



# Policy Monitor

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## CEE / NIS NEWS AND VIEWS

### UZBEKISTAN

## Resolution on Microfinance in Uzbekistan

BY ABIGAIL WILLMER, TECHNICAL ADVISOR, UNDP UZBEKISTAN

The main problem in Uzbekistan for the expansion of microcredit implemented by local NGOs was the absence of the legal framework for this sort of financial activity. In recognition of this problem, the UNDP and the government decided in late 2001 to form a working group to develop a draft resolution on Microfinance operations by non-banking institutions (NGOs) to be issued by the Cabinet of Ministers. The working group worked closely together with a

group of various international donors (USAID, OSI, Mercy Corps, UNDP), local NGOs and government institutions.

The first draft of the decree was submitted to the Cabinet of Ministers in February 2002. When it was returned it had been edited drastically and did not resemble the original draft. Thus a meeting was called for at the end of July 2002 with donors and representatives of government ministries to discuss the edited version. The out-

come was the general acceptance of the original draft with some changes.

The final version of decree for the development of microcrediting in Uzbekistan was submitted to the Cabinet of Ministers on August 15, 2002 and was signed by the president on August 30, 2002.

This decree allows nonprofit organizations and international donors to implement microcrediting programs that support of vulnerable groups of population and development of private entrepreneurship. It further provides that microcrediting is to be carried out in national currency in the form of

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### KOSOVO

## Microfinance Regulation in Kosovo

BY BLERTA QERIMI, PROGRAM COORDINATOR, ASSOCIATION OF MICROFINANCE INSTITUTIONS OF KOSOVO (AMIK)

Pursuant to the Rule XIV on the Registration, Licensing and Supervision of Micro Finance and Financial Institutions of the United Nations Interim Administration Mission in Kosovo amended in April 2002, all financial institutions, including MFIs, are required to be registered with the Banking and Payments Authority in Kosovo (BPK) – a fairly independent body playing the role of the central monetary authority (the UN government is represented in BPK's board). According to Rule XIV there are two types of MFIs:

1) "Licensed MFI" which is defined as an MFI with deposits exceeding 125,000 Euro (or its equivalent value in another currency);

2) "Non-licensed MFI" which is defined as an MFI with deposits not exceeding 125,000 Euro (or its equivalent).

All MFIs, whether licensed or not (as well as other financial institutions) are subject to BPK inspection visits with a notice of one or two days. In addition, all MFIs must submit monthly reports to BPK though the reporting formats and contents are significantly different with banks and licensed MFIs being required to submit more comprehensive data. However, in general, licensed MFIs are subject to most of the same requirements that apply to banks, including in particular the minimum capital requirement.

As of today, there are no MFIs registered under the "licensed MFI" category in Kosovo. The MFIs

in Kosovo are urging the BPK to enact new regulations suitable for licensed MFIs (and different from the regulations applicable to commercial banks). Otherwise, the MFIs argue, licensed MFIs will in fact be commercial banks, which is likely to result into mission drift.

To leverage their arguments with BPK, AMIK (please find a detailed description of AMIK in the MFC Bulletin Fall 2002 available on the MFC website [www.mfc.org.pl](http://www.mfc.org.pl)) is hoping to set up performance standards among its members, standardize reporting formats and codes of conduct to enforce compliance with best practices. BPK is keen to work with AMIK as a representative body of MFIs and actually prefers dealing with AMIK as opposed to individual MFIs. There is however a rather strong feeling within BPK that any deposit taking institution whether MFI or bank should be regulated in the same way. In AMIK's opinion, this view clearly needs to be modified. ■

*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](mailto:marcin@mfc.org.pl)).*

cash disbursed in amounts not exceeding an equivalent of US \$3,000 per one borrower. Non-profit institutions will be exempt from income tax on income earned as a result of the microcrediting to cover operational costs, to increase the assets of the organization and to further microfinancing.

Shortly before this decree was passed another decree by the Ministry of Finance and the State Tax Committee was issued on June 2, 2002 followed by the resolution of the Cabinet of Ministers, issued on August 20 regulating the buying and selling of imported goods. According to these decrees, entrepreneurs are required to have a license and certificates showing that custom tax has been paid. Even though these new regulations are not directly related to the resolution on microfinance, it has produced a negative impact on the implementation of microfinance because a majority of microfinance clients were in small trade. After the new regulations were issued, many large markets were closed resulting in clients and potential clients having their businesses shut down and, in some cases, having their goods confiscated.

At the moment, the government is restructuring its management system in line with the memorandum signed with IMF earlier this year and a number of Ministries are being abolished or restructured. UNDP is waiting for the results of the process to be finished by the end of the year to negotiate a new Executing Agency for microfinance activities and start a process of developing new mechanism and regulations for microfinance as a follow-up to the August 30, 2002 decree. ■

RUSSIA

## September Meeting on Draft Law on Credit Cooperation in Russia

BY NATALIA BURTSEVA, LEGAL ISSUES ADVISOR, RUSSIAN MICROFINANCE CENTRE

A new draft federal law on Credit Cooperation is undergoing the legislative process at the State Duma, and may offer a way to improve the legal environment of Russian MFIs operating as savings and credit cooperatives. As we informed in the previous issue of the Policy Monitor, the draft has been approved in its first reading and is currently being discussed before the second reading.

