Report on the 2nd Newly Independent States Policy Forum on Microfinance Law and Regulation

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For:

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Annexes

Acknowledgements

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We appreciate your ongoing support and look forward to continuing our work with you in microfinance policy and regulation in the NIS.

Acronyms

ADB	Asian Development Bank
AKF	Aga Khan Fund
CB	Central Bank
CEE	Central and Eastern Europe
CGAP	Consultative Group to Assist the Poorest
CU	Credit union
E&E	Europe & Eurasia (USAID bureau)
EU	European Union
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit
IMF	International Monetary Fund
IRB	Interest-ratings based
MFC	MicroFinance Centre for Central and Eastern Europe and the New Independent States
MFI	Microfinance institution
MFO	Microfinance organization
NBT	National Bank of Tajikistan
NGO	Non-governmental organization
NIS	New Independent States
OSI	Open Society Institute
QIS	Quantitative Impact Study
ROA	Return on assets
SME	Small and medium/Small and micro enterprise
UCO	Universal credit organization

USAID	United States Agency for International Development
WTO	World Trade Organization

Executive Summary

The 2nd Newly Independent States (NIS) Policy Forum on Microfinance Law and Regulation was an "invitation-only" event held in Krakow, Poland, June 26-28, 2003, that the MFC organized in partnership with USAID and OSI. The forum successfully brought together a selected number of top-ranking public officials and policymakers from 10 NIS countries—Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russian Federation, Tajikistan, Ukraine, and Uzbekistan—along with donor representatives and other officials involved in microfinance and financial sector policies. The forum participants discussed key microfinance regulation and supervision issues. From the forum evaluations, the majority of the participants found the forum to be informative and well organized. Most rated the forum materials, topics, presentations, and speakers' skills to be good or excellent.

The forum began with several presentations on key microfinance issues in the legal and regulatory environment, gave an overview of legal and regulatory terminology, and asked the participants to examine and discuss microfinance regulation—its scope and its relationship to bank regulation. Over the three days, each country delegation gave a short presentation on its country's legal and regulatory framework and challenges. As the forum proceeded, participants heard from a U.S. bank regulator, results of studies on microfinance legal requirements in specific countries, and the impact of the new Basel Accord, and had further opportunities to discuss how best to address the country-specific challenges of integrating microfinance into the formal financial system. The forum included plenary presentations, group discussions, seminars, concurrent working sessions, and breakout groups as well as a reception and dinner to welcome the participants and facilitate networking.

At the forum's conclusions, each country delegation presented its next steps in microfinance regulation and supervision. The next step highlights were as follows:

- **Armenia:** A special working group will analyze legislative issues with the new three year USAID microfinance project.
- **Azerbaijan** will further develop the legal and regulatory environment for credit unions.
- **Georgia** will envisage building a legal framework for microfinance institutions.
- **Kazakhstan** will continue attempts to increase the population coverage of microfinance services, particularly by banks, and work to adopt a new Law on Credit Bureau and the Law on Non-governmental organizations (NGOs) and Social Orders.
- **Kyrgyzstan** will be implementing a new law on integrating MFIs into financial markets and provide training to examiners and supervisors.
- **Moldova:** The government is set to adopt prudential norms to CUs as well as expand MFI accessibility and support the MFIs' financial stability.
- **Russia** focused on the Voronezh oblast where ongoing efforts with the Savings Bank and State Fund, will continue supporting microfinance because of its role in SME development.
- **Tajikistan:** The Parliament is set to adopt a law on MFI. Normative acts will need to be developed. With donor support, the delegation will continue to develop the banking system and MFIs.

- **Ukraine** plans to restart dialogue on regulating microfinance activity, set up a governmental body regulating MFIs, promote population microfinance among the population, establish links between MFIs and banks and, finally, study market linkages.
- **Uzbekistan** will continue regulatory action in microfinance and the legal and regulatory environment. In 2004, the Parliament will discuss the draft microfinance law.

In terms of recommendations, most participants were interested in the following:

- Learning from other policymakers with more experience in regulating microfinance institutions, such as those in the European Union.
- Having access to regulation and supervision case studies and best practices.
- Obtaining information on how practical problems of microfinance institutions were resolved.
- Learning more about specific microfinance topics such as leasing, credit cards, microinsurance, and collateral.

The participants also recommended that future forums involve practitioners and that the MFC offer training for supervisors who will provide MFI oversight. In the final session, it was suggested that each delegation report back to the MFC on a regular basis on the status of microfinance policy and regulation in each country and that the MFC then post this information on its web site, so that all the groups could track the progress in each country. In addition, the MFC proposed to use its upcoming videoconferences through The World Bank as a way to continue the regional discussions and keep the information flowing between countries. OSI is interested in sponsoring regional internships and/or study tours beginning in September 2003 and the MFC indicated its support for this activity.

I. Introduction

The 2nd NIS Policy Forum on Microfinance Law and Regulation was an "invitation-only" event held in Krakow, Poland, June 26-28, 2003, at the Manggha Conference Centre. The MFC organized the forum in partnership with USAID and OSI. The event brought together a selected number of top-ranking public officials and policymakers from 10 NIS countries—Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russian Federation, Tajikistan, Ukraine, and Uzbekistan—along with a small number of donor representatives and other officials involved in microfinance and financial sector policy work to discuss key issues related to microfinance regulation and supervision.

The three-day event was conducted in English and Russian. About 75 participants attended. Interactive and participatory, the forum included plenary presentations, group discussions, seminars, concurrent working sessions, and breakout groups as well as a reception and dinner to welcome the participants and facilitate networking. Translators provided simultaneous translation in Russian and in English in the plenary sessions and whispering or consecutive translation in the smaller discussion groups and breakout sessions.

The forum was designed as a "policymakers' event" to provide actors in key positions with an opportunity for a free exchange of views and experiences among peers on the main issues concerning microfinance regulation. This included participants' country-specific plans, concerns regarding the growth of a strong and sustainable microfinance sector, and discussions on the sector's place in the broader financial sector. Participants had the opportunity to discuss critical issues with major implications for the microfinance sector. They exchanged views and their experiences with the aim of developing a healthy financial sector with a diverse range of financial institutions that deliver an array of services to a broad range of clients.

The forum is also a central unifying component of the MFC Law and Regulation Program. The forum's purpose is to:

- Benchmark the progress of the countries where initiatives to create a favorable environment for microfinance are taking place or took place during the previous year.
- Increase the awareness of policymakers from countries not yet selected for Phase I or Phase II Initiatives.
- Enhance the benefits of the MFC program's "clearinghouse functions."
- Build capacity among consultants and advisors who may become engaged in future reform initiatives.

The forum was designed to be highly interactive and participatory. Participants were encouraged to ask questions during and after presentations and to fully participate in all aspects of the forum. Prior to the forum, to facilitate the discussions in the breakout sessions and within the country delegations, the MFC selected a group of facilitators from the participants and sent them the facilitators' guidelines. [1]The guidelines included suggestions as to how to involve all the

[1] The guidelines had been developed for the 1st NIS Policy Forum in June 2001 and were updated for the 2nd NIS Policy Forum.

participants in their group and ensure that the sessions went smoothly. At the start of the forum, Ms. Towbin, an MFC communications consultant, provided the facilitators with hands-on training and discussed their role and the objectives of the sessions that they would be facilitating. She also met with the facilitators over the course of the forum to answer questions and provide additional guidance.

A. Policy Forum Goal and Objectives

The forum's overarching goal was to improve the legal and regulatory environment for the microfinance sector in the 10 participating countries. Microfinance experts and specialists in financial sector law and regulation assisted the participants to identify and discuss regulatory reforms that are needed to facilitate microfinance development in the NIS region.

The forum's short-term objectives were for the participants to leave with:

- A better understanding of the microfinance sector's impact on poverty alleviation and unemployment.
- New insights into microfinance regulatory and legal issues (including a clearer picture of microfinance as an integral part of the financial system).
- Ideas for future "microfinance-friendly" legal and regulatory reform measures.

In the longer term, the forum aims to advance the microfinance environment in each of the 10 countries by information sharing and creating a network of policymakers who are interested and supportive of microfinance.

B. The Organizing Committee

The policy forum organizing committee consisted of the following individuals:

- Katharine McKee, director, and John Berry, microfinance specialist, Office of Microenterprise Development, USAID.
- Piotr Koryński, director and Neal DeLaurentis, deputy director, Economic and Business Development Program, OSI.
- Katharine Lauer, JD, an international finance lawyer.
- Tim Lyman, JD, Day, Berry and Howard Foundation.
- Grzegorz Galusek, director, Marcin Fijalkowski, policy program coordinator, and Dina Towbin, communications consultant, MFC.

Staff from several Europe & Eurasia (E&E) USAID/Washington and field offices and from OSI participated via email in the committee's deliberations. Most discussions and decisions took place in twice-monthly conference calls, email or at the MFC's Moscow conference in May 2003.

The organizing committee played a multi-faceted role. The committee:

- Developed the forum goal, objectives, and agenda, including the decision to focus on policymakers.

- Worked with local partners (USAID/Washington and missions, OSI offices, etc.) to identify key policymakers and bank regulators and ensure their participation.
- Nominated and confirmed speakers and participants.
- Resolved technical and logistical issues.
- Provided funding.
- Provided guidance, and logistical and technical support.

The MFC organized and confirmed the conference venue, hotel, restaurants, and other local logistics including hiring the translators and providing local staff support.[2]

In contrast to the 1st Policy Forum held in June 2001, when both microfinance practitioners and policymakers were part of each country delegation, the forum organizing committee decided early on to make policymakers the target audience for the 2003 forum. Although two microfinance practitioners were added to the invitation list, they played a non-practitioner role—one was an MFC board member and the other served as a resource person. The forum's focus remained on policymakers, including central bankers, ministerial and parliamentary officials, and bank regulators. The reason was to recognize and support the policymakers' key role in the formal financial system and in promoting microfinance's integration into the broader financial system. In addition, with a targeted audience, it was thought that a more open discussion of microfinance might ensue and that the participants would be more open to sharing their concerns and issues, something that might not occur if practitioners were present. However, in contrast to the 2001 forum, no policymaker at the 2003 forum needed to be convinced of microfinance's importance in the economy. This was a *fait accompli*. There were many questions, though, on microfinance regulation.

Nevertheless, changing the forum's target audience created some resentment and raised issues among the microfinance practitioners. The MFC has attempted to resolve these issues by making the forum information and resources readily accessible to all on its web site (www.mfc.org.pl) and encouraging the participants to include microfinance practitioners in their "report back" sessions once they returned home. In addition, the majority of policymakers supported the idea of making the next forum a joint policymaker-practitioner event.

[2] Ms. Towbin produced a separate evaluation report for the MFC on its work organizing and conducting the forum.

II. Summary of Forum Sessions

A. Day One: Introduction, Plenary Sessions, and Breakout Groups[3]

1. Welcome and Opening Remarks

Katherine McKee, director, USAID, Office of Microenterprise Development
Piotr Koryński, OSI director, Economic & Business Development Program
Grzegorz Galusek, MFC director (See annex A for the presentations.)

Grzegorz Galusek opened the forum and welcomed the participants. He gave some background on the MFC, its role as a regional institution—as a microfinance resource center and network of almost 80 MFIs in 26 countries in the CEE/NIS region. He stated that the MFC is very active in microfinance training, and, in the past four years, the MFC has trained—in three languages, through a group of local trainers based in the region—more than 1,500 MFI managers in courses that cover all aspects of running MFIs. He mentioned the MFC's involvement in different microfinance research projects as well as policy and advocacy. He noted that he would be sharing the results from one of the MFC's most recent research products, the CEE/NIS Microfinance Mapping Study, later in the morning.

Galusek mentioned that those who were present at the 1st Policy Forum two years ago might remember the enthusiasm and positive energy that emanated from the discussions, and the participants' desire to make the regional initiative a regular event to discuss the trends and developments in the microfinance policy environment.

He gave a brief introduction on microfinance's role in alleviating poverty and as an important and dynamic contributor to economic growth and the vision for the sector— to provide all individuals and micro-entrepreneurs with adequate access to financial services that meet their needs. He then turned to examining where the sector is going and how the group could facilitate this evolutionary process, how the forum agenda fits into this process, and the participants' role in the forum.

He said that the industry has become more diverse both in terms of clientele and in the variety of institutions in the sector. As the industry becomes more competitive, Galusek noted, many of these institutions, in very short time, have become efficient, high performance organizations with state-of-the-art tools, processes, and systems. Many are becoming sustainable, delivering positive financial returns, the level of which can vary according to an institution's mission, strategy and business model. On the funding side, he gave examples of MFIs that are accessing debt financing from local commercial banks to finance the growth of their portfolios. He stated that the market infrastructure has improved—with more high quality information now available through reporting and institutional ratings.

Galuskek described how, in many NIS countries, microfinance is moving closer to greater integration into the formal financial sector, which involved:

[3] Note that, during the course of the forum, the organizing committee made some minor changes in the session topics and the session order. The information is presented in the report in the actual order, which differs from the printed agenda.

- ✓ Changing from a NGO institution to a more commercially oriented financial institution with a bottom-line orientation.
- ✓ Going beyond the initial target audience to a more diversified clientele, with a more diversified product and service portfolio.
- ✓ Moving from a reliance on donor funding to getting funds or underwriting from commercial banks.
- ✓ Being “rated” by commercial financial rating agencies.
- ✓ Using a targeted research agenda, training, and technical assistance to facilitate this move towards greater financial integration.
- ✓ Seeing increasing government involvement and support.
- ✓ A growing policy concern is that greater regulation and supervisory oversight is needed to ensure that the sector is viable.

Given this evolution in microfinance, he asked the audience to consider the type of enabling environment needed to support this process:

- ✓ **A legal framework** that supports the efficient functioning of a diversity of institutions.
- ✓ **Supervisory services** that ensure effective financial oversight and regulation.
- ✓ **Regulatory agencies** with a specific role, regulations, and sufficient staff to enforce this oversight.
- ✓ **Greater agreement on common industry standards**.

On the macro environment level, Galusek described the growing understanding among policymakers about microfinance, its fundamental role in development of a strong small and micro enterprise (SME) sector, and its contribution to economic growth and poverty alleviation.

The discussion then shifted to the significant changes in the legal and regulatory environment for microfinance and he gave a few illustrative examples from the NIS:

1. Kyrgyzstan has adopted one of the most progressive legal and regulatory systems, allowing for development of three types of MFIs: credit only, not regulated and non-commercial NGO MFIs; a commercial, credit only company; and deposit taking, licensed and regulated MFIs. Kyrgyzstan also adopted a law on credit unions.

2. The National Bank of Tajikistan is currently developing a draft microfinance law.

3. Kazakhstan adopted a law on microcredit organizations that allows for two forms of MFIs.

He added that the Russian MicroFinance Centre (RMC) is leading a policy effort in Russia and that similar initiatives were set to begin soon in Georgia and Armenia.

