, in market economies, the growth of the credit information industry has generally been seen as a positive development, providing creditors – as well as others, such as landlords and employers – with information that assists in assessing the potential risks of making a loan or entering into another transaction involving payment risk[5]. This development has thus been associated with growth in credit markets (as well as lower interest rates) that can lead to general economic growth.

Credit bureaus collect "positive" information (i.e., current and historic data on existing accounts, balances, credit limits and other non-bank information) or "negative" or "black" information (i.e., payment defaults, charge-offs, bankruptcies). The CRAs collecting positive information on individuals have various sources of information, including free sources (e.g., banks, retail stores and credit unions as well as public sector sources) and sources that charge for the information (e.g., other CRAs, insurance companies). In the United States, the CRAs collect positive information; the EU countries vary (for example, France only permits the collection of negative data). The negative information does not inform creditors regarding the extent of a borrower's indebtedness nor what could happen in the near future. However, the collection of positive information is more costly (due to the higher costs associated with, among other things: inputting data, follow-up procedures, more voluminous and complex files) and, among some commentators, is controversial[6].

## Credit Bureaus in the United States and the European Union

The two most established credit information markets are in the United States and the European Union. In general, the U.S. market, which is dominated by the three "giants" (Experian, Equifax and Trans Union), is more robust than the "market" of the European Union for two reasons: first, privacy is a greater concern in the EU than in the U.S. and the EU countries' laws regarding information sharing are therefore more restrictive than those of the U.S.; second, in part as a result of the lack of uniformity in the EU countries' markets, there has been a relatively low level of cross-border credit transactions (excluding bank-to-bank lending). The lack of uniformity among EU countries is due to differences regarding "credit culture" as well as the differing national legislation or regulation[7]. A recent study of the European Credit Research Institution noted that while the credit bureaus have become the "cornerstone" of consumer lending in the United States, in Europe, there is quite a bit of variation across countries regarding the type and quantity of data collected as well as the sharing mechanism[8]. Thus, some countries more closely resemble the U.S. market (e.g., the United Kingdom, Sweden); others place greater importance on privacy rights and thus restrict the operations of credit bureaus.

## Microlending-Specific Credit Bureaus?

As noted above, a private credit bureau is usually established either as a profit-making venture by entrepreneurs with or without financial institutions as shareholders or as a cooperative association by a group of lenders. While in some countries there are credit bureaus that focus exclusively on microloans (and at times, there is a requirement that a loan be of a specified minimum amount before it is reported to a credit bureau, thus leaving out data that are relevant to or essential for those engaged in microlending), neither the U.S. nor EU countries have such credit bureaus.

In some of the countries that have microlending-specific credit bureaus, bank information is not permitted to be disclosed to non-regulated financial institutions. In many of these countries, credit bureaus that provide information to non-regulated financial institutions do not have access to bank information; in countries where such credit bureaus do have access to bank information, they are only permitted to provide such information to regulated financial institutions. (Note that some microlending-specific credit bureaus only accept as members NGO microlenders, following the belief that this membership limitation will serve to benefit the NGOs.) Consequently, the microlender accessing information from a microlending-specific credit bureau may easily have incomplete credit information on potential borrowers. In fact, microlenders provided with information under such circumstances could be misled about the creditworthiness of a borrower who has loans outstanding with a bank. Furthermore, if banks have access to information processed by microlending-only credit bureaus, then the non-bank microlenders – who won't have access to information on microloans extended by banks – are at a competitive disadvantage. Thus, given that credit bureaus are generally more helpful to lenders if the information is more rather than less inclusive, there is a very strong argument against the establishment of a microlending-only credit bureau unless such a system is established as a short-term solution (due, for instance, to legal problems with non-regulated institutions accessing bank information).

## Legislation in the U.S. and the EU

Two primary concerns regarding credit bureaus and the development of a credit information market are individual privacy and ensuring the accuracy of information. There is a trade-off between, on the one hand, addressing these concerns and, on the other hand, not restricting lenders' access to credit information. The EU has given greater weight to privacy concerns than the U.S. and, within the EU, some countries have protected privacy more than others.

In general, legislation in the U.S.[9] and in EU countries (which must be harmonized with the EU directive on processing of personal data) address the following issues: (i) the type of information that can and cannot be processed, (ii) the right of access to information, (iii) the right to opt-out from having information available to third parties and (iv) correcting inaccurate information. However, there are significant differences, as noted below.

## U.S. Law

Under U.S. law, a CRA may furnish a credit report in accordance with the consumer's written instructions, pursuant to a court order or to anyone with a legitimate business purpose, including any person who intends to use the information in connection with a credit or other business transaction involving the consumer. Others who may be entitled to access a credit report – in addition to current creditors of the consumer and insurance companies – are landlords, employers and potential employers, child support agencies and certain other government agencies. With respect to credit or insurance transactions not initiated by the consumer, a CRA may furnish a credit report if the consumer authorizes the release or the transaction consists of a "firm offer of credit or insurance" and the consumer has not opted out. Any consumer may "opt-out" from having his name and address sold to creditors for marketing

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solicitations. However, the consumer must take affirmative action to opt out.

A financial institution must tell its customers the categories of information that it collects about them and how it uses such information. The consumer, in turn, has the right, subject to important exceptions, to "opt out" from the otherwise implied consent to sell such information to third parties[10]. A customer may not opt out with respect to the provision of information to any CRAs, affiliates of the financial institution and certain others. All financial institutions are also required to adopt policies to prevent fraudulent access to confidential financial information and to disclose such policies to its customers.

Importantly, if any entity receives nonpublic personal information about a person from a financial institution, then such entity steps into the shoes of the disclosing institution and is subject to the same restrictions as the disclosing institution.

Regarding accuracy of information, U.S. law requires a CRA to ensure that the information in a credit report is accurate, complete and up-to-date[11]. In addition, anyone who furnishes information may not provide information that he "knows or has reasonable cause to believe" is inaccurate. There are affirmative duties on the part of CRAs and furnishers of information to correct inaccurate information. Furthermore, financial institutions must notify a customer if it is furnishing damaging information to a CRA; non-financial institutions do not have the same obligation.

As for "impermissible information," the following facts may not be included in a credit report: medical records, age, marital status, race, debts that are more than seven years old (provided that such limit does not apply to credit transactions involving $150,000 or more or to tax liens).

## EU law

All EU countries must enact legislation that implements the requirements of the 1995 EU directive on the protection of individuals with regard to the processing of personal data and the free movement of such data. As noted above, the directive sets the minimum for what the EU member countries' legislation must provide.

The directive prohibits the processing of certain data (e.g., relating to race or ethnic origin, political opinions, religious or philosophical beliefs, trade union membership, health or sex life), although certain exceptions apply (for example, if consent is given or if such data are necessary to protect the vital interests of the data subject). Data may be processed only if the data subject has given consent or if processing is necessary with respect to certain specified acts or situations (for example, for the performance of a contract to which the data subject is a party or in order to take steps at the request of the data subject prior to entering into a contract; to protect the vital interests of the data subject; to serve the public interest). This standard is clearly more restrictive than the "legitimate business purpose" standard of the U.S. In addition, the directive requires that processed data be "relevant" and not "excessive" in relation to the purposes for which they are collected and/or further processed.

Unlike under U.S. law, the directive requires a "data controller" (defined by the directive as an agency with access and the right to process personal data), including any CRA, to provide any "data subject" (defined as a person with respect to whom data are gathered) with the following information (unless he or she already has it): the controller's identity, the purposes of processing for which the data are intended and any further information necessary to guarantee fair processing in respect of the data subject, including identification of the recipients or categories of recipients of the data. With respect to data that are not collected from the data subject, he or she should be informed when data are recorded or at the latest when the data are first disclosed to a third party.

