

Financial Services for Low- Income People in Russia

New Challenges of the Economic Boom

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ABOUT THE SERIES

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Introduction: Social, Historical, and Economic Background of Microfinance¹ in Russia

The Russian microfinance market is characterized by a unique set of social, economic, and structural characteristics. As a result, it does not always fit traditional definitions and approaches. Some aspects of the Russian social and economic situation that make the Russian microfinance market unique include:

- High population mobility and amorphous social structure during the period of economic transformation in the 1990s, weakness of inter-group relations in society, and a crisis of public morals;
- Extremely uneven population distribution, with low population density over most of the country's territory (for example, the population density in the Republic of Yakutia is 0.33 per sq. km);
- High concentration of industrial capital in the hands of the few as a result of poorly-designed privatization initiatives;
- Discrepancy between the current size of the country's economy and budget and its former economic power and international prominence (particularly felt in the 1990s to early 2000s);
- Lack of success of government measures to support microbusinesses and SMEs;
- Excessive centralization of private and public finance, which limits access to capital in regional financial markets;
- Priority development of regulated credit institutions as opposed to other types of finance providers, coupled with frequent financial and banking crises and the fact that only regulated institutions are allowed to perform banking transactions (including deposit-taking);
- Virtual absence of internal financial market and financial services for the population before the 1990s – except for savings in government-controlled savings banks and state-provided insurance – led to a lack of financial education among the general public;
- Existing programs of social support for the poor continue to focus on the distribution of benefits, such as government-provided, non-repayable subsidies and direct compensation;
- Consumers who lived through the hyperinflation of the 1990s perceive the current 30-50% annual interest rates on consumer loans as acceptable, even though the current inflation rate is 9-10%.

A period of economic decline and social crisis ended in the 1998 financial collapse. The post-crisis era of rapid economic recovery brought new challenges to donors, microfinance institutions (MFIs), elected officials, and government regulators. Microfinance institutions began to explore new niches, marketable services, and forms of operation.

1. By microfinance, the author means the entire palette of financial products designed for businesses as well as consumers, including diverse services such as credits, savings, transfers and remittances, insurance, leasing, etc. - even though many of these services are not yet common in microfinance.

Russia has achieved impressive economic growth during the last seven years. The average annual GDP growth rate was 6.5%, and the average nominal per capita GDP for 2007 is expected to be USD 7,000, a substantially higher average than in other Newly Independent States (NIS).² Favorable trends in global commodity markets have strengthened the Russian currency and increased the country's gold reserves (USD 420 billion, as of August 2007). Russian bank assets and capital increased seven-fold (in nominal terms),³ while the stock market capitalization grew almost twenty-fold, reaching USD 1 trillion. Some of Russia's economic performance indicators have been steadily closing the gap with the top industrially developed countries.

Even though the economic growth rate is high, wealth distribution in Russian society remains highly uneven. The decile dispersion ratio was 15 in 2006,⁴ exceeding 55 in Moscow and the surrounding metropolitan area. More than 20% of the population lives below the poverty line. Development among Russia's regions and the local supply of financial services are extremely uneven. The economies of rural regions continue to stagnate, causing internal migration and outflow of labor from depressed regions (in particular, Siberia and the Far East).

The above circumstances dictate the need for a new perspective on the role of microfinance⁵ in the country's financial system. In November 2006, the State Council Presidium, for the first time in recent Russian history, raised the issue of retail finance accessibility at a top-level government meeting. Addressing the State Council, President Vladimir Putin stated that more than 42% of the Russian population lacked access to banks and financial products.

Since then, the objective of building an inclusive financial system has been high on the domestic policy agenda, although the issues of quality, structure, composition, and regulation of such a system have not been sufficiently addressed. In particular, most Russian bankers still believe that providing access to banking transactions is the exclusive domain of regulated credit institutions.

Microfinance Landscape

The microfinance industry in Russia is represented by two broad groups: banks and non-banks. While comprehensive statistics are available from the Central Bank concerning the former group, data on non-banks are fragmented and impossible to verify. Moreover, such institutions are visible only if they publicize themselves or join one of the public associations.

In addition, the extent of microfinance operations run by regulated credit institutions (banks) is unclear,⁶ and the author does not know of any comprehensive research focusing on this issue. The size of loans, remittances, etc. does not guarantee that

2. The Newly Independent States were formed upon the breakup of the Soviet Union. In addition to Russia, the NIS include Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.

3. As of June 1, 2007, the total assets of Russian banks reached approximately USD 650 billion (17.03 trillion rubles), or 63% of the country's GDP, while their equity totaled USD 90 billion (2.3 trillion rubles), or 8.5% of the GDP.

4. A decile dispersion ratio is the ratio of income of the 10% richest population to the income of the 10% poorest population. In the USSR, this ratio was within 3.5 to 4.5. In post-reform Russia, it has increased since 1991, reaching a high of 24 in 2000.

5. As noted by R.P. Christen, T.R. Lyman and R. Rosenberg in "Microfinance Consensus Guidelines – Guiding Principles on Regulation and Supervision of Microfinance," the term "microfinance" may be used in a broad or narrow sense. Used in a narrower sense, it refers principally to microcredit for tiny informal businesses of microentrepreneurs, delivered using methods developed since 1980 mainly by socially-oriented non-governmental organizations (NGOs). Used in a broader sense, "microfinance" means the provision of banking services to lower-income people, especially the poor and the very poor. Like the above authors, we use the term "microfinance" in a broader sense.

6. A relatively well-developed banking sector and a specific history place Russia apart from most Asian, African or Latin American countries, where microfinance institutions have evolved. Ignoring this fact may hinder a correct understanding of the role played by conventional banks in providing finance to the poor.

the service is provided to the poor. Neither is the fact that the borrower operates a 'small or medium enterprise' (SME), as banks may offer loans of USD 1 million or more to SMEs. A more relevant indicator may be the amount of bank lending to individuals.

Banking Sector

Since late 2003, the banking system has shown increasing interest in lending to the public, leading to a consumer lending boom.⁷ Over the past five years, the volume of consumer lending has increased multifold (see graph), and its share in the credit portfolios of banks has soared from 2% to 21%.⁸ Retail deposits with banks have grown just as dynamically, encouraged by the introduction in 2004 of mandatory bank deposit insurance. As this retail finance boom is a new phenomenon in Russia, the current trends do not avail themselves to a reliable assessment of "saturation points" or "efficiency thresholds" for retail deposit and credit products offered by banks.

Banks continue to expand their credit product lines. They have lowered minimum loan amounts, reduced loan application processing times, and added new card-based (non-purpose) loans. In a highly competitive market environment, regulated credit institutions seek to maximize their customer base by relaxing their borrower screening requirements. As a result, a standard consumer credit product (USD 1,000 - 3,000) is available to virtually anyone who is capable of accessing a bank's retail branch.⁹ From the perspective of serving poor customers, there is no difference between a consumer loan and a microbusiness loan;¹⁰ the only difference lies in the actual use of the borrowed funds. This, in turn, creates unrealistic expectations concerning the ability of regulated credit institutions to make financial services (in particular, loans and remittances) widely accessible without any involvement of non-bank operators.

