Policy Monitor

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

Nr 6, November 2004

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COUNTRY HIGHLIGHT

TAJIKISTAN

Development of Microfinance Legislation in Tajikistan

By Dilshod Kholmatov, Former Lawyer of Microfinance Legislation Development Project in Tajikistan, International Finance Corporation

Introduction

The Law of Republic of Tajikistan «On Microfinance Institutions» was passed on May 17, 2004. It constitutes the legal and organizational basis for microfinance activity and creates new prospectives for growth and competition of microfinance institutions (MFIs) in the country.

The adoption of the law is a result of the joint effort of various governmental bodies of Tajikistan, MFIs and international donor organizations involved in the process of reform of the microfinance sector in Tajikistan.

The development of the draft law was preceded by serious preparatory work carried out with the help of international organizations, which supported discussion at the governmental level of the existing problems in the microfinance sector in Tajikistan as well as the efforts to define the strategy for further development of microfinance in Tajikistan. Through these discussions and efforts, representatives of state bodies and existing MFIs reached a mutual understanding and agreement on the necessity of developing the legal and regulatory base for microfinance in Tajikistan. It was the beginning of the microfinance-related legal reform process. The Memorandum of Understanding entered into between the National Bank of Tajikistan and USAID in July, 2002, providing for consulting assistance in the development of the microfinance law, evidenced the first step in the process.

Preconditions of Microfinance Legal Reform

The majority of microfinance services in Tajikistan are provided by international assistance programs operated and funded by donor organizations from various countries in the world. Currently, microfinance activities in Tajikistan are carried out by more than 25 various organizations – local NGOs and international organizations – that engage primarily in extending credits and providing business development services. Most of the MFIs provide microfinance services within the framework of humanitarian relief projects.

Although MFIs operating in Tajikistan offer a limited number of financial products, there is a high potential for further development of these institutions. First of all, there is a significant demand for microfinance services in Tajikistan due to the poor access of a large portion of the population (basically in rural areas) to financial services offered by banks. MFIs operating in Tajikistan represent an alternative source of funds for micro-enterprises and private entrepreneurs.

At the same time, before the adoption of the microfinance law, the legal status of MFIs was uncertain, thus impeding their further development. The legal status of these institutions was not stipulated by legislation and according to a strict interpretation of the laws on credit activity, their operations were illegal (although, as in other NIS countries, the institutions were not prohibited from engaging in lending pursuant to the provisions of the Civil Code). This legal ambiguity caused many problems for the MFIs. Another problem faced by the MFIs was the unfavorable tax treatment when compared to the treatment accorded to other financial institutions. These tax burdens hampered the establishment and development of long-term sustainable microfinance institutions.

Taking all this into account, the majority of MFIs as well as international donor organizations initiated reforms aimed at addressing the various legal problems related to microfinance activity. The National Bank of Tajikistan and the Government – recognizing the importance and significance of MFIs to poverty alleviation, the supporting of business activity, jobs creation as well as other important social issues – undertook these initiatives. The result was the drafting and adoption of the Law «On Microfinance Institutions», which addresses a complex set of legal problems related to microfinance activity and is ultimately aimed at promoting the development of micro-finance in Tajikistan.

Process of Drafting the Law

The microfinance legislation development project (MLDP or the Project) was initiated pursuant to the Memorandum of Understanding signed by the National Bank of Tajikistan and USAID. The Project was a joint undertaking of two international advisers – the International Finance Corporation (IFC) and USAID – who prepared the initial version of the draft law «On Microfinance Institutions».

The work on the text of the draft law was preceded by a careful review and analysis of the existing legislative base for microfinance. Based on this analysis, Kate

EVENT

MFC DELIVERS TRAINING TO POLICY MAKERS ON THE ASSESSMENT OF MFIS

In July 2004, MFC delivered the training for Policy Makers in Kyrgyzstan. The course was an overview of the ACCION CAMEL rating tool used to assess MFIs. The training was delivered with the financial support from IFC and USAID within the project on the development of microfinance legislation in Central Asia.

The ACCION CAMEL is a diagnostic and management tool that measures the Capital adequacy, Asset quality, Management, Earnings and Liquidity of MFIs. It's designed to help managers and supervisors assess an organization's financial health and overall performance. The original CAMEL was developed in 1978 by the U.S. Federal Reserve to evaluate the solvency of U.S. banks. In 1993, ACCION adapted the CAMEL to depository microfinance.

The ACCION CAMEL has been used by the Bolivian Superintendency to evaluate regulated microfinance institutions in Bolivia, and is used as a due diligence tool for the Banco Centro Americano de Integracion Economica, based in Honduras. More recently, central bankers from various African countries received training in the use of the ACCION CAMEL as a supervisory tool. This tool has been implemented in the CEE and the NIS for the first time.

The training on ACCION CAMEL tool contributes to improving the capacities of regulatory and supervisory bodies and enables them to carry out their functions according to the best international practice in MFIs' supervision (as ACCION CAMEL is the only supervisory tool adequate to supervise microfinance institutions by the central bankers). Through ACCION CAMEL ratings, regulators and supervisors can better understand and assess the financial health of an institution, get better idea on how MFIs are compared to banks and thanks to that be able to understand how to develop legislation related to microfinance sector.

MFC plans to continue delivering trainings for regulators in our region to train them in the use of the ACCION CAMEL, so as to increase their capacity in MFI oversight.

Lauer and Timothy Lyman, legal advisers to the Project, prepared a report with recommendations for the legal and regulatory reform for microfinance sector in the Republic of Tajikistan. The recommendations were based on the objective assessment of the needs of the local microfinance sector and the economic conditions in Tajikistan, taking into consideration both national enforcement of law and international experience in regulating microfinance. This approach, employed by the advisers, allowed them to prepare the draft law following the best global practice of microfinance regulation and enabled them to formulate the basic regulatory requirements and provisions of the draft law, taking into account legal practice of Tajikistan and avoiding contradictions with the existing legislation and government policy in this area.

It should be mentioned that MFIs operating in the Republic, representatives of international organizations, experts and practitioners alongside the ministries and departments of the Republic of Tajikistan, were involved in drafting the law «On Microfinance Institutions». There was a constant dialogue and exchange of opinions between the MFIs and the international donor organizations involved in the drafting process. Meetings and discussions devoted to the draft law «On Microfinance Institutions» made it possible to pull together the positions of the participants of the law-making process on key issues of the draft law, to provide better approach in drafting the law and to consider remarks and suggestions of numerous stakeholders. Although not all suggestions and recommendations of the participants were incorporated, the adopted law presents a balance of different opinions, which in some cases were diametrically opposed.