In September, the Rural Credit Cooperation Development Foundation, supported financially

SERBIA

## Reforming the Serbian Legal Environment for MFIs

BY MARCIN FIJALKOWSKI, LEGAL AND REGULATORY PROGRAM COORDINATOR, MFC

LEESA WILSON SHRADER, REGIONAL DIRECTOR/BALKANS, MFC

### Introduction

After the collapse of the Milosevic's regime, Serbia started its way towards political and economic reforms. One of the major tasks of the new government consists of strengthening the legal basis for the expansion of the free market economy. Thus, virtually all of the commercially related legislation is undergoing substantial reforms. The legal environment for the microfinance industry should not be an exception.

Today, the microfinance sector in Serbia is comprised of 6 MFIs: 4 international NGOs, 1 microfinance bank and 1 savings bank.

### Non – bank MFIs

According to the National Bank's interpretation of Serbian law, all institutions engaged in lending activities (depository as well as non-depository) must obtain a license from the National Bank of Yugoslavia (NBY). The NBY has made a decision to strictly limit the number of new licenses granted, unwilling to allow new actors onto the financial stage of Serbia.

The four non-bank microfinance institutions were previously protected by the bilateral agreement between the government and UNHCR. However, recently, the National Bank ruled the agreement with UNCHR does not allow making microloans. In response to this new interpretation of the agreement with UNHCR reflecting an overall negative approach to microfinance on the part of the NBY, MFIs' partner banks have intermittently frozen international lending programs.

### Bank MFIs

MicroFinance Bank and the savings bank established by Opportunity International are not covered by the bilateral agreement (as they are not UNHCR operating partners). However, such protection is not necessary as they are both NBY licensed institutions.

In April 2001, EBRD along with other international institutions established the Micro Finance Bank (MFB). The MFB targets small and micro enterprises. However, loans granted by MFB are on the high end of "micro".

In June 2002, Opportunity International gained the right to run its microfinance institution – the savings bank (Stedionica Opportunity International – SOI).

### Serbian Officials' Position

Beside the commonly existing arguments against microfinance (like contribution to the "grey sector" and taking advantage of poor borrowers through high interest rates), the NBY's lack of enthusiasm for the microfinance industry apparently results also from NBY's bad experience with "loosely" regulated institutions (which were responsible for the collapse of the financial system in the early 1990s) and the NBY's misperception of microfinance. The unregulated institutions of the 1990s did take deposits from the public whereas the microfinance institutions operating under the UNHCR program are non-depository institutions. However the NBY position may change in the future.

by the Eurasian Foundation, brought together representatives of cooperatives, state authorities and deputies to discuss amendments to the draft and develop a common position. The outcome of the meeting (including developed amendments) has been distributed among the State Duma committees, deputies, state authorities and MFIs.

The lawdrafters foresee that the new federal law on Credit Cooperation will be the frame – law for all types of credit cooperatives. ■

Fortunately, other government bodies within both the republican and the federal government present a less conservative approach and understand the need of reaching low-income businesses with financial services. High ranking officers at the Ministry of Social Affairs, the Ministry of Privatization and Economy as well as the Ministry of International Economic Relations proved to be interested in the development of microfinance programs all over the country.

The support of Serbian policy makers for regulatory reforms in Serbia is extremely important, as the international donors are strongly interested in the development of the microfinance industry. Donors' resources for private non-bank MFIs are estimated at 20 millions USD. However, the donor community has not committed these funds due primarily to unsolved regulatory issues. Thus in order to attract these funds, it is crucial that Serbia have enabled a legal and regulatory environment for microfinance.

### Policy Initiatives

In January 2002, the MFC commissioned a survey of the legal and regulatory environment for MFIs in the Republic of Serbia.<sup>1</sup> The survey describes the existing legal and regulatory environment for microfinance and makes recommendations for reform measures. The survey clearly lays out the legal constraints faced by Serbian MFIs, which have prevented some donors from investing in the fledgling sector.

The release of the survey was followed by the formation of the Serbian Microfinance Policy Working Group in May, 2002 at the Annual MFC Conference in Budapest. The working group includes the non-bank microfinance institutions currently active in Serbia as well as the savings bank (SOI), the donors that support them and other stakeholders.

The goal of the Working Group is to support the development of a sound legal and regulatory framework for non-bank microfinance in Serbia. The group has worked closely with the international community, including the World Bank, EBRD and European Agency for Development, to coordinate policy efforts. A main activity of the group is to educate government officials about the benefits of microfinance and address an array of their concerns. It is hoped that by creating more widespread support for microfinance, multilateral institutions will be successful in including microfinance policy improvements in future programming in Serbia. ■

**The Microfinance Centre (MFC)** is a membership based resource centre in CEE and the NIS. Its mission is to promote the development of a strong and sustainable microfinance sector in order to increase access to financial services for low-income people, particularly micro-entrepreneurs. MFC fulfills its by providing high quality trainings, consulting research, mutual learning and legal and policy development services.