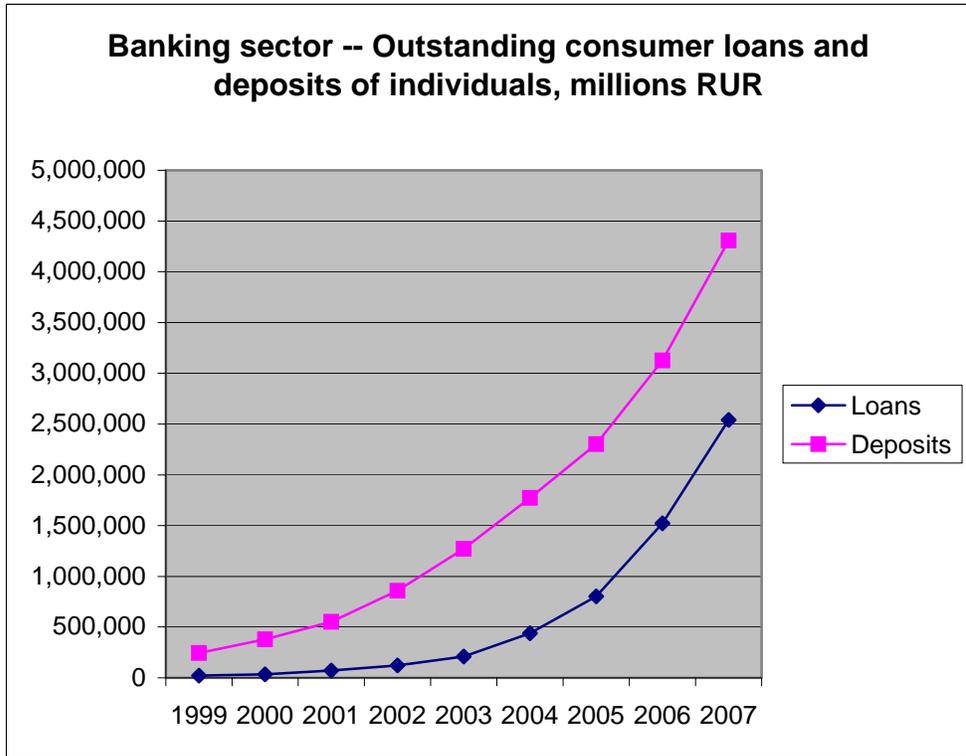
Of all of the financial market operators, regulated credit institutions have the best access to reliable, extensive, and relatively cheap (short- and medium-term) debt funding sources, including: loans in foreign currency from international financial institutions, Central Bank refinancing, interbank lending, retail deposits, etc. Therefore, the pricing, terms, and conditions of their credits are acceptable to the majority of potential borrowers, including low-income households.

7. According to the Russian Central Bank, by June 2007 (nearly three years after the relevant law was adopted), the national credit bureaus had collected information on the credit histories of more than 20 million individuals. Statistics suggest that more than 25% of all eligible citizens have borrowed from banks.

8. The aggregate consumer credit portfolio of banks approached USD 100 billion as of January 2007.

9. This strategy for building a solid clientele from a heterogeneous initial group of borrowers presumes high delinquency rates that are offset by charging high interest rates. It is commonly referred to as a 'credit cemetery' strategy.

10. Like loans offered by conventional MFIs, these loans typically are offered for small amounts initially, require no collateral, and are granted with minimal screening and documentation requirements.



The Russian experience reveals that in an environment characterized by high economic growth, a bank lending boom, and aggressive market penetration, even a substantial increase in operational costs as consumer credits get smaller does not discourage banks from microlending. In this situation, the gap between conventional bank (consumer) loans and products offered by microfinance institutions is virtually closed. Given Russia's enormous territory and low population density, **the main issue is the geographic accessibility of bank branches** – it is infeasible for banks to open branches in far-off, sparsely populated areas.

It should also be noted that Russia's banking system is very diverse. A total of 1,163 (as of January 2007) regulated credit institutions can be divided into four broad groups: major banks owned partially by the government (Sberbank, VTB, Rosselkhozbank, Development Bank – VEB), major commercial banks with federal branch networks (50 to 100 banks), small- and medium-sized regional banks, and subsidiaries of foreign credit institutions (as a rule, 100% owned by the parent bank).

To a certain extent, **state-owned banks** fulfill a social (non-profit) function by servicing the broader public, including the poor. Sberbank has retained some of its loss-making offices and branches in far-off regions; Rosselkhozbank is returning, albeit slowly, to rural areas and is offering support to rural credit cooperatives; and, VTB and the Development Bank have launched federal SME lending programs and are assessing the feasibility of lending to certain MFIs and credit cooperatives.

Additionally, Sberbank covers most of the population with such services as remittances and other money transfers, including housing, utility, and other bill payments.¹¹

In December 2006, the National Banking Council (NBC) discussed a report prepared by the Ministry of Finance entitled, "On the System of State Banks in the Russian Federation." The report emphasized the increasing role of these institutions in the country's economy and explained the main areas of their future development. Landmark events in 2007 have been Sberbank's and VTB's large-scale initial public offerings (IPOs), which allowed the banks to raise nearly USD 17 billion and expand their lending programs.

The consumer lending boom has allowed small- and medium-sized regional banks (with equities between USD 5 and 20 million) to strengthen their positions and increase their returns. Due to their small size and local knowledge, these banks may be in the best position to service poor customers, even though low capitalization limits their regional network expansion.

Non-Bank Sector

In contrast to banks, little is known about non-bank lending (microfinance) institutions in terms of their total volume of transactions, actual number of organizations, and membership. Only very rough estimates are available concerning the size of this market, growth rates, and movement. These estimates are based on comparative performance indicators of certain selected institutions¹² and on statistics and research findings published by regional and federal industry groups and associations.¹³

Credit cooperatives are the most significant category of non-bank MFI. As they grow, however, existing cooperatives leave behind their role as finance providers for the poor by raising eligibility requirements for new members and increasing the size of loans and savings. At the same time, they adopt better lending practices and raise their performance standards. Some of the biggest urban credit consumer cooperatives of citizens (CCCCs) approach smaller banks in the size of their credit and savings operations and membership. Russian Microfinance Centre (RMC) experts estimate that cumulative savings deposited with credit cooperatives doubled each year between 2004 and 2006, while their lending volume increased by 60-90%.

Notable differences are increasingly observed in the development of **rural credit cooperatives** (agricultural credit coops or "ACCs") and **urban credit cooperatives** (CCCCs). Efforts to encourage household farms to cooperate – a key element of the top-priority National Project for agrobusiness development launched by the Government in the second half of 2005 – resulted in many new ACCs. Agricultural cooperatives now have a powerful advocate and patron – the Ministry of Agriculture – along with a well-resourced lender: Rosselkhozbank. Most regions have launched rural cooperative development programs,

11. According to a survey conducted by the National Agency for Financial Research in July 2007, most people use one of two preferred options for paying their regularly recurring bills: via a post office (54% of respondents) or a branch of Sberbank (46%). Less often, they pay the service providers directly in their offices (18%), in cash (12%), in retail stores through their cash registers (10%), or using prepaid cards (7%).

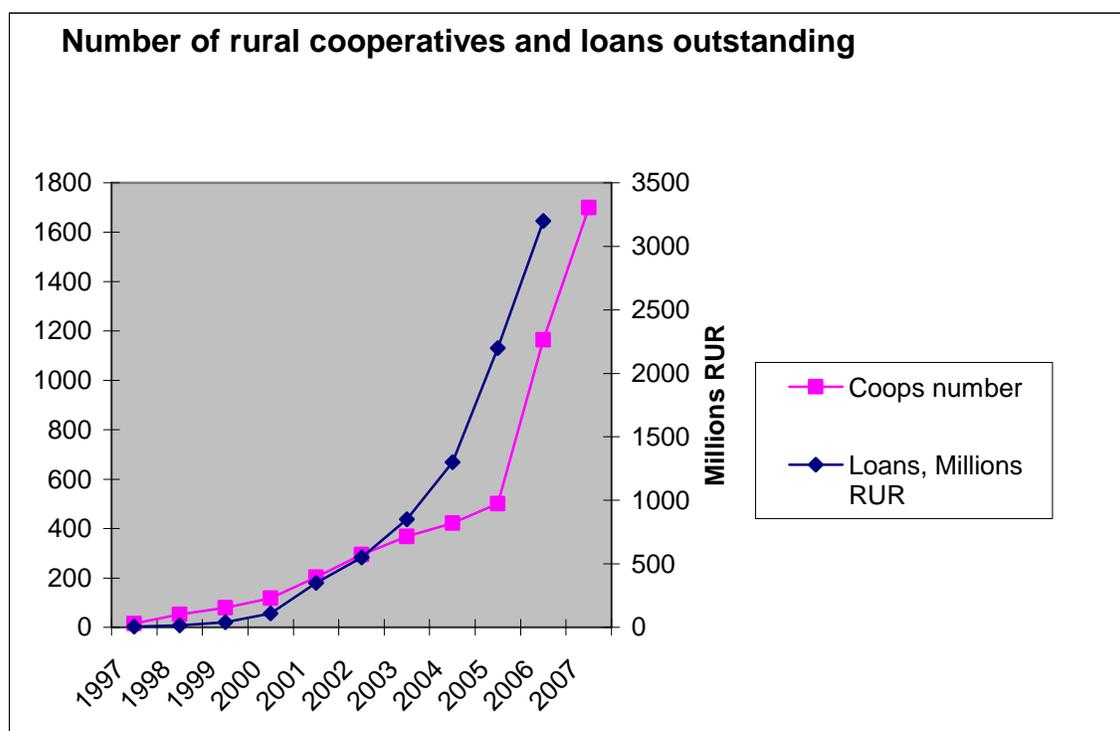
12. See, e.g., RMC's Research of Current Status and Trends of Non-Bank Microfinance Market in Russia /2003-2005/.