It is necessary to mention the significant role of the MLDP in maintaining and promoting the entire law-making process. Due to the technical assistance provided by the MLDP to the National Bank of Tajikistan at all stages of coordinating and passing the draft law, its adoption was not dragged out in a long process of searching for trade-offs between the participants of the law-making process. The Project employees, together with specialists from the National Bank of Tajikistan, took part in the discussions of the draft law in the Government and Parliament, providing explanations of the draft law and requested information (including on the peculiarities of microfinance regulation in other countries) and preparing and presenting information needed to debated issues. In addition, the MLDP organized and conducted workshops on microfinance fundamental based on the experiences of the Microfinance Centre and CGAP for representatives of government bodies involved in the process of drafting the microfinance legislation. There is no doubt that all those actions promoted better understanding of the fundamentals of and legal issues relevant to microfinance as well as international practice and legislation in other countries with developed microfinance legislation.

Currently, the National Bank of Tajikistan is in the process of drafting normative acts stipulated by the law «On Microfinance Institutions». The development of the normative acts regulating MFIs' activities is directly supported and assisted by the MLDP. The representatives of MFIs are involved in this work, which to a certain extent, guarantees the adoption of a regulatory framework that promotes the growth and development of microfinance and attracts investments in this sector.

The legislative work necessary to improve the tax situation of MFIs is proceeding. A draft revised Tax code which aims to simplify and lower the tax burden of local MFIs has been submitted to the Government of the Republic for its consideration.

The Law on MFIs

The law provides the legal and organizational basis for carrying out mainstream microfinance activity by three types of MFIs. Two of these (commercial and non-commercial) are MFIs specialized in granting microloans; the third is a deposit-taking MFI with the right to attract deposits from the public and from legal entities. The depositary MFI is to be supervised and regulated by the National Bank of Tajikistan.

Though now there is a very low probability that there will be a significant number of MFIs in Tajikistan that are institutionally ready to be transformed into deposit-taking organizations in the near future, the law – having as its purpose the development of a variety of types of MFI – stipulates the full spectrum of alternatives for carrying out microfinance activities. The choice of several institutional alternatives provides MFIs with an opportunity to realize a wider range of financial transactions that will allow diversification and an extension of the market for microfinance services and will promote additional foreign investment in the microfinance sector of the Republic.

The mode of regulation and supervision of depository MFIs in the law is basically similar to that applied to commercial banks. Non-depositary MFIs are not overloaded with burdensome demands and provisions. Instead, the regulation thereof is limited to monitoring given that the activity of these organizations does not entail any systemic risks and cannot seriously affect the stability of a financial system as a whole.

The law includes provisions providing for "transparency" of MFIs, which will enable the population of the Republic, as well as other market participants, to have fair and accessible information on the financial performance of MFIs.

Prospects for Microfinance Development

The goal of the reforms in microfinance sector is to develop MFIs, which will allow Tajikistan to extend and diversify its financial sector and to meet the demands of wider sections of the population for financial services. In the long run, these reforms should promote general economic development of the Republic.

Taking into account the living standards and employment rate, as well as the level of small and medium business development and support, the role of MFIs in the Republic is significant. The development of microfinance in the Republic can really contribute to the solution of numerous existing social and economic problems without putting additional burden on the national budget and with minimum participation of the government, stimulating the population to get engaged in private business and self employment, instead of being forced to look for a job abroad.

Microfinance is officially recognized and legally approved in Tajikistan. Its further development in many respects depends on international donor organizations, which have repeatedly expressed their readiness and desire to invest in the emerging microfinance sector of Tajikistan. n

Community Development Finance Institutions in the UK

By Bernie Morgan, Chief Executive, CDFA

The growth of community development finance institutions (CDFIs) in the UK has been rapid in recent years. UK CDFIs provide financing for a wide range of clients that includes social businesses, small businesses, micro-businesses, high growth businesses in deprived areas, charities and community groups as well as individuals.

The reason for the rapid growth is that an enabling framework is being created since the Labour government came into being in 1997. In doing so, it has helped to create a sector but one that was so new it had no points of reference in the UK. Therefore we have looked to the US for the modelling of the sector as it has the variety of CDFIs types that is needed in the UK. There is, of course, a different legal, fiscal and cultural framework in the US, so the modelling is limited and we are now having to learn how the sector can work in the UK ourselves.

Since coming into power in 1997, the UK government created a series of policy action teams, two of which focused on finance: one looked at enterprise finance and the other at personal finance. The enterprise finance action team recommended the creation of a fund (called the Phoenix Fund) which would create CDFIs supplying enterprise finance to disadvantaged areas or underserved communities: examples of these being rural areas, women, refugees and those over 50. This fund came into being in 1999 and provided more than £40m of finance to the sector. The Phoenix Fund has been instrumental in establishing the sector as it has provided seed funding, revenue and capital for on-lending for many CDFIs. The Fund is due to wind down in the near future, more of this later.

A recent announcement (July 2004) by the government supported its commitment to personal financial inclusion when the Chancellor stated that a Task Force to look at the issues would be created and a fund would be available to support the issues. The **cdfa** is working with the government as it forms its work in these areas.

Early in its administration, the government also established a series of Task Forces, one of which looked at creating wealth in disadvantaged areas. This is called the Social Investment Task Force and is chaired by Sir Ronald Cohen, one of the world's leading venture capitalists. It made its recommendations to the Chancellor in October 2000. Among the suggestions were the creation of a tax relief for individuals or organisations investing in CDFIs and the establishment of a trade association for CDFIs. The tax break, Community Investment Tax Relief, started early last year and has levered millions of pounds of private investment into the sector, more of this later too.

The trade association, the Community Development Finance Association (**cdfa**) of which I am chief executive, was launched in April 2002 and has quickly established itself as a dynamic and credible organisation capable of representing the many needs and views of its members.

There are approximately 60 CDFIs in the UK and the **cdfa** has 52 in its membership. They are mainly small and serve a specific geographic area or target market. Most of them have been financing for less than two years so they are a very young group of organisations. There are groups of CDFIs in the North West of England, the Birmingham area and greater London. Others are more spread out across the UK. They mostly provide debt products and specialise in one type of market. Therefore, the sector has yet to achieve scale or coverage. The recent survey of the sector, Inside Out, undertaken by the **cdfa** and published in May 2004 indicated that the top three issues facing UK CDFIs over the next three years are (in order):

- revenue funding;
- deal flow;
- access to capital for on-lending.

This indicates that the sector is still dependent on public or charitable funds and will be for some time to come. We look to the US here and note that the sector there is about 20 years older than in the UK and it still takes significant public funds to support its work.

As the sector is made up of many different CDFIs, they have different legal forms. Those that are charities are regulated by the Charity Commission. Those that are banks are overseen by the Financial Services Authority, which also registers Industrial and Provident Societies (IPSs), another form that CDFIs take. Other CDFIs are companies and are regulated by Companies House.