In addition, any person has the right of access to data relating to him or her that is being processed in order to verify the accuracy of the data and lawful of the processing. Specifically, a data subject has the right to obtain from the controller information on the purposes of the processing of the data at issue, the categories of the data concerned and the recipients or categories of recipients to whom the data are disclosed; the data undergoing processing and any available information as to their source; and, with respect to data that are subject to automated processing intended to evaluate certain personal aspects, such as creditworthiness, knowledge of the logic involved in the processing[12]. In addition, any data subject has the right to obtain from the controller: (i) the rectification, erasure or blocking of data which do not comply with the directive and (ii) notification to third parties to whom the data have been disclosed of any rectification, erasure or blocking.

The directive requires member states to give a data subject the right to opt out of direct

EVENT

### MFC DELIVERS TRAININGS TO POLICY MAKERS IN CENTRAL ASIA

In 2003, the International Finance Corporation (IFC) with financial support from the United States Agency for International Development (USAID) initiated a project on the development of microfinance legislation in three Central Asian countries – Kyrgyzstan, Tajikistan and Uzbekistan. The goal of the project is to facilitate the regulation and supervision of microfinance institutions through the provision of training and consulting support to regulatory bodies from the listed countries.

Within the scope of the project, the MFC has engaged in delivery of a series of microfinance training courses for central bankers from Kyrgyzstan, Tajikistan and Uzbekistan from March to May 2004. The purpose of these courses was to help policymakers better understand how MFIs function. A better understanding of MFIs should contribute to a more effective regulation and supervision of microfinance and, consequently, strengthen the stability of the financial systems and foster the development of financial markets in the aforementioned Central Asian countries.

The trainings conducted by MFC trainers, received very positive feedback from participants. "I understand microfinance much better now," said one of the participants. The trainings have been possible owing to the IFC support.

marketing through objecting either to the processing of data that the controller anticipates being used for direct marketing or to the use and disclosure of such data for direct marketing. Unlike under U.S. law, the directive provides data subjects with the right to be informed before personal data are disclosed for the first time to third parties for the purposes of direct marketing and to object to such disclosure.

The EU directive also includes the following overarching provisions not applicable in the U.S.: (i) member states are required to establish an independent supervisory authority with respect to the "data controllers" (which, as noted above, include CRAs) and (ii) transborder data transfers to a third country are prohibited unless the third country ensures "an adequate level of protection."

## Application to Armenia

Armenia[13], as well as each other country that has signed a partnership and cooperation agreement with the EU (for example, Azerbaijan, Georgia, Russia), has agreed in its respective agreement to "endeavor to ensure that its legislation will be gradually made compatible with that of the Community." In accordance with its agreement, Armenia passed a Law on Personal Data (adopted in late 2002; effective in February 2003) that incorporates many of the provisions required by the EU directive. The law, however, would impose limitations greater than those required by the directive on the ability of a credit bureau to process personal data and may, in fact, prevent the effective operation of a credit information market. Specifically, the language in the law permitting a person to withdraw his or her consent to the processing of personal data casts a pall over credit information gathering. In addition, there are other requirements, which would need clarification[14].

In addition, there are other various pieces of legislation relevant to the establishment of private credit bureaus: the Law on Bank Secrecy, the Law on Freedom of Information, the provisions of the Civil Code related to trade secrets and a resolution of the Central Bank of Armenia ("CBA") establishing a public credit registry maintained by the CBA. The Law on Bank Secrecy, in the absence of the customer's consent, restricts the dissemination of "bank secrets"[15] to banks, the CBA and certain other specified parties, including those performing work for or representing the bank. Non-bank recipients of bank secrets, which could possibly be read to include private credit bureaus, are prohibited from disseminating the information to others. (Some involved in the debate in Armenia have argued otherwise.) The Law on Freedom of Information requires government bodies and other specified entities to provide information contained in the relevant entity's records pursuant to a request for such information, although the entity can refuse to provide certain information, such as bank secrets, trade secrets or information that "infringes the privacy of a person." Although information made available pursuant to a request might be relevant to a private credit bureau that processes positive information, the law does not pro vide the person receiving such information with the right to disseminate such information further and therefore is not helpful to the operation of a credit bureau. Finally, the Civil Code places blanket restrictions on distributing information constituting a commercial (or trade) secret without the consent of the person "owning" the secret.

Given the restrictions on use of information that are established by the three laws, it is our view that there will need to be law specifically permitting private credit bureaus (i) to process personal data (as well as data on commercial entities) and (ii) to access and process "bank secrets." In addition, due to the fact that the three laws mentioned above are relatively new[16] and have not yet been "tested," it would be advisable for the Armenian parliament to clarify ambiguities and remove potential inconsistencies in the legislation that could cause problems for the effective operation of a credit information market. ■

[1] The basic research for this article was conducted under the auspices of the USAID funded Armenia Micro Enterprise Development Initiative (MEDI) project being implemented by Chemonics International

[2] In March 2004, 350 senior banking personnel from 40 countries attended Standard Chartered's "International Credit Bureau Conference" in Seoul to discuss how to manage loan portfolio risks.

[3] This article focuses on private credit bureaus – usually established as a profit-making venture by entrepreneurs with or without financial institutions as shareholders or as a cooperative venture by a group of lenders– as opposed to public credit registries, which are typically run by a public (i.e., governmental) institution or by an organization operating on behalf of a government agency. Private credit bureaus are voluntary mechanisms whereas public bodies require certain financial institutions to participate in public credit registries and more often than not exclude non-regulated institutions. Although not always the case, public credit registries tend to focus on regulated financial institutions with the data being used in connection with the supervision and regulation of the participating financial institutions.

[4] Although some countries have an integrated market for individuals and businesses, in the United States and most EU countries, the markets have generally been separate due to market forces as opposed to any legal requirement. (There has, however, been movement of some commercial reporting firms into the consumer reporting business.) In contrast, according to a World Bank study of 64 countries, over 93.8% of public credit registries collected information on both individuals and firms; 6.3% collected information on firms only. See World Bank report "Doing Business in 2004: Getting Credit Project: Results on the Global Survey of Public Credit Registries in 64 Countries" at rru.worldbank.org/Documents/PCR_Data_Results.pdf. For an interesting overview of the history of the largest business-related credit information processor, Dun & Bradstreet ("D&B"), see www.dnb.com. D&B, through its affiliates, covers more than 83 million companies worldwide.

[5] See keynote speech by Hun-Jai Lee, Korean Deputy Prime Minister and Minister of Finance and Economy at the March 2004 conference hosted by Standard Chartered regarding the lack in South Korea of a system enabling financial institutions to assess individual creditworthiness and manage credit risk. As noted in the speech, in Korea, there are only two CRAs and they need a better enabling environment. www.mofe.go.kr.

[6] For a discussion on whether there is a correlation between access to "positive" information and consumer overindebtedness, see Working Paper entitled Information Sharing and Its Implications for Consumer Credit Markets: United States vs. Europe by Nicola Jentzsch and Amparo San José Riestra prepared for the European University Institute Workshop "The Economics of Consumer Credit: European Experience and Lessons from the U.S." at www.iue.it.

[7] While the countries of the European Union are required to harmonize their legislation with the EU directives, under the data processing directive (described in more detail below), countries may impose greater restrictions than those required by the directive.

[8] See ECRI Research Report No. 4, "Credit Bureaus in Today's Credit Markets" by Amparo San José Riestra (Sept. 2002) at www.ecri.be.

[9] In the U.S., both federal and state legislation are relevant to the operation of CRAs. Due primarily to space limitations, this article will address the federal legislation only. However, state legislation is less relevant today than in the past due to recently-enacted federal legislation that pre-empts the ability of states to regulate much of the issues regarding privacy and credit bureaus and also pre-empts lawsuits under state law with respect to other issues.

[10] This opt out right is different from, and must be done separately from, the opt-out provision referred to above.

[11] Any person may order a copy of his credit report and can thereby check for inaccuracies. Under a new federal law, a person may request, by phone, internet or mail, one copy annually for free.