Galusek stated that the participants would be hearing about the state of microfinance and policy and regulation issues from representatives from each of the 10 NIS countries here today. He added that, while there have been some very positive changes, which have already improved the financial infrastructure for micro-entrepreneurs, significant gaps remained. Galusek added that change is occurring on a country-by-country basis and not at all levels of MFI operations. He stated that there is room for MFIs to improve their institutional capacity. For example, microfinance products may be limited as a result of the restrictive policy environment; in some countries MFIs still have unclear legal or tax status and many are facing additional competition from government loan programs, which offer subsidized interest rates. As a result, many poor people in the region remain without access to basic financial services, which people with steady jobs may take for granted.

He stated that the policy forum would address the gaps in the policy environment and explore ways to increase the potential of microfinance.

He closed by noting that two important donors—USAID and OSI—would speak next about their involvement in the sector, to be followed by a discussion on how microfinance has evolved in Western vs. Eastern Europe and then a look at how financial reform is progressing in Russia's transitional economy. Participants would then be asked to participate in an overview of microfinance legal and regulatory issues and terms, followed by breakout groups to discuss microfinance regulation. Then they would regroup in the plenary to hear about different approaches to prudential regulation and supervision.

Participants were asked to participate actively in the forum, to ask questions and provide the speakers with comments based on their own experience, but also to be brief. And, in deference to the translators, participants were asked to speak slowly and carefully.

He then introduced Ms. McKee and Mr. Koryński (see annex C for the speaker bios).

Ms. McKee welcomed everyone on behalf of USAID. She mentioned some of the similarities and differences between the current forum and the 2001 forum. The similarities were that both were held in Krakow, with a distinguished group of people, and a wide range of legal, regulatory and supervisory aspects of microfinance were discussed. The important difference she noted was that the 2003 forum is for senior NIS policymakers, invited senior bank staff, parliamentarians, and officials from other relevant ministries. She explained that the focus at the current forum is on policymakers' interests and concerns and on whether and how to improve the enabling environment for microfinance. She added that two full delegations from Azerbaijan and Tajikistan were present at the 2003 forum, while in 2001 they were observers; both countries had made progress. In Tajikistan, she noted that there was substantial progress in considering how to promote microfinance for entrepreneurs and households, and in making microfinance more clearly legal and improving the enabling environment.

McKee remarked on the very impressive growth of the microfinance sector in the NIS when compared with other geographic regions. She described it as a "very dynamic sector in the CEE/ NIS," as compared to other regions. McKee added that the sector promotes entrepreneurship and the very rapid growth of institutions; in addition, the sector is becoming more "professional." It makes a strong base for the development of financial services across the region.

McKee stated that USAID has been supporting microenterprise development for more than two decades and that it now supports microfinance in almost every country in the region. She was pleased to see that a number of her colleagues were in the audience.

She then shifted the discussion as to why USAID is active in the transition countries. She noted two of USAID's pillars:

1. Support to economic growth initiatives across the region, more so than any other region in the world. There is a very substantial opportunity for microfinance to contribute to economic growth.
2. An opportunity to extend credit to households and microenterprises; microenterprise development can broaden opportunities in the region.

McKee provided the following information on USAID's activities:

> In FY 2002, USAID provided almost $50 million for supervisory and regulatory/ policy activities in the E&E region. Currently, MFIs in the region are serving more than 150,000 clients. But there is a substantial need and opportunities to improve the enabling environment. In some places, it's unclear if the MFI that is extending loans is "legal." How do we create the legal environment to permit MFIs to grow, extend their branch network, etc.? We need a minimum of legal and regulatory provisions.

McKee added that she hoped that, in three to four years, USAID could add to the countries that have these provisions in place. In the near term, by Saturday, she hoped to have concrete next steps to create this vision of ever-widening financial services to people in the region from the country delegations.

Next, **Piotr Koryński** welcomed everyone on behalf of OSI and thanked the MFC for its work preparing for the event. He discussed a few points about microfinance policy in terms of what to regulate, how to regulate it, and who was responsible for the enforcement of the contract. He noted that microfinance had started as small credit/loans to poor people and that now it is progressing towards becoming a regular financial service. It started as a developmental paradigm in response to failures in the regular financial sector. For Koryński, it's becoming less and less clear to see what microfinance is and what it is becoming.

He saw microfinance as a subset of overall financial services to the poor, an innovation in the financial market. He challenged everyone to think critically about this and to look at microfinance institutions vs. products.

Worldwide, he saw a change in the approach to regulation—moving away from specific financial institutions to regulating specific financial products. He saw a lot of competition in microfinance sector; from consumer lending/finance, which is penetrating the low-end market for the poor. He remarked that microfinance is similar to consumer credit. He asked, "What is consumer lending? What is microenterprise credit?"

Koryński viewed technology as a new challenge that could allow services to be delivered through the Internet, especially in the CEE countries and eventually in the NIS.

He also noted the changes in the way that financial services conduct business. Whereas an institution used to hold a loan until consumer paid it back, now MFIs can sell loan in the market to other institutions; this is a new complication for microfinance regulation. He asked the audience, "Are these sales allowable? Can they be done in an efficient way?"

He then asked why microfinance was important for OSI. Koryński mentioned the issue of financial exclusion. OSI is striving to create an open and democratic financial market. He said that microfinance could contribute to a lessening of overall financial exclusion; he asked, "How can it contribute to this? What microfinance products and services can contribute to this?" He looked to the audience and the forum to answer these questions.

2. **Microfinance – A Tool for Economic Development,** *Maria Nowak,* Association pour le Droit à l'Initiative Economique

Ms. Nowak began by stating that she was "here to learn from you. You are more advanced than we are in old Europe." She mentioned that was born in the Ukraine, but has lived in the West.

Nowak began by asking, "Why make regulations to help the development of microfinance and its integration into development of the financial sector?" She noted that it is an essential factor for economic growth, that the economy of Russia has declined by one-third, and in Moldova, the economy has declined by two-thirds. She noted that capitalism is linked to individual profit, but it also linked to a judicial system and it subordinates private interest to the public good.

She stated that if Russia wants to double the GDP in 10 years, it would require an enormous effort. "It would be easier if a larger part of population participated in the economy. They need to give everyone access to credit. Microfinance would benefit the whole country."

She noted that microfinance is also an essential factor of social cohesion. With a decrease in income, she remarked that a concentration of wealth is a major risk for the economy, an obstacle to economic growth and a cause of social unrest, which characterizes the world economy. She said that bankers know how to estimate risk but don't know how to deal with uncertainty.

Nowak described microfinance as giving everyone an opportunity; "it creates future wealth and reduces financial, social and economic risk. The NIS experience demonstrates microfinance's relevance for industrialized countries. In France, only 20% of entrepreneurs have access to credit. In the EU, 93% of enterprises have less than 10 employees and poverty affects 50 million out of 370 million. The gray economy is 12-14% of the economy, close to the size of the microenterprise sector in Mongolia. With other institutions, we have created a European network with the MFC."

She added:

> We don't have all your advantages. There is a financial sector revolution going on in your countries. Microfinance bridges a market gap in all industrialized countries. Microenterprise development wanted to keep capital & labor; Utopian socialists tried to keep the production unit small. With the growth of technologies and services, microenterprise development has a second chance—where is the capital? The issue of microfinance goes beyond the NIS—a real globalization – create a continuum of appropriate final services. Western Europe wants to learn from Eastern Europe and the NIS.

3. **Reforming the Financial System and Microfinance: The Transition Economy Perspective,** *Alexey Simanovskiy*, Director, Department for Banking Regulation and Supervision, Bank of Russia

Mr. Simanovskiy thanked the forum for the opportunity to be in the beautiful city of Krakow. He came right to the point, and stated that the problem he was dealing with was the issue of the regulation of microfinance and that there was no organization to regulate microfinance in Russia. He said that some MFIs in Russia would be subject to regulations in a short time and that his bank needed to learn how to: provide solutions for the best regulations; avoid mistakes and errors in regulating MFIs; implement the approaches needed; and prepare the documents for this difficult challenge. He said that reforms are needed in the financial and banking sector, and in this context, he discussed the issues that refer to MFIs.

In the NIS, so as not to reinvent the wheel, he said that banking regulations are needed to foster the growth of the economy. He asked, "Why do we speak in terms of reform and not development?" He mentioned that the banking sector in Russia (and not only in Russia) was faced with many problems that are needed to reform the sector. He said that the microfinance sector has not had as many problems as in the banking sector, but they need to create the proper environment for microfinance development in Russia.

He issued a "red alert" concerning important obstacles; microfinance is new and still developing and has avoided some problems encountered by the banking sector. In terms of developing conditions for developing MFIs, he saw the conditions and solutions as having the same goal: they need to be adopted in context of the banking sector.

Simanovskiy added that the legal framework needs to be established with law enforcement for banking and the microfinance sector; rights of creditors must be strengthened and conditions developed for competition within the financial sector and all its components; improved quality is needed in managing internal audit systems.

He then discussed the development of supervision and regulation in the sector.

1. Why, how and what should be regulated?

Simanovskiy agreed with the suggestions delivered earlier in the morning (in the presentations and the binder), that MFIs must meet a specified set of criteria. He said that the goal and aim is to achieve and attract broad circles of participation. If the broad public is not attracted, the sector is not so important for regulators and it could be "self-regulated" based on risk management and other factors. These efforts must be united efforts of donors and investors. However, if they attract a broad audience, they must be regulated. It is not a black and white approach.

He asked the audience:

> We start with a framework that reflects different aspects; attracting a broad public—what does this mean? It's not easy to answer. It can mean credit unions and savings institutions that attract capital. Credit cooperatives—he stated—with a number of clients, attract funds and become a public issue. The same pertains to other institutions. The Germans insist that credit unions be regulated. We don't have the answer for defining what is the larger answer.

2. Do we need to regulate small banks, i.e., MFIs? Is it worthwhile to regulate them in same way as regulating banks?

Simanovskiy stated that if MFIs attract deposits from the public, they must be regulated as the banks are. Concerning the approach to small banks being regulated in the same way as large banks, he said "We need to find the best possible solution to this problem. For transition countries, market values are important; after Marx and Lenin, everyone is equal. But this can prevent the development of the state. It is a challenge to create real conditions and the proper framework for these institutions. MFIs cannot be given favored treatment. Formal regulations are important to ensure the safety of depositors." He noted that there are different approaches such as used in the Basel Committee II Accord—the intensity level of bank supervision depends on the institution's size and operations. And since MFIs are construed as small institutions, the level of supervision and regulations will differ than that for larger financial institutions.

3. As for issues associated with the supervision of credit unions, banks, and MFIs, he said it is too early to discuss these issues.

Simanovskiy noted that MFIs occupy their own niche in the financial system but this niche is expanding. He believed that there is a positive forecast for this sector. Although traditionally, banks love the rich, not the poor, Simanovskiy stated. He said that the state needs to create conditions for microfinance sector development. The state should not be faced with the issue of assisting MFIs financially. This would put the MFIs in the position of being the "weak partner" and not becoming self-sustainable.

He added "We need to insist on creating normal regular business conditions for MFIs. The economic forecast and evaluation need to be defined. In sum, the microfinance sector seems to be pretty well organized, the institutions are pretty well organized; their tasks should not only be economically but politically viable."

4. **Development of Microfinance in Central and Eastern Europe and the Newly Independent States: Results of the Microfinance Mapping Study,** *Grzegorz Galusek*, MFC director

Galusek discussed the mapping study highlights:

- There has been a dramatic growth in the number of active borrowers and in the loan portfolio in commercial banks.
- Credit unions and NGO/MFIs have the lowest loan sizes.
- Credit unions often extend consumer credit; this may skew loan size.
- The depth of outreach is average loan balance/GNP; penetration of MFIs is fairly shallow; there is a gap in terms of services in different market segments.
- In comparing the CEE vs. NIS, clients are growing faster in the NIS region, mainly in Central Asia where the infrastructure is new.
- Credit unions may skew the number of borrowers and of depositors.
- Microfinance is still very new in the CEE/NIS.
- NGOs serve the lowest end of microfinance market, but a large number of microfinance banks are serving micro and small businesses.
- The portfolio at risk averages 3.3% across the region.
- MFIs with a positive return on assets (ROA): 10% have financial sustainability on POA on investment. Define: financial sustainability as the ability of MFIs to cover all their expenses.

He defined the features of each institutional type, as follows:

- **Group methodology:** A group of microentrepreneurs who get a loan and guarantee loans for each other; village banking may involve a larger group of people.
- **NGOs** with a larger loan basis ($10M+) have lower overhead costs.
- **Credit unions** are the least subsidy-dependent; their capital base comes from savings; they have an uncertain legal status and poor governance; primarily they offer consumer loans but this is changing in some countries to offer microenterprise development loans.
- **Microfinance banks** have advantages and disadvantages. They offer a wide range of services, are well capitalized, have the lowest operating costs, serve primarily urban clients and high-end clients, and are heavily dependent on donors for upfront investment costs.
- **Commercial banks** are similar to microfinance banks as they offer a wide range of products, can tap into the existing financial system, and have good portfolio quality and low operating costs.
- **Regional Outlook**: There are 2 million microfinance clients, but this covers only 5% of the established market.

Galusek closed by saying that the bottom line was that there is a lot of room to improve and expand microfinance services in the region.

Q&A:

Q: What is the percentage of MFIs that have reached financial sustainability?
Galusek: Over 30% of NGOs have reached operational sustainability; nine NGO/MFIs in the study have reached financial sustainability.

Q: What are the operational costs of different institutions?
Galusek: The cost ratio is lower for smaller NGOs (those that invest in infrastructure have a higher cost).

Comment from Kate McKee: "When comparing this region with other parts of the world, why have MFIs here reached sustainability faster here than in other regions, even some with a smaller client base? One reason is that the average loan size in this region is higher, and staff quality (loan officer/client numbers) is higher (e.g., the portfolio amount that each loan officer can manage). Also, communications are better and clients are often starting from a higher education level and facing better economic prospects, so that loan demand and the ability to take larger loans over time, increases their rate of economic growth. The potential for developing a profitable MFI is quite positive in the NIS region."

Galusek showed a slide from his presentation on growth rates from September 2001 to December 2002, which showed high growth rates among microfinance banks; there was a 122% in change in total gross loan portfolio, and 142% in the number of active clients over time.

Q: On credit unions, the research shows that they are less "subsidy dependent." What does this mean?
Galusek: This means that while NGO-MFIs need donor funds to start their activities, credit unions can start up using member savings, but they may still need subsidies and technical assistance is subsidized on a national level.

5. **Overview of Microfinance-Related Legal and Regulatory Issues in the Newly Independent States and the World:**

a*)* **Discussion***:* Ian overview of terminology, concepts and key issues and principles that regulators face, with questions and answers interspersed. *Timothy Lyman*, JD, President, Day, Berry, & Howard Foundation

Mr. Lyman, JD, presented a common vocabulary for discussions of microfinance in the NIS and in the world and invited the audience to ask questions during the discussion and share ideas. The "*CGAP Guiding Principles*" was the source for the definitions (see annex A for the presentation).