The government is currently reviewing charity law and creating two more forms, the Community Interest Company and the Charitable Incorporated Organisation. They may prove to be good forms for CDFIs: time will tell. The government is also reviewing IPS law. This makes the current regulatory environment complex, fluid and challenging. The **cdfa** is working on codes of practice for its members and it is hoped this will be a significant step towards self-regulation.

The forthcoming scaling down of the Phoenix Fund has been accompanied by clear messages from central government that public support for CDFIs should from March 2006 come through organisations called Regional Development Agencies (RDAs). There are nine RDAs covering England (support for Scotland, Wales and Northern Ireland should come from the devolved administrations). Some of these RDAs are already engaged with the CDFI agenda but many are not yet involved. There is also a difficulty here, as central government cannot tell RDAs what to do as RDAs are autonomous bodies. The **cdfa** is concerned that, even if by 2006, it can engage all RDAs, CDFIs will still be subject to changes in RDA policy.

The Community Investment Tax Relief (referred to above) has levered millions of pounds into the sector, but this has been mainly through three of the most mature CDFIs. This indicates that other CDFIs need to be given more time to establish themselves and become investment-ready before they can use this helpful tool.

So the CDFI sector in the UK is emerging yet vulnerable. It is faced with the withdrawal of public funds before it has achieved full scale, coverage or sustainability. It is fighting for survival while at the same time making access to a range of finance available to those who need it most. n

A Western Perspective on Eastern Europe

BY ROSALIND COPISAROW, FORMER CHIEF EXECUTIVE, STREET (UK)

"This article contains highlights of the issues more comprehensively explained in the document entitled "Street(uk), a micro-finance organisation: Lessons learned after its first 3 years' operations". The document will be published in December 2004. Hard copies can be requested from Street(UK)'s Birmingham office or downloaded from Street(UK)'s website: www.street-uk.com"

What is the Rationale for Micro-finance in Western Europe / USA?

Whereas the development of the micro-finance industry has largely been driven by a poverty alleviation agenda in the developing economies, and by an enterprise development agenda in the transition economies of Eastern Europe, micro-finance in the West has been primarily introduced as a tool to combat the social and financial exclusion of a segment of society that lies between the poor and non-poor: i.e. a population group that falls below the radar screens of commercial banks but above the upper limits of most forms of charitable/state support.

It is a huge "no man's land" (possibly 2-4 million people in the UK alone) with two main sub-groups: i) people living off some state benefits supplemented by informal income-generating activities; and ii) people living solely off their own business income but declaring either none or some of this income for tax purposes.

What are the main factors impeding the development of small business potential clients of Micro-finance Institutions (MFIs)?

- A highly competitive and developed private sector, making the ongoing chances of survival of a small business much lower than in emerging markets. (In the UK, just as many new businesses go bankrupt each year as start up.)
- The often poor design of the welfare system (e.g., the UK), including a) disincentives for people to graduate off welfare into self-employment (typically benefits terminate long before the business has generated sufficient income to manage without them) and b) the manner in which the benefits are paid, frequently bypassing the beneficiary and going straight to the service provider, thus creating a serious financial illiteracy problem because people are no longer in full control of their household budgets.
- Lack of necessary skills to undertake bookkeeping and keep proper records.
- An unacceptably high level of legal and regulatory requirements for small businesses. This 'red tape' is at least as big a problem as the financial disincentives.
- A minimum wage which in some countries is significantly higher than the informal market rate.
- The deterioration of traditional social bonds, particularly the mutual support links between family members, reducing the risk protection and insulation against problems for any single individual.

What are the main factors reducing the demand of small businesses for MFIs's services?

- The easy availability of consumer finance (although often at very high interest rates of 150-500% APR) and of consumer goods for purchase on a zero deposit instalment payment basis. This has also exacerbated the financial illiteracy problem and created a mass over-indebtedness culture (due to predatory lending practices) in which savings are no longer considered necessary.
- A plethora of credit card offers which most clients are not eligible for but which set relatively low interest rate expectations.

As a result of the above mentioned problems, MFIs face the following issues:

- Few clients are easy to reach as they are either not creditworthy or frightened to be visible;
- High levels of delinquency due to a lack of basic cashflow management skills
- Low social impact, as the underlying social and economic issues facing these clients are only marginally addressed with supportive credit tools. [This is not a problem for all MFIs – just those who have a social (as opposed to commercial) goal as their primary purpose].

In addition, with respect to those clients who do use MFI services, there tends to be a speedy graduation into the mainstream finance market, reducing the number of repeat clients.

What additional obstacles face Western MFIs?

In addition to the above-described general obstacles faced by most MFIs, the following impediments are typical for Western MFIs:

- Difficulties in finding and retaining good staff due to attractive private sector alternatives.
- Difficulties in obtaining funding from public, private and voluntary sector sources. Taking a business approach to a social issue is still not widely accepted because investors believe that they will not get a good return (over the next 3-5 years) nor will they get the tax-relief and PR benefits (especially private sector donors) of donations to the poorest.

Potential pathways to overcoming these obstacles

For people in the economic category between poor and "non-poor", various services are needed to help address their needs. Designing appropriate products is therefore essential to the creation of sustainable financial services for this market.

A. Client Products and Services

- Non-credit products which reduce risk (e.g. advice, savings, insurance)
- Support through small business "red tape".
- Bookkeeping assistance
- More sophisticated business skills (e.g.

breakeven/sensitivity analyses)

- Increased financial literacy/cash flow-management skills
- Development of mutual support networks

B. Dialogue with government

Ongoing discussions with governments are needed to improve the environment for both MFIs and their clients.

With respect to MFI clients, the following are issues that can be addressed:

- Adjustments to the benefits system to provide people with the incentive to transition into self-employment.
  This would include advocating for the elimination of a savings cap for welfare eligibility as evidence shows that it holds people back and jeopardizes efforts they make to advance.
- Reductions in red tape for microenterprises. The more red tape required to run a small business, the greater will be the population of businesses operating in the cash economy, either because they are unable to afford the costs of 'going legit' or because the paperwork is too complicated for them to understand. My proposal is for a commonsense approach to be taken in respect of each trade or industry sector, where the business has no more than five employees. In particular, this should benefit women whose microenterprises are disproportionately high in strictly regulated trades such as beauty, childcare or catering.
- Funding support for financial literacy training initiatives
- Funding support to encourage savings by microentrepreneurs

With respect to MFIs, the following is a list of issues to be addressed:

- Support for a regulatory framework that will promote and strengthen MFIs. A new regulatory framework is needed for financial institutions that are not governed by a profit-maximizing mission. A safely regulated, tiered mechanism can offer a number of options to community finance organizations, depending on their management experience, capital base and lending track record: ranging from pure loan funds (i.e. not involving depositors' funds at all) to credit unions (involving members' deposits only) to institutions fully licenced for deposit-taking, insurance provision, and so on[1]. There are a number of countries where variations have already been introduced, creating useful precedents and working models around the world.
- Grant funding support to new/developing MFIs in realistic amounts that reflect the scale of desired impact and the costs of building sustainable organisations.
  There is a crucial need for core funding for the operations of community finance institutions until they are able to become financially self-sufficient. In addition to this, equity and debt capital is needed to fund the clients themselves, wherever this cannot be obtained from the mainstream financial institutions. In return for this funding, community finance institutions will be delivering some of the government's key objectives, particularly in the areas of financial and business education and skill development, regeneration of deprived neighbourhoods and small business and job creation, as well as less quantifiable benefits in the areas of health, law and order.
- Financial incentives for the creation of semi-commercial investments in MFIs. Tax incentives for investors in community finance organizations would help the sector's funding needs. In the UK, the Community Investment Tax Relief has been introduced for individual and institutional investors who want to invest their funds in something socially worthwhile, but require a financial benefit. This is adapted from a scheme in the USA which has been running extremely effectively for over ten years.
- Stricter regulations on commercial lenders including banks, consumer finance companies and loan sharks, to discourage borrower over-indebtedness and predatory lending practices.

C. *Organisation Design Issues*

MFIs should explore ways to build on existing infrastructure through partnerships with compatible organisations, rather than exclusively attempting to build independent MFI branches, back office systems, new product or service tools and/or direct marketing databases.

They should also seek to divide the key elements of the products and services needed by clients into those which must be offered on a manual, local or tailored basis and those which can be "de-skilled" and offered remotely. Consider the use of volunteers, secondees and partners for the first category and technology to support the second.

These approaches would all be geared towards trying to increase outreach and drive down costs to create a sustainable MFI.

Lessons for the East

1. Macro-economic warning signs / progress markers

In addition to the regular indicators of outreach, performance and social impact, it may be worth starting to track some of the macro-economic conditions, particularly in the most advanced economies of Central Europe, that provide the key determinants of a favourable/unfavourable environment for MFIs and their clients, for example:

- Measures of market economy maturity and competitiveness;
- Relevant policies and regulations of a country's welfare system;
- Average availability of mainstream consumer credit;
- Average levels of financial literacy amongst MFI clients;
- Average annual ratios of start-ups to bankruptcies.

Countries could be scored or rated along two measures- favourable environment for MFIs and favourable environment for MFI clients – and these ratings would provide a quick marker for where priority attention should be given by donors to policy makers. (If cleverly packaged, they might also be used to promote some positive competitive rivalry between countries towards progress).

2. Preferred client products/services and MFI models

In relation to the degree of similarity between a given Eastern European country and the Western environment described above, due care needs to be paid to the provision of risk-reducing products and services (savings, insurance, business advice) as opposed to solely offering risk-increasing products (credit) in an effort to ensure that clients are well insulated against difficult economic conditions, even possibly at the expense of MFI size/efficiency measures.

Even if credit unions were to show lower growth and/or poverty outreach potential than NGOs, their foundation in savings and mutuality (two key risk insulators) could well outweigh their disadvantages over the long term.

3. *Dialogue with Government*

Whilst the legal, regulatory, tax, accounting and funding regimes of most Eastern European countries (as they relate to both MFIs and their clients) are still in such an early stage of development, and whilst there is still some donor 'leverage' in the remaining years of funding to be made available to Eastern European countries, this is a one time opportunity to influence their direction relatively easily, which should not be missed. Nor should it be limited to MFI regulation. What is needed is a comprehensive, integrated set of measures which can be presented at the Cabinet of Ministers level, and then applied to the development of individual policies in the Ministries of Finance, Industry, Employment, Home Affairs, in the regional governments, the national bank and the relevant regulatory bodies (e.g., the bodies overseeing or regulating foundations, financial services and accounting standards). It might also be worth donors' considering making part of their funding to MFIs conditional upon some contribution from the relevant government and/or progress in formulating favourable policies.

1 Editor's note: This raises serious and complex issues regarding (i) the type of MFI that is prepared, financially and institutionally, to engage in deposit-taking and (ii) what body would regulate and supervise such MFIs and whether such body has the capability, in terms of both staffing and expertise regarding microfinance activities and (iii) what prudential norms would apply to such MFIs.

BRIEFS FROM THE WORLD

EU Consumer Protection Compliance and Non-depository Microfinance Institutions (MFIs)

By Julie Robie[1]

Introduction

What consumer protection requirements would apply to non-depository MFIs in EU countries? This topic is of interest not only to MFIs in the countries of CEE and the NIS that have already become EU members or are (or hope to become) candidates for future EU accession, but also for MFIs in the numerous countries in the region that have signed treaties committing to harmonize their laws with EU directives.

Before discussing this question in more detail, it needs to be explained that the EU consumer protection directives[2] described below do not apply to all non-depository MFIs. While reading this article, we have to keep in mind that the EU consumer protection directives are aimed at consumers. This means that microcredit which constitutes "professional" credit (i.e. lending to a business entity for a business purpose) does not fall under the directives.

In microfinance, the distinction between lending that would constitute consumer lending by EU standards and lending that would not (because it would be considered professional credit) is not always clear. (The CGAP Guiding Principles on Regulation and Supervision of Microfinance, for example, point out that "[t]he clients are not just microentrepreneurs seeking to finance their businesses, but the whole range of poor clients who also use financial services to manage emergencies, acquire household assets, improve their homes, smooth consumption, and fund social obligations".) Moreover, many MFIs in CEE and the NIS do are a variety of lending, some of which would be considered consumer lending under the EU standards and some of which would be considered professional credit. In the article below, "non-depository MFIs" should be interpreted to cover those MFIs engaged in consumer lending as defined by the EU directives.

Consumer Protection Directives in the EU

Non-depository MFIs in EU countries are required to comply with at least four EU consumer protection directives. These relevant directives cover the following topics:

- Loan cost disclosure;
- Distance marketing of consumer financial services;
- Contracts negotiated away from business premises; and
- Misleading advertising.

Loan cost disclosure

The EU's primary consumer credit protection directive was enacted in 1987 and amended in 1990 and 1998[3]. The directive protects consumers by mandating written information disclosure by lenders. Under the directive, all credit agreements must be made in writing, the agreement must state the "essential terms of the contract," and the lender must supply a copy of the agreement to the consumer. In the written agreement, the lender must state the total cost of the loan expressed as an "annual percentage rate" (APR). All lenders, regardless of their legal form and other activities, must use the same mathematical formula to calculate the APR. This standardized formula can be found in Annex I to Directive 98/7/EC.