## MFC Policy Program

The Policy Program created within the MFC has a broad goal to foster improvements to the legal and regulatory operating environments for microfinance institutions in the countries of CEE and the NIS. To achieve this goal MFC has engaged in a combination of regional activities and country specific activities.

Within the scope of the Policy Program, MFC conducts diagnostic analysis of the existing legal and regulatory environment for microfinance in CEE and the NIS undertaken on a country-by-country basis. These assessments have already been undertaken in Armenia, Georgia, Serbia and Tajikistan. The assessment reports are available on the MFC web site ([www.mfc.org.pl/policydiagnostic.php4](http://www.mfc.org.pl/policydiagnostic.php4)).

Another important activity conducted within the Policy Program is the clearinghouse project designed to provide a new tool – a database containing legal acts related to microfinance industry in the CEE and NIS. The database supplies reliable updated information to practitioners, policy makers and the donor community involved in microfinance legal and regulatory reform.

Finally, MFC organizes an annual Policy Forum on microfinance law and regulation in CEE and NIS. Please find the announcement of the 2nd NIS Policy Forum on page 4.

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

### COUNTRY HIGHLIGHT

#### UKRAINE

## The Microfinance Sector in Ukraine

BY LYUBA LUBIANETSKA, LEGAL ADVISOR, COUNTERPART META CENTER

Like other countries in the Central and Eastern European region, Ukraine faces the challenges of transition from Soviet times into a market economy under democratic rule. This process is accompanied by the emergence of the small business sector. Unfortunately, due to practical and legal constraints (which permit only banks and credit unions to extend loans and charge interest), the current possibilities for small and very small businesses to access loan funds are limited. Consequently, these businesses have been forced to seek financing from non-official private sources that operate outside of the legal environment.

### The Banking System

In 1992, Ukraine established a two-tier banking system comprised of the National Bank of Ukraine and commercial banks. The National Bank – which is responsible for, inter alia, supervising commercial banks – does not provide commercial loans. The commercial banks engage in a variety of banking services, including crediting, but mainly work with large businesses. Practically speaking, the commercial banks in Ukraine have

neither the interest nor the capability to finance small and very small (i.e., micro) businesses. Specifically, they do not have the credit technologies necessary to process loan orders of small and very small businesses nor are they able to assess credit worthiness of a micro-entrepreneur. In addition, the banking procedures are highly costly, thus making such lending unprofitable both to the bank and the clients. Furthermore, according to Ukrainian legislation, commercial banks must observe the rules of the National Bank of Ukraine, including reserve requirements and loan guarantee requirements, neither of which facilitate the development of small business and, in fact, make their access to commercial loans practically impossible.

Notwithstanding this situation, in February 2001, IFC, EBRD and other international organizations founded the Micro Finance Bank Ukraine (MFB). MFB was established to provide financing to SME sector. Providing loans up to \$250,000 for a maximum term of three years, MFB's goal is to set new standards in micro lending and other financial services. However,

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<sup>1</sup> The survey – funded by DFID, UNHCR and the MFC and finalized in May of 2002 and prepared by MFC consultants, Tim Lyman and Kate Lauer. – is available on the MFC website: <http://www.mfc.org.pl/policydiagnostic.php4>

## COUNTRY HIGHLIGHT

MFB's offices are located in big cities and do not have access to the clients in small towns and rural areas. Thus far, over 30 million dollars have been disbursed since the bank's establishment.

### Credit Unions

In 1992, with the help of USAID, WOCCU and CIDA, the credit cooperative movement was born in Ukraine. Today, there are more than 400 credit unions registered with the National Bank of Ukraine. Since September 1993 until December 2001, credit unions in Ukraine operated under a presidential decree <sup>2</sup>. In December 2001, a new law on Credit Unions was passed. It provides clear definitions of credit unions and activities and clarifies the tax status as nonprofit. The law allows credit unions to extend loans to individuals as well as businesses and to provide specialized deposit services for short and potentially long-term savers. The bulk of credit union lending is uncollateralized in the traditional sense, whereas banks require between 100-200 percent of the value of the loan in collateral. And although deposits in all Ukrainian financial institutions are low, members are increasingly trusting their savings to the credit unions to which

they belong. Although credit unions have to learn and to institutionalize the methodologies to lend to microenterprises, currently the competitive environment favors credit union growth.

Credit Unions are demonstrating that they have a viable niche in the financial market place, and can play an important role in savings mobilization and meeting the personal loan requirements of a sector that lack access to financial services and that can make effective use of access to those services.