[12] Under the EU directive, data subjects have the right not to be subject to a decision that is based solely on automated processing of data intended to evaluate personal aspects of the person, including creditworthiness, unless the decision is taken in the course of entering into a contract or is authorized by a law that provides for measures to safeguard the data subject's legitimate interests. There is no comparable provision under U.S. law.

[13] Armenia was selected for purposes of this article due to its robust microfinance sector and the fact that credit information services – and the availability of such services to microfinance institutions – is actively being debated.

[14] For example, the law appears to require a data processor to give any data subject who consents to the processing of personal data information on each entity to whom the data might be provided, as opposed to categories of entities who might receive the information. Another example: a data subject can block processing of data if he or she disagrees with the accuracy of the data without having to prove that the data is, in fact, inaccurate.

[15] The law defines "bank secrets" as "information on the accounts of the customer that became known to the bank as a result of provision of services to the customer of that bank, information on the transactions conducted at the instruction or in favor of the customer, as well as the commercial secret of the customer, information on any project or invention and any other information on the customer which the latter intends to keep confidential and the bank is aware or could be aware of that intention."

[16] The Law on Bank Secrecy was adopted in 1996; the other two laws and the CBA resolution were all adopted in the past 18 months.

# Microfinance in Central Asia: Varied, Growing, Reforming

BY TOM JACOBS, PROJECT MANAGER, MICROFINANCE LEGISLATION DEVELOPMENT PROJECT (MLDP)

## Introduction

In recent years the microfinance sector in Central Asia[1] has been gaining increased attention from practitioners, the international donor community, investors and, importantly, from local governments themselves. While the microfinance phenomenon in this region dates back only to the mid-90's, a consensus is quickly building that microfinance can, and should play an important role in helping to reduce poverty, improve living standards, create jobs, and, over time, attract sorely-needed investment to the region. That said, while all Central Asian countries have a common ideological, socio-economic and legal predecessor (i.e., the Soviet Union), practitioners, governments, and policymakers in each country have approached the microfinance sector in a unique way, taking into consideration their own country's particular economic, social and political realities.

The Kyrgyz Republic was an early "convert" to microfinance and has been successful in developing a relatively advanced microfinance sector whereas Turkmenistan is only now beginning to consider the role microfinance and microfinance institutions (MFIs) should play in its economy. Kazakhstan, Tajikistan and Uzbekistan lie somewhere along this continuum. This article will briefly describe the current state of the microfinance sector in post-Soviet Central Asia, highlighting current or proposed legislation specifically designed for MFIs. Throughout this article, MFIs are considered distinct from member-based MFIs such as credit unions.

The microfinance market in Central Asia is changing quickly; hence, any market information that is gathered is soon dated, especially given the different market conditions across the countries under review. In the absence of a comprehensive, up-to-date survey of Central Asian microfinance, the author draws upon two key sources[2] to provide an overview of the microfinance sector across the region acknowledging that different survey methodologies and collection dates limit the comparability of available information. However, a broadly accurate, if imperfect, picture can still be drawn to understand better the state of the sector in each country.

## The Current State of Microfinance in Central Asia

By all accounts, microfinance portfolios in Central Asia are growing rapidly, albeit from low levels. While high rates of growth augur well for the sector, they do not tell the whole story. In fact, market conditions in each country are quite varied. Chart 1 compares the outstanding microfinance portfolios of each country on a per capita basis. The figures reflect outstanding microfinance portfolios for commercial banks[3], MFIs (both NGO and commercial forms) and credit unions as of December 2002[4]. One can see that Kazakhstan and the Kyrgyz Republic have similar portfolio sizes on a per capita basis whereas Uzbekistan and Tajikistan lag far behind. In the case of Uzbekistan, this significant difference is due to its much larger population, approximately 25 million versus 5 million for the Kyrgyz Republic and 6 million for Tajikistan. In fact, the Kyrgyz Republic and Uzbekistan have roughly equal aggregate microfinance portfolios in total (about $40 million each), but Kyrgyz citizens clearly have greater individual access to microfinance than the average Uzbek.

It must be noted that what is commonly referred to as "microfinance" is, in the context of Central Asia, typically no more than "microlending[5]" as few other financial services are offered. In fact, the National Bank of the Kyrgyz Republic has only recently granted its first license to an MFI to engage in micro-leasing, and the very limited opportunities for micro-client savings products are provided mainly by credit unions and not by traditional MFIs. In addition, as is often the case, significant differences exist in how microfinance is defined. For example, per the World Bank Report "microfinance" through Kazak commercial banks can include loans up to $50,000, hardly amounts typical of traditional MFI clients. At the other end of the spectrum, the average loan of an NGO-MFI in Uzbekistan is only about $115, per the IFC Report. Thus, a radical difference exists as to what "microfinance" actually is.

The manner in which microfinance is delivered also varies considerably across countries. Chart 2 illustrates the percentage of the microfinance portfolio of each country by institutional form. Reflecting weaker institutional strength and lower levels of state resources and intervention, the microfinance

CHART 1: OUTSTANDING MICROFINANCE PORTFOLIOS ON PER CAPITA BASIS

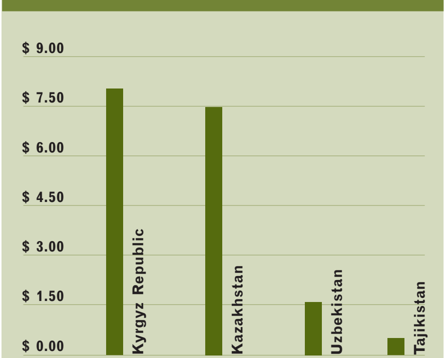



CHART 2: OUTSTANDING PORTFOLIOS BY INSTITUTIONAL FORM

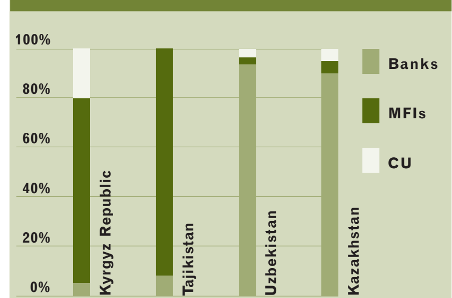
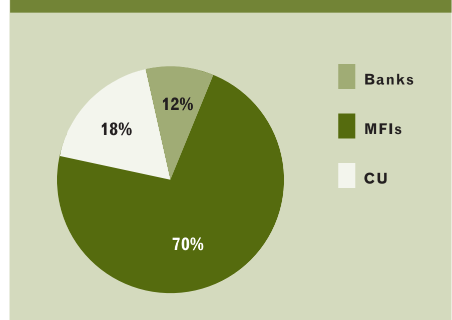



CHART 3: PERCENT OF ALL MICROBORROWERS SERVED BY INSTITUTIONAL FORM



markets in the Kyrgyz Republic and Tajikistan are driven primarily by donor-supported MFIs. In Kazakhstan and Uzbekistan the formal banking sector dominates the microfinance sector as bank lending programs sponsored by international financial institutions (in the case of Kazakhstan) and government-directed programs (in the case of Uzbekistan) drive the vast majority of the market. Regardless of which country one examines, MFIs have reached large numbers of microfinance clients, more so than either banks or credit unions. As can be seen in Chart 3, MFIs service approximately 70% of all microborrowers in Central Asia versus only 12% and 18% by banks and credit unions respectively. This situation is reversed, however, if one considers the dollar value of portfolios: banks service 74% of the market and MFIs only 20%. This striking difference is explained by much smaller loan sizes granted by MFIs that average only $273 compared with bank "micro"-loans that average almost $6,000. Institutional forms and funding sources impact individual portfolio sizes, but MFIs across Central Asia are demonstrably more effective in reaching true microborrowers.

