Non-bank Microfinance Development Trends in Russia

2003-2004/

Analytical Paper

Moscow 2006

This research was supported by a grant from FINCA International.

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This material has been commissioned by the Russian Microfinance Center and prepared by the SME Resource Center jointly with the Russian Microfinance Center as part of the project *Promoting the Legal Environment for Microfinance in Russia*.

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Summary

In an environment characterized by a number of unmet social and economic needs, it is extremely important for the Russian society to improve access to finance through microlending for those borrowers who find it difficult to access bank credits.

Comprehensive information on the current market situation, operators, structural and quantitative parameters is key to designing effective policies to promote and monitor microfinance programs and to identify potential areas for investment.

This paper is based on the second round of annual monitoring of Russia's microfinance market, using the same methodology as the first round. Periodic market surveys using the same methodology, in addition to providing information on the current market situation, allow us to track any changes of the market capacity and parameters. The first survey using this methodology was conducted in 2004 and looked at the performance of microfinance institutions in 2003. The second round looked at the microfinance market performance in 2004.

These findings will provide all stakeholders, such as government, investors, financial market operators, business associations, and representatives of the academia, with a consolidated qualitative and quantitative overview of the microfinance services market and its dynamics.

Another, equally important objective of our monitoring was to provide a case-by-case analysis of key microfinance providers and to build their profiles. The use of a uniform methodology, regardless of the institution's organizational and legal format, status and history, allows us to compare across different types of microfinance providers. These case-by-case data will be useful to potential investors and donors in and outside Russia in choosing their best strategies for investing in the Russian microfinance.

The findings of the second survey will be published in the electronic and print *Catalogue of Russian Microfinance Institutions (MFIs)*, featuring profiles of microfinance service providers.

This research was commissioned by the Russian Microfinance Center (RMC) and carried out by the SME Resource Center with RMC's methodological support.

Key Findings

The findings of annual sample-based surveys of microfinance institutions demonstrate a progressive growth of this market segment. This method of debt financing is increasingly common in Russia, gradually becoming a part of the country's finance system, complementing conventional banking and providing access to loans for those businesses and consumers who do not meet banks' requirements. The overall growth of microfinance operations is estimated to be 1.3 – 1.8-fold between 2003 and 2004.

The growth was observed both in the volume of credits to SME - the overall increase of loan portfolio and amounts was 150% across the sector - and in the number of borrowers that increased by one third over the past year.

Credit cooperatives were the fastest growing type of MFIs in 2004. Specifically, credit consumer cooperatives of citizens increased their membership by more than 70%, virtually doubling their portfolios and loan amounts.

In 2004, alongside the growth of operations, MFI performance improved, making microfinance providers even more efficient and financially sustainable. Thus, operational sustainability rates in a group of comparable MFIs[1] grew by an average of 10 percent points (hereinafter – pp.) between 2003 and 2004.

In 2004, as in the previous year, microfinance portfolio quality was fairly high. In particular, the risks of most microfinance institutions were comparable to best practice. In one out of two microfinance institutions, portfolio at risk of more than 30 days' delinquency was within 3%, while the average delinquency rate of more than 30 days for outstanding loans was 1.9% or less in half of all MFIs surveyed, comparable to similar performance indicators of commercial banks.

The market's structural parameters, namely: the types of operators, geography, client base, and the purposes of loans, did not change significantly.

By expert estimates based on a sample survey, the market for microloans was at least 7.8 to 9.2 billion rubles on 1 January 2005. In 60% of cases, the loans were made for business purposes, and in more than 80% these were short-term loans. The averaged maximum annual interest rate written in the institutions' policies was 46%, and the minimum interest rate was 24% annually. In 2004, microfinance institutions built a client base of 240 – 264 thousand.

Although the current microfinance market growth is already significant, we can expect further growth in the future, due primarily to the high unmet demand for microfinance services, high efficiency of operations, and easy entry of new institutions into the market.

In addition to quantitative growth, we should expect further institutional development. We have already seen some initial important transformations in this market:

- A leading microfinance institution that formerly operated as a non-profit partnership – the Russian Women's Microfinance Network - was transformed into a non–bank deposit and credit institution (NDCO). This development is extremely important for the institutionalization of the Russian microfinance market, evidencing the emergence of a new market niche comprised of more sophisticated operators seeking investment and debt funding to finance their microloan portfolio. In the future, this market segment, on the one hand, may admit those banks which were excluded from the deposit insurance system. On the other hand, major current microfinance operators may chose to re-register as NDCOs at some point.
- The largest microfinance fund in Russia – the FORA Fund – established FORUS Bank, with microfinance as its main area of operation.

[1] Hereinafter, by ***microfinance institutions (MFIs)*** we understand non-bank institutions providing microfinance services as their main operation or as part of their overall operations.

- Those institutions that formerly operated as representative offices of international MFIs are currently in the process of re-registering as Russian commercial and non-profit organizations.

These developments are consistent with the broader international trends of microfinance market evolution, where microfinance institutions without membership increasingly seek investment and commercial debt to finance their microloan portfolios. This trend is likely to result in a significant increase of microloan volume and at the same time improve the sector's transparency and investment attractiveness.

What is Microfinance: Background Information

Microfinance means legitimate provision, to SME and individuals having limited access to conventional banking services, of financial and complementary social services aimed, from the macroeconomic perspective, at mitigating social tensions in society, improving the standards of living, promoting employment and enterprise development. For the purpose of this research, microfinance includes the provision of services worth 300,000 rubles or less.

The original list of institutions to be surveyed in the second round took into account the first round findings and included about 400 institutions (plus their associations, unions and networks, each representing a certain number of MFIs). We received a complete set of data from 183 institutions (without affiliates, territorial divisions and networks) in 54 subjects [regions] of the Russian Federation (with affiliates, etc. – 750 outlets).

These are the most active and transparent microfinance providers. By expert estimates, the surveyed institutions account for 25-35% of all microfinance providers that operate legally in the Russian market, while their volume and scope of operations cover between 40% and 50% of the market.

A Typology of Microfinance Providers

This survey looked only at non-bank MFIs. Based on the most common organizational and legal formats, the following types of microfinance providers were identified:

- Credit consumer cooperatives of citizens (CCCC);
- Agricultural credit consumer cooperatives (ACCC);
- Credit cooperatives (consumer societies, CC);
- State-sponsored (regional and municipal) SME support funds;
- Private funds;
- Private commercial MFIs;
- Non–bank deposit and credit institutions.

As a main focus of this research, we analyzed the developments in Russia's microfinance industry.

Similarly to our finding in 2003, more than 60% of the market operators were cooperatives, primarily credit consumer cooperatives of citizens. In 2004, the proportion of microfinance operators registered as cooperatives increased from 62% to 67% (Diagram 1).

Funds were the second major type of MFIs - primarily state-sponsored funds that accounted for 21% of all microfinance providers in our sample in 2004 (as opposed to 25% in 2003). It is possible that this drop was caused by the amendment, in August 2004, of the Law on State Support of Small Enterprise, by striking out the provision on the Federal SME Support Fund. While the amendment did not directly affect regional and municipal funds, some of them faced administrative barriers that they had to overcome to continue their operations. This factor must be taken into consideration in designing further efforts to improve legislation on microfinance.

Private funds account for 8% of the MFIs surveyed.

Diagram 1 ***A Typology of Microfinance Providers (without autonomous divisions, affiliates, and networks), number (2004 to 2003) and % of the MFIs surveyed: external circle - 2004, internal - 2003***

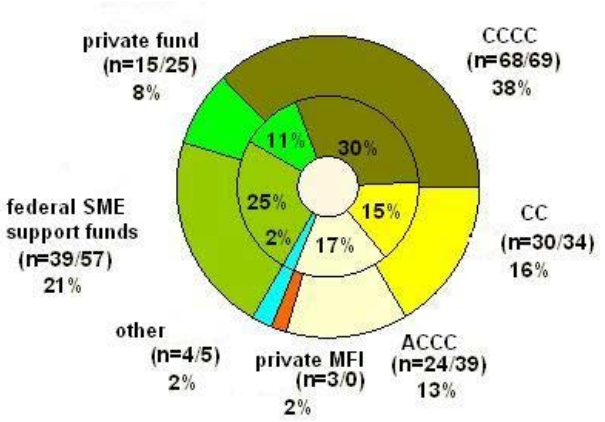
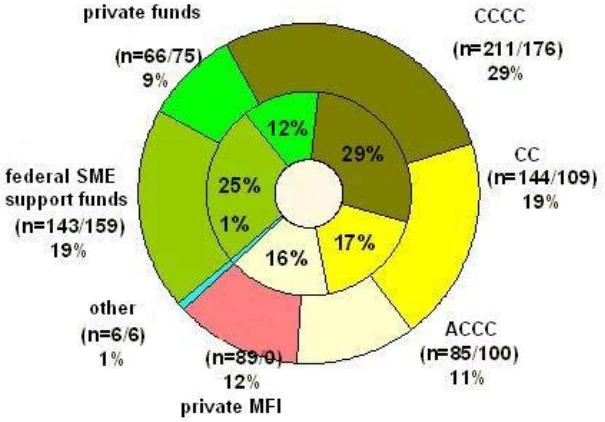


Diagram 2 ***A Typology of Microfinance Providers (with autonomous divisions, affiliates, and networks), number (2004г. to 2003) and % of the MFIs surveyed: external circle - 2004, internal – 2003***



The above percentages of MFIs did not account for autonomous affiliates and branches of these institutions. In fact, more than one third of the surveyed MFIs had such affiliates, with different affiliates and parts of the networks often located in different regions.

In 2004, private MFIs were the ones with the most branches - up to 49 autonomous divisions (the Center of Microfinance, Kazan).

Similarly, regional state-sponsored funds with their networks of municipal funds can be fairly large.

CCCCs often have many branches as well.