13. Data provided by the Foundation for the Development of Rural Credit Cooperatives, the League of Credit Unions, the Association of Credit Unions of the Central Region, the National Union of Organizations for Mutual Financial Assistance, and others.

including credit schemes.¹⁴ Amendments to the Federal Law on Agricultural Cooperatives boosted ACC integration and the emergence of uniform audit and control standards through self-regulating organizations called "review unions."

As of August 2007, 1,536 ACCs existed in Russia,¹⁵ with a total membership of approximately 110,000 (less than 0.3% of the entire rural population) and 3.2 billion rubles in loan portfolio (approx. 0.1% of all bank loans to natural persons).

14. In April 2006, the Ministry of Agriculture approved a Concept Paper on the Development of Agricultural Consumer Cooperatives, a Concept Paper on the Development of Rural Credit Cooperatives, Methodology Guidelines for Drafting Regional and Municipal Programs to Promote Rural Credit Cooperatives, and other documents.



Rural cooperatives have benefited from federal support. For example, the National Project smoothed over some of the inequality across regions after a decade of rural credit cooperative development. Thanks to support from foreign donors and programs, leading regions (such as Volgograd and Rostov oblasts) have gained valuable experience, set up second-tier institutions, and even introduced self-regulation at a regional level. In some regions, such as Krasnoyarsk Krai, this type of financial institution was nonexistent before 2005. Today, however, second-tier ACCs have been established in 23 regions.

15. Unofficial data provided by the Foundation for the Development of Rural Credit Cooperatives.

It should be noted that some rural credit cooperatives established over the past two years as part of the federal campaign are more sustainable and successful than others. By some estimates, more than half of ACCs cannot survive without governmental support. Rural co-ops capture a very limited amount of savings as compared to CCCCs, which can be explained both by the scarcity of savings in rural areas and by the

fact that this form of cooperative has been used primarily for the onlending of debt funding allocated by the Rural Credit Cooperative Development Fund (RCCDF) and Rosselkhozbank.

The growth rates of (urban) CCCCs lag substantially behind those of rural co-ops, and the urban co-ops are still unevenly distributed across Russia. In the absence of uniform supervision and a federal regulator, CCCCs (credit unions) are left to take care of their own integration and advocacy. Nevertheless, CCCCs and other forms of cooperatives (credit cooperatives, consumer societies) have been engaged in consolidation, establishment of second-tier co-ops, and enlargement of cooperative groups (associations), even though these processes have been less dramatic than in rural areas. Following the same development pattern as the rural co-ops, the League of Credit Unions¹⁶ came up with an initiative for designing a Framework Concept of credit cooperative development in Russia for 2007 through 2011.

As of August 2007, the League of Credit Unions had 202 member organizations, and the National Union of Non-Profit Organizations for Mutual Financial Assistance included, either directly or indirectly,¹⁷ 194 cooperatives from 21 Russian regions serving in total more than 205,000 member shareholders (0.2% of the entire urban population).¹⁸ In addition, data from newly registered urban credit cooperatives with small memberships usually do not find their way into official statistics, especially if the new co-op is not a member of a larger association. As a general rule, CCCCs have been set up in smaller urban communities with populations between 5,000 and 50,000, or in constituent districts of medium-sized cities with populations between 100,000 and 500,000,¹⁹ or on the basis of occupation.

State-controlled (regional and municipal) SME support funds have historically been the next most important providers of microfinance in Russia. However, their market share has decreased in recent years from 25% (2003) to 18% (2005).²⁰ There are a few reasons for this decline. First, in 2004, a few specific provisions on state and municipal SME support funds were deleted from the Federal Law on State Support of SME in Russia, causing some of the funds to face administrative and financial difficulties. Second, the growth rates in this sector lag behind those of rapidly expanding credit cooperatives.²¹ Third, “donor” regions, which have established the most successful SME development programs, have refocused their support structures from distributing loans to providing guarantees for bank credits (which usually increases the volume of one-time transactions). Since the Federal Development Bank (VEB) was established in the spring of 2007, there is a possibility that state SME support funds may form a vertically integrated structure bringing together federal and regional development institutions (banks). This in turn may result in these institutions engaging in major infrastructural projects and lending to successful small- and medium-sized entrepreneurs, in addition to providing finance to the poor.

16. The League is the largest federal association of CCCCs and their regional unions and associations.

17. The National Union's members include both cooperatives and associations of cooperatives. Some cooperatives are the members of an association but not directly members of the National Union.

18. Cooperatives are extremely diverse in their size. In early 2007, one of the country's largest cooperatives, EKPA (Urai, Khanty-Mansiyski Autonomous District), reported total assets exceeding 1.2 billion rubles and a membership exceeding 21,000, even though the entire Urai population is only 41,000.

19. There are 1,095 cities and 1,350 urban settlements in Russia today. Their populations vary between 1,000 and 10 million.

20. These numbers indicate the ratio of loans from SME support funds as a percentage of total loans extended by all MFIs.

21. In absolute figures, loan amounts made by SME support funds have been increasing, even though the number of loans has dropped at a rate of 3-5% per year. The overall number of regional and municipal SME support funds was approximately 320 in mid-2007.

There have been a number of developments in the ***private microfinance segment***. These providers are represented by a range of charter types, including non-profit institutions registered as funds or autonomous non-profit organizations (ANOs), commercial institutions registered as limited liability companies, and even regulated credit institutions (NDCOs).

Private microfinance support funds pioneered microfinance in Russia. Generally, they are financed by international programs or grants. The first microfinance schemes to encourage microentrepreneurship were launched in Russia in the mid-1990s and were supported by global microfinance networks such as Opportunity International, Women's World Banking, Counterpart International, FINCA International, ACDI/VOCA, and USAID.

These MFIs are usually characterized by extensive branch networks. For example, as of August 2007, FINCA had 18 branches in 7 Russian regions (total number of customers approx. 7,000), and the Microfinance Center Managing Company had 116 structural subdivisions operating in 45 regions (more than 21,000 customers; 788 million rubles in loans). Experience demonstrates that MFIs of this type have been more committed than others to their stated mission of providing finance to the poor. Theoretically, their customers can access loans of 1,000 rubles or less (approx. USD 40 as of October 2007).

An important restriction faced by private MFIs is a total ban on taking deposits from the public, which raises the issues of funding availability and potential transformation (including the choice of appropriate institutional types). Given a favorable macroeconomic environment, this market segment has high growth potential, making it attractive to investors. The examples of Microfinance Center Managing Company and other recently established private MFIs in Russia reflect an increasing interest of domestic investors in this type of financial institution (at the start-up stage). Another trend is "transformation" of rapidly growing private MFIs established by foreign donors into regulated credit institutions – non-bank deposit-credit organizations (NDCOs) or conventional banks – in order to access new sources of funding traditionally available only to regulated banks. Thus, between 2004 and 2005, RWMN "transformed" from a non-profit partnership into an NDCO, and having registered, began to build a branch network. In addition, FORA Fund was the first Russian MFI to establish a commercial bank: FORA Opportunity Russian Bank (FORUS).

Effective Regulation and Supervision of Microfinance

A notable feature of the Russian banking law is the indivisible link between the concepts of “*regulated credit institution*” (bank) and “*banking transaction*”²² – a link that eventually migrated to civil law and has stayed there. A major factor behind this policy has been the unyielding position of the regulator – the Russian Central Bank – which insists that only regulated credit institutions should be allowed to perform banking transactions (i.e. provide financial services). This policy has been a major barrier to the adoption of legal provisions on non-bank financial institutions (cooperatives, MFIs) delivering certain types of financial and banking services to the public.