Lyman discussed the terminology and the meaning of microfinance and microfinance regulations, including prudential and non-prudential regulations and their relevance. He noted that microfinance is not just for entrepreneurs, but for other participants as well. It involves their obligations and, in a broader sense, the transfer of services. He discussed micro insurance and bank regulation. Lyman stated that MFIs are not just NGOs, but also other institutions such as funds and foundations engaged in lending. Some of these are deposit-taking institutions that take deposits from their members. He added that commercial banks engage in lending to small and medium businesses and lend to various types of clients.

Q: How does microfinance differ here and the rest of the world?

Lyman: Availability. Credit cooperatives are in disproportionate numbers to other types of MFIs, due to greater regulatory procedures. Also, micro lending is going on without formal coverage. Parliaments and non-executive bodies have adopted laws over MFIs. To prevent losses to depositors vs. non-prudential regulation, prudential regulation focuses on protecting solvency. External oversight is monitoring of a less intrusive nature.

Q: Are NGOs engaged in mediation?
Lyman: They are not lending from repayable funds. This should not trigger prudential regulations. There may be governmental regulations, such as licensing on how they work. How do you manage non-prudential regulations?

Q: What is a license?
Lyman: In Kyrgyzstan, there are deposit-taking microfinance institutions, but those that are not, they need a permit from the national bank. It does not trigger non-prudential regulations. In many countries MFIs work without any special regulations or laws, within existing rules and laws. Sometimes there are special windows for MFIs. How do they apply in broader financial sector? Special windows are sometimes created.

Q: Where there is a significant legal tradition: If something not stipulated by law, it is not legal vs. in the other developed countries, if it is not prohibited, it is permitted.

Lyman: There is a risk that the institutions may fit into certain regulatory categories and it may lead to under-regulation. For example in Macedonia, banks are trying to become microfinance banks. There can be a "special window" either by law or by normative acts of the Central Bank.

Lyman then discussed non-prudential issues in terms of who can legally handle this. He said that the banking law describes credits – a banking license for prudential regulation, but how do we define what is crediting and what is not? It depends on the speed of development.

He defined consumer protection and truth in lending laws as the transparent disclosure of the true cost of borrowing savings, for example, costs and up-front fees. He said that in the developed world, there are some legal regulations. For example, Ukraine has developed credit reference bureaus; there is no need for prudential regulation.

Lyman spoke briefly on the subjects of collateral, interest rate caps, tax and accounting treatment, VAT taxation, taxation of profits, and feasible mechanisms for legal transformation.

Q: What was the experience in a successful transformation? XAC bank is the only transportation example; some are in process in Russia. Should donor (foreign) capital be prudentially regulated?

Lyman: Collateral (financial savings) should not be associated with prudential regulations. Key policy recommendations involve adjustments; to keep healthy is to be prudential. Some institutions must be able to operate in a regulatory environment. There are lots of debates. Don't impose prudential on lending only and the like, it is not justified.

Q: Prudential by government or non prudential – What is the right authority? Who regulates what?

Lyman: Non-prudential vs. prudential: There is no exact answer as cases differ.

b) Breakout Sessions on: **Why regulate microfinance and to what extent?**
Participants were divided into four groups that were mixed in terms of specialization and nationality. Each group was asked to focus on several key issues that policymakers face and to summarize their findings in a 5-minute "report back" presentation to the plenary. Each group had two questions assigned to them; they could cover the other two questions if there was enough time. The facilitators for the breakout sessions were: Kate Lauer, Kate McKee, Piotr Koryński, and Natalya Burtseva. The four questions were:

1. To what extent should microfinance be regulated?
2. What should be the scope of regulatory oversight over the MFIs (i.e., which MFI types or activities should be regulated and how?)
3. If microfinance is subject to specific regulation, (either by law or normative acts), what is the risk of abuse and what are the possible consequences?
4. How should the regulation of MFIs relate to the regulation of banks (with a particular emphasis on the capacity of regulators)?

c) Report Back to Plenary:

- **The first group** included participants from four countries and addressed question #1, the extent of microfinance regulation needed, in relation to their countries. They reported that:
    - Kyrgyzstan has four types of MFIs that are subject to prudential regulation.
    - Ukraine has non-prudential regulation for pawnshops and prudential regulation for credit unions.
    - Armenia has prudential regulation for credit organizations, pawnshops, and agricultural credit clubs.

- **The second group** addressed the second question on the scope of MFI regulatory oversight needed. They reported that:
    - Special regulation depends on the type of MFI (e.g. microfinance bank); regular arbitration is the result of the varying extent of regulation.
    - The tougher the legal requirements are, the higher is the extent of abuse.
    - They concluded that a regulatory authority needs limitations on its role and a definition of its authorities.

- **The third group** addressed question #3 on the risk of abuse if microfinance is subject to regulation.

    - They concluded that there should be a favorable environment that allows all MFIs to have equal rights. Excessive prudential regulation will not allow supervisory bodies to supervise the activities of MFIs effectively enough.
- **The fourth group** addressed question #4 on MFI regulation in relation to bank regulation. They reported that:
    - Deposit taking is regulated by the central bank in most NIS countries; loans are regulated and supervised by other bodies, and MFIs sometimes are self-regulated.
    - All but Azerbaijan agreed that there is no need to regulate MFIs' lending services.
    - The Azerbaijan representative thought that controlling loan interest rates was needed. In terms of starting capital, the more aggressive the control is, the more expensive it will be.
    - <u>Conclusion</u>: We should be rational to define the extent of the control required.

6. The Legal and Regulatory Framework for Microfinance in the Russian Federation, Kyrgyzstan and Azerbaijan: Achievements and Challenges.
Each country representative made a 10-minute presentation of her/his country's key achievements and challenges, followed by a Q&A discussion. (See annex A for a copy of the delegation presentations.)

Russian Federation
Mr. Mikhail Emilianov, Deputy Chairman of the Property Committee, State Duma

Mr. Emilianov discussed both commercial and non-commercial MFIs that exist in Russia. The MFIs do not need a license for their activity. He said that in 1999, the State Duma adopted a law that was supposed to regulate microfinance, but Putin vetoed this law. He provided the following details on the microfinance policy and regulatory environment in Russia:

- They are working to decrease VAT for MFIs by 18%, but the government is trying to cancel this preferential condition.
- The MFIs serve about 100,000 individual entrepreneurs or 5% of the potential market. Even in the regions where several MFIs operate, the market coverage does not exceed 20%.
- Credit unions in Russia are not allowed to give loans to non-members.
- Banks are reluctant to go into microfinance. Some of them do (the KMB pioneered this).
- The state controls credit organizations.
- The Central Bank issues licenses for bank institutions. Rules for non-bank institutions are not as tough as those for banks.
- The Law on Agricultural Cooperatives was passed recently.
- The tax code (the chapter on taxation of small businesses) has to be improved for MFIs and small businesses.
- Changes and amendments need to be introduced to the "Law About Governmental Support to Small Entrepreneurship in Russian Federation" that was adopted in 1995.
- The draft law on credit cooperation was considered by Gosduma in spring 2002 and is going to be passed soon; the second reading was held recently.

He stated that legislative reform should actively facilitate the development of microfinance (which is a requisite instrument for small business support in Russia) by the state.

Q: What is the distinction between agricultural and other types of cooperatives; how do you define them in order to distinguish them?
A: Agricultural cooperatives are involved in agricultural operations (machinery rings, marketing. etc.)

Q: Are there any special taxes for MFIs in Russia?
A: The term "microfinance" is not literally used in Russian legislation. MFIs pay the same taxes as other types of businesses.
Q: Do they pay VAT?
A: They do not pay VAT on lending operations. The law that Putin vetoed was to level banks and MFIs in terms of VAT payments.

Kyrgyzstan
Mr. Erkin Jumabaev, Head of Supervision Methodology Division, National Bank of Kyrgyz Republic

Mr. Jumabaev presented the following information on the Kyrgyz Republic:

- The National Bank of Kyrgyzstan (NBK) is the regulatory body for MFIs. Recent highlights of the NBK's activities include:
    - Developed the law on MFIs in Kyrgyzstan (although credit unions are not regulated by this law), which the Parliament passed in August 2002.
    - The NBK) handles registration (certificate) for MFIs that do not mobilize deposits; licensing; external supervision; and on-site inspections.
- There are three types of MFIs: microfinance companies (closed and open joint stock companies); microcredit companies (commercial organizations); and microcredit agencies (a non-commercial entity).
- There are different regulatory requirements for each type of MFI

He discussed recent reforms and their impact on microfinance. He said the key legal impediments to the development of microfinance in Russia are:
- Imperfect judicial system (in the process of reformation).
- Imperfect tax legislation.
- Lack of amendments to tax legislation.
- Shortage of resources and experience with respect to such institutes' regulation.

Jumabaev said that Kyrgyz legislation and regulation are not "perfect" and that they are now working on improving legislation related to collateral. He hoped that forums like this one would help them to apply best ideas in their country.

Q: How does your law distinguish between loans and credits?
A: Microcredits are funds for small and medium enterprise development, creation of new jobs etc., while microloans are used for managing emergencies mainly.

Q: Do MFIs pay income tax?

A: Yes.

Q: Who is reading the MFI reports? What happens if they do not submit reports?
A: Non-depository institutions report regularly to the Central Bank, and a special division reads them regularly. If an MFI does not submit a report, it will lose its certificate (which proves that it operates legally).

Q: Is there a law on microloans?
A: No.

Q: How are MFI customers taxed?
A: In line with the Tax Code

Q: What are the limits of microcredits?
A: Regulatory bodies set themselves the amount of microcredits. Those MFIs that are not subject to prudential regulations do set such limits themselves.

Azerbaijan

The speaker stated that Azerbaijan does not use the concept of microfinance in legislation. He said that any credit institution can offer microloans and the Central Bank (Department of Supervision and Licensing) licenses all of them. He then provided more details on the microfinance industry in Azerbaijan, as follows:

- There are four types of microfinance institutions:
  - Credit unions.
  - Non-bank credit organizations established by international donor organizations.
  - Non-bank credit organizations implementing state programs.
  - Commercial banks.
- Micro lending credit resources are:
  - Grants from donor organizations.
  - Credit lines of international financial organizations.
  - Funds of Enterprise Support Fund.
  - Deposits from banks.

He stated that the National Bank of Azerbaijan licenses and regulates MFI activity as follows:
  - Licensing – Department of Supervision and Licensing

  - Regulation – Department of Supervision of Credit Organizations

He described the legal barriers for MFIs as the lack of a legal basis for MFI activity and limited opportunities for the growth of private capital and to attract funds for loans. For commercial banks, licensing and supervision are done on the basis of Laws of the Republic of Azerbaijan and regulations of the National Bank of Azerbaijan. He said that they are now working on a new draft law on banks that will provide a definition of a non-bank credit organization. In compliance with the new draft Law, draft rules on licensing and the regulation of activity of non-bank credit organizations were developed.

Q: What could the MFI agreements and licenses be about?
A: MFI accountability is different, simplified.

Q: Could there be different approaches to different organizations?
A: Yes. Only the National Bank is the supervisory body for the credit entities. Different limits are imposed for MFIs and banks.

Q: Is there a responsibility for non-banking organizations and, if so, what is it?
A: We can only close them, nothing more. We had no cases so far.

Q: You impose interest rates because they credit poor and rural clients; what sorts of limitations are presented here?
A: We calculate an average % rate, because loans are given to poor people.

Comment: **Richard Rosenberg**, Consultative Group to Assist the Poorest (CGAP), noted that the World Bank does not allow interest rate caps.

7. Different Approaches to Prudential Regulation and Supervision of Microfinance: The Global Experience – What has Worked Elsewhere and What Has Not? *Richard Rosenberg,* Senior Specialist, CGAP

Mr. Rosenberg began by differentiating between supervision and regulation.

He described the central bank's role as ensuring that a financial institution had adequate capital for it to function safely and efficiently. He said that there was a conflict between the central bank's intentions and a large segment of economic activity, which is excluded from the financial system, the latter wants the capital limits to be lower.

Comment: Rationing scarce supervisory resources is often a subject of political discussions.

Rosenberg stated that he would never let an MFI leverage funds as aggressively as banks do for this reason: people repay microloans to keep access to the service (similar to credit cards). Still, there is a great risk in microfinance because no collateral is involved. He said that many MFIs, for the reason of internal policy, choose not to leverage their funds aggressively.

Comment: The higher the capital adequacy, the lower the return on equity for investment.

Q: Do we need to use risk weighting or is leveraging sufficient?
A: We need to apply risk weighting.

Q: What should be required from MFIs?

A: An assessment of the client's repayment capacity or an investigation of the client's household finances. Reporting procedures should have less documentation. MFIs often have a weak internal communication infrastructure.

In defining **ownership,** Rosenberg said that there are two major issues—foreign investment in MFIs and restrictions on the amount of shares that a shareholder can hold. He said that there is a need to be flexible towards these requirements.
In terms of **supervision,** there are different testing procedures for banks and MFIs. For MFIs, if there are too many borrowers, sampling is needed. It is very hard to get responses to confirmation letters from borrowers. In term of what to test, Rosenberg mentioned information systems, repayment performance, key collection figures on loans, actual response to delinquency, and organizational procedures. He also made the following comments regarding supervision:

- Capital calls, no speedy response, because of no deep pockets, too much bureaucracy.
- Stop lending orders.
- You can supervise the microfinance sector, but a different regulation is needed.

Q: What are those appropriate tools?
A: Depending on the supervisor and staff capacity, be active, meet with the MFI's management, and see their plans. If there is delinquency, all other usual operations are put on hold, and everybody tries to settle this problem.

Q: The microfinance sector depends on supervision. U.S. supervisors have had lots of training. But NIS supervisors seem to lack training. How would you advise to start this process?
A: It depends on the central bank's personnel rules. Maybe a small group of central bank personnel should be trained in microfinance, with a specialized department created. On funding availability, my advice for central banks is that, if you have a donor pushing you to develop microfinance, suggest that they fund training for a supervisor group first.

Q: How can a supervisory team manager make sure that his team has done its work well?
A: Develop a procedures manual for a normal inspector with what to look at, how many branches, how many loan officers, what systems to see, etc.

Q: What countries were successful in establishing MFI supervision systems?
A: In Latin America, Bolivia and Peru, and in Asia, Indonesia.

Comment: Stephan Staschen added that Ghana was successful at the level of laws. Speaking about costs in Peru, the costs of supervising a MFI were 30 times higher than those for supervising a commercial bank. For an NGO to transform into a bank (licensed or unlicensed), the cost was US$ 500,000 to $1 million. It took 1.5 years to finish the transformation.