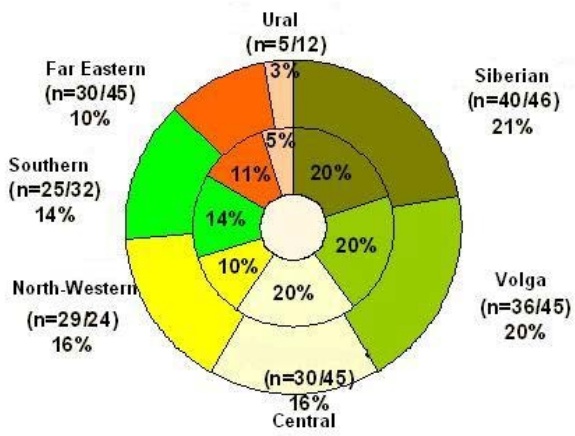
If we include all affiliates, autonomous branches and networks, the proportion of private MFIs will increase from 2% to 12%, and the proportion of consumer societies will increase from 16% to 19% (Diagram 2).

The history of key providers' operations is recognized as a factor of market sustainability: the more providers with a long history, the more sustainable the market. Currently, virtually one third of the surveyed institutions have an established presence of more than six years in the microfinance industry.

The Geography of the Russian Microfinance

Microfinance providers are distributed unevenly over the Russian territory.

Diagram 3 ***Geographic distribution of MFIs, % of the MFIs surveyed (internal circle – 2003, external – 2004)***



The pattern of geographic distribution is determined by a number of factors, such as the geography of international microfinance support programs operating in the Russian territory, availability of enabling regional legislation, and importantly, the attitude of regional and local governments to SME, credit cooperatives, and SME support funds. Of course, other factors that contribute to the geographic pattern of the Russian microfinance include the level of regional economic development, primarily finance markets and customer base.

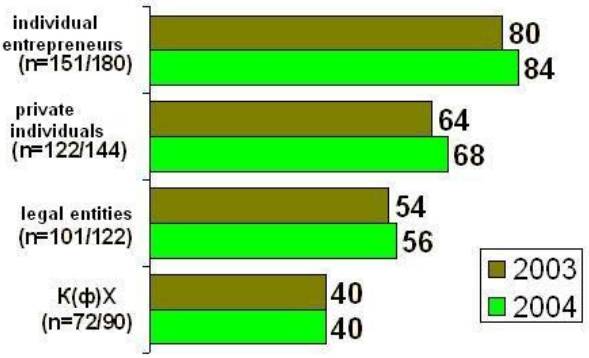
In the riskiest of Russian regions we either did not find any functional microfinance institutions, or found a single microfinance provider per region. It may be explained by the overall underdevelopment of the local market infrastructure. Microfinance institutions cannot operate effectively and carry out their functions without certain institutional prerequisites to enable this debt mechanism, and without a minimum level of the market economy development.

In such underdeveloped regions, the emergence and growth of microfinance industry are not a natural result of the market evolution, but rather a product of outside intervention, such as specific policies of local and regional administrations or donor programs.

Target Customers of Russian MFIs

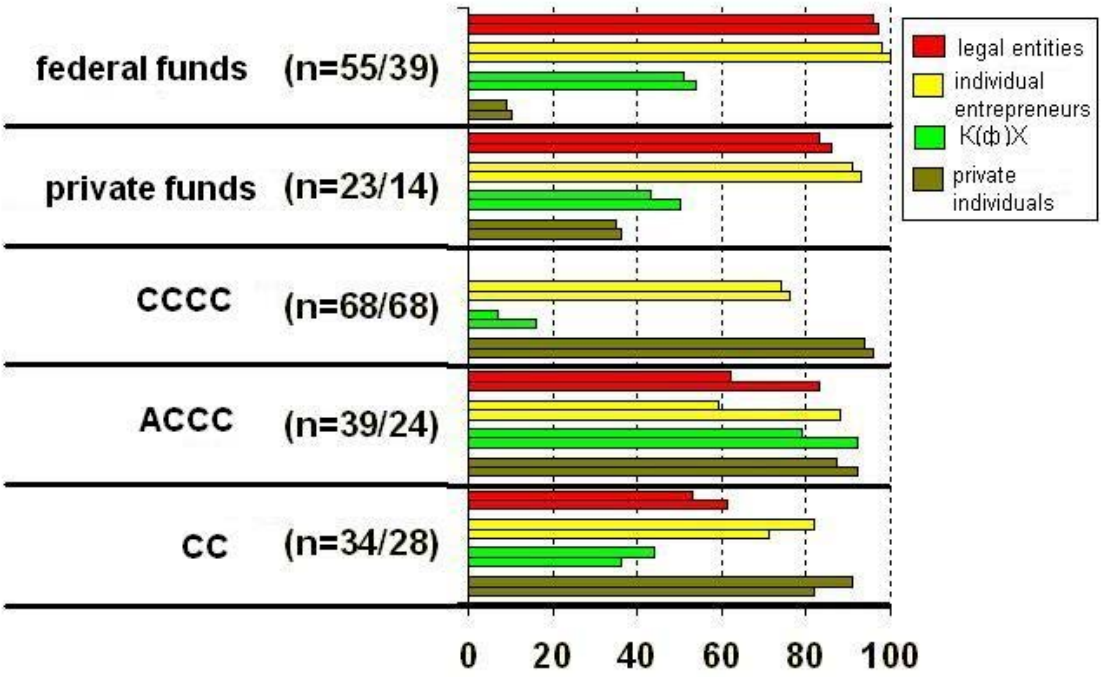
As before, individual entrepreneurs were found to be key customers served by 84% of the surveyed MFIs. Private individuals (natural persons) were the second largest MFI customer group, including both start-ups and consumer borrowers. One surveyed institution out of two lends to SME – legal entities, and 40% of MFIs in out sample made microloans to farmers. Understandably, the latter were mostly ACCC (agricultural credit consumer coops) (Diagram 4).

Diagram 4 ***Russian MFI customer base, % of the respondents (n=224 – 2004 and n=180 – 2003)***



The customer base was largely determined by the type of microfinance provider - partially due to the fact that different institutional types face different legal restrictions. On the other hand, prevalence of certain borrower types depends on the MFIs' objectives, their choice of target, funding sources, and location.

Diagram 5 ***Customer base of certain MFI types, % of the respondents (in brackets – the number of respondents in years 2003/2004). The upper bar: 2003; the lower bar: 2004***



Funds serve mostlly small business operators, in particular individual entrepreneurs and SME (in 100% and 97% cases, respectively). Most natural persons among state funds' customers were start-ups (Diagram 5).

Virtually all CCCCs (96%) provided microfinance services to natural persons, and two thirds served individual entrepreneurs.

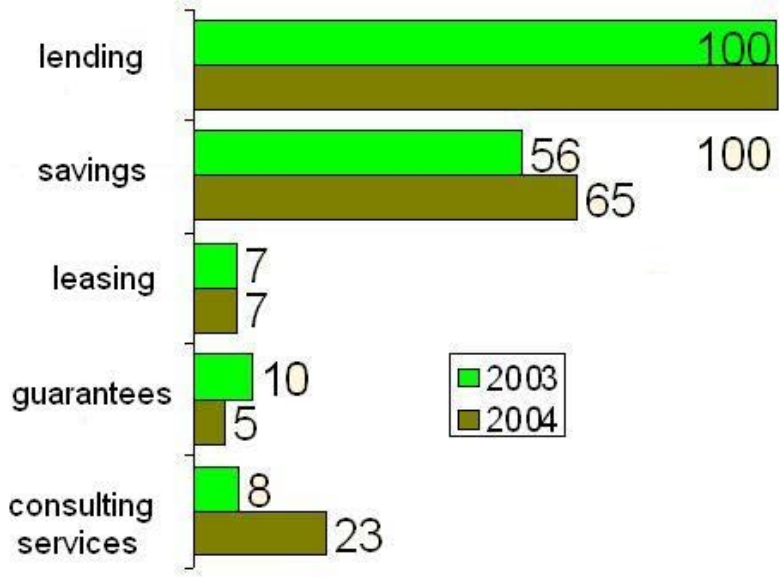
ACCCs, as opposed to other MFI types, serve a diversity of different borrower types, although they also tend to specialize - 92% lend to farmers (in 2003, only 79% of ACCCs made loans to farmers). So in 2004, they targeted farmers even more than before. There was a notable increase in the proportion of ACCCs serving individual entrepreneurs (from 59% in 2003 to 88% in 2004), and legal entities (from 62% to 83%).

The Range of Microfinance Services Provided by Russian MFIs

Just like in 2003, lending was the main service provided by all microfinance institutions, without exception, in 2004. A total of 65% MFIs also captured savings, and their number increased as compared to 2003.

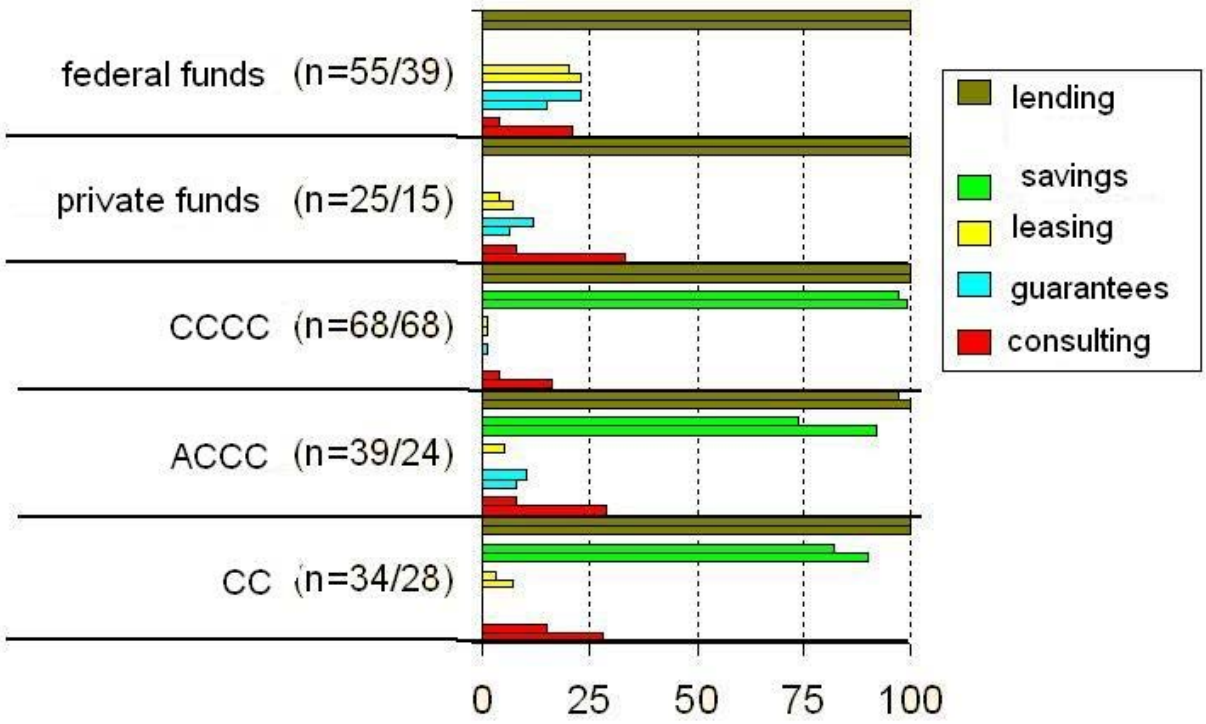
Only some MFI types, and not others, are allowed to capture savings, and our findings show once again that only cooperatives take their members' savings. Other financial services include guarantees and micro-leasing services provided by 5% and 7% of MFIs, respectively (Diagram 6).