### Donor-Supported Microfinance Projects

Beginning in 1998, USAID has financed a number of projects aimed at support of small business in Ukraine pursuant to an Agreement on Humanitarian and Technical and Economic Co-operation concluded with the government of Ukraine. Under this agreement, a small business support organization, Meta Center, was established in Lviv. Similar small business support programs are operating in Zaporizhya and Uzhgorod (HOPE), in the Autonomous Crimean Republic (CREDO), and in the Odessa region (the British Know How

Fund). These organizations operate under different legal forms. Some are formed as citizens associations; others are formed as charity organizations. However, none of them formally engage in "lending" as Ukrainian law permits only banking institutions and credit unions to lend and charge interest. The citizens associations referred to above (which are governed by the law on Citizens Associations) provide guarantees. According to the Civil Code, any legal entity may provide guarantees to other legal entities. Charity funds referred to above are governed by the law on Charity Organizations and extend funds by effectively granting and collecting charity donations.

### Legislative Reform Efforts in Ukraine

In 2001, the law on Financial Services and State Regulation of Financial Services Markets was approved in Ukraine. According to this law, all financial services are to be regulated by the state and may only be offered by institutions licensed by and registered with the National Bank. While the National Bank is responsible for supervising banks, another agency of the government (not yet created) will supervise other financial services.

Over the last few years, USAID has been working to support amendments to the Ukrainian legislation that would permit the establishment of nonprofit institutions that would extend interest-bearing loans to small and very small businesses. In 2000, USAID financed the development a draft law on Specialized Micro Finance Institutions; however, it was not approved by the Verhovna Rada of Ukraine. Establishment of such microfinance institutions would have provided an opportunity to create a network of institutions for supporting small and very small businesses in Ukraine according to the microcrediting model executed by Fundusz Mikro in Poland.

It is anticipated that Verhovna Rada will pass a new civil code in the near future which may include a definition of non-profit institutions. While this alone would not be sufficient to enable such institutions to make loans and charge interest, it would represent a step forward.

The economic development in Ukraine over the recent period show some promises and hopes. For the first time over the independence period there was noticed the GNP growth, reduction of inflation level, the macroeconomic indicators points at the stabilization in Ukraine. However, the political and economic reforms should support this tendency. Perhaps the new Verhovna Rada will bring change to the legal environment of Ukraine, which change could be favorable for the development of private businesses, in particular small and very small ones.

## Second NIS Policy Forum on Microfinance Law and Regulation – May 2003

The Second New Independent States (NIS) Policy Forum on Microfinance Law and Regulation is a "by invitation only" event organized by the Microfinance Centre (MFC) in partnership with the United States Agency for International Development (USAID) and the Open Society Institute (OSI).

The Forum will be a three day event held in May 2003 and will be conducted in English and Russian. The location and the exact agenda will be available soon. The 2nd Policy Forum will be followed by the 6th MFC Annual Conference. The Policy Forum's participants are welcome to stay on to participate in the Annual Conference.

**Participants.** This Forum will bring together highly positioned policymakers from NIS countries along with donor representatives and experts deeply involved in microfinance and financial sector policy work.

The Forum is designed as a "policymakers event" in order to provide actors in key positions with an opportunity for a free exchange of views and experiences among peers on the key issues concerning the regulation of microfinance. This will include participants' plans and concerns connected with the growth of a strong and sustainable microfinance sector and discussions of its place in the broader financial sector.

**Goals.** The broad objective of the Forum is to improve the legal and regulatory environment for the microfinance sector in participating countries. The participants will be assisted by microfinance experts and specialists in financial sector law and regulation in the process of identifying and discussing regulatory reforms needed to facilitate the development of microfinance in the NIS region. It is the hope that the policymakers will leave the Forum with:

- a better understanding of the impact of microfinance sector on poverty alleviation and unemployment,
- new insights into the regulatory and legal issues of microfinance (including a clearer picture of microfinance as a integral part of the financial system) and
- ideas for future "microfinance-friendly" legal and regulatory reform measures. ■

<sup>2</sup> The decree granted credit unions the right to form, described their basic structure and permitted them to accept deposits from individuals and extend loans to their members businesses.

## COUNTRY HIGHLIGHT

AZERBAIJAN

# Legal Environment for Microfinance in Azerbaijan

BY CHINGIZ MAMMADOV, EXECUTIVE DIRECTOR, AZERBAIJAN MICROFINANCE ASSOCIATION (AMFA)

On October 10-11, 2001 the first Azerbaijan Microfinance Conference was held in Baku. On December 19, 2001 ten international non-governmental organizations (INGOs) presented on this conference, including ACDI/VOCA, ADRA, FINCA, NHE, NRC, MC, OXFAM, IOM, SCF and WVI, signed a Memorandum of Understanding to form Azerbaijan Microfinance Association (AMFA). Of these ten organizations nine provide microfinance services to the clients. One of them – Mercy Corps is not providing direct microfinance services to the clients, but became one of the active members of AMFA because of being umbrella grant manager for a 6-year \$45-million Azerbaijan Humanitarian Assistance Program, one component of which channels micro-finance services through other INGOs. Of the 9 implementing agencies only three were registered as local micro-finance institutions by the Ministry of Justice and obtained the license from the National Bank<sup>3</sup>. Therefore, it has been decided to postpone the formal registration of AMFA until all the members are formally registered. In the meantime, AMFA will operate as an Initiative Group to create Azerbaijan Microfinance Association and its activities are regulated by the respective by-law adopted by the Initiative Group's founding members.