Per capita analysis of microfinance access when considered in light of the sources of funding suggests substantial demand for microfinance services that government-funded programs and private banks are unable or unwilling to satisfy. This conclusion, relatively new in most of Central Asia, has forced governments to consider reforms designed to improve the environment for microfinance, promote growth in the sector and attract investment from donors, international financial institutions (IFIs) and private sources. Legislation has been the primary area of recent reforms.

## Microfinance Institution Legislation in Central Asia

Recognition of the need to reform legislation governing microfinance activities has come at different times and has been driven by different factors in each Central Asian country. As noted above, all Central Asian countries share a common historical legislative system. Post-Soviet legal systems, broadly speaking, provide the right to lend or to grant credits. While the two activities are almost identical (one distinction in most countries is that lending can involve non-monetary fungible goods while crediting involves monetary assets only), the range of institutions that can engage in crediting is restricted while lending is not generally an activity restricted to a specific group. For banks and credit unions, specific legislation governs such institutions. However, for institutions such as NGOs (or general commercial entities) engaged in microlending as a primary activity, the right to do so under the civil legislation is not clear.

Without an unambiguous right to lend as a primary activity, NGO-MFIs and commercial MFIs could be considered operating outside of the law (or, at least, could be accused of doing so) which increases MFI risk and uncertainty, especially as MFIs grow and become more visible. This situation could limit expansion of microlending activities as funding providers (donors, IFIs, and, in particular, private investors) tend to be uncomfortable operating on uncertain legal grounds. Clarifying the right of MFIs to lend as their primary activity has been one of the main focuses of legal reform in Central Asia.

An in-depth discussion of microfinance legislation in each of the countries under discussion is clearly not possible in a short article. The overview given in this article briefly describes recent legislative reforms (or those currently under consideration) that focus on MFIs (excluding member-based organizations.) While this overview is not intended to be comprehensive, it attempts to highlight the key provisions the author believes would be of greatest interest to the reader. For additional information, the author refers readers to the relevant legislation itself and to experts in the field.

Both the Kyrgyz Republic and Kazakhstan have adopted specific laws governing MFIs though these laws differ in significant ways. The Kyrgyz law[6] established three new legal entities to allow for both depository and non-depository microfinance. Both commercial and non-commercial forms can engage in non-depository microfinance while only commercial forms may engage in deposit-taking. The legislation defines permitted activities and grants MFIs the right to raise capital (both debt and equity.) The legislation further provides that the national bank is to regulate and license depository forms through the adoption of normative acts. Recognizing the value of solid legal ground, over 70 MFIs have already registered under the law as of March 1, 2004.

The Kazak MFI law[7], on the other hand, is more limited in scope defining commercial and non-commercial forms of MFIs, but restricting them to lending and related operational activities. Whereas the Kyrgyz MFI law outlines a series of prudential norms and requirements applicable to select types of MFIs, the Kazak MFI law provides no central bank oversight, but instead lists detailed operational requirements for record keeping and loan agreements. Importantly, the Kazak MFI law restricts funding sources to initial capital contributions, loans and grants. It does not allow MFIs to issue shares as a means of raising additional capital[8].

In Tajikistan, a draft "Law on Microfinance Organizations in the Republic of Tajikistan" is currently under review by the Tajik parliament[9]. This draft law is similar to the Kyrgyz MFI law in that it seeks to establish depository and non-depository forms of MFIs. It would also allow commercial and non-commercial forms of MFIs. Allowable MFI activities are defined, which include greater transactional services (e.g., demand deposits) than in the Kyrgyz MFI law. Due to the high incidence of poverty in Tajikistan (even by regional standards), MFI legislation that effectively promotes sector growth and investment has been a key driver behind government efforts to improve MFI legislation.

Since independence Uzbekistan has relied primarily on government-directed lending programs[10] through local banks to fund its micro-borrowers. However, growing recognition of the benefits of microfinance has spurred reform efforts. In April 2002, the "Law on Credit Unions" was adopted that allows members access to both microcredits and deposit services. In August 2002, the Government of Uzbekistan adopted Resolution 309, a temporary measure that has given select NGO-MFIs a legal basis to lend, among other rights. The Government is now considering a recommendation to draft and adopt a specific law governing MFIs that would build upon Resolution 309, and, importantly, allow for commercial microfinance and commercial funding of MFIs, neither of which is sanctioned by Resolution 309.

## In Conclusion

While legislative reform for MFIs is important and necessary, one must recognize that MFIs can only be as successful as the clients they serve. In all Central Asian countries MFI clients continue to face obstacles that limit their activities, restrict their growth and reduce their profitability. These include excessive bureaucracies, political biases against trading activities, and, in some cases, currency restrictions. Central Asia, as all regions in transition, face a multitude of social, political and economic issues that need attention. Fortunately, MFIs are increasingly receiving positive attention that is helping to improve their chances of success.

*continued on page 10* ▶

In various forms and to varying degrees, microfinance is developing successfully in Central Asia. Each country has taken a unique approach, but all have moved forward, recognizing the benefits that a healthy, growing MFI sector can bring to its citizens and economies. Governmental reforms recently undertaken, and/or currently under consideration, should, over time, significantly improve the prospects for growth in the sector, notwithstanding the very difficult environments in which MFIs and their clients currently operate. Ultimately, a better operating environment for MFIs and their clients should enhance the prospects of commercialization of microfinance activities on which the long term hopes for the sector are pinned. ■

Tom Jacobs is the Project Manager of the Microfinance Legislation Development Project (MLDP) a joint effort of IFC's Private Enterprise Partnership and USAID. MLDP works in Tajikistan, Uzbekistan and the Kyrgyz Republic to improve the enabling environment for microfinance through legislative reform and specialized training programs focused on regulation and supervision of microfinance institutions.

[1] Given the very early stage of development and limited information available regarding the microfinance sector in Turkmenistan, the author excludes Turkmenistan when referring to Central Asia unless specifically mentioned.
[2] These include a yet-unpublished report dated June 2003 by the World Bank entitled "Central Asia: Microfinance and the Poor" (the World Bank Report) and a report prepared by the Microfinance Legislation Development Project, a joint effort by the International Finance Corporation (IFC) and United States Agency for International Development (USAID), entitled "Microfinance in Uzbekistan: Sector Survey, Legal Diagnostic and Recommendations for Legislative Reform," released to select stakeholders in January 2004 (the IFC Report).
[3] Commercial bank information includes credits made from microfinance facilities established by the European Bank for Reconstruction and Development (EBRD) and the IFC to promote microfinance through commercial banks. Except as noted in Footnote 4 below, all figures are taken from the World Bank Report.
[4] The specific figures for Uzbekistan have been revised to reflect more recent data contained in the IFC Report. This includes portfolio information as of August 2003 for the EBRD/IFC Uzbekistan microfinance facility, and MFI and credit union data as of September 2003.
[5] Although under post-Soviet legal systems, there is a difference between a "loan" and a "credit," unless otherwise noted, the author uses both terms interchangeably throughout this article.
[6] Law "On Microfinance Organizations in the Kyrgyz Republic," adopted July 3, 2002.
[7] "Law of the Republic of Kazakhstan on Microlending Organizations," adopted March 6, 2003.
[8] Resolution 271 of the National Bank of the Kazakhstan, dated August 16, 1999 (which replaced Resolution 221 originally adopted on May 23, 1997) sets out alternative rights and obligations for non-bank financial institutions under which select MFIs may operate.
[9] The Microfinance Legislation Development Project worked closely with the National Bank of Tajikistan to develop the draft and continues to support passage of the draft law.
[10] These include lending programs subsidized by related tax incentives and other programs that are directly funded from government receipts.