Diagram 6 ***The Range of Microfinance Services Provided by Russian MFIs, % of the respondents (n=226 – 2004 and n=182 – 2003)***



In the second round of our monitoring, we detected an increased proportion of institutions that offered their customers consulting and training services – from 8% in 2003 to 23% in 2004 (Diagram 6). Notably, this development cuts across all MFI types, and we find it positive.

Diagram 7 ***The Range of Services by MFI Type, % of the respondents (in brackets – the number of respondents in years 2003/2004). The upper bar: 2003; the lower bar: 2004***



As it was the case with the customer base, the range of services provided was determined by the MFI type. Thus, state (municipal) funds are not allowed legally to capture savings. Nevertheless, given their function as part of SME support infrastructure, funds offer a wide range of services, including leasing, guarantees, and training services; they have adopted a comprehensive approach to SME support.

Only consumer cooperatives capture savings. As long as most customers for such services are general consumers (natural persons), CCCCs focusing mainly on this customer category take savings more often than other types of consumer cooperatives (99% against 92% and 90% in ACCCs and CCs).

Private MFIs tend to only lend to their customers and train them.

Besides an increase of consulting services offered by certain MFI types and an increase of savings services offered by ACCCs (from 74% in 2003 to 92% in 2004), we did not find any other significant developments (Diagram 7).

Loan Profiles

Russian Non-Bank MFIs' Loan Portfolio

The aggregated loan portfolio of surveyed institutions was 4 bln. rubles on 1 January 2005. By extrapolating this finding to all microfinance providers, we assess this market segment at no less than 7.8-9.2 bln. rubles.

Diagram 8 ***Aggregate Loan Portfolio Distribution as of 1 January 2005, mln. rubles, % of the respondents (aggregate loan portfolio of all MFIs surveyed in 2004 – 4,0 bln. rubles)***

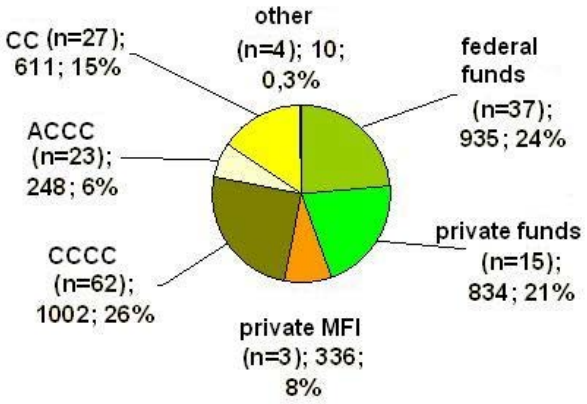
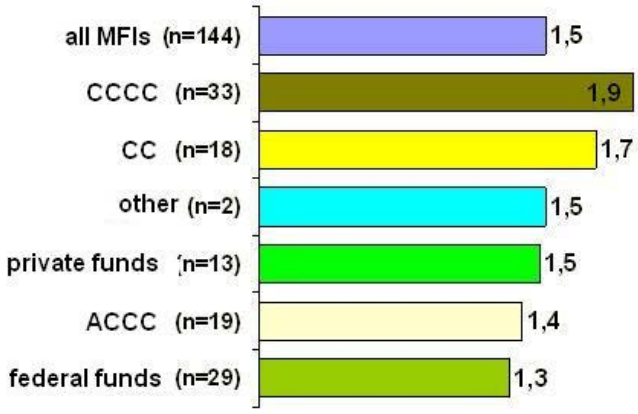


Diagram 9 ***Loan Portfolio Dynamics in 2004/2003, times / in the respective institutions/, median***



Credit consumer cooperatives of citizens contributed 26% of the aggregate loan portfolio; 25% was contributed by state (municipal) SME support funds; and 21% came from private funds (Diagram 8).

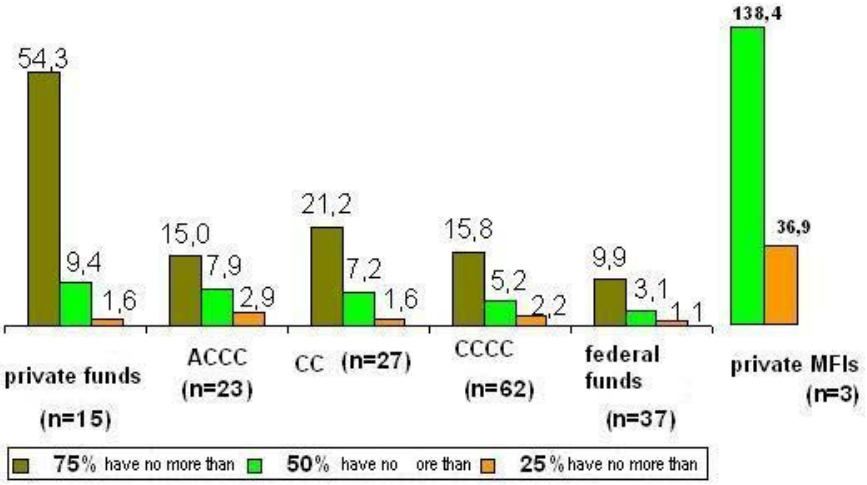
Depending on the MFI type, in 2004 portfolio growth varied between 1.3 and 1.9 times, with the average 1.5-fold growth (Diagram 9). Consumer cooperatives experienced the highest growth rates, while state SME support funds hardly increased their portfolios at all, because with the adoption of the Federal Law on State Support of SME in the Russian Federation they had to justify their existence and actively seek alternative funding sources, as the state no longer supports them.

A positive development facilitating their access to finance was a letter from the Central Bank allowing lenders to class SME support funds and other MFIs as first or second (i.e. less risky) category of borrowers, making them more attractive customers for banks. Another regulation is in the pipeline to help SME support funds establish non-bank deposit-credit institutions to enhance their microlending operations.

Our quantitative analysis shows that the microfinance portfolio growth is most sensitive to increased deposits, as the customer deposits finance the portfolio to a large extent.

In contrast, the portfolio is not sensitive to loan interest rates; it proves once again that borrowers are prepared to accept even a higher rate than currently established.

Diagram 10 ***Average Loan Portfolio, 2004, mln. rubles.***



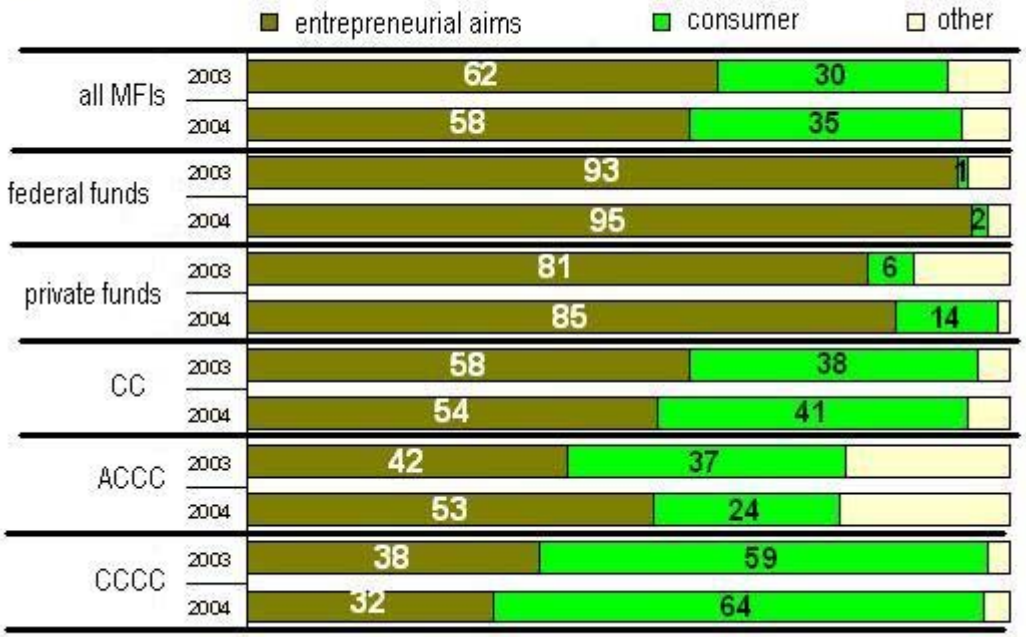
We cannot estimate an average loan portfolio either across MFI types or even within any particular type, because in 2004, similarly to 2003, the sample was extremely diverse in terms of portfolio size. Any average would not be typical and would not contribute to our understanding of the market, so we use quintiles instead of averages to describe portfolio characteristics.

Our sample was similarly diverse in terms of other quantitative indicators reflecting their scope of activity.

Private MFIs had the largest loan portfolios. In half of them, the loan portfolio was at least 138.4 mln. rubles. Private funds also had relatively big portfolios - as of early 2005, one out of two had at least 9.4 mln. rubles worth of outstanding loans. We should also note the rural credit consumer cooperatives, where 50% of institutions had loan portfolios of at least 7.9 mln. rubles (Diagram 10).