The directive imposes certain other disclosure responsibilities on lenders. When displaying at business premises an advertisement or offer of credit that indicates an interest rate or other loan cost-related figures, the lender must "include a statement of the annual percentage rate of charge, by means of a representative example if no other means is practicable." In the written loan agreement, in addition to the disclosures of APR and "essential terms" described above, the lender must state the following:

- the conditions under which the APR may be amended;
- "a statement of the amount, number and frequency or dates of the payments which the consumer must make the repay the credit, as well as of the payments for interest and other charges; the total amount of these payments should also be indicated where possible"; and
- the cost items excluded from the APR.

The lender must also notify the borrower of any changes in the annual interest rate or other loan charges at the time those changes occur. Where credit is granted as an advance on a current account (other than on a credit card account) and the lender is unable to state an APR, the lender must instead inform the borrower in writing of the credit limit, the annual rate of interest, the applicable charges and conditions under which the charges can be amended, and the procedure for terminating the agreement. This information must be provided at or before the conclusion of the loan agreement.

The directive also grants certain rights to borrowers. First, borrowers may prepay their loans before the maturity date, and borrowers who do so are entitled to an equitable reduction in the cost of credit. Second, when a lender assigns a loan to a third party, the borrower retains certain rights with respect to the loan and may enforce against the third party any defenses the borrower had against the original lender, including set-off (if allowed by the EU member state in question). Third, when a credit transaction involves both a lender and a supplier of goods or services, and the borrower seeks redress against the supplier but fails to obtain satisfaction, the borrower under certain circumstances may seek redress against the lender.

In addition, the directive imposes certain duties on EU member states to regulate lenders involved in consumer credit transactions. Member states must ensure that consumer credit lenders obtain official authorization to extend consumer credit, subject consumer lenders to official inspection and monitoring, or promote the establishment of entities to advise consumers and receive complaints regarding credit transactions. Regarding credit granted for the acquisition of goods, member states must set rules for repossession, ensuring that repossession does not unjustly enrich the lender. Also, "[i]n [m]ember [s]tates where tacitly accepted overdrafts are permissible, the [m]ember [s]tates concerned shall ensure that the consumer is informed of the annual rate of interest and the charges applicable, and of any amendment thereof, where the overdraft extends beyond a period of three months." In addition, member states must prevent creditors from structuring loan agreements in a manner that circumvents the mandates of the directive, in particular ensuring that creditors do not use "the device of distributing the amount of credit over several agreements." The directive also provides that member states may enact more stringent rules than those imposed by the directive.

The information set forth above reflects the status of EU law regarding consumer credit and loan cost disclosure as of March 2004. However, the European Commission and European Parliament are currently engaged in a process to revise the EU loan cost disclosure directive. In September 2002, the Commission presented a proposal for a new directive[4]. The proposal would greatly expand the applicability of loan cost disclosure requirements and other consumer protection measures to cover all "credit intermediaries" and all credit agreements offered to consumers, with the single exception of home loans. The proposal would mandate registration of lenders and credit intermediaries, require lenders to engage in "responsible lending" by investigating a borrower's credit-worthiness prior to lending, revise APR calculation conventions to include more cost items in the APR, introduce three new rates and rate calculations, ban certain "unfair terms" in loan agreements, and ban all door-to-door sales of credit, among other changes. In May 2003, a policy debate took place regarding the proposal in which a large majority of member states agreed that the scope of the directive should be expanded to include all forms of unsecured consumer credit[5]. On October 20, 2003, the European Commissioner for Health and Consumer Protection gave a speech acknowledging certain concerns with the original proposal and indicating that the Commission and Parliament will continue to work to amend the proposal[6]. It is not clear when an amended proposal will be released.

Distance marketing of consumer financial services

In 2002, the EU adopted a directive regulating the distance marketing of consumer financial services[7]. The directive applies to distance contracts[8] concerning financial services, defined to include "any service of a banking, credit, insurance, personal pension, investment or payment nature." The directive would thus apply to a distance microcredit contract supplied by a MFI, assuming that the borrower is a "natural person who, in distance contracts covered by this Directive, is acting for purposes which are outside his trade, business or profession."[9]

Under the directive, suppliers of distance financial services contracts must provide detailed information to consumers regarding the identity of the supplier, the terms of the financial service, the parties' rights under the distance contract, and the means of redress available to the consumer. This information must be provided "in a clear and comprehensible manner in any way appropriate to the means of distance communication used." The directive also imposes specific disclosure requirements for voice telephony communications. For example, "the identity of the supplier and the commercial purpose of the call initiated by the supplier shall be made explicitly clear at the beginning of any conversation with the consumer." If the consumer expressly consents during the telephone call, the supplier must then provide additional information regarding the characteristics and price of the financial service being offered. In addition, a supplier must provide all other information regarding the financial service that is mandated by other EU disclosure directives.

The supplier's disclosure duties continue beyond the initial contact with the consumer. "[I]n good time before the consumer is bound by any distance contract or offer," the supplier must communicate all contractual terms and conditions and other required information "on paper or on another durable medium available and accessible to the consumer." If the consumer requests that the contract be concluded at a distance, the supplier must fulfill the paper/durable medium obligation immediately after the contract is concluded. The consumer can also request a paper copy of the contractual terms and conditions at any time during the contractual relationship. The directive gives the consumer the right to withdraw from the contract, without penalty and without giving reason, for a period of 14 calendar days after the contract is concluded.

The directive regulates unsolicited services and communications by suppliers. Suppliers cannot engage in distance marketing by automatic calling machines or by fax without the consumer's prior consent. Those member states that permit tacit renewal of distance contracts must "prohibit the supply of financial services to a consumer without a prior request on his part, when this supply includes a request for immediate or deferred payment" and "exempt the consumer from any obligation in the event of unsolicited supplies, the absence of a reply not constituting consent."

The provisions of the directive are mandatory and non-waivable by consumers, and member states are required to sanction suppliers who violate the directive as implemented by national law.

Contracts negotiated away from business premises

The EU has enacted a directive[10] to protect consumers who, acting outside their trade or profession, enter contracts away from the seller's business premises, as in a door-to-door solicitation. The directive applies to all "contracts under which a trader supplies goods or services to a consumer," with certain exceptions not applicable to MFIs. Specifically, the directive applies to contracts concluded "during an excursion organized by the trader away from his business premises" or during a visit by a trader to the consumer's home or place of work, where the consumer has not requested the visit. When a consumer does request a visit by the trader regarding goods or services, the directive nevertheless applies to contracts that may be concluded for certain other goods or services. The directive also applies to certain offers made by the consumer during the door-to-door solicitation, whether or not the consumer is bound by those offers. Thus MFIs that solicit contracts with borrowers away from business premises may be subject to the consumer protections afforded by the directive.