The treatment of banks (regulated credit institutions) as exclusive providers of banking products is deeply ingrained in the doctrines of civil and financial law. In particular, only banks are allowed to make *credits* (enter into credit agreements) and take *deposits* (enter into deposit agreements). The nature of the parties to such civil law contracts is an important qualifying characteristic. Other financial institutions (such as credit cooperatives) are limited to “second rate”²³ civil law contracts instead, such as a *loan agreement* (a real contract), rather than a *credit agreement* (consensual contract); or a member’s agreement to authorize the credit cooperative’s use of his/her personal savings, rather than a deposit agreement.²⁴ Until now, there have been two ways for non-bank institutions to perform transactions similar to those allowed to banks: (1) by establishing a regulated credit institution, or (2) by inventing a new type of contract. In particular, the second option was used by legislators in the Law on Credit Consumer Cooperatives of Citizens.

Banking Sector

It took the Russian parliament almost 15 years to adopt framework legislation on banks. Starting in 1990, the Duma adopted the Law on Banks and Banking²⁵ and the first version of the Law on the Central Bank.²⁶ In 1999, in the wake of a devastating financial crisis, the Duma adopted the Law on Insolvency (Bankruptcy) of Credit Institutions,²⁷ and in 2001, the Anti-Money Laundering & Combating the Financing of Terrorism (AML/CFT) legislation²⁸ was approved. The adoption of the Law on Insuring Deposits by Natural Persons with Russian Banks²⁹ came in 2003 but was preceded by more than nine years of debate. Eventually, in 2004 the parliament approved the Law on Credit Histories.³⁰ A system of bank deposit insurance and an infrastructure of credit history providers were built over the subsequent two years. The recent emphasis on the state role in the country’s economy, finance and investment, and the strengthening of the state budget system triggered the establishment of the state-owned Development Bank (VEB) in the summer of 2007.

Under federal law, the Central Bank (CBR) is responsible for supervision of regulated credit institutions. The Law on the Central Bank established a framework for banking regulation and supervision. The CBR oversees compliance with banking

22. The list of banking transactions virtually coincides with that of the EU Directive 2000/12/EEC of the European Parliament and the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, as subsequently amended. Under the Law on Banks and Banking, banking transactions include:

- 1) taking demand and time deposits from natural and legal persons;
- 2) investing the deposited funds indicated in par. 1 on the bank’s behalf and at its own cost;
- 3) opening and maintaining bank accounts for natural and legal persons;
- 4) remittances ordered by natural and legal persons, incl. correspondent banks, through their bank accounts;
- 5) collection of cash, promissory notes, payment and settlement documents, and cash services for natural and legal persons;
- 6) purchase and sale of foreign currency in cash and through bank transfers;
- 7) taking and placing deposits of precious metals;
- 8) issue of bank guarantees;
- 9) money transfers ordered by natural persons without opening a bank account (except mail orders).

23. These contracts are ‘second rate’ in the sense that they are not clearly defined in the Civil Code, while ‘prime rate’ contracts are. For instance, the cooperative’s ‘personal savings contract’ is not mentioned in the Civil Code at all.

24. Under the Russian Civil Code, a credit agreement is a special agreement whereby a bank or another regulated credit institution (creditor) agrees to make finance (credit) available to the borrower in the amount and on conditions detailed in the agreement, while the borrower agrees to repay the credit and interest. Also under the Civil Code, a party to a deposit agreement (bank) accepts money from (or money intended for) the other party (depositor) and agrees to repay the deposit and accrued interest according to terms and conditions and following a procedure detailed in the agreement.

legislation, the CBR regulations (normative acts), and CBR-established required performance standards. The main declared purposes of banking regulation and supervision are to ensure stability of the banking system and to protect depositors' and lenders' concerns. The CBR is not allowed to interfere with the operation of credit institutions, except in cases specified by applicable federal laws.

The current banking legislation does not contain any definitions or rules addressing specialization of banks or microlending. Indeed, CBR executives have repeatedly emphasized the "universal bank" model, where the same requirements apply to all regulated credit institutions without exception, regardless of the volume or nature of their transactions. This policy rules out the possibility of relaxing regulatory and supervisory requirements for any financial institution taking retail deposits.

The law recognizes two types of regulated credit institutions: banks and non-bank credit institutions (NCOs). Of the two, only banks are allowed to take deposits from natural persons. NCOs may perform any other banking transactions or a combination of such; in practice, however, only a limited number of NCOs focus on remittance and cash collection services. Under the law, NCOs and banks are largely subject to the same requirements regarding registration, licensing, supervision, reporting, etc.³¹

Due to the non-specific nature of the framework banking legislation and the broad discretionary powers of the Central Bank, the latter's normative acts play a major role in the regulation of the banking sector. In particular, some CBR acts are designed to expand the limited range of regulated credit institutions established by the law. Thus, under strong market pressure, the CBR supported a broader interpretation of the law³² and permitted the establishment of a specific NCO type: non-bank deposit-credit organizations (NDCOs). These organizations are allowed to take deposits from legal entities, and their minimum capital requirement is 500,000 euro, which is one tenth of the capital requirement for banks. This appears to be a palliative measure, however, and so far, few market operators have shown an interest in NDCOs. Nevertheless, this type of credit institution may be of interest to private MFIs contemplating transformation.

The current boom in retail banking has pushed the CBR to take certain measures to improve access to banks and to facilitate the establishment of new offices in locations that would otherwise be cost-prohibitive. Between 2004 and 2006, the CBR normative acts were amended to expand the range of permitted transactions for "credit and cash offices" (CCOs) and "operational offices."³³ Banks offering retail products to consumers substantially reduce costs by opening these new types of outlets, rather than expensive "additional offices" (the latter cost between USD 200,000 and 500,000 to open and equip, compared to approx. USD 100,000 for CCOs). According to the relevant Central Bank Instruction,³⁴ CCOs may lend to the public and SME operators (natural persons as well as legal

25. The Federal Law of 2 December 1990 No 395-1 on Banks and Banking.

26. In 2002, this law was substantially amended to clarify the Central Bank's status and governance.

27. The Federal Law of 25 February 1999 No 40-FZ on Insolvency (Bankruptcy) of Credit Institutions.

28. The Federal Law of 7 August 2001 No 115-FZ on Combating Legalization (Laundering) of Proceeds from Crime and Funding of Terrorism.

29. The Federal Law of 23 December 2003 No 177-FZ on Insuring Deposits by Natural Persons with Russian Banks.

30. The Federal Law of 30 December 2004 No 218-FZ on Credit Histories.

31. The only differences in prudential regulation of banks and NCOs result from the acceptance of deposits, which is only permitted for banks: participation in the deposit insurance system, minimum capital requirements, etc.

32. There appears, however, to be a limit to how much such interpretation can achieve. The dynamic market requires a law establishing a new classification of credit (finance) providers. For more on this topic, see the discussion of a Draft Law on Microfinance Institutions in the section entitled "Required Policy Improvements and BB (Branchless Banking) Challenges."

33. Additional offices, credit and cash offices, and operational offices are internal structural subdivisions of banks distinguished by the volumes of their operations and the requirements that they must meet.

34. The Bank of Russia Instruction of 14 January 2004 No 109-I on the Central Bank Procedure for Decisions Regarding the Registration of Credit Organizations and Licenses to Conduct Banking Transactions.

entities). CCOs may also provide remittance and teller services to their customers. Notably, banks may open CCOs even in regions where they do not have branches (opening a bank branch costs between USD 500,000 and 1 million).

A representative office (involving reasonable costs³⁵ for setup and operations) is a preferred form of local presence for some credit institutions. A representative office may offer advice, but it is not allowed to perform banking transactions. This option has been adopted by some banks. For example, the Russian Standard Bank has 69 representative offices and only 2 additional offices, and Home Credit and Finance Bank has 71 representative offices and just one additional office. Regional representative offices also coordinate all of the bank's managers working in retail stores. Consumers fill out credit applications and have them processed and approved in the store, and they can make their first contribution at the cash register.

Another important barrier to microlending by credit institutions is the cost of loan loss reserve allocation. However, between 2004 and 2006, the CBR made some important positive changes in its rules – in particular, by allowing special treatment of loan portfolios in terms of reserve allocation.³⁶ In the summer of 2007, the CBR amended this Regulation³⁷ by deleting the rule that loans to SME support funds, credit cooperatives, and other MFIs should be considered high risk, which increases the required reserve allocation. The CBR continues to improve this Regulation.³⁸ Currently, the CBR is considering an amendment whereby a guarantee provided by a regional SME support fund will be regarded as “high quality loan security,” allowing substantially lower reserves for such credits.