A key recommendation was to use audits as a supervisory tool, but don't rely on auditors, if you do, have special agreed-on procedures for microcredit audits.

8. The Legal and Regulatory Framework for Microfinance in Kazakhstan, Georgia, Moldova and Tajikistan: Achievements and Challenges (see presentations in annex A)

Kazakhstan:

Mr. Tuimebal Pernebayev, Head of the Office of Normative Regulation, National Bank of Kazakhstan

Mr. Pernebayev described the legislative situation in Kazakhstan as being similar to that of Russia. He said that there are certain rules in the MFI market to avoid and protect against abuse; banks were not interested in downscaling. Therefore, laws on MFIs and CU's were developed and adopted in March 2003 (i.e., the Law on Microcredit Organizations and the Law on Credit Unions).
He described the four types of organizations that provide microcredits in Kazakhstan as:

- Organizations with particular types of banking operations (including funds with foreign donor support, CU's, Kazposte office, and pawnshops).
- State agencies for entrepreneurship support.
- Special commercial MFIs.
- Commercial banks.

He said that, at present, 37 organizations are authorized to provide all types of credits, and there are 38 CU's and 55 pawnshops.

In terms of the microfinance environment, he provided the following details:

- MFIs are not licensed or supervised. There are a number of potential risks and advantages with this arrangement. Key requirements concern minimum capital, loan file documentation, and a limited loan size. Specialized microcredit organizations cannot accept deposits.
- MFIs can be both commercial and non-commercial. There are no restrictions on unsecured lending.
- Most people in rural areas do not have access to microfinance. Given Kazakhstan's dispersed and largely rural population, this is a problem.
- Recently, a number of national guarantee funds were established; these include the National Development Fund, the Fund of Bank Deposit Guarantees, and the State Development Bank. By the end of 2003, the Innovation Fund, Corporation on Export-Import Operations, and Insurance Fund of Insurance Payments on Obligatory Types of Insurance Guarantees will have been established.
- There are 450,000 small businesses that employ over 1 million people or nearly one-quarter of all employed people.
- In 2002, the small business growth rate surpassed that of the country's oil sector. However, excess regulations of small businesses are hindering their growth.
- The Fund for Support of Small and Medium Entrepreneurship has been in operation for several years. The government also created the Commission on Small Business to coordinate small business activity.

- Commercial banks provide the greatest volume of credits to small businesses; from 2000 to 2002, they increased the credit provided from 74.2 billion *tenge* to 672.5 billion *tenge* (US$1 = 151 tenge).
- Banks are growing faster than MFIs, but banks are more reluctant to work with small businesses because of transparency issues, a lack of good business plans and collateral, and the high cost of services.
- By the autumn 2002, all supervisory functions of financial organizations had been transferred to the National Bank. By January 2004, a new independent financial supervisory agency will be developed in the Department of the National Bank to provide supervision of banks and insurance firms, the securities market, and pension funds. Parliament is now considering the draft law on this.
- Decreases in VAT rates, individual income taxes, and social taxes should be implemented by January 1, 2004, which should help the SME sector.

Georgia:

Ms. Mzia Tepnadze, Director of Non-Bank Depository Institutions, National Bank of Georgia

Ms. Tepnadze described Georgia's microfinance sector as including credit unions (CU's), pawnshops, and some MFIs such as CONSTANTA, FINCA, World Vision, and OXFAM. Of these, she said that the Central Bank supervises and controls only the CU activity, according to the Law of Georgia on Credit Unions that was enacted in June 2002 and effective since October 2002. The Law on Business Activity and other legislation also protect CU activity.

She said that the MFIs have few assets in Georgia and are underdeveloped. They suffer from poor management and the absence of a legal basis. To rectify this, OXFAM and the Institute of Georgia's Economic Development drafted the "Law On Microcrediting Organizations" to create a better legislative basis for MFI activity.

Q: What is the current status of the draft microlending law? How soon will it be adopted?
A: I don't think that the law will be adopted in the near future because of the parliamentary election. A draft law is still being developed.

Moldova:

Ms. Julia Iabanji, Director of the Small Business Development Department, Ministry of Economy

Ms. Iabanji described Moldova's microfinance sector as including the: Saving and Credit Association of Citizens (SCAC), Corporation For Rural Financing, MEC, and MICROINVEST.

She said that the SCAC is a non-commercial organization that was set up to support its members' entrepreneurial activities. It accepts deposits only from members and provides loans only to members. The SCAC is governed by the Association's:

- General Meeting of the Council.
- Director.

- o Audit Commission.

Iabanji stated that several laws, decrees, and normative acts pertain to the SCAC. These include:

- The Law about Savings and Credit Associations of Citizens (adopted February 18, 1998).
- The Law about Licensing of Separate Types of Activities (adopted July 30, 2001).
- Decree About State Supervision over the SCAC's Activities (adopted September 30, 1998).
- Regulations of the Unit of the State Supervision over SCAC's Activities (adopted September 30, 1998).
- Norms of Financial Prudence for SCAC (adopted September 30, 1998).

She said that there are several legal impediments to microfinance development in Moldova such as:

- o No law is in place about microfinance.
- o There is ambiguity in existing legal acts.
- o There is a lack of clear legal regulations regarding some aspects of SCAC's activities.
- o The body of the state supervision does not have effective and efficient supervision.
- o There is a cumbersome procedure of adopting amendments to legal and normative acts.

The decree of the Government of Moldova no. 850 of June 27, 2002 is a planned legal reform. Unfinished legal reforms include developing new financial prudential norms and amending:

- o The Law About Savings Associations of Citizens.
- o The Degree of the Government About the State Supervision Over the Activities of Savings and Credit Associations of Citizens.
- o The Regulations About the Unit of the State Supervision Over Amending the Degree of the Government About the State Supervision Over the Activities of Saving and Credit Associations of Citizens.
- o Administrative Code.

Q: What is the number of saving and credit associations that were closed down?
A: Two associations lost their licenses; 15 are currently functional.
Q: Were there any associations functioning prior to the law?
A: Yes, they were until 1998, until the law was adopted, and after that all associations were re-registered and re-licensed.

Tajikistan:
Mr. Djuma Eshov, Vice Chairman, National Bank of Tajikistan (NBT)

Mr. Eshov described MFIs in Tajikistan as being in a training stage and that they are gaining experience. There are 26 MFIs in Tajikistan, including NGOs that provide microfinance services. Most have USAID support.

He described the microfinance sector as follows:

- The official financial sector is in an early stage of development and is mostly composed of banks.
- The majority of the population lives in rural areas with no access to bank services.
- The MFIs' growth and outreach have been hindered by the absence of legislation on their status and activities.
- The NBT undertook several measures to support MFIs within the framework of current bank legislation, by adopting of statutory acts aimed at setting the problems of establishing and operations of MFIs as non-banking financial organizations. However, this development scheme has not progressed because of a number of drawbacks and does not cover all types of financial institutions.
- With this purpose, with the direct participation of international advisers and experts from NBT, the draft "Law on microfinance organizations in the Republic of Tajikistan" was developed after an analysis of existing international patterns and legislation on microfinance and modified with respect to political, economic, and social features typical to Tajikistan. The draft law:
    - Establishes an effective system of regulation of MFIs with minimal governmental intervention, minimizes the tax burden and the responsibility of MFIs, ensures transparency and openness in terms of regulation and supervision of MFI activities.
    - Determines the legal and organizational basis of microfinance activity, which can be conducted by specialized microfinance organizations that are divided into three types of institutions:
        1. A deposit-taking institution that the NBT licenses, supervises and regulates.
        2. One of two different types of non-depository institution that the NBT certifies:
            a. A non-commercial foundation or
            b. A commercial company (established either as a limited liability company or a joint stock company).

Eshov stated that the development of the draft law was a participatory process that involved MFIs operating in Tajikistan, international organizations– donors that were implementing projects and programs in the microfinance sector, and government officials involved in the process of drafting the legislation on microfinance. He said that expected reforms in the microfinance sector would focus on improving skills, providing primary support and development of microfinance programs in new regions, and providing support to and continuous development of MFIs.

He noted that the draft "Law on Amendments and Additions to the Tax Code of the Republic of Tajikistan" was submitted to the government. This law aims to simplify and lower the tax burden of the local MFIs and will benefit their development. It covers:

1. The VAT mode concerning the operations of microlending organizations,
2. Profit tax exemption for microcredit depositary organizations, and
3. Clearing of profits of microcredit funds.

Q: Please give us more information on the tax issues mentioned in the presentation.
A: Besides the draft law that will be adopted soon, we have prepared a draft on changes to the Tax Code. In addition, we developed a special microfinance regulation (normative act) with the objectives:

1. To change the taxation of lending (current options for a new MFI are either to get a license from the Central Bank or work according to the Civil Code and pay 20% VAT tax).

2. To provide tax waivers for MFIs, especially a profit tax exemption.

As a result of these changes, MFIs will be regulated as banks are. There are special requirements for MFIs that want to get a tax waiver. There is a risk that the MFI funders will use the profit.

B. Day Two: Plenary Sessions & Breakout Groups

1. Increasing Access to Financial Services while Balancing Legitimate Supervisory Interests: A Bank Regulator's Perspective. Legal and Regulatory Frameworks for Microfinance in the USA, *Ricki Tigert Helfer,* former Chairman, Federal Deposit Insurance Corporation (see annex A for her speech).

Ms. Helfer gave some insights into the complexity of the U.S. financial system and the financial risk that financial service providers assume that ensures economic activity. She explained loan leveraging with banks and other financial institutions and the varying degrees of risk. She noted that, "Regulations differ with the complexity of risk." The greater the risk, the greater the regulation; and the inverse is true. MFIs generally are not engaged in the range of risk that would necessitate extensive regulation.

She covered the general principles of regulation and supervision in market economies. She quoted Alan Greenspan:

> We must prevent financial disruptions through prudential regulations and through market events. We must ensure that with the regulatory framework that financial institutions can take risks even though there are unanticipated results and bank failures. . .The tension between trade and business practices is necessary—laws never be fixed in perpetuity.

She stated one rule of economic activity is that it should "reward safe and sound practices."

As FDIC chairman, she put bank information on the FDIC website to help regulators and individuals assess the risk. She recommended that MFIs make audited financial statements publicly available so that the public could assess risk. And to avoid issuing government guarantees that allow insolvent financial institutions to remain open, as happened with the Asian banking crisis.

She said that financial institutions need to assume risk even if it leads to the institution's failure and—again quoting Greenspan—"our goal as supervisors is to maintain sufficient banking standards so that market failures do not become widespread. Transition countries must balance immediate economic needs with needs for limiting risk. Sometimes bank failures must be allowed to happen."

Poor bank staff oversight, and management problems and decisions can lead to bank failures, she noted. But these did not lead to widespread failures. She said to look at Japan, where badly managed insolvent institutions were allowed to remain in business.

She discussed the 1980's U.S. banking crisis and how the U.S. worked its way out of the problem by using a bank insurance fund, closing most savings & loan banks, but leaving some open, and removing bank equity. She mentioned regulation by risk and that "after the fact regulation" could mean inappropriate actions that would lead to enforcement actions by the court that could lead to fines or imprisonment.

Of the 25 Basel Core Principles, 9 are important to banks, Helfer said. She discussed banking standards and bank capitalization and the differences with the microfinance industry, where the financial institution doesn't have the same level of information as banks.
She closed by stating that regulating by risk— balancing costs and benefits of regulation—is not easy. And that it is important to ensure sound, strong, and worldwide economic activity.

Q&A / Comments

Q (Kate Lauer): Avoiding excess restraints on risk can be a detriment to economic development. In the NIS, private banking has a short history; there is less trust by the public. There is little banking insurance in the NIS; and it is not the same judicial enforcement system as in the US.
Helfer: We need to emphasize the system's legitimacy; there is no replacement of trust in the financial system. It is important to let an institution fail in circumstances where you had sound regulations. We try to ensure that they engage in risk so the financial system can serve economic needs of the country. What is the purpose of the banking system? We need laws in place that eliminate "bad" actors. In the U.S., regulators can remove individuals from banks if they have engaged in financial wrongdoing. We need to improve bank regulations. It is important to look and see where the risks are, and focus there. In the U.S., banks ensure up to $100,000. That's too much.

Q (Stephen Staschen): The arms-length lending requirement: microfinance puts you very close to the client. Can you rely on market forces?
Helfer: As the microfinance industry grows, the client will have more options. Arms-length lending means you have unbiased lending. It isn't a good idea, when the MFI is only making small loans, to have a lot of documentation. Leave it to the market.

Q (Stefan Staschen): The "fit and proper test"—What do you put in regulations to ensure that this is followed? Risk-based regulations can be defined in different ways.
Helfer: In the USA, you can check a person's background with law enforcement activities. Risk-based regulation is an analytical process. Regulators try to understand where there are risks to the financial systems and clients and where there are not.

Q: (from Kyrgyzstan) Regarding the recommendations that you made that commercial banks should sometimes be allowed to go bankrupt. In our case, we were required to rescue the bank. It was cheaper to save the bank than allow it to go bankrupt. Around 10 banks went

bankrupt—this had a negative impact on the banking industry's stability. The same rules should be applied to large MFIs.
Helfer: It is difficult to know how much to let the economy suffer from bank failures. In the U.S., during the savings & loan crisis—this involved the total bankruptcy of the insurance fund for S&L institutions. The U.S. Congress redefined what capital was so as to let the S&L's stay open, even when they were insolvent. Unhealthy institutions bid against healthy institutions for capital. This cost U.S. taxpayers $250 billion. It is a difficult choice: unhealthy institutions can harm healthy ones. If you allow the financial system to be distorted, it will destroy the people's trust in the system.

Q: (from Kyrgyzstan) With regard to the small MFIs and credit unions whose assets are so small that they cannot even buy software, cannot equip themselves. This would be over-regulation.
Helfer: There are two kinds of MFIs: larger MFIs that make loans to the agricultural population and smaller MFIs. I can only speak in general principles. In the U.S., we've had some problems with U.S. agricultural cooperatives where there's no financial oversight of lending activities. They serve a large market. For the smaller MFIs, we had some very successful banks in the USA before there were computers. Computers can effectively monitor risk on a broad basis, but this may not be needed for small MFIs that do not accept deposits. Look at the circumstances on a risk basis.

For very small credit unions, people with a similar or common bond come together to lend each other money. In the USA, some credit unions had an insufficient capital cushion when loan losses increased. You need to ensure that there is enough capital, so that with more losses, the credit union would survive.

Where they are only make loans, we don't need advance regulations. But if they are getting into trouble, we need to look into this. Don't regulate where there is no obvious risk. But if an institution is getting into trouble, you need to look into it.