Across MFI types, business loans made up the largest part of their portfolios (58%). Of course, relative proportions of business, consumer and other loans are determined by the institution types: e.g. state SME support funds servicing small entrepreneurs provided 95% of their loans for business purposes.

Diagram 11 ***Lending Purposes as of 1 January, %***

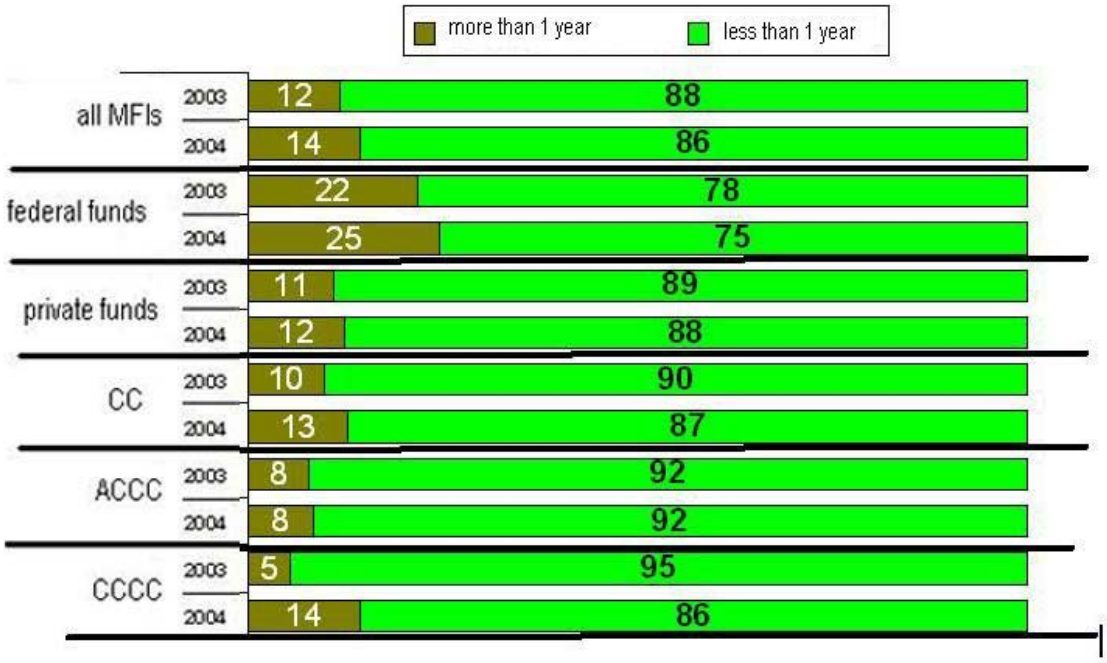


CCCCs are characterized by the highest proportion of consumer loans - 64%, consistent with their customer base of natural persons. Notably, 32% of lending by this type of cooperative is for business development, which is close to the legally established limit for these cooperatives (no more than 50%, Diagram 11).

In 2004, there were no major changes in the composition of loan portfolios. The only thing we would note is the increase of business lending by ACCCs from 42% in 2003 to 53% in 2004.

Similarly to the previous year, short-term loans with less than one year's maturity prevailed as of 1 January 2005. 'Long' loans with maturities of more than one year did not exceed 14% of the portfolio, which is indirect evidence that microloans are used to finance working capital. They meet the needs of most clients concerned about continuous financing of their current operations.

Diagram 12 ***Portfolio Composition by Loan Maturity, as of 1 January, %***



We observed investment-type lending only by state SME support funds. One fourth of the surveyed state funds were lending to investment projects with maturities exceeding 12 months.

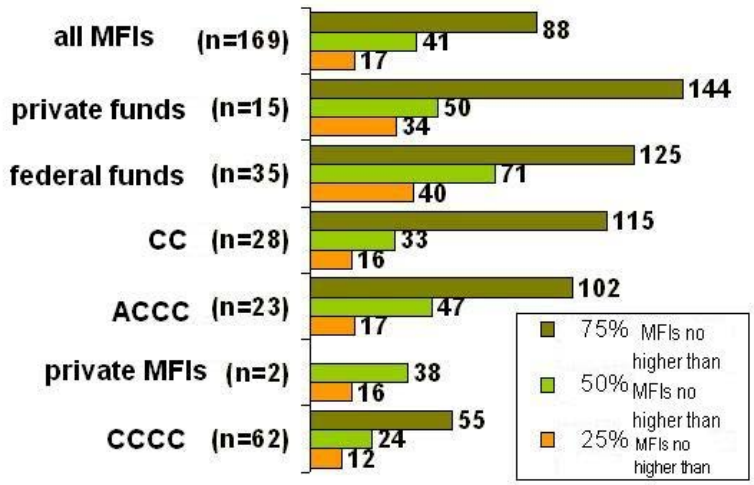
To sum up, we did not see any major changes in the proportion of short-term and long-term loans in 2004 (Diagram 12).

Small average loan amounts evidence once again that microloans are used to finance working capital. Two thirds of the surveyed MFIs made average loans under 88,000 rubles, half of MFIs made loans under 41,000 rubles, and one fourth of MFIs did not usually lend more than 17,000 rubles. In addition to the purpose of borrowing, small average loans also suggest that all types of Russian MFIs service mainly small borrowers and start-ups, because only this category of borrowers requires small loans.

The biggest loans were made by private funds: in 50% of them, average loans were at least 50,000 rubles. State SME support funds also made sizeable loans, with half of them lending at least 71 thousand rubles.

ACCCs also made relatively big loans to agricultural producers. Half of them made average loans of at least 47,000 rubles (Diagram 13).

Diagram 13 ***Average Loan Size in 2004, thousand rubles.***



In 2004, the average loan size grew by 20% across the industry, with the highest growth rate of 25% observed in private funds.

Nevertheless, MFIs with a long history of microlending operations prefer to keep their loans small and service smaller clients, disbursing available funds to a maximum number of borrowers. Underlying this policy is the nature of microfinance seeking to provide access to debt finance to a maximum number of borrowers.

MFI Borrower Base

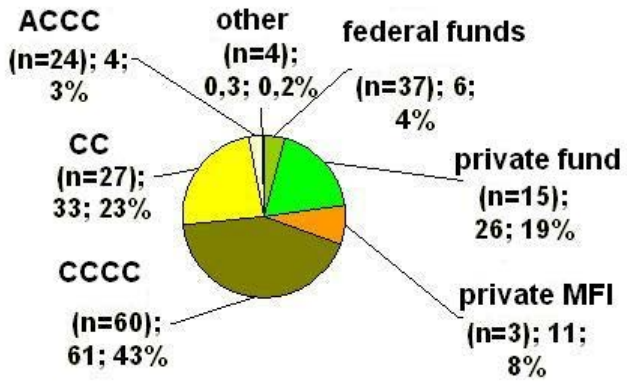
The total number of active borrowers in the surveyed institutions was around 141 thousand; extrapolated to all MFIs in the country, the estimate would be between 240 and 264 thousand borrowers.

This substantial borrower base is generated mainly by:

- credit consumer cooperatives of citizens, whose 43% share of active borrowers is the largest; and
- credit cooperatives (consumer societies), contributing 23% of active borrowers (Diagram 14).

State funds, including the network of municipal funds, only lend to 4% of all microborrowers, due, on the one hand, to larger average loans size, and on the other hand, to some specifics of their credit portfolio (some of their funds are not used to finance microloans as we define them in this paper).

Diagram 14 ***Active Borrowers as of 1 January 2005, thousand and % /the total number of borrowers in surveyed MFIs is 141,000/***



In 2004, customer outreach increased by 1.3 times across the industry. Credit consumer cooperatives of individuals were more active than others, increasing their member-borrower base by 1.7 times, while the state funds experienced the least growth of customers - 10% - for reasons described above.

The MFI customer base pattern reflects the fact that the sample included the largest microfinance providers in the country. Thus, half of the surveyed CCCCs had memberships of at least 225 individuals, while one fourth had 570 and more members. Given the current state of industry development in Russia, these are fairly large institutions. ACCCs are also represented by large institutions, with 25% having at least 250 members (Table 1).

Private MFIs had the highest outreach per institution (there were only three private MFIs in our sample), with an average of 3,558 borrowers reached by each provider.

Table 1. **MFI Borrower Base** ***(No of active borrowers as of 1 January 2004) /We sorted the sample into three parts - 25%, 50%, and 75% by increasing value of indicator/***

	25% - maximum	50% - maximum	75% - maximum
A	*1*	*2*	*3*
All MFIs (N=170)	39	120	478
including:			
state funds (N=37)	18	47	140
private funds (N=15)	25	117	1,099
private MFI (N=3)	3,102	3,328	
CCCC (N=60).	48	225	570
ACCC (N=24)	47	88	250
CC (N=27)	33	139	1,494

Reference: Loan Sizes and Number

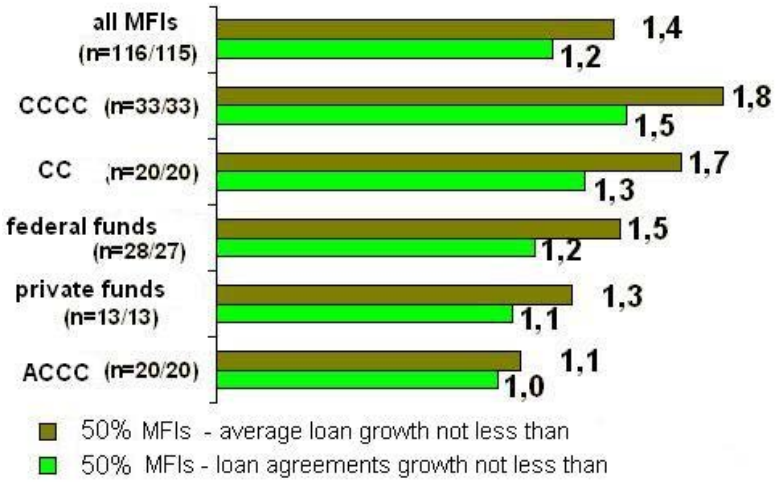
In 2004, the microfinance providers surveyed in round two of this research made a total of 261,000 loans worth 7.3 bln. rubles.