These consumer protections include the following:

- Traders must give consumers written notice of the consumer's right to cancel the contract within seven days after the consumer receives the notice. The notice must be dated, must identify the contract, and must include the name and address of the person against whom the cancellation right may be exercised. The date on which notice must be given depends on the type of contract solicitation method used.
- If the consumer cancels, national laws govern reimbursement of any payments the consumer made for services provided.
- The consumer's rights under the directive are non-waivable.

Misleading advertising

The EU has enacted legislation to protect consumers, business people, and the public from misleading advertising and to establish conditions under which comparative advertising is permitted[11]. The EU directive would apply to any MFI that engages in advertising, defined as "the making of a representation in any form in connection with a trade, business, craft or profession in order to promote the supply of goods or services."

"Misleading advertising" is defined as "any advertising which in any way, including its presentation, deceives or is likely to deceive the persons to whom it is addressed or whom it reaches and which, by reason of its deceptive nature, is likely to affect their economic behaviour or which, for those reasons, injures or is likely to injure a competitor." Whether an advertisement is "misleading" is determined with reference to the information it contains concerning the following:

- the characteristics of goods or services, such as their availability, nature, execution, composition, method and date of manufacture or provision, fitness for purpose, uses, quantity, specification, geographical or commercial origin or the results to be expected from their use, or the results and material features of tests or checks carried out on the goods or services;
- the price or the manner in which the price is calculated, and the conditions on which the goods are supplied or the services provided;
- the nature, attributes and rights of the advertiser, such as his identity and assets, his qualifications and ownership of industrial, commercial or intellectual property rights or his awards and distinctions.

Misleading advertising is prohibited, and the directive authorizes member states and other persons and organizations to take legal or administrative action against misleading advertising.

"Comparative advertising" refers to advertising "which explicitly or by implication identifies a competitor or goods or services offered by a competitor." Unlike misleading advertising, the comparisons in comparative advertising are permitted by the directive when the following conditions are met:

- it is not misleading;
- it compares goods or services meeting the same needs or intended for the same purpose;
- it objectively compares one or more material, relevant, verifiable and representative features of those goods and services, which may include price;
- it does not create confusion in the market place between the advertiser and a competitor or between the advertiser's trade marks, trade names, other distinguishing marks, goods or services and those of a competitor;
- it does not discredit or denigrate the trade marks, trade names, other distinguishing marks, goods, services, activities, or circumstances of a competitor;
- for products with designation of origin, it relates in each case to products with the same designation;
- it does not take unfair advantage of the reputation of a trade mark, trade name or other distinguishing marks of a competitor or of the designation of origin of competing products; and
- it does not present goods or services as imitations or replicas of goods or services bearing a protected trade mark or trade name.

In addition, comparisons referring to a "special offer" must state "in a clear and unequivocal way the date on which the offer ends or, where appropriate, that the special offer is subject to the availability of the goods and services, and, where the special offer has not yet begun, the date of the start of the period during which the special price or other specific conditions shall apply." n

1 This article was researched and drafted by Julie Robie while she served as the Day, Berry & Howard Foundation Summer Fellow. The article was edited by MFC's Policy Coordinator Ania Wisniewska and Timothy R. Lyman, MFC's International Legal Issues Advisor and Policy Advisor to CGAP. Editors received contributions from Mr. Christophe Guene, Director, SOFI Brussels and Prof. Dr Udo Reifner, IFF in Hamburg.

2 The directives of the European Commission are not laws per se, but rather are enforceable standards that the national laws of the EU member states must generally meet as a condition of EU membership.

3 Council Directive 87/102/EEC of 22 December 1986 for the approximation of the laws, regulations and administrative provisions of the Member States concerning consumer credit [Official Journal L 42 of 12.02.1987]. The directive has been amended by Council Directive 90/88/EEC (Mar. 1, 1990) and Council Directive 98/7/EC (Apr. 20. 1998).

4 Proposal for a Directive of the European Parliament and of the Council on the harmonisation of the laws, regulations and administrative provisions of the Member States concerning credit for consumers, COM(2002) 443, Official Journal C 331 of 31.12.2002.

5 Policy Debate on the Proposal for a Directive on Credit for Consumers at the Competitiveness Council (May 19, 2003), http://www.europa.eu.int/comm/consumers/cons_int/fina_serv/cons_directive/policy_debate_en.htm.

6 David Byrne, European Commissioner for Health and Consumer Protection, Speech/03/477 at EP Committee on Legal Affairs and the Internal Market, Strasbourg (Oct. 20, 2003), available at http://www.europa.eu.int/rapid/start/cgi/guesten.ksh?p_action.gettxt=gt&doc=SPEECH/03/477|0|RAPID&lg=EN&display=.

7 Directive 2002/65/EC of the European Parliament and of the Council of 23 September 2002 concerning the distance marketing of consumer financial services and amending Council Directive 90/619/EEC and Directives 97/7/EC and 98/27/EC [Official Journal L 271, 09/10/2002 P. 0016 – 0024].

8 "Distance contract" means "any contract concerning financial services concluded between a supplier and a consumer under an organised distance sales or service-provision scheme run by the supplier, who, for the purpose of that contract, makes exclusive use of one or more means of distance communication up to and including the time at which the contract is concluded."

9 While the directive expressly applies only to consumers acting outside the context of "trade, business, or profession," the directive allows member states to extend the protections contained in the directive to "persons making use of financial services in order to become entrepreneurs." Whether any member states have in fact extended protections to borrowers using loans for business or entrepreneurial purposes is beyond the scope of this article.

10 Council Directive 85/577/EEC of 20 December 1985 to protect the consumer in respect of contracts negotiated away from business premises [Official Journal L 372, 31/12/1985 P. 0031 – 003].

11 Council Directive 84/450/EEC of 10 September 1984 relating to the approximation of the laws, regulations and administrative provisions of the Member States concerning misleading advertising [Official Journal L 250, 19/09/1984 P. 0017 – 0020]; Directive 97/55/EC of European Parliament and of the Council of 6 October 1997 amending Directive 84/450/EEC concerning misleading advertising so as to include comparative advertising [Official Journal L 290, 23/10/1997 P. 0018 – 0023].

Financial Leasing: A New Form of Financing for Micro, Small and Medium Enterprises (M & SME) in Central Asia

By Rachel Freeman, Project Manager, Central Asia Leasing Project, International Finance Corporation

Financial leasing is a medium-term financing technique for the procurement of machinery, equipment, vehicles and/or properties. Based on the proposition that profits are earned through the use of assets, rather than from their ownership, leasing focuses on the borrower's ability to generate cash flow from business operations to service the lease payment, not on the balance sheet or on past credit history. This is why leasing is particularly advantageous for new, small and medium-sized businesses that do not have a lengthy credit history, nor a significant asset base for collateral, as required by traditional bank lending.