The legal environment in Azerbaijan for microfinance institutions is still not friendly. Currently there is no comprehensive legal framework in Azeri legislation that covers microfinance activities. The main law regulating microfinance activities is the mentioned law on Banks and Banking Activities. Addendum made to this law currently allows the registration of non-governmental organizations as non-banking credit organizations. However, the language of the addendum is vague, and the lack of lobbying power, especially, on the side of local NGOs significantly impedes the process of registration. Therefore, even though the members of AMFA continue their microfinance activities, the lack of formal registration is a serious obstacle, in particular in dealing with the delinquent clients, when non-repayment cases are taken to the court.

Since majority of clients are the very poor, refugees and internally displaced persons from Nagorno Karabakh and surrounding regions, the main tool to guarantee repayments is group solidarity principle. However, collateral is also used, especially with individual loans. The law on Mortgages covers cases when real estate is secured as collateral. However, the only item of real value the poor have is land. Even though

the land was privatized in Azerbaijan, there is no mechanism allowing for the registration and use of land as collateral. Subsequently, this hinders the economic development of rural areas. Finally, the third impediment is how even existing laws and regulations are implemented. For example, regular notary registration fees for a collateral agreement vary between 0.45%-1% of the credit amount depending on the size of the loan. However, bribes to collect necessary documents may reach 10 % of the value of collateral, which makes micro-credits non-attractive to clients and increases the risk.

On June 25, 2002, representatives from the government of Azerbaijan, the United States Agency for International Development (USAID), the representatives of the embassies located in Azerbaijan, members of INGOs gathered to discuss the legal framework for operating in Azerbaijan. The seminar was devoted to establishing a standard legal framework for all INGOs operating in Azerbaijan. In September, two meetings brought together representatives from the INGO community and the government of Azerbaijan to follow up on issues raised at the June 25 conference. The Ministry of Justice meeting on September 24 focused on licensing and registration issues, in particular on the status of applications submitted by AMFA Initiative Group members; the meeting with the Ministry of Taxation on September 25 focused on VAT reimbursement. Similar meetings are planned between AMFA and National Bank and other respective agencies. ■

## BRIEFS FROM THE WORLD

## CGAP to Publish Position Paper on Regulation and Supervision of Microfinance

BY TIMOTHY R. LYMAN, LEGAL ISSUES ADVISOR TO THE MICROFINANCE CENTRE, PRESIDENT OF THE DAY, BERRY & HOWARD FOUNDATION AND FOUNDING CHAIR OF ITS MICROFINANCE LAW COLLABORATIVE

### Introduction

Many countries – in CEE/NIS and throughout the world – are considering whether and how to regulate microfinance. Experts working on this topic do not agree on all points, but there is a surprisingly wide area of consensus. This fall, CGAP will publish a position paper to guide future discussion on these important topics. Its authors, CGAP Senior Advisors Robert Peck Christen and Richard Rosenberg and MFC's Legal Issues Advisor, Timothy R. Lyman, hope this paper will

provide useful guidance not only to staff of the international donors who encourage, advise, and support developing- and transitional-country governments, but also to the national authorities who must make the decisions and the practitioners and other local stakeholders who participate in the decision-making process and live with the results. On some questions, experience justifies clear conclusions that will be valid everywhere with few exceptions. On other points, the experience is not clear, or the answer depends

on local factors, so that no straightforward prescription is possible. On these latter points, the aim of the paper is to suggest frameworks for thinking about the issues and identify some factors that need special consideration before reaching a conclusion.

### Scope of the Position Paper

What is 'microfinance' and what is 'microfinance regulation'?

The paper begins with a discussion of what is meant by 'microfinance' and by 'microfinance regulation.' The authors observe that 'microfinance'

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<sup>3</sup> Three registered local microfinance institutions obtained registration under the Law on Banks and Banking activities. Local still non-registered MFIs were established with the assistance of the INGOs as separate projects, not as independent institutions. Even though local still non-registered MFIs currently continue their operations, registered MFIs have better business opportunities and legal power. Non-registered MFIs do not exist as legal entities and their business and legal environment is not unilateral, but varies across the regions depending on the relations with the local authorities. Registration of all MFIs established with the assistance of INGOs would signal to the entire society that MFIs are enduring and sustainable entities.

must be understood to include a broader range of activities than just microcredit – particularly where the topic under consideration is the appropriate regulatory treatment of institutions engaging in microfinance activities. Similarly, the authors stress that ‘microfinance regulation’ includes not just prudential regulation – i.e., regulation aimed at protecting the soundness of the financial sector as a whole and protecting depositors – but also a range of non-prudential regulatory issues. The paper points out that regulation can serve an enabling function, where it removes specific barriers that otherwise impede institutions from providing microfinance services. It is noted that prudential regulation of deposit-taking microfinance institutions has also been advanced as a means of promoting the development of such institutions (although, the authors observe, this sometimes occurs without adequate attention to the costs and limited effectiveness of regulating the resulting licensed MFIs). The initial discussion of what is meant by ‘microfinance regulation’ concludes with some cautionary observations about whether a microfinance-specific ‘special window’ is needed in particular situations, or whether instead appropriate non-prudential and prudential regulatory treatment of microfinance activities can be integrated into more general laws and regulations governing the financial sector.