Table 2. Lending Operations in 2004 /We sorted the sample into three parts - 25%, 50%, and 75% by increasing value of indicator/

	Total loan amount, mln. rubles				Number of loans .			
	25% - maximum	50% - maximum	75% - maximum	total lending	25% - maximum	50% - maximum	75% - maximum	total number of loans
A	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*
All (n=171/170[2])	**2.3**	**8.7**	**29**	**7,294.5**	**62**	**181**	**647**	**261,150**
including:								
State funds (n=35/35)	1.5	4.7	20.1	914.1	24	61	156	10,368
Private funds (n=15/15)	2.6	16.8	130	2,064	58	239	3,880	57,515
Private MFI (n=3/2)	106.2	321		809.3	6,400	6,512		13,023
CC (n=22/21)								
CCCC (n=60/56)	0.9	2.9	7.4	644.8	25	87	263	19,261
ACCC (n=18/18)	0.3	1.0	2.4	139.1	4	15	25	939

As compared to 2003, an average loan grew by 1.4 times across the industry, and the number of loan agreements increased by 1.2 times.

Diagram 15 ***Loan Size and Number Dynamics in 2004 and 2003, times / in respective institutions/***



(In brackets: the number of respondents to the question about loan amounts/number of loans)

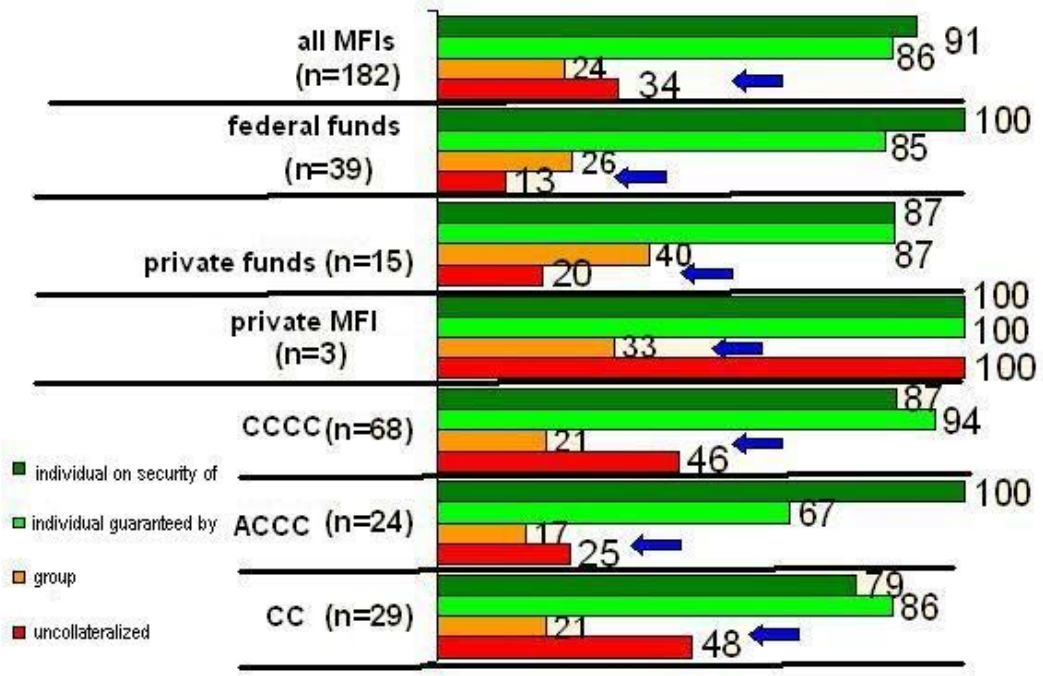
Access to Microfinance

Loan Security

Many surveys show that absence of collateral satisfactory to banks is the main reason why small borrowers find it difficult to access debt finance. As opposed to banks, MFIs are not bound by formal regulations concerning collateral availability and quality so they have developed an extensive experience of using unconventional forms and methods to secure loan repayment.

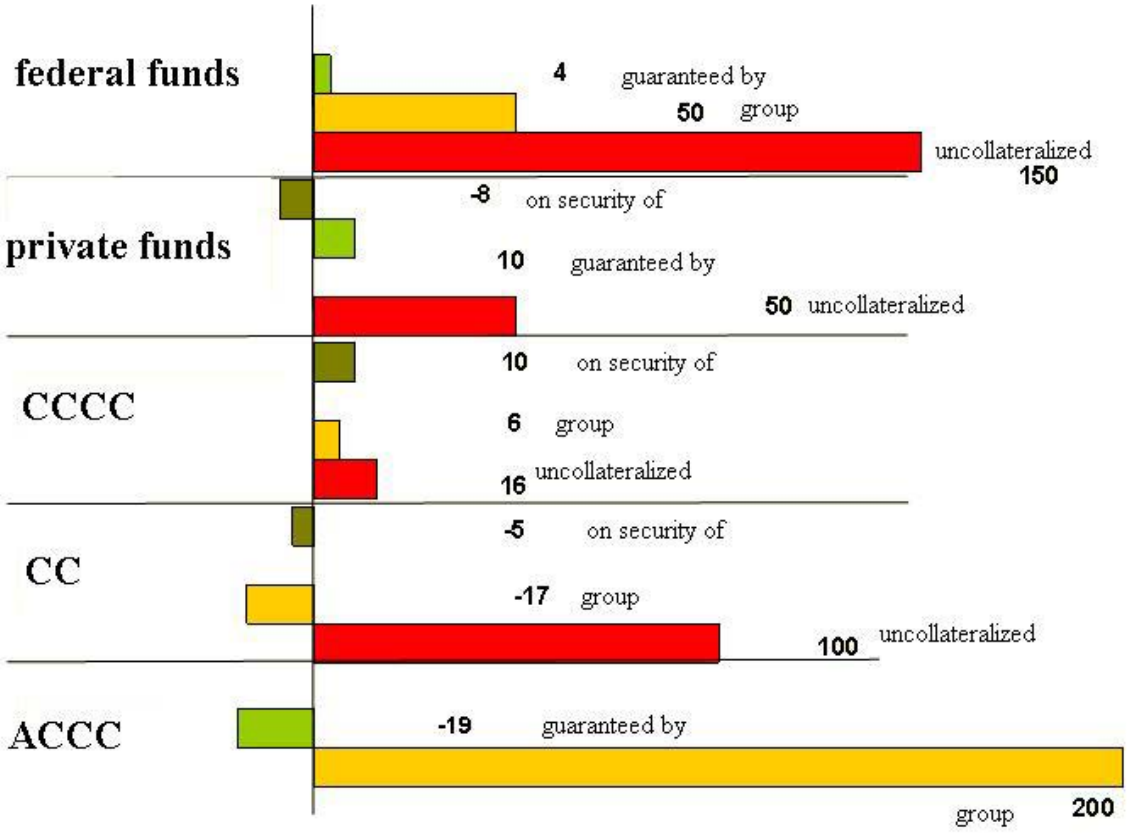
[2] In brackets: the number of respondents to the question about loan amounts/number of loans.

Diagram 16 ***Loan Types by Form of Collateral, % of the respondents, 2004г.*** */arrows point to non-conventional forms/*



Some MFIs servicing a specific customer group and appealing to psychological motives to ensure repayment make uncollateralized loans. Uncollateralized lending is particularly common in consumer cooperatives where members/borrowers are acquaintances and trust one another. Thus, almost half (48% of the respondents) of CCs do not require collateral; 46% of CCCCs and 25% of ACCCs also use 'psychological' motives to ensure repayment. Moreover, in 2004, the number of cooperatives making uncollateralized loans increased: half of the CCs doubled their uncollateralized loans, and 16% more CCCCs adopted uncollateralized lending. State funds experienced the most dramatic growth of uncollateralized loans – 2.5 times (Diagram 17).

Diagram 17 ***Dynamics of Collateral Requirements by MFIs, 2004 to 2003, % /in respective institutions/***



The Russian market has widely adopted peer group loans - an unconventional form of loan security proven effective in many other countries. In 2004, private funds used peer group guarantees in 40% of their loans, more often than other MFI types (Diagram 17).

Agricultural cooperatives and state funds have adopted peer group lending as well.

Minimum and Maximum Loan Size

The biggest barrier faced by small entrepreneurs and low-income people in accessing conventional bank credits is that banks are not interested in making small loans. The size of microloans is more consistent with the needs of small business and low-income population.

One fourth of the surveyed MFIs, theoretically, would lend 1,000 rubles or less - these included credit cooperatives of citizens, ACCC, and private MFIs. Of course, small amounts like this are required by individuals to 'make ends meet' before payday; there is no question of meeting the funding needs of small business.

Another quarter of the surveyed MFIs did not lend less than 5,000 rubles. State funds had the toughest policies with regard to minimum loans size, with half of them making loans of 10,000 rubles and more, while in one fourth loans started at 15,000 rubles. But as long as state funds are designed to support the largest among small enterprises, relatively high minimum amounts do not make loans less accessible and are consistent with the demands of their customer group.