Q: Protection of deposits; to grow the population's trust in the banking industry. But if an MFI begins to take deposits from clients, we need to protect the deposits. When an MFI takes part in a depository fund.
Helfer: If an MFI begins to takes deposits, they should become part of the depository insurance system. In the USA, we passed a law that if you are taking deposits, you must have deposit insurance. Some countries only have a government guarantee, not a deposit insurance fund. This can be a problem, i.e., Japan, where the government does not have sufficient funds to cover the guarantees.

10. The Legal and Regulatory Framework for Microfinance in Armenia, Ukraine and Uzbekistan: Achievements and Challenges (see annex A for the presentations)

Armenia:

Piruz Badalyan, General Counsel, Legal Department, Central Bank of Armenia

Ms. Badalyan noted the new laws as achievements in microfinance in Armenia: the law on pawnshops, law on non-banking credit institutions, and law on agricultural credit services. These laws allow for the legal transformation of banks because of a minimum capital requirement of US$5 million.

She stated that there are five types of MFIs and that the Central Bank supervises the MFIs. There are less rigid regulations for MFIs. The Ministry of Finance supervises pawnshops. There are 14 microcredit organizations that receive donor funds. She mentioned that there are legal discussions re: VAT exemption for MFIs.

Q: Can you clarify the "universal credit organization" (UCO)?
A: UCO - The commercial ones must be licensed and are regulated by the Central Bank. They have the right to provide all kinds of operations including taking deposits. The legal transformation period is six months; it is a simple procedure.

Q: Clarify what kind of transformation is meant
A: If banks cannot increase capital, they can be transformed into credit organizations, agreed with the CB without taking deposits from people.

Q: Are all MFIs based on the membership principle?
A: No.

Q: Should all members of MFIs be natural entities? Are there any limitations on number?
A: No.

Uzbekistan[4]

Mr. Rovshan Gulyamov, Deputy Chairman, Central Bank of Uzbekistan

Q: NGOs are highly dependent on donor funds – why do you consider this as a problem?
A: We want them to be financially independent and sustainable.

Ukraine

Andriy Olenchyk, State Committee of Ukraine for Regulating Entrepreneurship

Mr. Olenchyk gave an overview of the microfinance environment in the Ukraine, as follows:

- There is no special legislation on microfinance; the first attempt in 2002 failed.
- There is an absence of special legislation on microfinance or microcredit issues and an absence of legal definitions of these notions.
- Banks, credit unions, pawnshops and specialized state credit funds and companies offer m
- icrofinance services.

- <u>Bank small/micro finance services</u>:
    - During the period from 1990 – 2002, banks issued US$380.1 million in loans to small businesses (10% of all loans outstanding).

[4] The notes from this presentation are unavailable.

- o Since 1997, the Joint Microlending Program of EBRD and German–Ukrainian Fund is being implemented through banks (the program budget is US$120 million. 15,500 loans (for a total amount of US$130 million) were issued between 1997 and 2002. The average loan size is US$8,400.
- o The Microfinance Bank specializes in lending to small and micro businesses. (Founders: EBRD, DUF, WNISEF, IFC, IMI AG, DOEN. 13,563 loans for a total amount of US$75 million were issued between 2001-2003 with the average loan size of US$5,500 and 70% of all loans being under US$5,000.)

- Credit union microfinance services:
  - o According to experts, there are approximately 350 credit unions in Ukraine.
  - o Due to the absence of government supervision, reliable data is available only on those credit unions that are members of the Ukrainian National Association of Savings and Credit Unions (UNASCU). As of April 2003, UNASCU unites 127 member credit unions with total loan portfolio of US$16.5 million and 197,604 members.
  - o Between 2001-2002, UNASCU members issued 174,750 loans for a total amount of US$46 million (15% of all loans and 25% of a total loan portfolio were issued to private entrepreneurs and farmers. The average loan size is US$260 in the range of US$10 to 10,000.)
  - o During the last two years (2001-2003), credit union membership doubled and the total amount of assets grew by over four times.

- Other financial institutions:
  - o There are about 1,000 pawnshops in Ukraine that issue short-term loans (under 45-60 days) with 250-400% secured by collateral of jewelry and home electrical appliances (the credit is 60-75% of collateral's assessed valuation).
  - o State funds and companies: The Ukrainian Fund for Entrepreneurship Support, between 1998-2002, issued 291 loans for a total amount of US$10.8 million, with the average loan size being US$37,000. The State Fund for Youth Housing Assistance—Since 1998, it has issued over 4,000 loans for a total amount of US$45 million. (150,000 applications have been submitted for a total amount of US$1.32 billion). There is also the National Innovation Company and a number of other companies.

In terms of special legislation in the microfinance sector, he mentioned the following laws:

- o Banking – The Law on Banks and Banking Activity, 2000
- o Credit unions – The Law on Credit Unions, 2001
- o Pawnshops –no special legislation.
- o Specialized state credit institutions – The Cabinet of Ministers issues separate laws and regulatory provisions

In terms of regulation and supervision, the Central Bank of Ukraine regulates banks. The State Committee on Financial Markets Regulation regulates credit unions, pawnshops, and specialized state credit institutions. Olenchyk added that the State Committee on Financial Markets Regulation was established in December 2002 according to the Law on Financial Services and State Regulation of Financial Markets, 2001. In addition, he mentioned these legal changes:

- Adoption by the Parliament of revised editions of the Civil and Economic Codes in January 2003 and the Law on Mortgages in June 2003.
- Pending adoption of draft laws on creditors' rights protection, credit bureau activity, registration of real estate property rights, circulation of storage certificates, and creation of secondary market for mortgage financing.

Olenchyk discussed the following problems in microfinance sector development:

- <u>Banks</u>: There is limited attractiveness of microfinance services due to high credit risks and the high transaction costs of microcredit. Banks offer microfinance services that are subsidized by international financial organizations.
- <u>Credit unions</u> potentially can work with a large number of small borrowers. The main obstacles are the high costs and short-term nature of deposits from the population. Potential creation of a three-level system for credit cooperatives: credit union – local cooperative bank – central cooperative bank.
- <u>Specialized state credit institutions</u> have significant problems with attracting resources (oriented to using state budget resources) due to low operational effectiveness and lack of true market motivation in credit relationships.

Q: To what extend are credit unions supervised?
A: No state regulations existed before the Commission was set up. It was mainly self-regulation.

Q: The law on microfinance: why did it fail, its purpose, any further attempts?
A: Due to parliamentary opposition it failed. Now it is in line in the Parliament, but there have been delays caused by the political reform process.

11. A Discussion on Microfinance Development in Different Countries, *Piotr Koryński*, Director, Economic & Business Development Program, OSI

Piotr Koryński: The developments in different countries in the sphere of microfinance go differently in different countries. He asked the audience: What are your ideas on different models, ways, and definitions? How do we define microfinance? Are these particular types of organizations or small businesses, which require state support? He stated that it is not possible to find a common solution and definition for all countries. It is a sphere of activity with defined criteria. Thus it is better to develop law on microfinance activity than on MFIs.

In terms of regulation of microfinance activities, Koryński said that regulations in post-Soviet states help to reduce pressure on MFIs, but over regulation is dangerous. Too many bodies could interfere, while sound regulation could protect MFIs. Overall, he stated that it is important to determine what is the MFI's aim. For example:

1) In non-deposit taking institutions that are supported by donors, local MFIs do not take deposits, the donors set the rules, no law is required, only general rules.
2) In deposit-taking structures, law is required to avoid risk and protect depositors.

He gave the Ukraine as an example where the second type is more widespread. In this country, the credit union system has been operating and it needs to be state-regulated. The emphasis is on the separation of two types.

Koryński stated that laws or other regulations motivate the activity. In new markets an opportunity to experiment is needed, while taking into account the country's development level before operations are begun.

Furthermore, he added that the term "microfinance institution" is not a clear term as it implies many actors such as banks, credit unions, etc. Thus such a legal term is limiting, it is better to work out a more general term, e.g. "non-banking institutions." Defining "microfinance" as loans to the poor is also limiting. Koryński discussed channeling microfinance via different institutions, e.g. commercial banks, but that this is not possible in remote or mountainous areas. Credit unions are not perfect either, he added; access is limited as they provide loans only to their members. MFIs could help in this situation.

He stated that microfinance is important to the governments, therefore support is required, but regulation should be very flexible especially in countries that are developing. If an organization is involved in a deposit-taking activity from the general public, then it needs to be regulated. In terms of supervisory authority, it always conflicts with the financial market. In Kazakhstan, there is no supervision of MFIs, they are beyond the banking regulations. It simplifies the activity of MFIs.

Koryński noted that:

> We should agree that microfinance means access of small clients to certain financial services and to stop using the word 'poor' because margins of poverty differ from country to country, it is better to use 'small businesses.' Also we have to think how can the state create a favorable environment for MFIs. In the Ukraine, a separate law on MFIs is not needed, they could operate within the existing legal framework (law on credit unions).

Koryński closed with a brief discussion on the expectations from MFIs. These included poverty reduction, entrepreneurship, civil society, and new class development. He thought the government should be flexible in piloting different schemes and adopting the most effective ones.

12. Concurrent Sessions (see annex A for these presentations)

a. <u>Session #1</u>**: An Analysis of the Legal Requirements for Microfinance Based on a Recent 11-Country GTZ Study**. *Stefan Staschen,* Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ)

Stefan Staschen presented the major points of his recently completed paper. This included the study methodology and scope, different regulatory approaches, drawing a line between microfinance and other types of financial institutions, and the regulatory mechanisms in 11 countries.

He conducted a desk study of the microfinance legal framework in the 11 countries.

He began by asking “What type of institution is regulated in 11 countries?”

- Deposit-taking MFIs in Uganda, Bolivia, Kyrgyz Republic, Bolivia, Ghana, Indonesia, and Pakistan – by prudential regulation.
- All MFIs in Ethiopia, Nepal – by prudential regulation.
- Credit-only MFIs, some of which are non-profit (BiH, South Africa, Kyrgyz Republic) – performance monitoring.

Staschen also described the levels of rule-making, as well as specific regulatory requirements in the 11 countries studied. In the majority of cases, the central bank regulates and supervises MFIs.

An international trend was to introduce a separate supervisory authority (like the Superintendencia in Bolivia and Honduras; UK, Germany).

In terms of criteria for drawing a line between MFIs and other credit institutions, he mentioned:

- Definition of permissible and prohibited businesses.
- Commercial vs. non-profit institutions (Kyrgyz Republic, BiH, Honduras).
- Restricting product characteristics.
- Definition of target group – necessary for knowing the market.

Major regulatory instruments: In his opinion, the selection is similar to those instruments that regulate bank activities.

Minimum capital requirements for deposit-taking MFIs range from US$24,000 (Ethiopia) to US$8.6 million (Pakistan). Staschen noted that, in some countries, the minimum capital requirements differ depending on:

- Area of operation (Pakistan, Indonesia).
- Range of financial products offered (CACs Bolivia).
- Retail vs. wholesale financial institution (Honduras).

For **capital adequacy requirements**, it is important to look at:

- Risk weighting (Basel 1998 rules are the most common, but sometimes there are only two weights – 0% and 100%).
- Exact definition of capital.

According to Staschen, **provisioning requirements are** very important, but should be stricter than in the case of banks due to more frequent installments. There are provisions against risk concentration; risk-weighted capital adequacy requirement; exposure limits.

He discussed **reserve and liquidity requirements:**

- In rural banks in Ghana, the percentage rate depends on the loan recovery rate.
- Less liquidity to be held against term deposits.
- The definition of liquid assets is crucial.

In many countries, to transfer shares, Central Bank approval is needed.

Looking at **sanctions and corrective actions**, Staschen covered the following:

- Fines (in Indonesia big institutions do not care about fines, as they are rich enough).
- Imprisonment.
- Suspension/removal of directors.
- Issuing warnings and policy directives.
- Management takeover.
- Putting MFI under receivership.
- Revoking the license.

Staschen closed by noting the following lesson to be taken from the presentation: Look at your own country, before you regulate anything, and remember that regulation is a service industry and is not about controlling.

Comments and questions, presentation 1

Q: Which type of approach towards supervision do you favor?
A: Credit-only MFIs should be outside of the mainstream supervisory authority; in the case of deposit-taking MFIs, the same authority may do this.

Q: Are there any specific points in legislation developed in any of those 11 countries that were used as an incentive for commercial banks to do microfinance?
A: We have to adapt some regulatory provisions (auto-physical security etc.) to make them attractive for commercial banks.

Comments and questions, presentation 2

Q: What is your idea about diversity? Why does it exist? What is your opinion on best practices?
A: In Pakistan, for example, they have a very high minimum capital requirement, as they do not want to have too many MFIs. As far as best practices are concerned, there are interesting ideas as to how to deal with specific problems, e.g. restructured loans require stricter provisioning requirements.

Q: Why didn’t you include West African countries that are known for well-developed microfinance?
A: It was due to the availability of information. Other interesting countries that I’d like to include are India and the Philippines.

Q: You mentioned imprisonment, does this happen in microfinance?
A: In microfinance regulations, imprisonment is envisaged by defining who should be imprisoned and for how long.

Comment: Staschen mentioned an extremely high minimal capital requirement in Pakistan, it was due to the fact that they wanted to keep the number of MFIs minimal, but almost immediately they introduced Fund for Poverty Elimination to support NGOs.

b. <u>Session #2</u>**: The New Basel Accord and its Impact on Microfinance**. Is the risk-based supervision approach a chance to deepen the outreach of microbanks? *Hirotaka Hideshima,* Basel Committee on Banking Supervision

Mr. Hirotaka Hideshima spoke on these topics:

- Capital regulation and the 1988 Accord.
- Timetable and objectives of Basel II.
- Outline of the new framework.
  - The First Pillar - Minimum capital requirements
    - Credit risk
    - Operational risk
  - The Second Pillar
  - The Third Pillar
- Third Quantitative Impact Study.
- Where we are in the process.

He began by discussing the importance of capital regulation as a way to keep financial stability in the economy and the 1998 Basel accord's main points:

- For internationally active banks in G-10 countries.
- Capital requirements cover credit risk (and market risk since 1996)–but with inherent buffer for other risks.
- Uses a simple risk-weighting structure: 0, 20, 50, 100%.

And its benefits:
- Created an internationally recognized, relatively simple standard.
- Adopted worldwide.
- Contributed to financial stability.

And issues:

- Capital requirements not always reflective of economic risk.
- Does not address innovation in risk measurement and management practices.
- Arbitrage opportunities through e.g. securitization.
- Little recognition of credit risk mitigants.
- "OECD Club-Rule."

He then presented the Basel II timetable.

Basel II is the result of an active dialogue with:

- Supervisors from countries outside the Committee.
- Banking associations, banks and other market participants (and thus based on leading industry practice).

The Basel II objectives are to:

- Enhance the framework making use of the roles played by bank management and the market.
- Better align regulatory capital to underlying risk.
- Encourage banks to improve risk management capabilities.
- Provide comprehensive coverage of risks.
- Provide applicability to a wide range of banks and systems.