#### **Non-prudential issues**

The paper next outlines areas of regulatory concern that do not call for prudential regulation. Topics addressed include non-prudential approaches to granting regulatory ‘permission to lend,’ consumer protection issues such as protection against ‘abusive’ lending and collection practices and interest rate disclosure requirements, prevention of fraud and financial crimes, the value of credit information services (to lenders and borrowers alike), the problem of interest rate caps and similar limitations, certain critical tax issues as applied to microfinance, and a wide range of legal and regulatory issues that affect the practical and legal feasibility of transforming from one type of microfinance institution to another.

#### **Prudential issues**

Next, the paper discusses various issues relating to the prudential treatment of microfinance and MFIs. After reviewing the objectives of prudential

regulation, the paper turns to the line-drawing problem: when to apply prudential regulation in microfinance? The authors note that prudential regulation is sometimes advocated prematurely, when the microfinance sector in a given country has not matured to a point where there is a critical mass of institutions ready to assume (and justify) the burdens and costs of prudential regulation and supervision. The paper observes that MFIs’ search to diversify their funding base through new sources of capital doesn’t necessarily mean the sector needs prudential regulation. A variety of sources of funding are outlined that should generally not trigger prudential regulation. In addition, the paper discusses reasons why the decision might be made not to require prudential regulation of small community-based MFIs.

After dealing with the universe of activities and institutions that justify prudential regulation, the paper turns to a discussion of specific prudential standards that may appropriately be varied in the microfinance context. These include standards on minimum capital and capital adequacy, treatment of unsecured lending and loan loss provisioning, requirements for loan documentation, restrictions on co-signers as borrowers, physical security and branching requirements, frequency of required reporting, reserves required against deposits and ownership suitability and diversification requirements. The authors stress that, in most instances, any prudential rules devised for specialized depository MFIs should also be available to conventional commercial banks offering microfinance services.

#### **Supervision**

The discussion of prudential regulatory issues finishes by focusing on the supervisory challenge of depository microfinance. The authors note that some supervisory tools used to regulate commercial banks are generally of limited effectiveness in the case of typical depository MFIs, and they stress that the high costs of microfinance supervision – both for the supervisory authority and for the supervised institutions – merits careful consideration. The discussion of supervision concludes with the question where to locate microfinance supervision. The authors argue for the need to have specialized supervisory staff – whether or not a separate ‘microfinance-specific’ supervisory unit is created

within a country’s existing supervisory authority – and they raise cautions about vesting both prudential and non-prudential functions within a single regulatory body. Finally, the authors discuss the concept of ‘self-regulation/supervision’ (in the sense of a supervisory body under the control of the institutions it is supposed to supervise) and delegated supervision (in the sense of out-sourcing supervisory responsibilities to private service providers such as audit firms). ‘Self-regulation/supervision’ of this type is dismissed as rarely – if ever – effective. In the case of delegated supervision, the paper observes that this approach – if it is effective – is more likely to shift rather than reduce the overall burden and cost that microfinance supervision entails.

### **Key Policy Recommendations**

Discussion of microfinance regulation and supervision is necessarily complex, and filled with qualifications and caveats. For the sake of clarity and emphasis, the paper concludes with a brief reiteration of some of its more important recommendations.

- Powerful new ‘microfinance’ techniques are being developed that allow formal financial services to be delivered to low-income clients who have previously not had access to such services. In order to reach its full potential, the microfinance industry must eventually be able to enter the arena of licensed, prudentially supervised financial intermediation, and regulations must eventually be crafted that allow this development.
- Get a competent financial and institutional analysis of the leading MFIs before deciding the timing and design of prudential regulation, at least if existing MFIs are the main candidates for a new window being considered.
- Use non-prudential regulation, including regulation under the commercial or criminal codes, to address problems that don’t require the government to attest to the financial soundness of regulated institutions. Relevant forms of non-prudential regulation tend to be easier to enforce and less costly than prudential regulation.
- Where feasible, support development and use of credit information services.
- Be careful about steps that might bring the topic of microcredit interest rates into public and political discussion. Microcredit needs high interest rates. In many countries, it may be impossible to get explicit political acceptance of a rate that is high enough to allow viable microfinance. In other contexts, concerted education of relevant policymakers may succeed in establishing the necessary political acceptance.