Non-Bank Sector

Credit cooperatives are highly regulated microfinance providers, although their critical difference from banks lies in the absence of supervision and licensing,³⁹ and also in the absence of consistent policies (there are a range of diverse regulations and a lack of a systemic approach). From a contractual perspective, transactions performed by credit cooperatives have nothing to do with banking transactions. In the second half of the 1990s, when legislation on credit cooperatives was drafted, the banking lobby intentionally sought to marginalize financial cooperatives due to concern about potential competition in the finance market.⁴⁰

Credit cooperatives are regulated by a number of different laws, with specific provisions often conflicting, incompatible, or referring to different legal categories. These include the Russian Civil Code, the Law on Consumer Cooperatives (Consumer Societies and Their Unions) in the Russian Federation,⁴¹ the Law on Credit Consumer Cooperatives of Citizens,⁴² and the Law on Agricultural Cooperatives.⁴³

Russian law lacks established legal definitions of *credit cooperative*, *mutual lending society*, *credit union*, etc. This lack of definitions often results in terminology confusion leading to

35. The expenses incurred for a representative office include two main balance sheet accounts only: rent and salaries. The cost of opening such offices depends upon the region.

36. The Bank of Russia Regulation of 26 March 2004 No 254-P on the Procedure of Loan Loss Reserve Allocation by Credit Institutions with Regard to Loans and Similar Debt.

37. See p. 3.14.1, the Bank of Russia Regulation of 26 March 2004 No 254-P.

38. The Central Bank amends its Instructions and Regulations fairly often, sometimes twice a year.

39. This may seem counterintuitive; however, special laws (including the Civil Code) establish rules and regulations for credit cooperatives with respect to founding, structure, management, members' rights, liquidation, etc. Other MFIs are not regulated as heavily.

40. The Federal Law on Credit Consumer Cooperatives of Citizens, for example, was discussed by the Parliament for seven years and rejected by the President three times.

41. The Law of 19 June 1992 No 3085-1 on Consumer Cooperatives (Consumer Societies and their Unions) in the Russian Federation.

42. The Federal Law of 7 August 2001 No 117-FZ on Credit Consumer Cooperatives of Citizens.

contradictions in the law and in specialist literature. A *credit consumer cooperative* is a broad term applicable to credit consumer cooperatives of citizens, agricultural credit cooperatives, credit cooperatives and societies registered under the Civil Code (rather than a specific law), and also to mutual lending societies.⁴⁴

By law,⁴⁵ a ***credit consumer cooperative of citizens*** (CCCC) is a consumer cooperative established by individuals who voluntarily pool resources to meet their needs for mutual financial assistance. CCCCs may be established by residents of the same community, employees of the same company, members of the same profession, or they may be based on any other commonality of people. Only individuals (natural persons) may join a CCCC. A cooperative is not allowed to lend to non-members. The law also provides for a CCCC regulator – an authorized federal executive body. However, no such regulator has been appointed since the adoption of the law in 2001.

Certain credit cooperatives of citizens do not fit the requirements of the Law on Credit Consumer Cooperatives of Citizens - e.g. by exceeding the maximum of 2,000 members. Such cooperatives register with appropriate federal authorities under Article 116 of the Civil Code or under the Federal Law on Consumer Cooperatives as “credit consumer cooperatives,” rather than “credit consumer cooperatives of citizens.”

Agricultural Consumer Credit Cooperatives (ACCs) are consumer cooperatives established by agricultural producers (individuals and/or entities). Members are required to participate in the economic operation of the coop, which offers lending and saving services to the members.⁴⁶ An important distinction of ACCs is that their membership may include organizations as well as individuals, making it possible for them to establish second-tier (regional-level) cooperatives with a membership of grassroots (district-level) cooperatives.

To add structure to the system, the law⁴⁷ now provides for ‘review unions’ of agricultural cooperatives. Each cooperative (including credit co-ops) must join one of the review unions, which in turn join together in self-regulating organizations (SROs). The main tasks of a review union⁴⁸ are to review the cooperative’s operations for: reliability of its financial reporting; compliance with legally established accounting procedures, applicable laws, and its charter and principles; and any violations which should be corrected. The Ministry of Agriculture regulates and maintains a register of SROs covering these review unions. As noted above, the Ministry uses these powers primarily to ensure appropriate use of public funds and Rosselkhozbank resources allocated to agricultural cooperatives.

CCCCs and agricultural co-ops evolved independently of each other during the past decade and were overseen by different government departments. This explains the complexity involved in integrating the two institutional types.

43. The Federal Law of 8 December 1995 No 193-FZ on Agricultural Cooperatives.

44. This institutional form remains unclear, because the Federal Law only mentions it without any details.

45. The Federal Law of 7 August 2001 No 117-FZ on Credit Consumer Cooperatives of Citizens.

46. A provision of the Federal Law of 8 December 1995 No 195-FZ on Agricultural Cooperatives.

47. Relevant amendments were adopted in November 2006 to strengthen supervision over the spending of public funds allocated to coops under the National Project for agrobusiness development.

48. Review unions adopted the functions formerly exercised by external auditors.

Russian legislation does not define terms such as *microfinance*, *microfinance institution*, *microloan*, or *microfinance activity*, nor does it regulate **private microfinance institutions** established as non-profit funds or commercial companies (e.g. LLCs). The legal competence and status of such MFIs are determined by their respective charters.

In practice, as well as in theory, the effective legislation does not prohibit microlending by such institutions, i.e. they are allowed to lend to individuals and SME operators. The Russian Civil Code does not establish any specific requirements or restrictions for either lenders or borrowers. Legal entities and natural persons, either domestic or foreign, may enter into a loan agreement, unless otherwise established by other federal laws. The lender may charge interest to the borrower pursuant to the loan agreement's terms and conditions. Where the amount of interest is not indicated in the loan agreement, it is determined according to rules established by the Civil Code.

In the absence of a dedicated regulator, private MFIs have been challenged by the tax authorities regarding their right to lend on a consistent basis (as their main operation) without a special permission (license) or legal provision. Currently, no Russian law requires a license to make loans,⁴⁹ regardless of whether such lending is incidental or frequent and whether it is the core operation (or the sole operation) of the institution.⁵⁰

MFIs formalized as **non-profit organizations** (funds, ANOs, and others) are established, governed, and operated in accordance with the Law on Non-Profit Organizations, whereas those established as **commercial companies** operate under the Laws on Limited Liability Companies and on Joint Stock Companies.

In 2006, **pawnbrokers** suddenly raised their voice at the federal level by proposing a draft law, The Federal Law on Pawn Offices.⁵¹ The law was promptly adopted in the summer of 2007 and will become effective on January 1, 2008. The law regulates pawnbroker lending in exchange for possession of and custody over the borrower's personal items. The law establishes requirements for pawnbrokers, rules of lending and specifics of loan agreements signed between the pawnbroker and clients, provisions concerning the custody of pledged items, and procedures for debt collection against non-redeemed property. Until now, pawnbrokers have been regulated by the Civil Code, particularly by provisions about storage and custody contracts. Adoption of a new, special law would encourage the development of pawnbrokers and facilitate their lending operations. In addition, a special law would be another step towards comprehensive legal regulation of non-bank institutions lending to the public.

No nationwide statistics are available as to microlending by pawnbrokers. So far, these financial institutions have been monitored at the regional level only; no federal data on pawn offices and their operations have been collected. Roughly

49. As discussed earlier, there is a distinction between loans and credits under Russian law.

50. However, the Central Bank's position is still unclear as to whether such transactions might qualify as illegal banking. The regulator appears to allow uncertainty in order to enjoy freedom to maneuver in the future. Privately, CBR officials have expressed their willingness to allow lending as the core operation (i.e. making credits as well as loans) not only for regulated credit institutions but also for other institutions, such as cooperatives, pawnbrokers, etc. This point of view, however, is not supported by the top judicial and executive authorities.

51. The Federal Law of 19 July 2007 No 196-FZ on Pawn Offices.

speaking, pawnbrokers' volume of lending is comparable to that of credit cooperatives (or less), and their operations are concentrated in big cities. According to the Moscow City Government, in early 2005, about 200 pawnbrokers operated in Moscow, serving more than 2 million customers annually. In one year, around 5 million pledge transactions are performed in Moscow, with a total value of about 10 billion rubles (approx. USD 400 million) in total.