He then presented an outline of the New Accord - Basic Structure (three pillars) with details on the First Pillar - Minimum capital requirements and credit risk. He explained the difference between the standardized approach, interest-ratings based (IRB) approach, and the credit risk models. Next, he covered the evolution of regulatory approach to operational risk. The second pillar is the Supervisory Review Process and Hideshima discussed the issues that it addresses. The third pillar is market discipline, which is another lever to strengthen the system's safety and soundness.

Third Quantitative Impact Study (QIS3) was conducted in the autumn of 2002 to field test the impact of Basel II, with more than 350 banks from 43 countries participating. He presented the study results.

In conclusion, he recapped where the Basel Committee is in the process, with implementation schedule for late 2006. In sum, Basel II is:

- A major improvement in capital regulation.
  - Intended to enhance safety and soundness of the banking system.
  - But has a lot of challenges in its implementation.
- Capital requirements are more aligned to underlying risks.
  - Less incentives for regulatory arbitrage.
  - Transactions are likely to be motivated more by funding and credit risk management needs.
  - Better risk management and pricing by institutions.
  - More efficient allocation of capital.

Q&A

Q: Participants asked Hideshima on the Basel II accord's:

- ✓ Impact on microfinance
- ✓ Risk-based microfinance approach

Hideshima: The focus on Basel II is on large sophisticated banks. There is the European Union (EU) and the international competitive issue and domestic competition; Basel II will be applied to all banks in the EU. Other members want to apply it to large banks only. The scope of Basel II had systemic relevance and competitive consequences. The standardized approach will make risk dependent on client's risk

He discussed the impact on retail institutions (p. 15 of PPT) and risk weights (table). In Basel II, there will be a greater reliance of systems and management. Hideshima discussed supervisory resources vs. flexibility given to institutions and that through this accord, we might be able to gain some insights into how MFIs are managing risks.

Kate Lauer: Basel II seems to raise the cost of supervision. There is a higher risk rating for an uncollateralized loan (75% vs. 35%) so it's more costly for the client/bank.

Hideshima: There are lower risk rates in Basel II for mortgages as compared to Basel I; higher rates for other retail loans.

Comment: Later in the plenary, Ricki Helfer made a comment that Basel II was only going to apply to large international/multinational banks, not MFIs.

13. Vision for an Enabling Environment for Microfinance (Part 1):

1) Discussion:

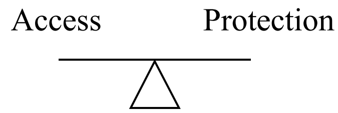
- What does the integration of microfinance into the formal financial system mean for regulatory and supervisory bodies?
- What are the financial system's costs and benefits from microfinance integration?

Moderated by *Katharine McKee*, Director, USAID/Office of Microenterprise Development and *Katharine Lauer*, International Finance Lawyer

McKee: As an introduction to the next breakout session, McKee opened the floor to discuss the vision of the enabling environment for microfinance. She described this environment as having the following elements:

- ✓ Legality of microfinance by diverse institutional types.
- ✓ Serves diverse markets.
- ✓ Offers diverse products.
- ✓ Growth and sustainability of different institutional types.
- ✓ Ongoing innovations.
- ✓ Legal and secure savings.
- ✓ Transparency in the enactment of changes in the policy environment.

She stated that it is necessary to seek a balance between access and protection.



Key issue: Can NGOs borrow funds and from which type of organization?

McKee asked the participants to look at the:

- ✓ Adequacy of supervision for existing credit unions. What can you effectively supervise?
- ✓ Transparency, good management and internal controls.
- ✓ Burdensome supervisory process.
- ✓ Dynamic process.

She categorized countries according to their state of microfinance:

I. **NGO-based**—Georgia, Armenia, Russia—don't have a clear legal structure. Options: Legalize via normative acts or add a paragraph in existing regulations to clarify legal and tax aspects

II. **Credit union (CU)-based**: Ukraine, Moldova, also Russia, Kyrgyzstan, Uzbekistan, less Georgia and Armenia). It's necessary to define an adequate legal basis, a basis for effective supervision. Options to explore include cost sharing and delegation, minimum size of small institutions (number of members).

III. **Somewhat developed--**Kyrgyzstan, Kazakhstan, Tajikistan soon, Russia—The key issues are normative acts and ensuring effective supervision.

IV. **Relatively poor microfinance environment, unclear how it will develop**—Azerbaijan, Uzbekistan. Questions: supervision of credit-only institutions; need in law (now or wait to see the market development)

V. **Sector starting to mature**—None, although Kyrgyzstan has a variety of institutions and products but there are still gaps). Questions: How do we eliminate prohibitions, to analyze what the gaps are and how do we solve them?

Issues relevant to all categories: Taxation

1) NGOs, foundations: tax exemption if they borrow.
2) VAT.
3) A level playing field with banks.

2) Breakout Sessions: Participants regrouped into country delegations to discuss how best to address the challenges of integrating microfinance into the formal financial system in their country. They were to propose solutions (below) to overcoming potential obstacles and summarize their findings in an 8-minute presentation on Saturday morning.

C. Day Three: Reporting Back, Wrap-Up, Recommendations and Closure

1. Microfinance as an Integral Part of the Financial System: Overcoming Challenges and Seeking New Solutions (Part 2).

Each delegation reported back on the next steps for their country.

Armenia

The delegation representative presented the delegation's next steps:

- To pass legislation providing for MFI regulation/non-prudential regulation of MFIs. There are still some obstacles to overcome and decisions to make.
- There is a law that covers non-prudential regulation.
- There is a taxation issue on activities.
- A special working group will work on analyzing current issues with the legislation will work with the upcoming USAID project.
- The upcoming three-year USAID Microenterprise Development project will address the main issues and concentrate on MFI development.
- They hope to be able to report on the establishment of the legal framework for MFIs in Armenia at next policy forum.

Azerbaijan

The delegation reviewed its laws and regulations as a result of the forum. The delegation representative presented the following information:

- The Armenian micro credit organizations can be divided as follows:
  - Humanitarian organizations using donor money.
  - Credit unions.
  - Non-banking organizations.
  - Special programs.
- Humanitarian organizations get permits/ non-depository/ registered by central bank/report by balance sheet only.
- Credit unions do not take deposits, but they will in the future and so they will be supervised more rigidly; credit unions that don't take deposits are allowed in Azerbaijan due to the earlier problem with the pyramid scheme.
- The World Bank and the Asian Development Bank both suggested that Armenia develop CU's that take deposits; so they are developing/amending a law on this; the CU will need to provide transparent information and must wait two years after the start of operations to begin taking deposits.

  Q (McKee): Concerning the CU's, can you provide some background on their status? Did the World Bank/Asian Development Bank project establish CU's or did they exist before?
  A: Today's CU's were created in 1998, before the adoption of the law on CU's. Then the CU's were allowed to take deposits from their members. When the new law was adopted on CU's in 2000, they were not allowed to take deposits. They can make deposits in the form of a share and the equity could be deducted from CU with three months' notice. So the central bank issues a license and norms to be met by CU's with regard to this. The CU's receive funds from other banks. NGOs are developing a network of branch offices to provide microfinance to clients.

  Q: (Lyman) Is there any special supervision of CU's? Or any plans for this?

A: There is no special supervision/supervisor so far. The Central Bank has a supervisory department and a unit within this that is responsible (5 people) for noncredit organizations (46 organizations, 11 are NGOs, 35 are CU's)(*Note: numbers may not be exact.*)

Georgia

The policymaker from Georgia said she obtained a lot of information that she will disseminate among the experts in Georgia and use this information to develop a framework for the MFIs. She also stated that:
- The Central Bank (CB) of Georgia does not deal directly with MFIs because the laws have not been fully developed with regard to those that take deposits.
- The CB established requirements for MFIs that take deposits.

Kazakhstan

The delegation representative explained that legislation of Kazakhstan uses the term "organizations implementing select types of bank activity" instead of MFIs. The term allows for the creation of any type of MFI, whose activities are regulated by licenses.

The delegation representative stated that the Kazakh population is accustomed to and prefers using bank services. The representative added that they would like to offer a broader approach to these issues, especially in Kazakhstan. He asked why the discussion was only about micro business and MFIs. He questioned if MFIs and micro businesses were two different concepts. He stated that, in many countries, microfinance is linked to this sector, but micro business has its own problems. The microfinance market has a different set of targets & a different way of development. Kazakhstan has different forms of MFIs. He said that we should also include small business.

The delegation provided the following information on SMEs in Kazakhstan:

- Small business problems are quite topical. Microfinance is closely related to small business. Many SME issues are developed and solved by the government. There is a plan to use banking system protection. Microfinance is an additional and supplemental instrument. Banks are rigidly supervised. Only banks can service SMEs effectively. Banks can take over money MFI functions.
- Kazakhstan's MFIs are also tied to small business. The clientele is developed. MFIs are not capable of solving all the small business problems, especially social problems. Maybe the Kazakh approach is not an experience to be adopted on a larger scale. The state or government is responsible for small business and has financed many social projects. The government has been developing industries.

The current financial situation in Kazakhstan is characterized as follows:

- A sustainable overall financial system.
- A high level of bank, insurance, pension, and securities market regulation.

- An optimal legislative base for the development of all types of businesses and foreign investment.
- An effective fiscal and budget system (i.e., steady decrease of the tax burden).
- Comprehensive sectoral, regional, and national development programs, including innovative-industrial, agricultural/agricultural processing, financial sectors, and poverty alleviation.
- IAS in the banking sector.
- Implementation of the market system of real estate accounting and appraisal.
- Deposit insurance, investment fund, national development fund, and innovation fund.
- Incorporation of export-import insurance.
- Adoption of the Law on Privatization of Arable Land.
- Availability of sufficient funds in the budget to finance social and other programs.
- Steady growth in living standards and salaries.
- Sustainability of the national currency.
- Substantial mortgage lending development.
- Consolidation of legislative and enforcement authorities in the area of small business development.
- An operational postal savings system.
- Microcredit organizations that are not subject to licensing and regulation and other MFIs that are subject to simplified National Bank supervision.
- MFIs are not regulated; created this year; we look forward to their development.
- Banks need to be well developed.
- High level of trust in the banking system.

The delegation noted that Kazakhstan has its own specific features. It needs to be more efficient with the bank's potential. MFIs have an ancillary role as they complement the bank's capacity. Why the stress on banks? A unified financial supervision system is being developed. They added more information on the financial system:

- Banks turn their backs on small business, but they have advantages with regard to small business.
- Given the large spread of population across a wide geography, the delegation thinks that only banks could provide the infrastructure to reach the population.
- Legislation is very well developed/ plans to open credit reference services.
- MFIs may offer services that are cheaper than banks. But banks with a good branch office may compete with MFIs. Post office offers banking/credit services.
- Electronic card system.
- Transparency in financial transactions; Internet technology used in financial movements.
- The Kazakh government has been very keen on developing banking systems, so banks have developed well since the collapse of the Soviet Union.
- An optimal and comprehensive legal framework has solved all financial problems. Establishing a credit information office (using the Canadian/US model, not the Polish one).
- Microcredit is still a significant issue.
- There has been a dynamic growth of entrepreneurship and middle class development.
- Both the EU and the U.S. have recognized Kazakhstan as having a market economy.

In terms of a micro business versus a small business, it has not yet been defined. The delegation was not sure what should be treated as a microcredit as this area has not been regulated. By not defining the size of the business, the government does not put them under regulation and does not stifle them.

The delegation representative noted that the Kazak population has a good education level, which has been noticed by investors. Businessmen need thousands of dollars. The delegation is interested in the experience of Asian countries.

The very active government role makes Kazak a special case; microfinance is regarded as a commercial service. Following market rules, the delegation believes that the market should govern microfinance.

Other priorities are**:**

- Unified financial regulator.
- Laws to be adopted (in 2003): the Law on Credit Bureau and the Law on NGOs and Social Orders.
- Further protection of consumer interests/rights (consumers of financial products).

Outstanding issues are**:**

- Increase coverage of the population with financial services.
- Reduce the cost of credit.

The delegation presented ways to implement the outlined priorities, as follows:

- **Legal changes**:
  - Define the terms "small entrepreneur" and "microcredit" for uniform usage and accurate statistics.
  - Further lower the tax burden.
- **Government**:
  - Take measures to ensure transparency in the activity and reporting of SMEs, including the credit bureau.
  - Provide/promote business incubators, technological parks, leasing, and business consulting.
  - Implement various social protection schemes.
  - Further expand measures for support of various groups of producers, including through the above-mentioned funds.
- **National Bank**:
  - Monitor the economic sector.
  - Remove constraints among sectors of the financial market.
  - Increase competitiveness in the supply of financial services.
  - Encourage SROs.
  - Encourage business ethics standards for financial institutions.

Expected results

- Expand bank branches to cover bigger territories.

- Substantially reduce the lack of the credit supply in the next four years by the means of the above-listed positive factors.
- Reduce the costs of credit resources.
- Expand the NBFI network on the voluntary basis.

Q&A

Q: (Lauer) What does the data show on how many micro entrepreneurs are being served and how many are not being served? Expand on how bank branches in rural areas are reaching the population.
A: The Central Bank regulates the opening a bank branch office. A foreign bank cannot establish a branch office. There are 25 banks with a branch office network. Many banks have a solid urban infrastructure. Major banks were inherited after the collapse of Soviet Union. Today the government has supported and provided them with funds to develop branch offices in rural areas. The law on NGOs will be adopted this year in Kazakhstan and will provide a good link to rural areas.

- Branch openings are supervised by National Bank Services to SMEs. There is no SME definition.
- 450,000 SMEs in total →25% of total populations is involved in SME activities.
- Small businesses employ up to 50 people. There are 450,000 small businesses in Kazakhstan and these businesses give jobs to 25% (1.5 M people) of the population. Banks serve these businesses. Last year, there was a moratorium for nine months. The government wanted businesses to abandon providing raw materials and move into production. A special council meets twice a year to reorient business activities. There are no major social problems in Kazakhstan (1/10 of Kazak territory is in Europe).

Q: (Helfer) Why have you prohibited foreign banks from having branch offices in Kazakhstan?
A: This decision was made 10 years ago when we were thinking about the development of the national banking system. There is another limitation on foreign banks; their capital in Kazak banks cannot be more than 30%, similar to what exists in insurance funds and pensions. We are rethinking this approach. We have applied to join the World Trade Organization (WTO) for a five-year interim period; we want to change the restrictions on foreign banks, including the portion held by foreign stakeholders. This problem is being discussed now. Many local banks do not meet international standards. A system of protection must be in place. Of the 37 banks, only about half comply with international banking requirements; if they don't comply within five years, they will need to transform into a different type of institution.

Comment: A law on agricultural land sales has been adopted so that land can be used as a credit collateral. Mortgages are well developed/ many structural funds opened. They start from supporting SME development.