#### **THE CONSULTATIVE GROUP TO ASSIST THE POOREST (CGAP)**

The Consultative Group to Assist the Poorest (CGAP), launched in 1995, is a consortium of 29 bilateral and multilateral donor agencies who support microfinance. Its mission is to improve the capacity of microfinance institutions to deliver flexible, high-quality financial services to the very poor on a sustainable basis. CGAP secretariat is located at the World Bank premises in Washington. More info on CGAP activities are available on [www.cgap.org](http://www.cgap.org)

## BRIEFS FROM THE WORLD

- Don't impose prudential regulation on 'credit-only' MFIs that merely lend out their own capital, or whose only borrowing is from foreign commercial or non-commercial sources, or from prudentially regulated local commercial banks.
  - Think twice about imposing prudential regulation on MFIs taking cash collateral (compulsory savings) only, especially if the MFI is not lending out these funds.
  - Where cost-effective prudential supervision is impractical, consider allowing very small community-based intermediaries to continue taking deposits from members without being prudentially supervised, especially in cases where most members do not have access to safer deposit vehicles.
  - As much as possible, focus prudential regulation on the type of transaction being conducted rather than the type of institution conducting it.
  - Be flexible with limitations on foreign ownership or maximum shareholder percentages if local microfinance is at a stage where much of the investment will have to come from transforming NGOs and other socially-motivated investors.
- Use simpler reporting requirements for microfinance institutions/programs than for normal commercial bank operations.
  - Wherever possible, adjust any regulations that would preclude existing financial institutions (banks, finance companies, etc.) from offering microfinance services.
  - Before deciding on regulatory reforms, pay MUCH more attention to issues of likely effectiveness and cost of supervision than is usually done. Financial intermediation licenses are promises. Before issuing them, a government
- needs to be clear about the nature of the promises and its practical ability to honor them.
  - Estimate supervision costs realistically and plan a sustainable mechanism to pay for them. Donors who encourage governments to take on supervision of new types of institution should be willing to help finance the start-up costs of such supervision.
  - Don't expect 'self-supervision' by an entity under the control of those supervised to be effective in protecting the soundness of the supervised financial institutions. ■

## IMF WORKING PAPER ON MICROFINANCE

In September 2002, the International Monetary Fund (IMF) published the Working Paper on Microfinance Institutions and Public Policy by Daniel C. Hardy, Paul Holden and Vassili Prokopenko. The IMF Working Paper, among others, discusses the pros and cons for supporting MFIs, forms of support, costs and benefits of regulating MFIs and strategies for prudential regulation. As the IMF Working Paper differs from the CGAP Position Paper, the MFC intends to publish in the next issue of the Policy Monitor abstracts from the IMF publication. The working paper is available at <http://www.imf.org/external/pubs/ft/wp/2002/wp02159.pdf>

## MEET THE POLICY MAKER

ARMENIA

## Interview with Samvel Avetissyan, The First Deputy Minister of Agriculture of Armenia

• *Some dozen microfinancing organizations are working in Armenia currently. Under the conditions how successful is the banks' microcrediting? Are the banks interested in microcrediting?*

S.A. Banking system is the main creditor in all countries of the world. But in transitional economies there is an alternative, namely microfinancing organizations, the existence of which is dictated by the economic situation. Suchlike organizations are functioning not only in Armenia, but in NIS countries and former socialistic states in Europe. The reason is that not all borrowers may afford banking services. They are facing the problem of collateral and necessity to make business plans. Sometimes drawing up a credit costs more than the microcredit itself. In this aspect, the microfinancing organizations are more flexible, maneuverable and their costs are not that much. But I must say that the banks should not render the microfinancing organizations as their serious competitors. Quite the opposite, the banks with

balanced policy should support the organizations as they are creating the basis for their future clients. As soon as the entrepreneurs gain a firm foothold in business they will not be satisfied with the microfinancing magnitude and will have to use the banks' services.

The peculiarity of the microcrediting is that it is not collateral – a guarantee for crediting – that is important, but a moral factor. That is collective responsibility for each member of the team engaged in the business. Everyone is responsible for the other one. The relations in such teams are naturally built on mutual responsibility and control. The matter of duty and prestige is very important here. The practice shows that as a rule microfinancing clients are very successful in making their business, namely in the agriculture business. For example Umcor-Aregak microcrediting program that mediates in providing financial support to women in rural areas.<sup>4</sup> The program allows development of households. Agriculture is closely connected with seasonality and weight share of hidden and

open unemployment is essential here. So, it is vital to create additional employment with the credits like this. At the moment we may state that the microfinancing organizations have allowed us to create 14-16 thousands jobs. More than 30,000 families have used the organizations' services. The annual actual demand amounts to \$50-60 thousands. Thus, we may see that the microcrediting is performing a few functions at a time, namely it provides employment, enables accumulation of initial capital for small groups and creates a base of potential clients for the banks.

• *How important are the microfinancing organizations as a factor of social tension reduction?*

S.A. In the period since 1998 there have been set up some dozens microfinancing organizations in Armenia. They are mostly funded by international structures. Initially the organizations had been financing exclusively with the funds of the international structures, now the microcrediting organizations have formed their own funds. This is important from the viewpoint of creation of alternative credit structures. It is also noteworthy that the authorities are paying much attention to programs on poverty reduction. In the aspect, the microfinancing program that is supporting the most needy and unprotected social class, acquires

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<sup>4</sup> Umcor/Aregak is one of 8 NGO MFIs in Armenia. Umcor/Aregak and MDF/Kamurj, another Armenian NGO MFI, are on MFC's list of the 20 largest MFIs (in terms of number of borrowers) in the CEE and the NIS.

a special significance and is very instrumental in the program implementation. On the whole, the role of the microfinancing organizations is increasing, as they help to develop small business and to create a middle class which is very important for development of economy.