KYRGYZSTAN

# Microfinance Regulation in the Kyrgyz Republic

BY KOUBANYCH ABDRAIMOV, HEAD SUPERVISION NON BANKING INSTITUTIONS DIVISION, NATIONAL BANK OF THE KYRGYZ REPUBLIC AND ERKIN JUMABAEV, HEAD SUPERVISION METHODOLOGY DIVISION, NATIONAL BANK OF THE KYRGYZ REPUBLIC

## Introduction

The development of microfinance institutions (MFIs) in Kyrgyzstan began in 1995 when, with the assistance of UNDP as well as international NGOs such as FINCA, Mercy Corps and ACDI/VOCA, a number of microfinance organizations were established. In 1997, with the support of the Asian Development Bank (ADB) project, credit unions began their activities. Since then, credit unions, operating on the basis of cooperation and members' self-assistance through mutual crediting and mobilization of savings, are among the most popular credit providers in rural areas.

In 1998, MFIs operating in Kyrgyzstan held their first nationwide meeting. In 2001, President Akayev initiated the National Forum on «The Role of Social Mobilization and Microfinance in Poverty Reduction» in which both microfinance and non-governmental organisations that provide microfinance services participated. In his speech, Mr. Akayev defined the priorities for the development of microfinance in Kyrgyzstan and stressed the necessity for creating a legal basis for a stable development of MFIs in Kyrgyzstan.

The role of the government in the development of the microfinance industry in Kyrgyzstan consists of creating good conditions for the expansion of the microfinance sector and competition between MFIs. Willing to bring MFIs to a qualitatively new level, the government should design a sound legal framework providing players with minimal requirements, equal for the same type of MFIs. A weak legal framework for MFIs does not create a predictable, favorable environment allowing further growth of the microfinance sector. Consequently, an effective legal and regulatory system development with minimum state interference was started in Kyrgyzstan.

## Law on MFOs

International consultants' recommendations and international experience in the development of MFIs were taken in consideration during the

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legislative process. Additionally, microfinance practitioners were invited to take an active role in drafting the microfinance legislation. Thus most of the provisions of the Law on Microfinance Organizations ("the law on MFOs"),[1] which came into force in July 2002, were discussed with practitioners, who highly contributed to the legislation process.

The law on MFOs creates three kinds of microfinance institutions: (i) noncommercial microcredit-only institutions, referred to as „Microcredit Agencies" (MCAs); (ii) commercial microcredit-only institutions, referred to as „Microcredit Companies" (MCCs); and (iii) commercial microcredit deposit-taking institutions, referred to as „Microfinance Companies" (MFCs). According to the law on MFOs, microfinance organizations are allowed to deliver, beside microloans, additional banking services such as financial leasing and factoring. According to the Law on MFOs, Microcredit Agencies and Microcredit Companies are subject to certification by the National Bank of the Kyrgyz Republic (NBKR) and Microfinance Companies are licensed by the NBKR. As noted above, MFCs can also engage in deposit-taking and are therefore subject to additional requirements. Additionally, the law on MFOs stipulates a simplified procedure for foundation and registration of MFOs. In addition to issuing microcredits, MCAs and MCCs as well as MFCs are permitted to provide services on factoring and leasing operations. These activities are subject for licensing. Specific normative acts issued by the National Bank of the Kyrgyz Republic govern peculiarities related to the establishment and regulation of each type of MFOs.

Kyrgyzstan was one of the first NIS countries that initiated work on microfinance-specific legislation. Thus neither sufficient regional experience on building such a legal system nor tools designed to measure the effectiveness of proposed provisions were available. Because of the relatively early stage of microfinance legislation development, the present article does not contain conclusions or recommendations for other countries trying to create legal basis for a microfinance regulation.

As the Kyrgyz legislation requires from a credit institution a license prior to launching its operations, the drafters of the microfinance law were required to elaborate the licensing process for MFOs. The issue was solved by implementing in the law provisions that create a free certification process for newly established MFOs. However certain types of financial services — such as deposit-taking, financial leasing and factoring — require a more complicated (but still relatively simple) licensing process. Although deposit-taking services are subject to a licensing procedure, the potential availability of such a product to MFCs plays a major role in the development of the microfinance system.

The law on MFOs does not list legal forms suitable for MFOs, except with respect to microfinance companies, which may only be formed as joint-stock companies. Additionally, the requirements regarding minimum capital, ownership and management are relatively important for such deposit taking institutions. For instance, an MFO wiling to start savings activities, needs at least two years of market experience, proven record of efficient assets management and a share capital of not less than KGS 25 mln. (circa EURO 450 000).

The registration (certification) process of non-depositary MFOs is relatively simple as the National Bank requires only to raise a minimum capital and to comply with accounting standards and truth-in-lending requirements. Before starting its operations, a microcredit company must raise a minimum capital of not less than KGS 50 000 (about EURO 900). If the microcredit company posses a network of branches, the requested capital must exceed KGS 100 000 (about EURO 1800).

Taking into consideration the particularities of microlending, the supervision of MFOs can occur to be a costly and time-consuming activity for the government. Consequently, to ensure the conformity of MFOs' operations with the legislation, the supervisory body relies on reports drafted by external auditors, the preparation of which is one of the MFOs' obligations. According to the Article 22 of the law on MFOs, each report shall follow the principles of transparency and data verification. However the law does not exclude the possibility of on- site inspection in case of necessity.

The presence in the market of diverse financial institutions such as credit unions, specialized credit institutions and commercial banks providing, alongside MFOs, a wide spectrum of credit products under various tax regimes specific for each type of credit institutions requires attentive tax policy. In order to secure a healthy competition, it is crucial different types of lenders enjoy equal treatment. Particularly important is the issue of taking deductions for loan loss reserves. Thus, a process of fiscal reform is underway and these provisions need to be taken into account in the process of drafting a new Tax Code.

The development of the microfinance sector in Kyrgyzstan directly depends on the quality, as well as the „quantity", of microfinance-related legislation and regulation. Excessive legal requirements can make the business unprofitable if MFOs' expenses related to complying with the requirements become too burdensome. The attempt to strike the balance between stability of the microfinance sector and its development was exercised in Kyrgyzstan. The majority of MFOs has already legalized their activity, and as of January 1, 2004 the number of certified microfinance organizations has reached 72. Among them, 56 registered as microcredit agencies and 16 of them as microcredit companies.

## Key prudential and non-prudential requirements for microfinance organizations

***Minimum capital requirements***

The minimum capital requirement is established for all non-bank institutions, except for microcredit agencies.

Microfinance companies:

- Not less than KGS 10 mln. (about EURO 180,000) (for microcredit only MFCs);
- Not less than KGS 25 mln. (about EURO 450,000) (for microcrediting and deposit taking MFCs).

Microcredit companies:

- Not less than KGS 50 000 (about EURO 900) (for MCCs without branches);
- Not less than KGS 100 000 (about EURO 1800) (for MCCs with branches).

Microcredit agencies:

- No requirements for the authorized capital (noncommercial organization).

Credit unions:

- Not less than KGS 30 000 (about EURO 550);
- Not less than KGS 100 000 (about EURO 1800) to participate in the Asian Development Bank project;
- Not less than KGS 200 000 (about EURO 3600) for deposit - taking CUs.

***Ownership structure***

Microfinance companies:

- No shareholder may hold more than 20% of the total authorized capital (except for international finance institutions enumerated by the NBKR, who can own up to 100%).

Credit unions:

- Any member may contribute (through initial membership investments or premiums) up to 10% of the total equity of CU savings.

***Fit and proper test***

The managers of microfinance companies have to comply with the NBKR requirements before being approved by NBKR.

The fit and proper test does not apply to managers of microcredit companies and agencies.

As to credit unions, the manager and the accountant of each CU must conform with NBKR's requirements.

***External audit***

Microfinance companies that intend to take deposits must follow the external audit rules established for commercial banks. As for microcredit companies and microcredit agencies, minimum requirements related to external audit are set forth in normative acts adopted by the NBKR. The requirements for credit unions are in the process of being developed.

***Financial reporting and accountability criteria***

Financial reporting standards are based on international accounting standards and apply to all types of non-banking lending institutions, including MFOs.