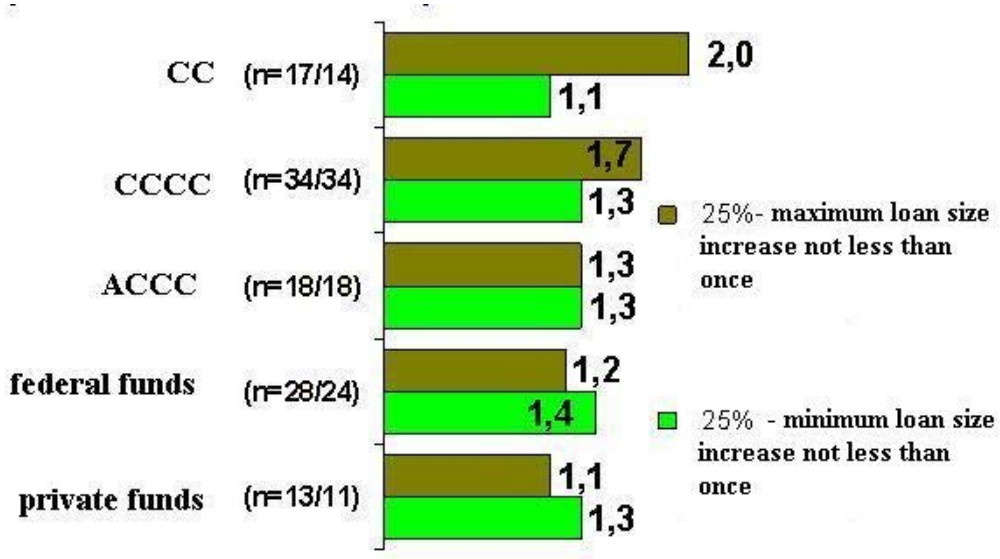
The maximum loan amounts quoted by the surveyed MFIs evidence that at least half of institutions in each type can be formally defined as microfinance, with maximum loans of 300,000 rubles. Among state funds and credit consumer cooperatives, two thirds of the surveyed institutions meet this criterion. All private MFIs are within the 300,000 ruble loan limit.

The largest loans are made by consumer societies and ACCCs. At the same time, our findings show that around one fourth of ACCCs avoid, even theoretically (as stated in their policies), providing investment funding, and so limit their loans size to 63,000 rubles.

We found a positive correlation between maximum loans size, portfolio, and outstanding loan amount.

The loan portfolio growth in 2004 allowed ACCCs and consumer societies to review their maximum loan size policies, so one fourth of them increased their maximum loans by at least 1.7 and 1.3 times (Diagram 18).

Diagram 18 ***Minimum and maximum possible loan size increase, according to MFI policies, in 2004 as compared to 2003, times / in respective institutions/***



(In brackets: no of respondents to the question about maximum loan size/no of respondents to the question about minimum loan size)

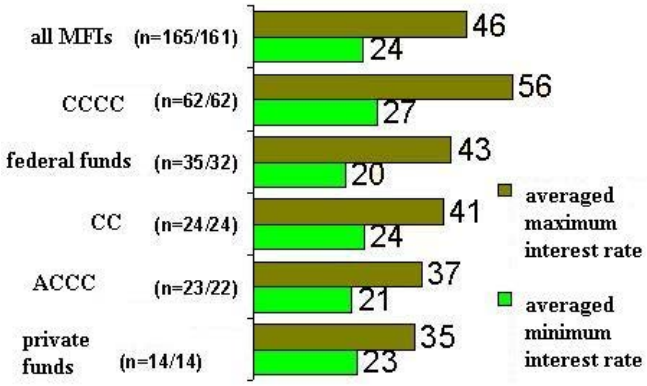
To sum up, where MFIs do not face portfolio limitations, they are prepared to make bigger loans to enable small borrowers to finance investment, as well as working capital.

Cost of Microfinance

We observed that SME operators do not find loan interest rates as big a constraint as collateral requirements or minimum loan amounts.

In most countries, relaxed – as opposed to banks – requirements to borrower profiles and paperwork in microfinance are compensated by higher cost of finance. Russia is not an exception, although the gap between the cost of commercial credit and microfinance loan I not so wide (Table 3 and Diagram 19). It should be noted that Table 3 quotes the interests rates declared by banks, whereas their actual interest rates are much higher.

Diagram 19 ***Averaged maximum and minimum interest rate on ruble loans, according to MFI policies, % annually in 2004***



(In brackets: no of respondents to the question about maximum loan size/no of respondents to the question about minimum loan size)

Table 3. Average weighted interest rates on ruble loans to individuals and non-finance institutions in the sector of commercial bank credits, 2004, % annually

	All maturities	up to 30 days	31 to 90 days	91 to 180 days	181 days to one year	1 to 3 years
A	*1*	*2*	*3*	*4*	*5*	*6*
Individuals (natural persons)						
January	18.6	17.5	19.9	15.7	23.0	24.3
April	18.0	15.3	16.6	18.2	18.7	21.1
July	19.5	16.8	19.1	18.9	21.4	20.9
October	20.5	16.4	19.8	21.5	22.3	20.7
Legal entities						
January	12.4	10.5	14.6	15.1	15.1	15.3
April	12.1	10.5	13.8	13.9	14.3	13.6
July	11.1	10.2	12.1	13.3	12.7	11.0
October	11.0	9.2	13.1	12.9	13.5	12.6

/Bulletin of Banking Statistics, N 1 (1410), Central Bank, Moscow 2005/

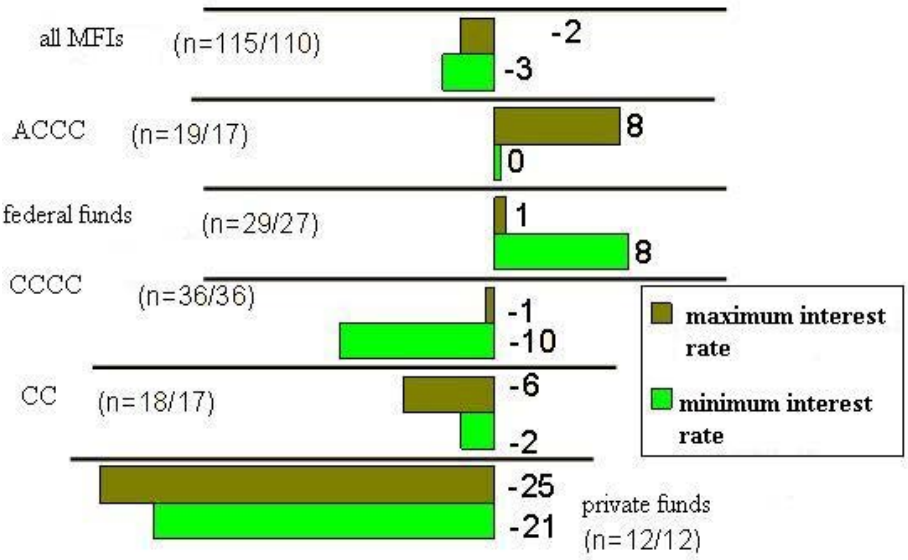
Based on our findings, the maximum interest rate written in the institutions' policies did not exceed an average of 46% in 2004. So the cost of microfinance is consistent with the 'market cost of short-term borrowing' in conventional banking.

The highest price of borrowing was observed in CCCCs due to the customer base, maturities and purposes of lending in this type of consumer cooperatives.

Private funds and ACCCs were found to make the cheapest loans. In the latter case, cheap rates were consistent with the specifics of agricultural business and limited paying capacity of their target borrowers - farmers and other agricultural producers.

In 2004, interest rates dropped across the microfinance industry. Borrowing from private funds dropped by 25 percent points (pp), making their loans particularly affordable, while credit consumer cooperatives of citizens decreased their minimum allowed interest rate by 10 pp. At the same time, ACCCs and state funds modified their loan terms and conditions, bringing them closer to free market standards (Diagram 20).

Diagram 20 ***Dynamics of the averaged maximum and minimum interest rates, as written in MFI policies, on ruble loans, 2004 as compared to 2003, percent points / in respective institutions/***



(In brackets: no of respondents to the question about maximum loan size/no of respondents to the question about minimum loan size)

Taking Savings: Amounts and Conditions

Volume of Savings Operations

Taking savings is the second most common type of microfinance services. The surveyed MFIs captured a total of 1.6 bln. rubles in savings as of 1 January 2005 (extrapolated to the entire microfinance industry, captured savings and deposits are estimated at around 4.8 bln. rubles) (Diagram 21). To compare, commercial banks held an equivalent of 2,495 bln. rubles in both ruble and foreign currency deposits as of the same date, so deposits taken by MFIs do no exceed a small fraction in the country's economy and do not pose any risk to financial stability.

As of 1 January 2005, of all MFIs the largest deposits were held by credit cooperatives (consumer societies). At any given time, one fourth of them held at least 17.7 mln. rubles on deposit balances, and half of them held at least 4 mln. rubles in deposits - primarily in voluntary savings deposited by members as part of the coop's services.

CCCCs also actively captured their members' savings based on agreements between the cooperative and its members, and these savings financed the mutual assistance fund used to make loans to other members. As of 1 January 2005, one out of two CCCCs in our sample held at least 4.8 mln. rubles in savings.

ACCCs take savings to a lesser extent, although they hold the highest amounts of savings per member[3]. In half of them, any individual deposit was equal to or higher than 84 thousand rubles, whereas it was 57 thousand rubles for consumer societies, and 33 thousand rubles for CCCCs. These numbers are consistent with the purposes of each respective type of cooperative. Besides, we need to take into account the fact that in rural areas local financial infrastructure is underdeveloped, so the public have no option of investing their savings other than an agricultural cooperative.

The low overall amount of savings held by ACCCs at the beginning of the year are due to specific characteristics of their target group - agricultural producers.

[3] Per depositor.

Diagram 21 ***Captured deposits, 1 January 2005, mln. rubles and % /all MFI respondents – 1.6 bln. rubles/***

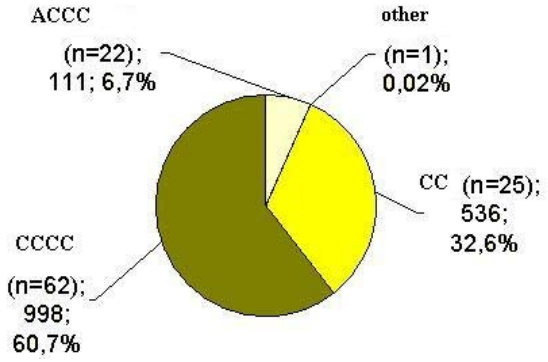
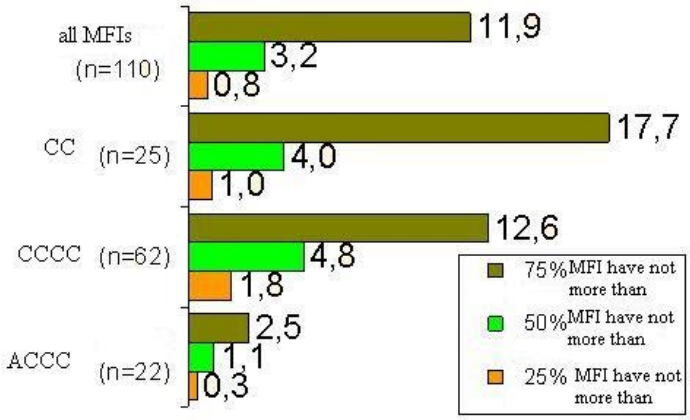


Diagram 22 ***Amounts of captured savings, 1 January 2005, mln. rubles***



Correlation analysis shows a strong correlation between deposit balances and the loan portfolio.[4] The observed dynamics support this correlation.