Q: (On business activities)

A: People can run business activities. People are employed by small businesses. Entrepreneurs do exist. They have tax allowances and a patent system, and entrepreneurship has been developing rapidly in Kazakhstan. The middle class is growing. Ten days ago we adopted a law on trade with agricultural land; land has become a commodity. 8-10% of Kazak arable lands will be sold or subject to trade. Land can now be used as collateral. We think that this will trigger housing development. The National Development Fund has $6.5B in housing funds. We created a Fund for Innovation; insurance of export credits. Standards of life are improving. Should we build up small business or microfinance first?

Q: (McKee) You've mapped out a compelling vision of mainstream financial services provided to small business. The Kazak Community Loan Fund and other MFIs have developed as a result of an earlier law. There is a great deal of interest in this model from across the region. Have there been unanticipated issues or judgments in administering the Kazak Community Loan Fund and how it operates?
A: The microfinance problem and a focus on poverty and poorest of society. The government took on the fight against poverty and is due to solve them by 2015. We will not have enough labor by 2015, so will be inviting labor from outside of Kazakhstan. There is the support issue. The government has started a program on social issues. MFIs are present in the range – CU's, microcredit organizations—most have foreign donor support. One drawback is that they mostly work in specific regions. So they have not resolved nationwide issues. We have two institutions: 1) microcredit organizations that are not subject to licensing or supervision without bank control; and 2) organizations providing a separate type of financial services that are supervised by the Central Bank (except CU's). These organizations prefer to be supervised so they have good accountability and auditing. They can then attract foreign investment. MFIs exist but are concentrated in certain regions; they do not cover broad territories. Their activity is supervised by regulations (normative act).

Kyrgyzstan

The delegation representative explained that Kyrgyzstan recently adopted a law and is implementing it. It involves the integration of MFI/MF organizations (MFOs) into financial markets and resolving the issues. The development of MFOs started before the law; within the framework of international agreements, the institute of microfinancing, with the participation of our president, drafted the law and it was recently enacted. MFIs in Kyrgyzstan have to conform to the law.

- Normative documents/acts are not prepared yet. The country has developed and adopted normative documents on registration and incorporation of a nonprofit organization. The legal framework is already built.
- The National Bank drafted the document on the rules of the game: Supervision of MFIs that are willing to work with depository funds. All regulatory documents can be viewed on the NBKR website: www.NBKR.kg. The documentation process continues and NBKR personnel are involved in these issues.
- The problems are: financial penetration; developing MFI clients; specific issues in each country, such as in the remote mountainous regions, people do not have access to banking services. Probably not all banks are interested to work in microfinance because it can be more expensive.

- MFOs are penetrating into remote areas.
- No mutual support between MFOs and banks; we think this is only a matter of time.

Selected problems in Kyrgyzstan:

- No mechanism for the participation in the payment system.
- No access to banking for the general public.
- No collaboration between MFIs and banks.
- No resources for supervision: lack of staff, money and experience.
- Undeveloped infrastructure.
- Religious obstacles/ Islamic banking.

Ways to overcome problems in MFI sector:

1. Time is required to build capacity.
2. Transparency.
3. Use the banks' financial network.
4. CGAP self-evaluation- meet all the requirements!
5. MFOs/MFIs:
    - 1st issue: For small credit to grow, it needs to have more resources and the institution of microfinancing needs to be more developed.
    - 2nd issue: No mechanism for participation in their cash system. They are serving their clients via banks. They need time to establish a network with banks. The competitive issue: Commercial banks are working to widen their subsidiaries where MFIs are operating.
    - 3rd issue: Human and financial resources.
    - 4th issue: Supervisors/inspectors are not very experienced and there aren't tests for them. Only depository institutions are subject to supervision. After two years, they can accept deposits.

In conclusion, the delegation stated that it thought that donors should be happy to work with them on these issues. And it added these recommendations and issues:
- Islamic banks wanted to work in Kyrgyz market, but Kyrgyzstan has certain interest rates so these banks could not enter the market.
- We need time to develop both banks and MFIs and for MFIs to develop their clientele.
- Better transparency of operations of MFIs is needed.
- In 2002, Kyrgyzstan adopted a law on accountability based on international standards. MFIs must keep their books in accordance with these standards.
- MFIs need to widen their services, use commercial banks, develop more skills, and install and use software for depository institutions to meet standards. CGAP made this assessment.

  Q: (Lauer) Under the new microfinance law, all MFIs need to register and file reports. For small groups operating in villages—are they below this threshold? Is this too burdensome? Is this a concern?
  A: We have developed the normative acts for MFIs that take deposits.
  Q: But is this too burdensome?

A: We have three types of MFIs. They must agree to conditions in the law after they are registered and certified by the government. It is more simplified for nondepository institutions.

Q: (Helfer) How many institutions have asked for certificates?
A: 43 MFIs are registered, included 38 non-commercial microcredit agencies and five MFIs. This includes all the oblasts of Kazakhstan. No microfinance organizations are present.

Q: (Helfer) What is the status of consumer protection regulation?
A: We want to get into the WTO so they have to agree with WTO country membership requirements. Two years ago, we began researching this issue and the result showed that such a new law could create obstacles in the creation of banking institutions. It's a complex issue. Congress was suggesting restrictions on the interest rate. The administrative code stipulates taking complaints from consumers, and they have a process to handle this. Officials can be fined and an institution could lose its license. But no special regulation on consumer protection is envisioned. A more general law pertains to the rules of the game. Actually there is some legislation in the Administrative Code.

Moldova

The delegation representative stated that the process of integrating MFIs into the banking system is taking place. The CB does not supervise them. Changes in accounts were based on the 30th International Accounting Standards. Financial reporting is done according to this standard. Prudential norms were prepared and will be adopted by the government this summer. The Law on Savings and Loan Association is to be adopted. Keeping to the requirements is a part of the integration process.

Other issues and next steps presented were as follows:

- **Integration**: There are many requirements for credit unions. Prudential norms are established and will pass this year.
- **Supervision and regulation**:
    - o The CB will not supervise associations. It does not have enough experience in supervision, as a small staff of six work with over 400 associations.
    - o The CB does not supervise the MFI sector. The MFI sector has a separate supervisory body.
- **Constraints**: There is not well-developed cooperation with NGOs. Support programs are in place but are not implemented properly.
- **Overcoming obstacles**: There is poor communications between NGOs and the government.
- **Two-fold objective**: To expand accessibility and support MFI financial stability:
    1. <u>Further steps</u>: Promote microfinance practices and make recommendations to the authorities. New prudential regulations are envisaged.
    2. The Law on Insurance of Deposits of Commercial Banks is being drafted, and the same should be developed for MFIs. The new tax code exempts deposits from income tax. Insurance on deposits in MFIs (credit unions)/no income tax on interest on deposits in credit unions. Non-deposit-taking structures are not supervised and operate under general rules.

Q: Is this a burden on credit associations? What is your approach towards strict standards?
A: Standards were introduced January 1, 2003 and showed good outputs for the 1st quarter, but improvements are needed in terms of transferring the information into an electronic form, though the very reports are good and cause financial discipline, self-discipline, and staff development.

Q: The use of credit cards in the loan system, how expensive are these systems?
A: In autumn 2002, many CU's introduced the card system in cooperation with a large Moldovan bank. Half of the credit for the CU may be from the commercial bank. Not all associations introduced the credit card system. Only 25-30% of association members use these cards. In terms of user-friendliness, it is very user-friendly as compared to other loan products. In terms of cost, I don't have this information.

Russia

Note: The delegation representative focused on the Voronezh oblast of Russia. He presented the following observations and next steps:

- There was progress in microfinance in 2000, as communist politicians were replaced. Microfinance services are very important in supporting small business.
- The oblast has created a government fund to support small business. This fund uses the services of donors and the annual budget of Vilnos that gives funds for microfinance services. The fund serves the MFIs. The client is the "commercial proletariat," a term borne of the entrepreneurial environment. This is a feature of the region.
- One more structure: Central Federation Bank. The oblast signed an agreement. The pilot project was started with the clients being small businesses (a $700 credit, with $1000 being an average loan size); the savings bank begins at $2500. If this system works, then a new law is not needed. Unfortunately, the laws are developed in the capital without local input. (He noted, "like soap in our hotel that looks stylish, but is not so convenient.")
    1. Microfinance is very important in terms of SME development
    2. The State Fund of SME support to help commercial proletariat – {$700-1000 loans}
    3. Saving Bank – loans $2,500 to small businesses. Saving Bank is regulated by Central Bank.

Future options and issues

- The oblast administration will provide guarantees to the Saving Bank
- Without donor funds the oblast budget is limited. The government is unable to efficiently manage this market segment.
- The portfolio is about $4 M.
- Issues are limited resources; the savings bank does not have a problem with credit but has a problem using collateral for credit.
- The oblast administration guarantees the savings bank with US$500,000 in assets.
- Credit for interest rate: For the first year, they don't pay, and the second year it is subsided.

Tajikistan

The delegation representative addressed how best to resolve the issue of integration of microfinance services in Tajikistan. He believed that adoption of a separate law and certain additional acts and preparation of tax code were needed.

In terms of supervision of MFIs, he recommended training/teaching the supervisory agent. However, potential obstacles remained. There is not a law on microfinance activities. The IMF, World Bank, USAID, and the Asian Development Bank are helping Tajikistan on this issue. Since last year, they have held meeting and became familiar with the issues with the National Bank of Tajikistan.

1. Next steps include:
   - Supervision of MFIs: To be probably implemented through the NBT. The draft law was submitted to the government and forwarded to Parliament for a vote.
   - The Parliament will adopt the law; normative acts need to be developed. The Institute of Micro Financing in Tajikistan. The first commercial microfinance bank was established in Tajikistan.
2. The Aga Khan Fund (AKF) is active in Tajikistan and supports the very poor, mostly in rural areas where financial services are inaccessible. The Tajik government has supported the AKF and has been working with them this year.
3. The First Microfinance Bank was registered with the AKF.
   - It has six years of experience in rural areas.
   - US$180 million legalized (invested/deposited in banks)
4. 28 commercial banks were restructured with IMF assistance
5. Trust in the banking system is growing. It is a very young system. After 1991, there were four national banks. In 1998, the commercial banks were restructured. Many had to be closed because they didn't agree with the new requirements.
6. With donor support, the banking system and MFIs will continue to grow.

Ukraine

The delegation representative presented three systematic problems with regard to microfinance development in Ukraine:
1. The **State Committee on the Regulation of Financial Services** needs to be established to regulate the microfinance market.
   - Commission establishment to develop legislation.
   - Information dissemination: To overcome fear and concerns in relation to MFIs.
   - Infrastructure: credit reference service and a mortgage institution of 2nd level are needed
2. An **information campaign** is needed on microfinance opportunities to introduce new financial products and to improve mortgage regulations and mortgage equities.
3. **Market problems**:
   a. The government should not be a part of market.
   b. The government's role is to build the legislative framework, create incentives, and develop depressed regions through market intermediaries not government institutions. Existing models are in the agricultural industry and housing for young families.

c. State funds are limited and nontransparent. There is a lot of fraud in state agencies. But the state should support antipoverty campaigns. NGOs should be used, not government bodies.

4. Youth housing development- microcredit initiatives
5. Banks have two directions
    - The Banking Law of Ukraine allows the market to receive regular and specialized banks as intermediaries for MFIs, but it should provide services such as those for CU's as well.
    - Banking:
        i. Universal and specialized MFI banks
        ii. Banks → (banks to credit union) → general public. Good model of symbiosis between banks and credit unions.
7. Three-tier credit cooperatives are needed. The credit cooperatives that are the most efficient—i.e., for–credit cooperatives—work with legal entities; others will provide small businesses/CU's with funds. In 2000, there was an attempt to pass a law on microfinance asking for USAID assistance in developing microfinance markets.
8. The dialogue with BizPro needs to continue; the delegation wants to establish links with CU's and study market linkages.

Uzbekistan

The delegation representative stated that it would continue regulatory action in microfinance regulation and the legal and regulatory environment. In terms of the best way to integrate microfinance into the financial environment, the delegation recommended:

- Interaction between MFI regulators and risk evaluation, risk weighting, setting up the sound rules.
- Law: Capacity building, improving legislation.

In terms of next steps, in 2004, the Parliament will discuss the draft law on microfinance.

Pilot projects—all MFIs are pilot projects. Transformation of pilot institutions into real MFIs. Regulators will set up plans so that work continues for the integration of MFIs into the microfinance system.

Q: Explain more about the normative acts that relate to MFIs.
A: What is an MFI, their operations? (He explained what MFIs and CU's do for their members.) The Ukrainian Act of self-organization of citizens: Citizens may form housing cooperatives, NGOs, and CU's and this is within the provision of the law.

CU's often not supported by foreign sponsors but need foreign aid to be sustainable.
CU's in Ukraine:

- Are guarantors for third parties.
- Participate in payment systems.
- Pay for services and goods in credit.
- Are associations of citizens or communities with common interests.

Comments: (McKee) In some countries, CU's are restricted to enterprise credit or credit for enterprise purposes. This happened in Morocco. This restriction was problematic and now the country is broadening its definition to allow consumer credit, housing loans, etc. I see in Ukraine and worldwide growing interest in remittance services. There is interest in MFIs getting involved in remittance services. The web site, www.microfinancegateway.org has information on the application of technology in microfinance. Technology can also be used the increase the efficiency of MFIs.

2. **Summarizing the Financial Integration Discussion, Conclusions, Emerging Issues, and Next Steps and Forum Closure,** *Katherine McKee*, Director, USAID/Office of Microenterprise Development
    - o Recommendations for USAID, OSI, & the MFC
    - o How the MFC can support the outlined activities.

Ms. McKee asked the participants for their feedback on the forum.

- **Uzbekistan**: Yes, the forum was useful. Everyone got some useful knowledge from it. What else can we do? Out of all the recommendations and discussions, let's look at the results. The positive effect – we had a chance to discuss them and share experiences. Useful implementation, recommendations, shared experience, and informal communications were helpful. The MFC can track what's happening and report back to the participants.

Galusek: We've identified certain needs at the forum. Supervisors need training on how to assess MFIs.

- **Kazakhstan**: There were many questions on the objectives of microfinance. The main microfinance objective—the objective of our efforts—is the fight against poverty. Microfinance instruments are tools against poverty. The analysis in the assessments did not include the poverty level information. The MFC should learn in more detail the barriers in the fight against poverty, its depth and penetration, and what instruments are usable in this fight. Sometimes people need some credit or information to improve their lives.
- We looked at the insurance market recently. We don't think there is any need to create microinsurance. Existing insurance agents can do this. Insurance is an expensive business. Insurance companies have strict guidelines. We don't think small business should be burdened with insurance contract. Insurance is possible only in a country where good insurers operate. There are risks in every industry.
  Kazakhstan's recommendations:
    - o The MFC should organize seminars to teach banking supervisors for MFIs.
    - o Information dissemination: We need to disseminate information to the populations that need it. There is no systematic plan for development. We need to reach rural areas. Could the center somehow unify the experience of different countries in different areas?
    - o Also microinsurance – is a black hole/Black Forest for us.