NBKR has developed uniform standards for financial reporting of non-banking lending institutions, which are licensed or certified by the NBKR. Microfinance companies are required to publish their financial statements that should fulfill in accordance with International Accounting Standards.

***Regulative reporting (call reports)***

In order to perform offsite supervision of microfinance companies, special rules for regulative reporting were set up which are, in fact, a simplified version of the rules applied to commercial banks. Similarly, common standards for regulative

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COUNTRY HIGHLIGHT

ROMANIA

# Long Overdue Legislation Gives Hope to Romanian Microfinance

BY TINA M. OHMANN, COUNTRY MANAGER, SHOREBANK ADVISORY SERVICES

As in many transition countries, the Romanian microfinance sector is plagued by unclear legislation and regulatory requirements. A regulatory framework for microfinance organizations to operate legally within Romania is currently being drafted under the umbrella of USAID's Enterprise Development & Strengthening Program for Small and Medium Enterprises. A final draft is ready and the lobbying process is underway. If adopted, this legislation will facilitate building the microfinance sector in Romania into a vibrant industry to continue combating poverty countrywide, reaching all geographic areas including the depressed mining and agricultural areas, which are most affected by lack of resources and access to capital, unmet financing demands, minimal technical assistance and community development needs.

Clear and concise microfinance legislation would likely place the industry on the fast track, which, in turn, would serve as a driving force in job creation, borrower education with respect to credit and basic finance and business. As a result, external funders would be able to start projects that currently are not workable and would consequently be a boost for social programs and community development projects as well as increased entrepreneurship and social welfare and development of micro and SMEs.

The draft law uses the Romanian Mortgage Company Law as a model (the primary reason being that mortgage companies are not deposit-taking entities and therefore are not required to report to the Central Bank), along with various microfinance laws recently drafted, including those of the Federation of BH and the Republika Srpska, Tajikistan and Kyrgyzstan. Some highlights include:

- Minimum capital requirement (currently EURO 200,000 but this figure is expected to change) designed to ensure self-sustainability for microfinance companies and to enhance market legitimacy and reputation.
- Limited regulatory barriers for microfinance institutions („MFIs") entering the market as non-deposit-taking entities.[1] Such MFIs can offer "Services for the economic development of the beneficiaries ...specialized consulting, information, educational and training services."
- Borrower protection . Two consumer protection issues are particularly relevant to microfinance and warrant attention: (1) protection of borrowers against "abusive" lending and collection practices, and (2) "truth in lending" – providing borrowers with accurate, comparable and transparent information about the cost of loans.
- The proponents of the Draft mirror the National Bank of Romania's concerns for protecting borrowers by ensuring truth in lending. Generally, the different combinations of transaction fees and interest calculation methods make it difficult for borrowers to compare interest rates of microfinance lenders when choosing a microfinance lender. This is the reason the Draft requires microfinance companies to disclose their interest rates and other material terms and conditions of the micro-credit contract to microfinance applicants prior conclusion of the micro-credit contract.
- Simple reporting requirements. Under the proposed legislation, the MFIs will submit annual reports on portfolio statistics to the National Bank of Romania exclusively for statistical purposes.
- Explicit provision for the right of microfinance institutions to take cash collateral in order to secure repayment and to borrow and then on-lend without being deemed to engage in financial intermediation or deposit taking.

The draft law includes a final chapter on "transitory and final provisions" which details the steps organizations must take in observing the regulations set forth. It also lists in detail what laws and regulations currently in place will be amended. An optimistic outlook would have the law passed in early summer.

## Background of Microfinance Sector in Romania

The microfinance sector in Romania principally consists of 14 NGOs and one microfinance bank, a majority of which are operationally self-sustainable and are currently seeking commercial funding. The outstanding loan portfolio is estimated to be $54 million, with the average loan size being $3,900. The sector serves about 14,000 active clients. According to a study done in May 2003,[2] the demand for the microfinance sector could be as high as $500 million covering 113,000 micro entrepreneurs throughout Romania. Currently 35 of the 41 counties are covered by the 14 NGOs offering microfinance services. It is expected that by the end of 2004 all counties will be represented.

The formal banking sector also serves the micro and SME sector, although banks have yet to downscale significantly. Several banks house finance facilities with EBRD credit lines for onlending to the SME sector. The average loan size is however, approximately Euro 45,000, leaving a gap that the microfinance organizations are currently trying to bridge. Relations between the MFIs and the formal banking sector are somewhat guarded, mainly due to lack of information about the microfinance sector. In a recent conference in Bucharest, representatives were brought together from MFIs and banks to discuss possible collaboration. MFIs may look to commercial banks for financing their loan portfolios, which may in turn be an

advantageous way for banks to gain experience in the microfinance sector.

There are three Guarantee Funds in Romania — two are government funds (established in 1995 and 2002) , the third (established in 1994) is private — that are mainly utilized in the SME sector, although one fund focuses on agricultural credits. The total registered capital of the three funds is EURO 11.5 M. A guarantee is provided based on an application submitted by one of the 12 participating banks. The guarantees provide up to 75% of the required collateral for the loans with a cost of 1.5% to 3% per year.

## Methodologies

Various methodologies are utilized by the MFIs in Romania. However, the majority of MFIs use individual loan products with their customers. Loans range from US$500 – US$20,000, with loan maturities of up to two years (with some exceptions). Interest rates vary from 15 – 18% (on hard currency loans), with some exceptions for programs who are utilizing grant loan capital. A few MFIs have a solidarity group loan product for a 12-month period, under which individual loans are made, but with each member of the group assuming joint liability for the entire loan. There are several MFIs offering agricultural loan products often combined with technical assistance to farmers.

## Sources of Funding for Microfinance Portfolios

The funding of the current and future micro-loan portfolios comes from a variety of sources. The NGO MFIs currently rely on funding from donors and other funders, such as the EU, USAID, and the Swiss Government. This grant money is becoming scarce as other regions such as Afghanistan and Iraq require immediate support. The commercial banks, on the other hand, use a mixture of external financing from donors/funders and their own internal resources. A key attraction of the external financing programs is the technical assistance that is often included as part of the package for loan officer training, marketing and credit scoring.

Several organizations —including the World Bank, EBRD, IFC, EU/Phare, Soros, KfW, Swiss Government, UNDP, and Oikocredit — have invested capital in the microfinance sector. A recent study indicates that all combined sources of external funding available for micro and SME is approximately US$215 million. An estimated guess is that 50% of the funds will likely be lent to the microbusiness sector through the formal banking sector and through MFIs.[3]

Other funding, such as venture capital and leasing are available, but these are more likely to be targeted at the medium sized companies within the SME sector. As such, they are not expected to have a significant impact on the microfinance market.

## Obstacles Faced by MFI's

Along with the need for a clear and concise operating environment, there are taxation issues that impede the development of MFIs. The issues are mainly related to tax officials' interpretations of the activities of microfinance organizations, how they register "profit,", and provisions for write-offs, only to mention a few. The draft legislation addresses and clarifies these issues, providing for a more transparent operating environment for the MFIs through specific accounting and fiscal provisions which follow International Accounting Standards.

Two other barriers to growth and development for MFIs are access to capital and lack of training and technical assistance. Under the umbrella of USAID's Enterprise Development Strengthening Program and in cooperation with the Microfinance Center and ShoreBank Advisory Services, a Capital Facility Concept Paper for MFIs in Romania was recently completed. It analyzes and evaluates potential options for the effective channeling of funds to the microfinance sector, including the identification of possible additional capital resources (which would be additional to the $215 million referred to above). The end goal is an industry-wide MFI Capital Facility that will serve as a tool to support MFIs to leverage needed capital resources. The capital facility is intended to function in a financially independent manner and be operational in early 2005.