Similar to the loan portfolio, the savings 'portfolio' increased by an average of 1.8 times between 2003 and 2004 in all institutions allowed to capture savings.

In certain MFI types, savings increased at a faster pace than loans. Thus, credit cooperatives doubled their deposit balances, while increasing their loan portfolio only by 1.7 times. ACCCs that captured 1.8 times more savings than before increased their loan portfolio only by 1.4 times. It can be partially explained by the fact that these MFI types lost some other sources of financing their loan portfolios.

In contrast, credit consumer cooperatives of citizens increased their savings by 1.7 times at the year end, while doubling their loan balances.

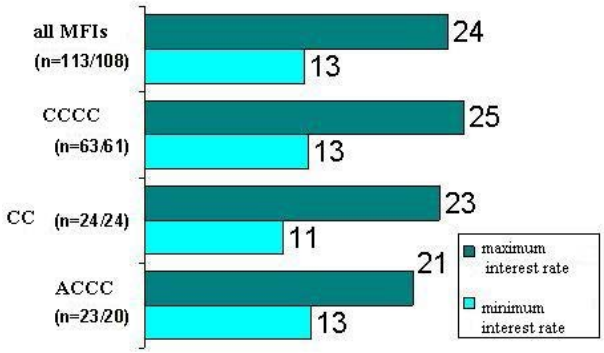
Terms and Conditions for Savings and Deposits

The interest rate on captured deposits is one of the factors influencing both the amount of captured funds and the number of members willing to keep their savings with a cooperative. A quantitative analysis supported a statistically significant correlation between the maximum established interest rate on deposits and the amount of deposits captured by an institution. At the same time, the interest rate provides only half of the explanation[5] for effective deposit accumulation; the rest is explained by the underlying principle of cooperatives where a certain level of trust among members attracts newcomers.

While MFIs of different types use similar approaches to determine minimum and maximum cost of attracted deposits[6], CCCCs and consumer societies had higher maximum interest rates (25% and 23% per year, respectively) against 21% in CCCCs (Diagram 23).

[4] Spearman rank-order correlation coefficient 0.77 with high statistical significance of 0.01.
[5] Explained variance coefficient is 50.7%.
[6] Notably, it was one of the few quantitative indicators with relatively homogeneous findings across the sample, suggesting that institutions use similar approaches to developing their policies.

Diagram 23 ***Averaged maximum and minimum interest rates on captured savings, according to MFI policies, % annually in 2004***



(In brackets: no of respondents to the question about maximum allowed rate/no of respondents to the question about minimum allowed rate)

Table 4. ***Averaged weighted interest rates on captured deposits and savings of natural persons and non-financial organizations, 2004, % annually***

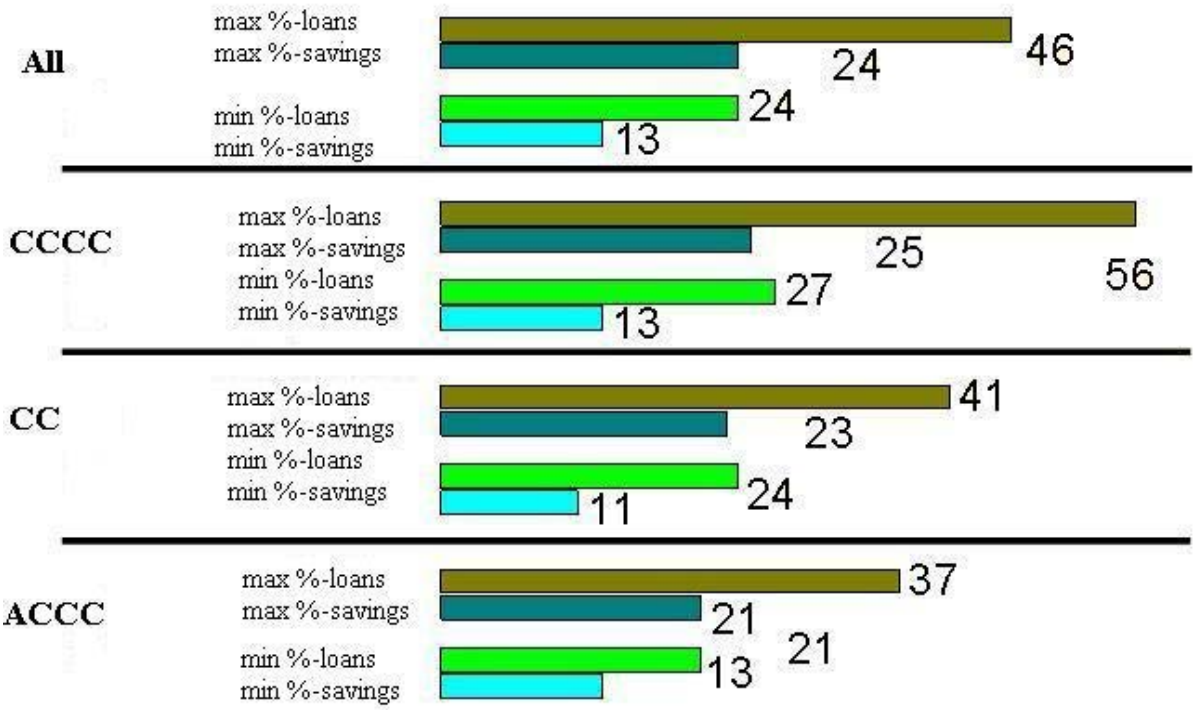
	All maturities	up to 30 days	31 to 90 days	91 to 180 days	181 days to one year	One year and more
A	*1*		*3*	*4*	*5*	*6*
Individuals (natural persons)						
January	5.7	1.8	7.9	9.6	11.6	10.7
April	4.9	1.3	7.2	8.7	10.6	9.4
July	4.4	1.0	7.7	8.7	10.5	8.2
October	4.9	1.5	6.7	9.0	11.0	8.1
Legal entities						
January	3.9	1.2	6.5	9.4	11.1	10.6
April	4.1	3.2	5.1	7.9	9.3	9.3
July	3.4	2.5	7.3	7.6	10.0	4.5
October	3.2	2.0	5.4	8.8	9.8	6.0

/Bulletin of Banking Statistics, N 1 (1410), Central Bank, Moscow 2005/

MFIs establish their interest rates so that they can compete with the terms and conditions offered by conventional banks for similar types of deposits. But as long as MFIs face higher risks than banks, they should pay more for their depositors' money, as it is reflected in Table 4 and Diagram 23. In 2004, the average weighted interest rate in commercial banks, all maturities included, was around 5% annually for natural persons, and around 3.8% for legal entities, whereas in MFIs, as written in their policies, the maximum interest rate was around 13% annually, i.e. at least 2.5 times higher.

MFIs cal 'afford' to take deposits on such terms, especially that they can still maintain a high margin between loan and deposit interest rates (depending on the MFI type it may range between 10 and 20%, Diagram 24). The actual interest income, however, is lower due to high cost of microfinance operations.

Diagram 24 ***Correlation of loan and savings interest rates, according to MFI policies, % annually in 2004***



In 2004, all types of cooperatives slightly lowered their interest rates on deposits - in particular rural cooperatives and consumer societies.

Savings and a Source of MFI Liabilities

In general, deposits made up 66% of MFIs' liabilities in those MFIs that were allowed to take deposits. In CCCCs, members' savings contributed more than two thirds (more than 77%) of their liabilities. Because of low cash incomes of agricultural producers, members' savings contribute only one fifth of ACCCs' capital (Diagram 25).

Across the microfinance industry, deposits with less than one year's maturity made up more than 79% of the total value of captured savings, and in CCCCs their proportion reached 85% (Diagram 26).

Diagram 25 ***Savings as part of MFIs' liabilities, % as of 1 January 2005***

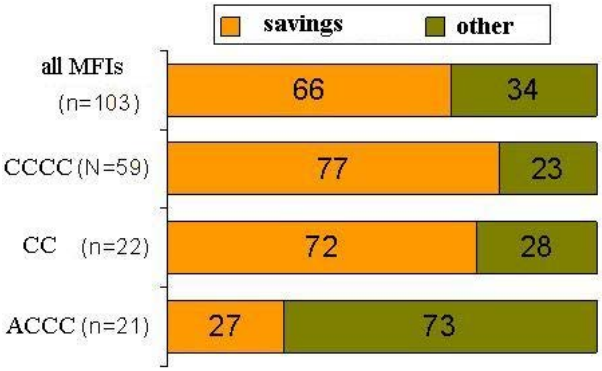
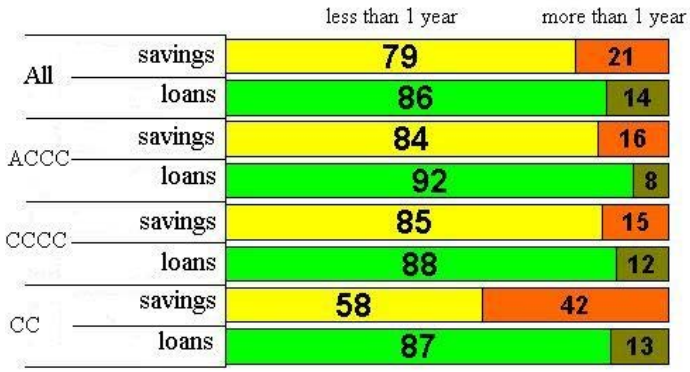