State Support and Promotion of SMEs

A specific element of the Russian economic legislation is the state support and promotion of entrepreneurship. It includes provisions which regulate, inter alia, the relations among borrowers, private lenders, and government authorities. Beneficiaries of support measures and programs are individual entrepreneurs, including micro and small businesses.

A fairly new development has been the recent adoption of the Federal Law on SME Development in the Russian Federation.⁵² This law will become effective on January 1, 2008, replacing the current Law on State Support of SME in the Russian Federation.⁵³ Most provisions of both laws, however, are merely declarative or framework-focused.

The Law on SME Development, for the first time in Russia, defines a *microenterprise*, a *small enterprise*, and a *medium enterprise*,⁵⁴ and it provides for collection of federal SME statistics. In addition, the law stipulates the main goals and principles of the government's SME support policies; defines types and forms of SME support (financial, in-kind, informational, etc.); and provides for special tax treatment and simplified taxation and accounting procedures.

Of special interest are provisions in the law concerning state and municipal SME support funds engaged in lending and funding programs.⁵⁵ The new law introduces a concept of **SME support infrastructure**, which includes a long list of specialized institutions, such as centers and agencies for SME promotion, state and municipal SME support funds, guarantee funds, equity investment funds and unit investment funds seeking to attract investments in SME, technology parks, science parks, innovation and technology centers, business incubators, artisan centers and chambers, subcontracting support centers, marketing and business training centers, export support agencies, leasing companies, consultants, and other institutions. It should be noted that beyond declarative provisions, the law does not make any rules directly applicable to the above institutions.

Anti-Money Laundering & Combating the Financing of Terrorism (AML/CFT)

A notable aspect of financial service delivery regulation in the new century is the AML/CFT legislation. Since 2002, Russia has adopted AML/CFT provisions⁵⁶ whereby transactions worth 600,000 rubles or more (approx. USD 24,000) or an equivalent

52. The Federal Law of 24 July 2007 No 209-FZ on the Development of Small and Medium-sized Entrepreneurship in the Russian Federation.

53. The Federal Law of 14 June 1995 No 88-FZ on State Support of SME in the Russian Federation.

54. The law defines three criteria for classifying a business as a micro, small, or medium enterprise: 1) 25% cap on participation of federal and regional authorities and some other parties; 2) maximum annual average number of employees (up to 15 for a micro enterprise, up to 100 for a small enterprise, and up to 250 for a medium enterprise); 3) maximum proceeds from the marketing of products and services (cap to be established by the Government).

55. Legal provisions detailing the procedures of financing and establishing such funds were repealed in 2004.

56. The Federal Law of 7 August 2001 No 115-FZ on Combating Legalization (Laundering) of Proceeds from Crime and Funding of Terrorism.

amount in any other currency are subject to mandatory supervision. In Russia, a dedicated body has been set up to exercise AML/CFT functions: the Federal Service for Financial Monitoring (FSFM), which is subordinate to the Ministry of Finance.

The term *financial monitoring* has been adopted to describe the AML/CFT function; such monitoring is exercised at three levels. Level One consists of institutions that perform operations with cash and other assets. These include credit institutions, insurance and leasing providers, stock market operators, real estate companies, postal and telegraph service providers that effect money transfers, and pawnbrokers. Level Two is the FSFM, the authorized government agency responsible for financial monitoring. It collects and screens data fed from Level One for signs of money laundering. At Level Three, law enforcement authorities investigate suspicious cases filed by the FSFM.

The current system of financial monitoring in the Russian Federation uses banks as a primary source of data for AML/CFT purposes. AML rules for Russian banks, however, are less sophisticated than those employed in many other countries. For instance, regardless of the specifics of transactions requested by a customer, a Russian bank cannot refuse to open an account, make a remittance, or accept or disburse cash. The Bank of Russia, however, is empowered to draft and issue administrative regulations to enable AML/CFT, in coordination with FSFM.

Notably, of all microfinance providers, only banks and pawnbrokers are subject to AML screening, while credit cooperatives, SME support funds, and private MFIs are left unmonitored.

Required Policy Improvements and Branchless Banking Challenges

Russian laws regulating financial (including microfinance) institutions are fairly comprehensive. Over the past twenty years, a market economy has been built in the country, while Russian law has established fundamental institutions and frameworks to facilitate commodity-money relations. Civil law and special legislation provide for detailed regulation of most financial intermediaries, including: credit institutions (banks), stock brokers, credit cooperatives, leasing and insurance companies, pension and investment funds, state SME support institutions, and infrastructural organizations (such as stock exchanges, credit bureaus, stock registers and depositaries, etc.). At the same time, various financial market regulators have been established, such as the Central Bank, the Federal Service for Financial Markets,⁵⁷ the Federal Anti-Monopoly Service, the Federal Service for Financial Monitoring, and the Federal Service for Insurance Supervision.⁵⁸

57. This service has the power to regulate and oversee stock market operators, asset management companies, exchanges, pension funds, credit bureaus, and participatory construction schemes.

58. This service is also authorized to oversee the insurance market and insurance companies.

However, the rapid growth and evolution of financial markets has created new challenges for legislators with respect to: addressing emerging financial innovations (derivatives, securitization, netting, etc.); fine-tuning certain legal instruments (taxes, supervision, civil law provisions for cession of claims, pledge, bankruptcy, etc.); and describing the new phenomena and processes caused by the increasing sophistication of the market and specialization of operators (collection agencies, credit brokers, new types of credit institutions, etc.). An additional factor is the cautious legal mentality that is common in Russia – even though the law formally stipulates the principle that “anything not prohibited is permitted” and guarantees the freedom of contract, government supervisors, regulators, and market operators prefer that arrangements and rules of conduct be explicitly stated in law. This approach, in their opinion, guarantees maximum legal certainty, even though it has the downside of being excessively restrictive.

This growth and evolution within the financial and lending market calls for the development of a new, more detailed framework for the classification of financial providers. In the banking sector, small local and regional banks are similar to MFIs and could be distinguished legally from large credit institutions that operate nationwide. In addition, large credit cooperatives look and act like banks (with respect to assets and clients) and should be regulated like banks. Also, some banks that are classified as universal banks act as building societies or mortgage banks, but without a special legal framework.

Draft Law on Microfinance Institutions

The search for a domestic model of microfinance regulation is closely linked to the discussion of whether Russia needs a special law on microfinance institutions (microlending). According to industry practitioners, such a law must recognize microfinance as a part of Russia's financial system that is complementary to the traditional banking sector. Currently, a working group is drafting this law under the auspices of the Russian Ministry of Finance.

The Russian microfinance industry cites models adopted in neighboring countries. Between 2002 and 2006, four NIS countries (Kyrgyzstan, Kazakhstan, Georgia, and Uzbekistan) adopted special legislation to regulate microfinance institutions. Certain members of the Commonwealth of Independent States (such as Armenia) have chosen to address microfinance by adding provisions to existing laws, rather than by adopting new legislation.

Nonetheless, the question of whether Russia needs such a law – and if so, what it should regulate – merits serious contemplation. As noted above, Russian law – as opposed to less-developed legal systems of other NIS countries – already provides for comprehensive, in-depth regulation of most microfinance providers, such as banks, credit cooperatives, state SME support

funds, and pawnbrokers. Therefore, the scope of a new law should cover only “pure” microfinance institutions without a special legal status or a legally defined competence that lend to natural persons and legal entities (microlending institutions). Such MFIs include organizations of diverse charter types and institutional forms, including nonprofit funds, ANOs, LLCs, and others. Each of these forms is already regulated by a specific law; therefore, a law on microfinance should only: (i) confirm that certain institutions are allowed to make microloans; and (ii) establish relevant non-prudential regulatory requirements for MFIs (for example, with respect to corporate governance, reporting, and other non-prudential issues). In addition, the law should clearly assign an authority to supervise the microfinance sector, which should increase confidence in the sector (see below).