Leasing has been an important source of medium- and long-term financing for companies, both in developed economies and in countries with economies in transition. Leasing plays an important role as an effective means to increase the lessee's asset base, particularly in private and/or new companies and in SMEs, which plays a key role in introducing innovation and competition in the economy and results in job creation.

Leasing is advantageous for all parties involved. With limited financial resources and no collateral, a lessee can acquire equipment that increases the company's productive capacity and, as a result, its profitability. A lessor's financial risk is less than an institution providing working capital because the lessor maintains ownership of the leased asset through the end of the lease agreement and is able to hold greater control over their investment through regular monitoring of the asset instead of having to monitor working capital loans. For suppliers, leasing expands their market base by providing businesses a mechanism to purchase equipment without having significant upfront cost.

Leasing can also be an effective mechanism for jumpstarting a growing economy:

- **Leasing offers a way to modernize production and develop small business.** Leasing companies play an important role in the financing of small and medium-sized businesses, which need funds to expand but often do not have the credit history or collateral sufficient for other financing sources. Leasing gives these enterprises the opportunity to create and modernize their production.
- **Leasing increases the total capital investment in an economy.** Leasing is a complementary form of financing that serves as an alternative to bank lending and increases a company's ability to source all types of financing.
- **Leasing creates competition in the financial marketplace.** Leasing, which is not as risky as working capital lending, creates an alternative method of financing businesses and directly competes with bank lending products (which often require collateral and extensive paperwork to process the loan). In transitional economies, leasing complements bank financing, allowing businesses to access both lease financing and additional bank financing without increasing their collateralized debt.
- **Leasing increases the sale of equipment**. Leasing offers domestic and foreign suppliers a new mechanism for increasing their customer base, and access to new clientele – previously poorly financed businesses.

Overall, a healthy leasing industry facilitates a country's economic development through increased financing flows to the productive sector of the economy, growth of domestic production, and increased financial options for private business.

What is Microleasing?

Microleasing, which is financial leasing to microbusinesses and sole proprietors, but not to individuals, using traditional leasing practices combined with microfinance monitoring, opens up additional access to finance for this segment of the market. Microleasing enables microbusinesses to acquire assets without outright purchasing the assets. The microbusinesses can then use the funds generated from the asset to pay back the lease. This financial mechanism is a crucial tool to assist microbusinesses expand into small businesses, based on the theory that business growth occurs through asset acquisition and not through working capital and income.

Microleasing typically works with "upper strata" microbusinesses that are too large for traditional microfinance but are still too small for commercial banks. Using IBRD terminology for microfinance – lower strata microbusinesses need access to working capital for purchase of inputs. Leasing is not appropriate for these businesses as these businesses need short-term injections of capital. Microleasing is appropriate for middle and upper strata microbusinesses which require financing for additional tools and equipments to expand their operations. These businesses needs larger loans with longer terms, and leasing is attractive for them. In addition, these businesses are particularly appropriate for leasing as they are larger than lower strata businesses, but maintain the cash-heavy aspect of a microbusiness.

How does Microleasing work?

Microleasing is most often conducted by microfinance institutions that are broadening their product and client base and that wish to meet a demand for long-term investments for the acquisition or renewal of an asset or a vehicle. In addition, a few leasing companies have scaled down to provide microleases and a few microleasing companies have been launched solely to serve the microbusiness niche.

Microfinance institutions make for good microleasing entities because microleasing allows the microfinance institution to grow with its clients – and because microbusinesses tend to be cash-heavy, thus credit-worthy leasing clients. Microfinance institutions in addition have strong monitoring practices, which is crucial to insure repayment from microbusinesses. Pitfalls of microfinance institutions launching leasing products include a potential lack of credit skills necessary to evaluate longer-term leases, and limited access to long-term funding.

Leasing companies looking to scale down to microleasing bring good leasing practices to microleasing; however, pitfalls include an inability to conduct the intensive monitoring needed for microbusiness finance and a tendency to look toward buy-back guarantees and residual value, important in larger ticket leasing but which do not play a role in microleasing. In addition, microfinance institutions which provide both leasing and lending can meet a microbusiness' total financing needs, thus reducing the time cost of borrowing for microbusinesses.

Typical microleased equipment includes vehicles, light manufacturing, packaging, sewing machines, bakery equipment, restaurant equipment, and retail equipment (ranging from kiosks to refrigerated counters).

Macro Challenges to Microleasing

One of the greatest challenges to microleasing is a constant need for long-term funding to finance the leasing company's expansion. Leasing operations are heavily based on access to finance to purchase equipment. 80% of leasing operations are financed through debt – and a microleasing company or a microfinance institution that has a leasing division needs to have a ready supply of capital to continually inject into the leasing operations. A long-term financial strategy should be built into any operation that is planning a leasing strategy.

To mitigate these risks, the World Bank has recommended that for microleasing:

- Entities providing microleasing have well-entrenched familiarity with the microenterprise market segments being opened up to leasing as a financial product, which is indispensable for controlling and managing risk.
- Entities providing microleasing have in place the organizational resources to cultivate and service microenterprises (as a result of its existing operations in the same or related geographical areas and market segments).
- Entities providing microleasing have the stature and capability to access resources from the formal financial sector to support their entrance into microleasing.

Legal and Tax Requirements for Leasing and Microleasing

Microleasing and leasing do not require any differences in legislation. Microleasing falls under the same governance and supervision structures that are for larger-ticket leasing.

Synchronization of Leasing Policy throughout Central Asia

In all four of the Central Asia countries, financial leasing is defined as:

"a transaction in which a lessor is obligated to purchase an asset upon the direction of a lessee from a pre-selected supplier and to provide the asset to the lessee for temporary use for a specific payment".

Additional aspects that define leasing in the region include:

- Mandatory participation of **three** parties to the lease: lessor, lessee, and supplier.
- Existence of a complex set of contractual relationships among the three parties. (Note that generally, subleasing is not typical in Central Asia although it does exist in Kazakhstan.)
- Classification of leasing as an investment activity and a financial service
- Availability of lease finance for commercial purposes only.

Legislative advantages for leasing that correspond throughout the region are:

- Non-bank financial institutions do not require a license to finance leases.
- Non-bank financial institutions are not restricted by obligatory capital requirements for leasing.
- Leasing as an activity is not supervised by central bank structures unless the lease is financed by an institution that is already under central bank supervision.

All four countries have set up classifications (characteristics) for leasing which are modifications of International Accounting Standard #17 and United States GAAP FASB #13. While each country has developed its own classifications, there are only slight variations among the four countries. Leasing must meet **one** of these characteristics in order to be classified as a lease:

- The lessee shall assume ownership of the leased asset by the date of the expiration of the lease agreement.
- By the expiration of the lease agreement, the lessee shall have the right to purchase the leased asset at a price lower than the market price of the leased asset on the date of the original transaction.
- The lease agreement should be more than 75% of the economic life of the asset; and in this case, the leased asset does not necessarily have to be transferred to the ownership of the lessee;
- The present value of the lease payments should be no less than 90% of the value of the leased asset as it is fixed in the lease agreement.