**• What do you think about credit clubs? How much does the law on credit clubs meet traditional trade unions? Are the clubs regarded as microfinancing organizations?**

S.A. Activity of the credit clubs carried out by United States Department of Agriculture – Marketing Assistance Program (USDA-MAP), differs from microcrediting a little. This is an interesting and good program, that is a precondition for creation of a credit cooperation in the republic. There are 32 credit clubs operating in Armenia, which include 470 members. As of June 2002, USDA-MAP provided more than \$545 thousands to promote the credit clubs. Taking into consideration their role, Armenian National Assembly passed the law on Credit Clubs. Our task was to bring the credit clubs into a legal framework and to ensure their protection. What was the necessity for the law? The microfinancing organizations seem to be operating well and within the framework of Civil Code, there is no problems with them. But, by acquiring the status and registration they will face tax liabilities, registration costs, etc. The organizations may have more problems in future, after the legal framework's being toughened. Thus, amendments to the law on banks may result in situation when the microfinancing organizations may be included into normative framework regulated by Central Bank. In fact the microcrediting organizations are self-regulating, their risks are not that great and the consequences of the risks are not going to be that serious as in case of the banks. To the credit of the parliament be it said that the issue has been settled and normative would be calculated starting from a definite level of crediting.

Mechanisms of the credit clubs is rather interesting and differs from activity of other microfinancing organizations. Credit club is a stable team consisting of 15-20 and more persons, who are to have their own agricultural business and to be linked with responsibility. The amount provided to them is not a grant or credit but a purpose loan. Its objective is to develop business with the funds, to save a part of the funds yearly and to create its own capital to be used as a basis for further independent crediting and new members' attraction. The structures are not entitled to draw deposits, crediting is interest-free and it is the clubs' members that

determine necessity for a collateral. Credit clubs are an independent, self-regulated structure and the main point is that they allow development and accumulation of capital. It means that the clubs will be able to function independently after USDA-MAP finishes its financing. The countries started with such like activity and now they have large systems of credit co-operation. It is interesting that their members are shareholders of the cooperative and are using the credit funds. They are able to attract deposits, make investments into securities and to get dividends. It is a very interesting mechanism and we should like the currently-forming credit clubs in Armenia to pass to the credit co-operation. At the moment it is the USDA that provides funds for the goals, the law stipulates for budget financing as well. The same took place in USA, when in the 30-ies the government provided an interest-free credit for 30 years to promote the sector and currently some 27% farmers of the country are making use of the credit co-operation system. This is very important for Armenia, where credit funds are rather limited, solvency is low and which lacks a high credit culture.

**• Does the government have plans on further activity of the microcrediting organizations and what is their role from the viewpoint of the government?**

S.A. Successful activity of a dozen microfinancing organizations testifies to the fact that we have a wide framework for the activity. I think that the financial-credit organizations that will fail to provide banking standards could launch a large-scale microcrediting. In the case, microcrediting criteria would change, namely the credit amount would grow from \$400 to \$2000 considering the fact that one of the flaws of the microcrediting is a small amount of the credits.

We can see the process of formation and development of microfinancing in Armenia based on the example of Umcor-Aregak. Parallel to growing credit amounts, there have been developed mechanisms, experience and set up credit traditions. The time shows that the system has proved to be correct and is profitable. Thus, aside from banks there are the microfinancing organizations being involved in servicing credit agreements concluded by the government and international credit organizations. This is good from the viewpoint of alternative. Especially in our case when there are problems with drawing up banking collateral and required documentation. There are 335,000 agricultural organizations functioning in Armenia now and

each household has some 1,3 hectares land on the average. The figures show that the microcrediting is playing a more important role in obtaining floating funds than banking credits.

**• Are donor organizations co-operating with the government, executive power and micro organizations to create favorable conditions for activity?**

S.A. It is important that the microcredit organizations have their own forum which advocates their interests. A team consisting of National Assembly deputies in close co-operation with the forum, is lobbying their interests and considers the organizations to be the best way to resolve many problems of villages and cities. While representing the executive power I have remained faithful to my principles and am assisting the microcredit organizations' assistance. We have 2 offices that are implementing the programs, the one is on the program supporting agricultural reforms funded by WB and the second is on the program of International Fund of Agricultural Development (IFAD). IFAD stipulates for provision of credit resources to credit organizations and clubs. The government supports and plans to continue supporting the programs.

**• Many people think that microfinancing organizations are unable to become financially self-sufficient. What do you think about it?**

S.A. I do not think so. Operational expenses of the organizations are not that large and service of the credits does not cost that much to them. They may become self-sufficient but there is another problem. It would be better if some of the microfinancing organizations get united. In the case their expenses would reduce and they would have more chances to become self-sufficient. This is undoubtedly their own right but I think it is worth considering. Everyone wants to act independently but the market rules are tough.

**• Thank you** ■

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