Initially, the drafters suggested that the law should only cover nonprofit MFIs. However, more recent versions of the draft (summer 2007) cover commercial MFIs as well (except credit cooperatives). The draft defines a *microloan* (a loan of up to 1 million rubles (approx. USD 40,000)), *microleasing*, and *microfinance activity*. It provides for registration of microfinance institutions and for mandatory external audits of larger MFIs. It also provides for a government regulator – an executive government agency responsible for supervision of the microfinance market and for maintaining a register of MFIs. Other provisions of the draft law pertaining to MFI operations and procedures are optional or effectively duplicate existing civil law provisions.

The approach described above may have negative practical implications. First, from a systematic perspective, a question will immediately arise as to whether institutions that are not explicitly mentioned in the above law or are not registered with the regulator are permitted to lend anyway, revisiting an old debate over whether one should seek permission to lend.⁵⁹ Second, regulatory logic presumes that legislators will stipulate certain rules and requirements restricting the operations of regulated MFIs (i.e. equity requirements, lending procedures, loan size, and other standards). The author believes that such restrictions would be inappropriate today. Third, lawmaking experience suggests that whether the market likes it or not, a new law may subject microfinance to strict supervision and licensing requirements to operate. A registration procedure stipulated by the draft may end up being almost as burdensome as licensing. Such developments will create a new source of administrative burdens for the market.

Despite the aforementioned risks and limitations, however, even an imperfect microfinance law has the potential for boosting industry growth, attracting new foreign and domestic investors, and creating more certainty. MFIs are in the best position to carry out the mission of microfinance and improve access in the most depressed and remote areas. The introduction of MFI regulation and supervision may encourage banks and other

59. At the same time, the author should note that there is already a debate as to whether nonprofit funds, ANOs, and other “pure” microfinance institutions without a special legal status are permitted to engage in microlending. At least the draft law would explicitly grant legitimacy to the types of institutions listed in the law. For greater flexibility, a specified governmental authority could be entitled to add other institutions to the list of institutions that are permitted to lend.

financial market stakeholders to finance such institutions' operations.

Therefore, the adoption of a special law on MFIs has benefits as well as drawbacks. Weighing these benefits and drawbacks is a complicated task that requires additional data and research. The author would propose a two-step approach: first, the Government or relevant Ministry (such as the Ministry of Finance) could develop a microfinance policy that bases regulatory guidelines on international best practices regarding issues such as permissible MFI institutional types, prudential regulations, and licensing requirements; second, a special law and regulations that are in line with the microfinance policy could be drafted.

Draft Law on Credit Cooperatives

For over five years, the Russian parliament has been debating the Government-sponsored draft Federal Law on Credit Cooperatives. Drafted in 2002, this legal act was designed to smooth out the “distortions” accumulated over the years in the sphere of credit cooperative regulation.

On one hand, after years of parliamentary debates in the 1990s, a draft law on credit cooperatives ended up becoming the Federal Law on Credit Consumer Cooperatives of Citizens, banning legal entities from becoming cooperative members and creating a barrier to a multi-tiered system. On the other hand, agricultural cooperatives – as well as the underlying legal framework – have evolved independently of the above under the auspices of the Ministry of Agriculture, governed by the Federal Law on Agricultural Cooperatives. The latter law allowed more flexibility in the establishment of rural credit cooperatives, offering multiple choices to the market.

The Ministry of Agriculture originally designed the draft law on Credit Cooperatives in 2002 to elaborate upon the relevant provisions of the civil law and the Law on Agricultural Cooperatives; to remove a membership cap and other restrictions affecting CCCCs; to establish a procedure for setting up second- and third-tier cooperatives; and by doing so, to encourage the development of cooperatives in rural areas. Formally, the adoption of a Law on Credit Cooperatives was mandated by the Civil Code,⁶⁰ which stipulated that the legal status of consumer cooperatives should be defined by specific laws on consumer cooperatives.

60. P.6, Art. 116 of the Civil Code.

The draft law provides definitions of *credit cooperative*, *member shares/contributions*, *shareholder*, and *cooperative funds*. It sets out incorporation and governance procedures, determines the legal treatment of cooperative assets and finances, and describes the governmental regulation of credit cooperatives. It should be noted that the structure of this law reflects that of the CCC Law, raising criticism due to duplication of legal provisions between the two laws.

The draft law was adopted by the parliament in the first reading, but then the drafters encountered a range of problems. As mentioned above, rural and urban credit cooperatives have followed different routes in their evolution, due to the launch of the National Project for agrobusiness development.⁶¹ The 2006 amendments of the Agricultural Credit Cooperatives (ACC) Law⁶² made a universal policy framework even less likely. In addition, the situation prompted heated debates around the issues of state supervision of credit cooperatives and the appropriate supervisory authority. Most market operators have opposed regulation by the Central Bank; in addition, the Central Bank is not yet comfortable dealing with this relatively new sphere. It is not clear which criteria should be used to differentiate larger cooperatives that are subject to prudential supervision from smaller entities that are not. Such criteria are difficult to establish due to a lack of reliable federal-level statistics.

61. See p7 above.

62. These amendments introduced "review unions," a special oversight body for ACCs.

Therefore, the relevance and potential advantages of adopting a single overarching law on credit cooperatives are questionable. At a minimum, such a move should go hand-in-hand with amending the CCCC and ACC laws.

Draft Law on Consumer Lending

The banking sector is also expected to undergo large-scale policy reform. As the Russian financial market evolves, it becomes increasingly clear that the current regulation of the banking sector and the broader financial sector – in particular concerning debt security (collateral), the application of certain civil law provisions, and financial innovation – unnecessarily restricts the market. Specifically, the current regulation hinders the growth of lending to producers and retail consumers. In addition, the lack of effective risk management strategies has led to heightened credit risk, interest rate risk, and currency exchange risk for the entire financial system. Ultimately, this places the Russian economy at a competitive disadvantage.

The Russian banking sector and capital market face the urgent task of upgrading certain domestic legal provisions in accordance with best practices developed by more advanced (European) financial markets. However, the policy objectives set out in the Banking Sector Development Strategy for the period 2005-2008⁶³ remain largely unmet. Over the past two years, the Russian parliament has considered just eight draft laws out of more than thirty provided for in the Strategy Paper. The drafts that they did consider – while important – tended to be of specific or secondary nature, whereas the most challenging and fundamental issues highlighted in the Strategy Paper have been largely ignored.

63. The Government's Official Statement of 5 April 2005 No 983p-P13.

One of the documents waiting to be adopted is the Draft Law on Consumer Lending. Government experts have worked for three years and have prepared several substantially different versions of the draft.

The Draft Law on Consumer Lending is a comprehensive document that – in addition to protecting the borrower/consumer – provides measures to secure the interests of lenders. It introduces the concepts of *effective annual interest rate*, *credit card*, and *collection operations*; and it sets out the rules for disclosure and for handling delinquencies. Related amendments are to be made in the Law on Advertising, the Civil Code, the Civil Procedure Code, the Criminal Code, the Labor Code, and the banking legislation. The Draft Law was introduced in the Duma by deputies in October 2007. The draft entitles the borrower to better information concerning the actual cost of the credit product, and it establishes terms and conditions allowing the borrower to withdraw from a credit agreement or make a prepayment.

An important issue is whether the new provisions on consumer lending will or will not cover microloans. Should the law address this issue, microloans and MFIs must be legally differentiated from other types of lending and other lenders, respectively. This problem can be avoided if legislators limit the scope of the law on consumer lending to the banking sector (and to credit agreements between customers and their banks).⁶⁴ On the other hand, exempting MFIs from compliance would reduce their costs, but at the same time could worsen service quality.⁶⁵

Heated discussions continue regarding the regulation and calculation of effective annual interest rates on consumer credit. So far, the public is less concerned about the amount of effective interest rate and more about the lender's honest disclosure of this amount to the borrower. However, the possibility cannot be ruled out that the interest rate may eventually come into focus, especially in microfinance where the rates are higher.

Branchless Banking

In Russia, branchless banking (BB) is a relatively new phenomenon.⁶⁶ At the beginning of the 1990s, the country adopted very restrictive banking legislation which designated banking operations – such as deposit-taking, lending, and remittance services – exclusively to regulated credit institutions. Rapid growth of BB (in the remittance segment) started in the summer of 2006 following amendments to the banking legislation that enabled retail agents to accept rent, utility, and telephone/internet payments from the public on behalf of banks. The law also held banks responsible for the actions of their retail agents. This development triggered an explosive growth of “cash-in”⁶⁷ payment terminals. At the same time, it caused an increase of cash-in ATMs, which are becoming progressively more relevant with the growing volumes of consumer lending (including credit cards).