- **Ukraine**:
- Executive officials are invited and legislators are developing the legal instruments.
- We know that microfinance is not only micro credit. How about micro leasing? We are developing a law on this in the Ukraine. We don't know how microinsurance works. Thought the forum was really great. We came here to learn, but also we have to think how to implement the new information in our country.
  The Ukraine's recommendations:
  - We need more time to present sensibly.
  - Such fora could be run in other countries as well.
  - Talking about legislators—we need a mechanism that MFC could develop—a standing informational space so that all information could be published somewhere, especially in the regulation field. Something permanent could be created for this.
  - At the next forum, invite legislators and bring juridical instruments to discuss these with executive officials. The challenge is to create legislative instruments that can help rather than destroy the industry.
  - It would be useful in the first part of the forum to provide an analysis of legislation and microfinance sector in each country. Then in the discussions, we could add more detail to be directed in our discussions.
  - It was my first time in Krakow and there are lots of interesting things to see. It would be helpful if someone from the Krakow Mayor's office could talk to us about the city.
  - Don't limit the presentations to 10 minutes – some countries need an hour ("we're choking the democracy") such as Armenia, Ukraine, etc.
  - Present the donors' rules regarding participation in funds.

- **Uzbekistan**: We have a constant dialogue (every month or every other month) with the MFIs. It would be useful to invite the representatives from MFIs to discuss issues with the legislators at the next forum.

McKee took an informal vote at this point. The majority of participants voted for having both policymakers and MFI representatives at the next forum over having just policymakers.

Stephan Staschen presented a proposal for the intermediate period before next forum. As there is now have a good overview on the state of the microfinance in each country, he recommended having someone from each delegation send in a monthly update to the MFC and having the MFC post it on its web site.

McKee mentioned that several countries have microleasing laws and that the MFC has a presentation on this on its website.

- **Armenia:** All delegations came to the conclusion that microfinance is multifaceted. Such fora are becoming a permanent process.
  Armenia's recommendations:
  - It would be nice for all the countries to present their achievements between fora. It would be good to get information from other countries on a regular basis. This would help us better prepare for the forum. I think the forum is appropriate.

- All we could improve is to add a day or two so the participants could have a more profound exchange of opinion.

Rosenberg added that, in terms of microleasing/equipment finance in the Latin American context, Glenn Westley, of the IADB, has a paper available on the IADB web site (www.iadb.org). Participants have expressed interest in a database; he stated that CGAP has commissioned a database that will be worldwide. CGAP expects to be online with the database soon; 25 countries will be included in the first round.

Galusek stated that the MFC web site has a limited database on legislative acts related to microfinance in the region.

3. Organizers' Response

Galusek thanked everyone for their comments and said that the MFC will incorporate them into its activities. He noted the following recommendations:

- Expand the participation of policymakers and practitioners in the MFC annual conference as a networking and learning opportunity.
- Facilitate participants keeping in touch after the forum.
- Provide MFC assistance in arranging exchange visits or seminars on a subregional basis.
- Organize videoconferences: Participants could select the topic and with the World Bank, the MFC could organize this.
- *Policy Monitor* (published twice yearly): Participants were asked to submit materials about their countries or suggestions about topics
- Central Bank of Kyrgyzstan: The MFC is providing them with training for MFI supervisors.

Koryński thanked all the participants. He stated that OSI would be happy to sponsor an exchange visit between countries. OSI could do this starting from September 2003.

McKee closed the forum by thanking the MFC for its technical and logistical support.

III. Forum Results and Recommendations

A. Lessons Learned on Microfinance Policy and Regulation

Microfinance policy and regulation are up-and-coming topics in the NIS region, and as such, they have generated much curiosity and interest among policymakers and central bankers. Questions remain on the role of policy and regulation, and the depth of regulation and types of training and support needed.

NIS –-What's Next? What Will Work?

Looking at the NIS region on a country-by-country basis, as illustrated in the table below, it is clear that legislative and regulatory actions have not kept pace with the microfinance sector's development. However, in the coming year, more legislation and regulation are expected to be in place that will recognize the sector's legitimacy and the important economic role that it plays.

All 10 countries have new or draft laws pending that aim to regulate or legitimize the microfinance sector. As these laws are enacted and put into practice, it will be interesting for the MFC to track (with input from the country delegations) both the changes in the microfinance sector—as the MFIs, credit unions, banks, and other financial institutions conform to the new laws and regulations—and the changes in geographic outreach and the range of financial services offered. The goal is to make financial services more accessible to a broader range of the people in the targeted markets.

Table 1: A Country-by-Country Comparison of the Microfinance Sector in the NIS Region

Country	Status of Microfinance Sector	Key Issues	New/Pending Laws & Legislative Issues	Technical Assistance, Training & Information Needs[5]
Armenia	NGO-based with some CU's	o No clear legal structure for microfinance o Need to define an adequate legal basis for microfinance	o Need normative acts or additional paragraphs in existing regulations to clarify legal and tax aspects o New laws: The law on pawnshops, the law on non-banking credit institutions, and the law on agricultural credit services o Under discussion: A VAT exemption for MFIs; taxation issues	MFC is following up with Armenia.
Azerbaijan	Relatively poor environment	Question on supervision of credit-only institutions	o Draft law on banks o Draft rules on licensing and the regulation of activities of non-bank credit organizations	
Georgia	NGO-based with some CU's	o No clear legal structure for microfinance o Need to define an adequate legal basis for microfinance	o Need normative acts or additional paragraphs in existing regulations to clarify legal and tax aspects o Draft law "On Microcrediting Organizations"	
Kazakhstan	Fairly developed	Normative acts and ensuring effective supervision	o New laws: Law on Microcredit Organizations, the Law on Credit Unions, and the Law on Privatization of Arable Land o Pending adoption: The Law on Credit Bureau and the Law on NGOs and Social Orders o Pending decreases in VAT rates, individual income taxes, and social taxes o Protection of consumer rights is an issue.	o Training for banking supervisors of MFIs o Information dissemination to reach rural populations o More information on micro insurance
Kyrgyzstan	CU-based; fairly developed;	o Normative acts and ensuring effective supervision	o Changes needed to legislation on taxes and on collateral o Recently enacted a law on integrating MFI/	

[5] See also III.C. Evaluation Results, below, for a list of topics that participants requested more information on.

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	starting to mature	o Need to define an adequate legal basis for microfinance	MFOs into financial markets o Recent law on accountability	
Moldova	CU-based	Need to define an adequate legal basis for microfinance	o Planned decree of the Government of Moldova no. 850 o The government is adopting new financial prudential norms this summer. o Pending: The Law on Savings and Loan Association o Being drafted: Law on Insurance of Deposits of Commercial Banks o Need amendments to various laws on savings, credit, credit associations and the Administrative Code o Need new prudential regulations for MFIs	
Russia	NGO-based & CU-based; fairly developed	o No clear legal structure for microfinance o Need to define an adequate legal basis for microfinance o Normative acts and ensuring effective supervision	o Need normative acts or additional paragraphs in existing regulations to clarify legal and tax aspects. o Draft law on credit cooperation pending with the Duma o Need improvements in the tax code for MFIs and small businesses	
Tajikistan	Soon to be fairly developed	Normative acts and ensuring effective supervision	o Draft law “On microfinance organizations in the Republic of Tajikistan” o Draft law “On Amendments and Additions to the Tax Code of the Republic of Tajikistan” o Prepared a draft on changes to the Tax Code o Developed a special microfinance regulation o Need normative acts	
Ukraine	CU-based	o Need to define an adequate legal basis for microfinance o Partial subsidizing of interest rates from the	o 2002 legislation on microfinance failed o Need to establish the State Committee on the Regulation of Financial Services o Drafting a micro leasing law o The Parliament adopted revised editions of	o Information on donors’ rules and on micro insurance

		state budget resources o Banks are using credit unions as a link to small borrowers (joint credit unions) by providing them with cheap long-term credit resources for special microcredit programs under refinancing procedures. o	the Civil and Economic Codes in January 2003 and the Law on Mortgage in June 2003. o Pending adoption: Draft laws on creditor's rights' protection, credit bureau activity, registration of real estate property rights, circulation of storage certificates, and creation of secondary market for mortgage financing	
Uzbekistan	CU-based; Relatively poor environment	o Question on supervision of credit-only institutions o Need to define an adequate legal basis for microfinance	o Parliament will discuss the draft law on microfinance in 2004.	

B. Evaluation Results, Recommendations, and Next Steps

Evaluation Results: Evaluation forms in Russian and in English were distributed to participants on a daily basis during the forum. Participants completed a total of 72 forms (16 in English and 56 in Russian) over the three-day forum.

1. Day One: Results

In terms of which sessions were the most useful in day one, in the 25 forms that the Russian-speaking participants completed and the 9 completed by English-speaking participants, the top choice was Rosenberg's session, "An Overview of Different Approaches to Microfinance Regulation and Supervision," with 16 votes from the Russians and 5 from the Anglophones.

The next two top choices for the Russians were:

1. The country delegation overviews on the legal and regulatory frameworks in the Russian Federation, Kyrgyzstan, and Azerbaijan (10 votes).
2. Galusek's session on the MFC Microfinance Mapping Study (8 votes).

Among the Anglophones, the next two top choices (in a tie vote) were:

- The country delegation overviews on the legal and regulatory frameworks in the Russian Federation, Kyrgyzstan, and Azerbaijan.
- Galusek's session on the MFC Microfinance Mapping Study.

2. Day Two: Results

On day two, both the Russian-speaking and Anglophone respondents voted the top session as Helfer's "Increasing Access to Financial Service in the USA" and the next most useful as Hideshima's on "The New Basel Accord," (although several respondents also noted that the Basel seminar was "not relevant" to the forum).

3. Day Three: Results

On the final morning, the Russian-speaking respondents rated the "Conclusions, Emerging Issues, and Next Steps" as the top session and the "Reporting Back" session as the next best session. They liked the broad scope of topics that the forum touched on, the participants' objectivity, and the discussions. Only three Anglophone respondents completed the final evaluation form; they found the "Final Remarks & Forum Closure" as the most useful session. Both groups of respondents noted that the breakout sessions were too short to have everyone participate meaningfully.

Both groups gave high marks overall to the forum logistics each day, marking them as good or excellent. This included the: forum materials, facilitators' skills and knowledge, technical experts' skills, presentations, organizational efficiency, networking time, and the quality of the hotel and luncheons. Several participants requested that the forum include a guided city tour and that tables be provided during the forum for easier note-taking and more comfortable chairs.

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Recommendations: Participants' recommendations included:

- Limiting the plenary sessions to 45 minutes and having longer breaks.
- Giving more time for the country presentations.
- Including a discussion on business law and its impact on MFIs.
- Adding a session on taxation issues and how regulators handle this in regard to MFIs.
- Adding an overall country-by-country comparison.
- Making the panel discussion longer.
- Presenting the slides in English and in Russian.
- Summarizing the reporting back.
- Using better time management.
- Sending out materials prior to the forum.
- Organizing a roundtable dialogue of MFI and central bank officials.
- Providing more information on each country's microfinance portfolio, number of clients, etc.
- Inviting policymakers with experience in regulating MFIs and with experience in poverty.
- Inviting more practitioners and fewer central bankers.
- Including more speakers from the CEE/NIS region.
- Presenting a model framework for MFIs.
- Including more concrete and less theoretical sessions.
- Having more opportunities for Q&A.
- Lengthening the forum to five days.

Participants requested more information on these topics:

- Business law and its impact on MFIs as an institution and on its products.
- Approaches to prudential regulation and supervision—more specifics.
- Market penetration in different countries.
- Estimated impact of regulation.
- Success stories and best practices from around the world.
- Fundraising.
- MFIs in the European Union including the text of laws.
- The development of microfinance in other countries.
- Microfinance supervision and regulation.
- Case studies on regulation and supervision.
- In-depth analysis of microloans.
- Practical problems of MFIs and concrete examples of MFIs from the NIS and how they were solved.
- Leasing.
- Credit bureaus.

Next Steps

It is important to keep the communication process flowing between the NIS delegations and move the integration process forward. These steps can help facilitate the process.

1. Keep the integration process moving ahead and disseminate information

Each country delegation was very interested in learning about how to move ahead with the financial integration of the microfinance sector into the formal financial sector. Each delegation articulated a country-specific action plan. To both motivate the delegations and keep the process moving forward, it would be useful for the MFC to follow up with each delegation on a regular (at least quarterly) basis and regularly request updates on the microfinance policy and regulatory environment in each country. These updates could then be posted on the MFC web site.

In addition, the MFC should add to its site links to the Microfinance Gateway, CGAP, the Inter-American Development Bank, and other microfinance web sites so as to provide its audience with additional resources. For example, some people asked for more information on microinsurance and credit/smart cards. These could be addressed through a "topics" page on the MFC web site with links and publications. This page should be regularly reviewed and updated.

The participants want to keep in touch after the forum, so the MFC could set up a more interactive page on its web site where people could share ideas and developments.

The MFC *Policy Monitor* is produced on a twice-yearly basis. Galusek requested that participants submit materials about their countries and/or suggestions about topics so that the publication remains current and relevant to its audience.

2. Expand participation to include other stakeholders and practitioners

The majority of participants were eager to involve stakeholders in the next forum and some delegations mentioned that they were already were involving practitioners in regular meetings at home. It was recommended that the delegations include practitioners in their post-forum debriefings. Developing in-country working groups with policymakers, practitioners, and donors would also help to move the agenda forward. In addition, the MFC could expand participation in its annual conference as a networking and learning opportunity for practitioners and policymakers.

3. Provide supervisory and other training

In terms of training and technical assistance needs, many participants requested that training be provided for supervisors who were responsible for assessing MFI performance. As the MFC is planning to provide this training to the Central Bank of Kyrgyzstan, the MFC could expand the program and provide this training in other countries.

The MFC is considering building on its training work and developing a "Boulder-style" training seminar that would last two to three weeks and provide practitioners, policymakers, and donor staff in the CEE/NIS with a more intensive, hands-on knowledge of microfinance. The MFC is also looking at the Southern New Hampshire University Microenterprise Development Institute (http://www.mdi-nh.org/) summer schedule for ideas on developing a longer, more varied training program.

4. Additional organizing committee and donor involvement

In terms of next steps that involve the organizing committee and donors, these include a World Bank-sponsored video conferencing series with the MFC that could address post-forum topics. The MFC will be following up on this event. OSI and the MFC can assist in arranging exchange visits or seminars on a subregional basis beginning this fall.

Annexes

- A Speaker Presentations
- B Resource Documents
- C Speaker Bios
- D Participant List
- E USAID E&E Microfinance Policy and Regulation Program Information