In addressing the technical assistance needs of the MFIs, Shore Bank Advisory Services has conducted various trainings on topics requested by the organizations, including risk management, strategic planning, loan fund management, forecasting & budgeting and financial planning/modeling. Upcoming sessions include: MF Industry Standards and Best Practices, MFI's Performance evaluation techniques, financial product design and development, and management techniques for branch managers, including communication & teamwork.

## Obstacles Faced by Clients of MFIs

As with the MFIs, micro entrepreneurs are faced with lack of available and affordable funds for developing and growing their micro businesses. They also face unclear, ever-changing, complicated legislation often resulting in misinterpretation and causing undue stress on the entrepreneurs. It is assumed that with the new legislation, clients will also benefit as the microfinance sector gets increased attention. The clients are also in need of better business development services as they often lack basic management fundamentals and coherent business strategies for long-term sustainable growth. Many MFIs offer consulting and training services in addition to their loan products, but gaps remain.

## Informal Association of Microfinance Institutions

There is a memo of understanding in draft form among all 14 MFIs in Romania indicating their wish to work as a cohesive group, though not yet ready to formalize as an association or coalition. "Microfinance Romania" is a network of microfinance practitioners whose members are committed to improving the lives of the underserved through the provision of credit, business development services, and other financial services.

The primary objective of the network is to build a vibrant, high-performing microfinance industry that is dedicated to serving the financial needs of micro-enterprises throughout Romania on a sustainable basis by developing and promoting standards for organizations that seek to provide microfinance services to the underserved. ■

If you would like to know more information on microfinance in Romania, please address queries to: SAS@fx.ro. See our website! www.micro-finance.ro

[1] "Limited regulatory barriers" means not having to deal with the banking law or the Central Bank. Note that there are no restrictions on foreign ownership, management or sources of capital of the MFIs.
[2] Graham Perrett, Report on the Current State of Microfinance in Romania, May 2003
[3] Graham Perrett, Report on the Current State of Microfinance in Romania, May 2003

COUNTRY HIGHLIGHT

# Microfinance Regulation in the Kyrgyz Republic

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reporting were also established for microcredit companies and microcredit agencies.

The norms for regulative reporting for CUs were developed following recommendations of ADB advisers and the Financial Company for Support and Development of Credit Unions.

### *Other prudential requirements*

Microcredit companies and agencies are not subject to prudential norms.

Microfinance companies, planning to take deposits or already taking deposits should comply with the following prudential norms:

- Capital adequacy
- Risk concentration
- Liquidity ratios
- Investments limitations
- Deposits / assets ratio (no more than 100 %)
- Limitation on insiders/affiliated persons lending

Credit unions should comply with the following norms:

- Capital adequacy
- Limitation of external borrowings
- Limitation on deposits
- Limitations on investments in the fixed assets
- Liquidity ratios

## Conclusion

The approach to regulating microfinance adopted in Kyrgyzstan provides stakeholders with a transparent image of the microfinance sector, does not the stifle the development of non-depository microfinance organizations, and does not limit innovation introduced on the market by service providers.

It is necessary to note that the year 2004 was declared by President Akayev as the year of diligent management and social mobilization. The President's initiative to fight poverty and deepen the social mobilization process requires the creation of a favorable environment for further growth of the microfinance industry, with emphasis on introducing microfinance services to remote regions of Kyrgyzstan. ■

[1] The term microfinance organizations (MFOs) is found frequently in texts translated from Russian. The terms MFI and MFO can be used interchangeably, as it is done in this text.

ARMENIA

# Test Case for Building a "Best Practices" Legal Environment

by Monika Harutyunyan, Legal Advisor, MEDI[1], Timothy R. Lyman, President Day, Berry & Howard Foundation[2] and Chrysanthos A. Miliaras, Chief of Party, MEDI

## Introduction

As is the case in many countries around the world, the legal and regulatory environment for microlending in Armenia is ambiguous. Currently no law or set of laws exists that governs how NGO microlenders should be regulated. This lack of legal clarity has not prevented several actors – both commercial and non-commercial – from establishing strong and promising microlending operations over the past few years. While these donor-backed initiatives have achieved a great deal in a relatively short period of time, Armenia's microlending sector will not achieve significant scale or sustainability unless microlending-friendly legislation and normative acts – based upon global best practices – are adopted. As a result, the sector's ability to help create jobs and alleviate poverty will be greatly limited.

## Scope of Microlending Activities in Armenia

Armenia has a combination of commercial and non-commercial organizations engaged in microlending. Specifically, the sector contains: eight NGO microlenders formed as foundations or as branch operations of foreign NGOs pending formation of a local legal vehicle; one commercial microlender operating as a limited liability company (LLC); a cooperative bank financed in part by international finance institutions that targets its lending activity to the agricultural sector of micro and small enterprises; and many commercial banks participating in various onlending programs with capital supplied by international financial institutions and NGOs.

The combined microloan portfolios of NGO microlenders, commercial microlenders, and commercial banks engaged in microlending totaled (in terms of outstanding principal balance) approximately $32 million as of 31 December 2003. Of this total, approximately $21 million is attributable to micro and small loan programs managed by commercial banks with support from the German Armenian Fund (GAF) and other donors in the form of technical assistance, credit lines (at concessional rates) and loan capital. These programs have approximately 3,400 clients. The remaining $11 million constitutes microloans granted by microlending foundations and one commercial microlender (established by an international NGO) who, in the aggregate, have an active client base of approximately 29,000. To place things in perspective, the total portfolio outstanding for the entire Armenian banking sector as reported by the Central Bank of Armenia (CBA) as of 31 December 2003 was $190 million.[3]

## Legal and Regulatory Environment for Microlending in Armenia

Over the past three years, the legal and regulatory environment for microfinance in Armenia has gone from being relatively benign to one in which the very right of

NGO microlenders to exist is open to possible legal challenge. This situation was somewhat predictable due to the fact that microlending foundations did not engage in the financial sector reform process that led to the passage of the Credit Organizations Law (COL) in 2002.[4] As a result, they were neither included in the law nor were they explicitly exempted from it, as were credit clubs and lombard institutions.[5]

Specifically, microlending foundations now face the following significant problems:

- ambiguities as to the ongoing legality of their lending activity in the wake of the adoption of the COL (which does not permit foundations to obtain licenses to operate as credit organiztions, but also does not exempt them from its licensing requirements);
- unavailability of the lending-related deductions in calculating profit tax that are enjoyed by banks and other credit organizations; and
- a ceiling on administrative expenses (which by law include all salaries) to 20% of total expenses under the new Law on Foundations (LoF), which was passed in 2002.

It should also be added that, NGO microlenders were also subject to 20% Value-Added Tax (VAT), unlike the credit organizations covered under the COL. Fortunately, this situation was reversed as of January 2004 with an amendment to the Law on VAT whose language appears amply broad to restore VAT exemption to microlending foundations.

## Recommendations for Reform

The various barriers identified above do not lend themselves to being solved through a single piece of "microlending" legislation. Some, in fact, are solvable simply by revisions to administrative practices and normative acts. Others will require amendments to several pieces of legislation.

The major problems of the NGO microlenders, however, could be resolved with a single package of proposed new legislation on microlending foundations, together with conforming changes to other existing laws and drafting of appropriate normative acts. Such a package could also address a critically important need of at least some NGO microlenders in the future: a viable legal means to "commercialize" (e.g., establish a commercial affiliate to run the microlending operations) and attract commercial sources of capital (debt and equity) when donor resources become scarce.

Without detailing the specific legislative changes and additions that would be required, there are two potential reform approaches that could be used to overcome the legal obstacles faced by NGO microlenders outlined above. First, NGO microlenders could be brought under the regulatory jurisdiction of the CBA, as is the commercial microlender registered as a non-bank financial institution (NBFI). Second, the Ministry of Finance and Economy (MoF), which regulates lombard institutions, could be given specialized non-prudential regulatory jurisdiction over microlending foundations.