The strict AML provisions require direct customer identification by bank staff for each transaction. The law does not make many exceptions based on the nature, size, or volume of financial transactions.⁶⁸ This restriction is a major barrier to offering remote customer services through branchless banking. In

64. This issue currently is at the center of the drafters' debates. Another position on the issue would be to have the law cover all lenders entering into retail loan agreements, credit agreements, and agreements on deferred payment or payment in installments (purchase on credit).

65. An important question related to this discussion is whether and under what conditions the MFI client should be recognized as a consumer (as opposed to an entrepreneur). The special Law on Consumer Protection defines general principles, and rules for consumer protection under sale, supply and servicing agreements as well as contract of work and labor also apply to consumer lending.

66. According to CGAP: “Branchless banking represents a new distribution channel that allows financial institutions and other commercial actors to offer financial services outside traditional bank premises [branches]. Some models of branchless banking . . . can be seen as modest extensions of conventional branch-based banking. Other models . . . offer a distinct alternative to conventional branch-based banking in that customers conduct financial transactions at a whole range of retail agents instead of at bank branches or through bank employees. What makes branchless banking work are information and communication technologies that customers, retail agents, and banks or nonbank e-money issuers use to record and communicate transaction details quickly, reliably, and cheaply over vast distances.” CGAP Focus Note No. 38, ‘Use of Agents in Branchless Banking for the Poor: Rewards, Risks, and Regulation.’ (October 2006), available at http://www.cgap.org/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Documents/FocusNote_38.pdf.

practice, however, there is a gap between the strict rules and actual business practices, particularly where new technology is used.

More than two years ago, the first 'embryonic' prototypes of the "nonbank-led model"⁶⁹ emerged in Russia. GSM phone operators offered customers virtual accounts that accepted customer deposits to be used for buying products and services. The number of potential recipients of such payments has been growing steadily, and now includes more than 1,000 companies. In addition, web-based payment systems and prepaid cards are the fastest-growing market segment. In practice, these schemes are similar to electronic money (e-money),⁷⁰ but from a legal perspective, there is no definition of e-money in the Russian law. Money transfers (of extremely low transaction amounts) prevail in such systems, while deposit and lending operations are absent. Credit institutions often participate in such systems only formally; by involving a bank, operators avoid facing charges of illegal banking.

The market regulator (the Bank of Russia (CBR)) finds it difficult to keep pace with the emergence of new technologies that allow payments via the Web and through GSM operators. The Central Bank's official position appears to be that this segment of Russia's financial market is still small, underdeveloped, and requires more research before it effectively can be regulated. Besides, this segment currently is too small to have a negative overall impact on the country's finance and banking system. Therefore, the CBR currently does not see any need for preventive regulation.

Since early 2007, there has been discussion about using post offices more widely for remittances and deposit/credit transactions. The current law only allows post offices to perform money transfers on behalf of the public. Similar questions have been raised with regard to microfinance institutions.

It has been proposed that major retail stores should be required to accept payment by cards. This summer, two bills were launched in the Duma that are designed to promote card payments. One bill⁷¹ would empower regional governments to establish an average monthly turnover threshold for companies and individual entrepreneurs accepting payments from customers for delivered goods and services (based on the previous six months' reported data); should a company/entrepreneur exceed the regional average threshold, the company/entrepreneur would be required to accept card payments for goods and services. In addition, proposed amendments of the Tax Code⁷² are designed to encourage loyalty-enhancing cash rebate programs by card issuers.

At its current level of development, BB has had little impact on banking sector outreach; the emphasis has been on improved services for traditional clientele. These services have developed in regions where banks have a major presence.

67. "Cash-in" terminals accept payments or deposits, while "cash-out" refers to the withdrawal of funds.

68. Under the law, customer identification is not required for exchange of currency in an amount below 15,000 rubles (approx. USD 600); or for the payment of taxes, utility and communications bills, and alimony of up to 30,000 rubles (approx. USD 1,200).

69. According to CGAP: ". . . In the typical nonbank-led model of branchless banking, customers do not deal with a bank, nor do they maintain a bank account. A bank may not be involved at all. Instead, customers deal with a nonbank firm – either a mobile network operator or prepaid card issuer – and retail agents serve as the point of customer contact." CGAP Focus Note No. 38 (see Footnote 66).

70. Under EC EMI Directive 2000/46/EC, e-money is "monetary value as represented by a claim on the issuer which is: (i) stored on an electronic device; (ii) issued on receipt of funds of an amount not less in value than the monetary value issued; (iii) accepted as means of payment by undertakings other than the issuer." See http://eur-lex.europa.eu/LexUriServ/site/en/oj/2000/l_275/l_27520001027en00390043.pdf.

71. Draft Law amending Article 284, Part Two of the RF Tax Code and Article 26.3 of the Federal Law on General Principles of Legislative and Executive Government in Russian Federation Subjects.

72. Draft Law amending Articles 23 and 25, Part Two of the RF Tax Code.

From the Banking Sector Strategy to an All-Inclusive Financial System

Today, two finance-oriented agendas are being implemented in Russia: the Banking Sector Development Strategy and the Financial Sector Development Strategy. Both strategy papers, however, concern ***the finance industry, rather than the public***. The first targets the banking sector, while the second is relevant to the capital market. However, the social agenda today is broader: policy-makers seek to ensure that every citizen benefits from the achievements of the country's financial sector.

Legislators have announced a plan to develop a new, comprehensive document defining a Strategy for building a financial system catering to all population groups – an all-inclusive financial system accessible not only to traditional bank customers but also to those who, for various reasons, either are not aware of available bank services or cannot access such services. The author recommends that the Strategy address the following issues:

Institutional and Regulatory Reform

This document should outline the institutional and regulatory reforms needed to improve access to financial services across the country. The document should reflect two dimensions. The first dimension is the structure and composition of such a system. It should provide for the operation and effective interaction of banks, credit cooperatives, microfinance institutions, specialized financial companies, mutual lending societies, mobile phone companies and internet providers, electronic payment systems, and e-money issuers. The second dimension relates to the technology underlying financial operations. This includes various mechanisms of remote financial service delivery, mobile phone-based and internet banking, the use of postal services, retail agents, and holding structures. This new technology will enable branchless banking using card-based or cellphone-based systems, payment terminals, web-based systems, or e-money. All of the aforementioned financial and communication intermediaries should be able to utilize this technology.

Financial Literacy

A program of financial literacy should be included as an important element of the new Strategy. Fast and sustainable development of the country's economy – in addition to the introduction of new, more efficient technologies of production and financing – depends upon the ability of the public to adopt and benefit from such technologies. The public can participate effectively in the modern economy only if they know how to benefit from the new financial products. Confident use of such products is impossible without some basic knowledge and skills.

Today, most Russians lack education in the areas of personal finance and family budget planning, and they receive hardly any information (other than advertising) about available financial

products. As a result, people encounter serious difficulties when they choose insurance or mortgage products, or consumer credits or deposits, and they have only a vague idea of their own tax obligations or pension entitlements. Improved access is not an effective solution to social problems without public awareness and education. On the other hand, educational programs will be of merely theoretical value for many Russians if not accompanied by financial service outreach to far-off provinces.

Conclusion

Current laws and policies that regulate Russia's financial market face large-scale reforms. This fact may not be fully understood yet by all authorities concerned, but dynamic market growth and technology penetration are rapidly breaking through the conservative approaches of policymakers. We should not, however, overestimate the Russian regulators' commitment to innovation. We cannot expect them to speed up the adoption of enabling policies for non-banks until and unless the objective inability of banks to reach certain populations becomes obvious.⁷³ Regulatory issues and appropriate regulatory responses will become clearer in the future, once the current banking sector boom subsides and the size and profile of the unbanked population are better understood.

73. It is possible that a debt crisis and liquidity squeeze may stimulate modernization of the regulatory framework. Such a crisis could indicate a "plateau" or a trend of linear (rather than exponential) growth of lending volumes; identify weaknesses and gaps in the legislation; test the viability and reliability of institutions and the infrastructure built over the recent years; and eliminate weaker market players.