Additionally, minimum lease terms have been set in all four countries. In Kazakhstan, the minimum lease term is three years and in Uzbekistan, Kyrgyz Republic and Tajikistan, the minimum lease term for tax purposes is one year. For accounting and taxation purposes, leased assets are accounted for on the balance sheet of the lessee in all four Central Asia countries. This is accordance with both IAS and GAAP.

Kazakhstan

Legal Framework for Leasing in Kazakhstan

Leasing is governed in Kazakhstan by the Civil Code and the Law on Financial Leasing, enacted in July 2000. Kazakhstan has amended its leasing legislation to create extremely forward-thinking legislation.

Benefits of the Kazakhstan legislative framework for leasing include:

- A new definition for the term of leasing that protects lessors against tax losses if the equipment is repossessed in the first 36 months of the lease.
- The introduction of secondary leasing to ensure that lessors can lease equipment repossessed from a first client to a second client.
- A more precise definition of subleasing and leaseback arrangements.
- Clearer non-court repossession rights for the lessor.
- Clearer rights and responsibilities of the supplier, lessor, and lessee.

Tax Advantages for Leasing in Kazakhstan

The Tax Code of Kazakhstan was enacted on July 1, 1999 and governs all taxation for leasing in Kazakhstan. While there have been regular changes to the tax conditions for leasing, taxation for leasing was significantly amended on December 1, 2003, and came into effect on January 1, 2004. Due to the new tax regime, it is expected that leasing will grow rapidly in Kazakhstan.

The tax advantages for leasing in Kazakhstan include:

- Lessors do not pay corporate income tax on any lease with a term of over 36 months.
- Lessors and lessees do not pay VAT on import for assets purchased for lease and imported into Kazakhstan (as approved through an extensive government list of equipment).
- Lessors and lessees have a simplified VAT payment structure for leaseback leases in which the lessee sells the asset with the

VAT included and then refunds the VAT to the lessor through its lease payments. Lessees are able to deduct the full interest portion of the lease payment from their taxable income.

- Lessees no longer pay withholding tax on principal payment for all cross-border leases; only on the interest. (Previously, lessees paid withholding tax on the principal and the interest – but that was changed with the new legislation.
- Lessees can structure VAT on delivery payments throughout the duration of the lease. (The lessor purchases the equipment and pays VAT and then passes the cost to the lessee. Pursuant to the new changes, the lessee can make the VAT payments throughout the term of the lease as opposed to having to pay the entire amount up front.)

Kyrgyzstan

Leasing is governed in Kyrgyz Republic through the Civil Code, which was enacted in January, 1998, and the Law on Leasing which was enacted on July 23, 2002. The Kyrgyz Republic has introduced third party commercial arbitration in connection with disputes over repossession of leased assets due to breach of contract. If lessors and lessees do not choose to utilize this system, repossession is conducted, through court proceedings.

Tax Advantages for Leasing in Kyrgyz Republic

The Tax Code is the major legislative act that governs taxation in Kyrgyz Republic. Financial leases are subject to VAT and profit taxes, which are calculated based on criteria and classifications determined by IAS. Additionally, all finance leases must be at least 12 months in duration.

The tax advantages of leasing are as follows:

- VAT is levied solely on the purchase of the leased asset by the lessor and not on the interest payment made by the lessee (as is the case in each other country discussed in this article). Lessors have the right to offset VAT based on the amount stated in the invoice at the transfer of the asset to the lessee.
- Technical equipment (based upon a government approved list) imported into Kyrgyz Republic for lease is exempt from import VAT.
- Interest income tax on leases is levied at 10%, whereas all other financial services are levied at 20%.

Tajikistan

Legal Framework for Leasing in Tajikistan

Leasing in Tajikistan is governed on the basis of the Civil Code and the Law on Leasing (which was signed by the President on April 21, 2003). The Civil Code has instituted several norms that are special for leasing and supercede the general norms applied to rent relationships including repossession, risk relationships among the three parties, the lease agreement, and the transfer of the leased asset. The Law on Leasing builds on these definitions and provides more detailed roles and responsibilities for all three parties.

Tax Advantages for Leasing in Tajikistan

The Tajikistan Tax Code is under complete review for re-enactment, coming into effect on January 1, 2005. In the new edition proposed by the Government, leasing will have a series of tax advantages including:

- Complete tax holiday for import VAT for all equipment subject to a financial lease
- Reduction on interest income tax for lessors from 12% to 10%
- Removal of corporate income tax on lease revenue
- Removal of property tax on assets
- Inclusion of double accelerated depreciation for leased assets
- Clarification in the process for VAT payments and offsets

Currently, VAT is not levied on the interest charged by the lessor, and lessors can import equipment without VAT to replace obsolete equipment.

Uzbekistan

Legal Framework for Leasing in Uzbekistan

Leasing is governed in Uzbekistan by the Civil Code, which was adopted in August, 1996 and the Law on Leasing which was adopted on April 1999. Both Civil Code and the Law on Leasing were amended in December 2002 to create a more progressive legislative framework for leasing. Also on August 30th, 2003 the Uzbekistan Parliament adopted amendments to the Code for Economic Litigation Procedures to simplify and strengthen repossession procedures for leased assets.

Tax Advantages for Leasing in Uzbekistan

The Tax Code, in effect since January 1, 1988, is the major legislative act that governs taxation in Uzbekistan. The tax advantages of leasing are as follows:

- Lease payments are exempted from VAT in Uzbekistan.
- Manufacturing equipment imported into Uzbekistan for lease is exempt from VAT on import, subject to appropriate certification from the importer's bank.
- The interest payable by the taxpayer for short-term loans only can be deducted from the total earnings, but with leasing, the lessor may deduct interest expense and other fixed payments related to the loan use regardless of the loan term for all loans borrowed to finance leases.
- When computing the lessee's taxable income, the interest paid on lease is deducted from the total earnings of lessee regardless of lease term. This is in comparison to loans in which there is limitations to deductions dependent upon the length of the loan.
- Lessees are not levied property tax on leased assets for the full term of the lease.
- For tax purposes, the lessee can depreciate the leased asset over the period of the lease.

[1] This paper will use the terms "lease" and "leasing" to refer to financial leases and financial leasing. (Note that the typical lease has two parties: the lessor and lessee; a financial lease has three parties: the lessor, the lessee and the supplier.)

[2] A leaseback arrangements is a transaction in which the lessee owns the leased asset, sells it to the lessor and leases it back to secure working capital.

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