Global best practices, as set forth in CGAP's Guiding Principles on Regulation and Supervision of Microfinance, indicate that a case can be made for either a country's Central Bank or Ministry of Finance to be responsible for regulation of microlending. In Armenia, for example, key issues to be considered include the cost to, and capacity of, the potential regulators to regulate microlending. The key point, however, is that regardless of which institution regulates the sector, the content of the regulation must be appropriate. Basic tenets of appropriate regulation include, with respect to "lending or credit only" microfinance institutions (such as those in Armenia), that regulation be non-prudential and transparency driven. For instance, this would mean requiring microlending foundations to submit simple reports to the regulator, which should consider the frequency, manner, and scope of information required to ensure that these are not overly burdensome. Note: regulation of "lending or credit only" microfinance institutions would not mean to require microlending foundations to meet minimum capital adequacy requirements, such as those required for deposit taking financial institutions. This is due to the fact that, as "lending or credit only" institutions, NGO microlenders do not present any systemic risk to Armenia's banking sector.[6] This logic would also hold true if NGO microlenders were to borrow from foreign sources, local commercial banks, or local sources other than public deposits. However, if the Armenian microlending foundations were to develop into deposit-taking institutions then, of course, global best practices dictate that they should be prudentially regulated. At this point in time, however, and for the foreseeable future, deposit taking is beyond the capacity of both Armenia's commercial and non-commercial microlenders.

## Strategy/Process for Reform

There are currently two key issues facing Armenian microlending with regard to its legal and regulatory environment. The first relates to the content of microfinance regulation being considered. The second concerns which institution will ultimately do the regulating: the CBA or MoF. Central to resolving both of these questions is ensuring that all key stakeholders – policy makers, practitioners, and donors – are involved in a constructive debate that sets aside their individual short term objectives in favor of what is best for the sector's development over the long term. To accomplish this larger objective, it is critical that all stakeholders first clearly understand global best practices for regulating microfinance and how they relate to the Armenian context.

To move the process forward, the USAID Armenia Micro Enterprise Development Initiative (MEDI) has conducted a Survey on the Legal and Regulatory Environment for Microfinance in the Republic of Armenia. The survey details the legal and regulatory environment for institutions carrying out microfinance activities in Armenia and recommends specific legal and regulatory reforms to be undertaken under the auspices of MEDI. The survey was distributed to stakeholders in January 2004. In follow-up to this, MEDI hosted a forum attended by key policy makers, international donors, and practitioners in February 2004. The purpose of the forum was threefold:

- to present an overview of CGAP's Guiding Principles on Regulation and Supervision of Microfinance and how they relate to Armenia,
- to place Armenian microfinance in a broader regional context by presenting highlights from the Microfinance Center's regional mapping study, and
- to present and discuss the results of the MEDI Survey.

The forum marked the first time that policy makers, practitioners and donors sat down together to discuss the issue of

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microfinance regulation. A key outcome of the meeting was that there was a general consensus amongst stakeholders that microlending foundations should be regulated in a non-prudential manner. While this is a significant and critical first step, much work remains to be done. Specifically this includes:

- determining the details of what constitutes non-prudential regulation and
- deciding which institution, the CBA or MoF, will regulate microlending foundations.

To settle these two issues, MEDI is assembling a working group that will include one representative from the CBA, MoF, and other relevant government agencies, as well as representatives from select microlending foundations. The idea is to keep the working group small and to set specific goals that will drive the process forward. The goal of this dialogue is to establish a consensus with regard to which body is the most appropriate regulator for microfinance in Armenia, the CBA or MoF. It is entirely possible that there could be different regulators for microfinance depending on the legal form of the institution engaged in microlending. For instance, presently, the CBA regulates commercial microlenders registered as NBFIs. This relationship could continue to exist while microlending foundations could simultaneously end up under the jurisdiction of the Ministry of Finance. The Ministry of Justice will also have a role in the matter due to the fact that, as was mentioned previously, changes will be required to the Law on Foundations in order to give microlending foundations a clear legal status. It is important to note, however, that in the case of multiple regulators that it will be critical to ensure that the content of regulation imposed by each regulatory body be more or less identical in order to prevent regulatory arbitrage from occurring. It would be counter-productive to have existing institutions and new entrants contorting in order to qualify as microfinance institutions under the specific regulator that they perceive as being more benign.

In addition to policy makers, microlenders (commercial and non commercial) will have representation on the working group. This is critical because, as was mentioned previously, Armenian microlenders did not engage in the policy dialogue that led to the passage of the COL. Today, however, Armenian microlending foundations can no longer afford to remain entirely unregulated. They have grown to a point where their collective impact on the financial sector is significant enough that the government wants them to be regulated – at least to mandate appropriate transparency in the operations. This, however, is a positive development for the microlending sector overall, due to the fact that Armenian microlending foundations will eventually need to access commercial sources of debt and equity in order to:

- increase their scale and sustainability and,
- compensate for scarce donor resources which will eventually run out.

Unfortunately, this will not be possible until microlending foundations obtain a clear legal and regulatory status.

## Conclusion

Microfinance in Armenia is at a critical juncture. Over the past few years the sector has grown from obscurity to a point where it is recognized by both the Central Bank of Armenia and the Ministry of Finance and Economy as having the potential to provide significant amounts of credit to micro and small enterprises. As a result, the Armenian government has made it clear that it wants to support the sector's further development and supports the notion that all microlending institutions should have a clear legal and regulatory status. While this is positive, in order for the sector to realize its full potential all stakeholders – policy makers, practitioners, and donors – must work together to ensure that microfinance in Armenia is regulated in accordance to global best practices. This does not mean, however, replicating legislation that may have worked in one country and applying it directly to Armenia. Rather, stakeholders must be well versed in the guiding principles on the regulation of microfinance to the point where they can properly adapt them to the Armenian content. Naturally, this will require effort and dialogue. However, if properly executed, the rewards of such a reform initiative will be high. Specifically, Armenia will have laid a solid legal and regulatory foundation that will enable microlenders to access commercial sources of debt and equity, which are fundamental to the sector's future growth and long term sustainability.

[1] The USAID Armenia Micro Enterprise Development Initiative (MEDI) is a three year project aimed at creating jobs in the micro and small enterprise sector through increasing access to finance and business development services as well as improving the enabling environment. MEDI is being implemented by Chemonics International Inc., a global development consulting firm headquartered in Washington, DC.

[2] Timothy R. Lyman is a co-author of the *Guiding Principles on Regulation and Supervision of Microfinance*, which was published as part of CGAP's *Microfinance Consensus Guidelines* in July 2003. Mr. Lyman also serves as a legal advisor to the USAID MEDI project and co-authored along with Monica Harutyunyan, MEDI's *Survey of the Legal and Regulatory Environment for Microfinance in the Republic of Armenia*, which was released in January 2004. He also serves as International Legal Issues Advisor to MFC.

[3] The source of the statistical information on microlending foundations is the Financial Banking College Foundation, an Armenian institution which tracks statistical data on NGO microlenders. Information on the German-Armenian Fund was reported by the ARKA News Agency on 13 January 2004. Commercial banking data was reported by the Central Bank of Armenia's Publications and Statistics Monetary Overview, December 2003.

[4] The COL, together with the normative acts thus far adopted under it, create explicit rules for a range of new credit institutions that might be used to carry out microlending activities. For the most part, the new rules are workable in their current form for the types of institutions they currently cover, and MEDI does not recommend making changes to the COL or its normative acts for these types of institutions a priority.

[5] Credit clubs funded by the U.S. Department of Agriculture (USDA) were granted legal status pursuant to a special law on such organizations adopted in April of 2002. It should be noted that these organizations are highly subsidy-dependent and are therefore unlikely to reach significant scale or to become financially sustainable. Lombard institutions (i.e. pawn shops) are regulated by the Ministry of Finance and Economy.

[6] It should be noted that the same logic applies to commercially formed microlending institutions, such as those that currently fall within the regulatory reach of the COL.

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