Diagram 26 ***Proportion of loans and deposits by maturity, as of 1 January 2005, %***

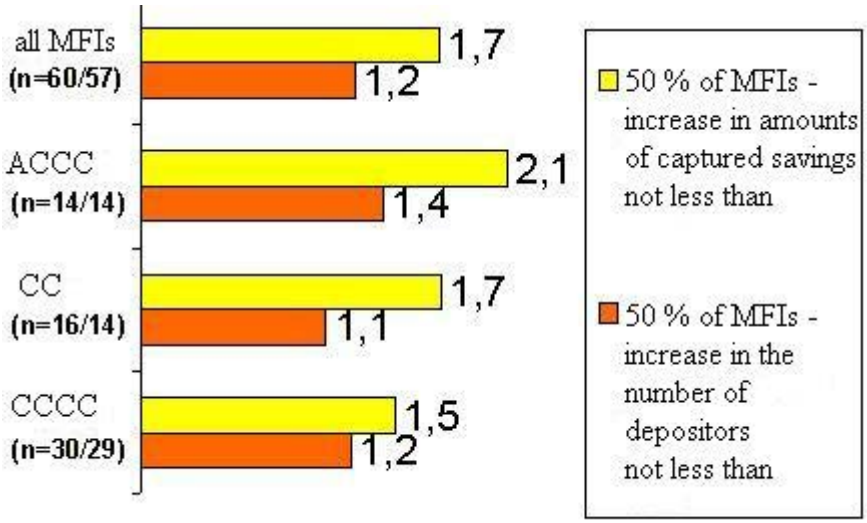


Deposit maturities are consistent with loan maturities, with most microloans having less than one year's maturity. Savings as part of liabilities have the same maturities as assets (the loan portfolio), so they can be successfully used to finance the loan portfolio without negatively affecting the asset/liability ratio. Moreover, with increased savings of the same maturity, a CC may even accumulate some extra 'long money'.

The policy of encouraging deposits as a source of finance for the loan portfolio enabled the surveyed MFIs to achieve a total increase of captured savings by 1,088 mln. rubles deposited by 29,000 customers.

Although in 2004 MFIs lowered their deposit interest rates, we observed an increase of both the amount of savings captured over the year, and the number of depositors. It means that MFIs sill offer a competitive interest rate as compared to conventional banks. Besides, people are more likely to trust a cooperative where they are members, than the formal banking sector (Diagram 27).

Diagram 27 ***Increase in amounts of captured savings and number of depositors in 2004, as compared to 2003, times / in respective institutions/***

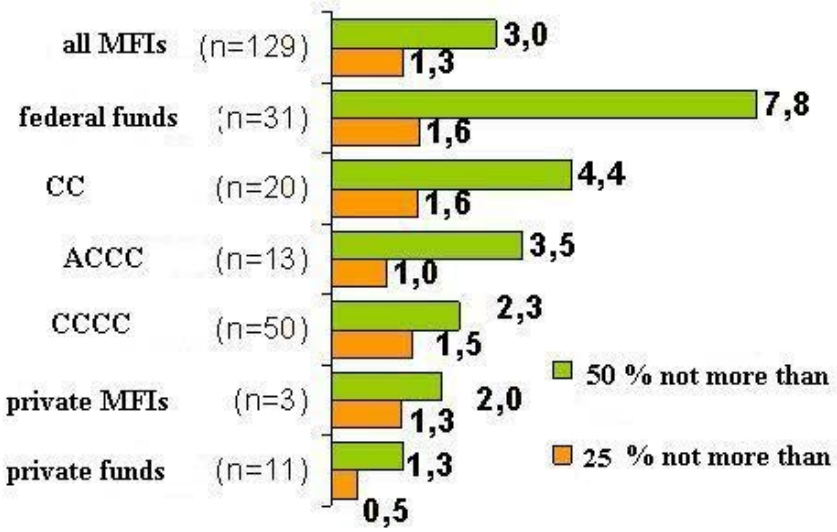


Loan Portfolio Quality

In the Russian market, a benchmark of 'good' microfinance indicators was provided by non-bank MFIs – members of the RMC's Standards Working Group; their portfolio at risk ranged between 1% and 3%.

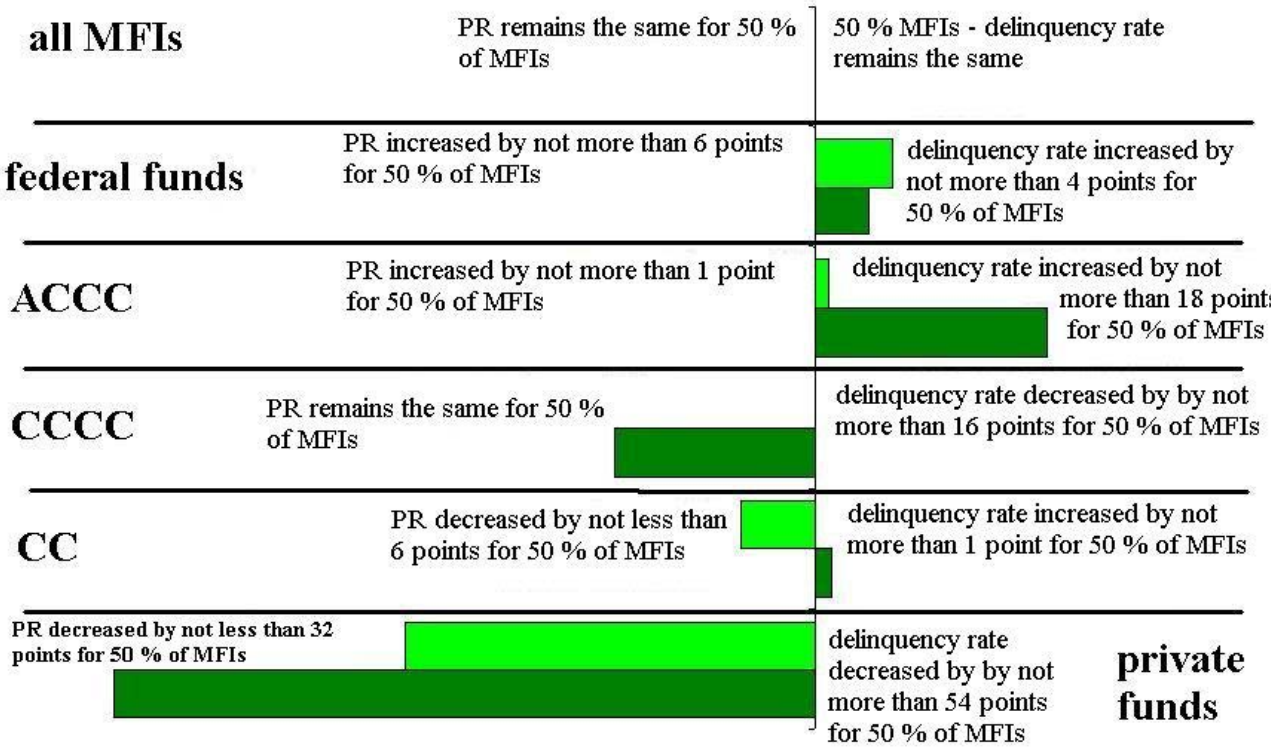
It was our finding in this survey that in 2004 the risks of most MFIs were within the established standards. Thus, in one out of two institutions in the surveyed sample this ratio did not exceed 3%, while in one out of four it did not exceed 1.3% (Diagram 28).

Diagram 28 ***Portfolio at risk of more than 30 days delinquency, as of 1 January 2005, %***



State funds had the highest portfolios at risk in 2004, as well as in 2003 - possibly, because, according to their stated purpose, they lend to start-ups. In contrast, private funds had the lowest and declining portfolio at risk: in 2004, it dropped by one third in 50% of private funds[7] (Diagram 29).

Diagram 29 ***Dynamics of loan portfolio quality, 2004 as compared to 2003 / in respective institutions/***



Our survey demonstrated a correlation between the size of MFI (portfolio, assets) and risks - larger institutions have lower portfolios at risk.

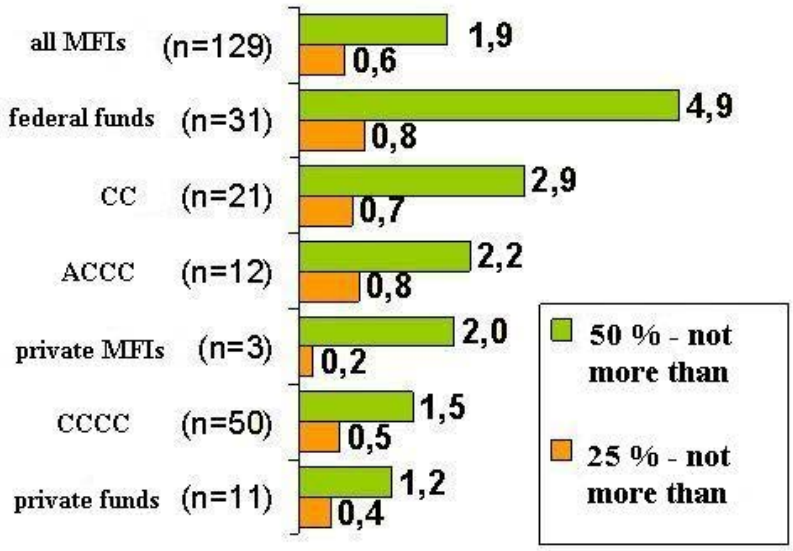
Besides, we obtained statistically significant, strong correlations between the number of loans made and the portfolio quality: the more loan agreements are signed by the institution, the less

[7] In the respective institutions.

is its portfolio at risk. Moreover, strict policies concerning maximum allowed loan amounts are associated with better portfolios, i.e. risk is minimized by making many small loans.

In 2004, most Russian MFIs had high repayment rates, comparable to those of banks, suggesting high sustainability of this non-conventional form of finance. Thus, at the start of 2005, average delinquency rate of more than 30 days on outstanding loans[8] was 1.9% or less in half of all MFIs surveyed, and less than 0.6% in 25% of MFIs (Diagram 30).

Diagram 30 ***Delinquency rate of more than 30 days on outstanding loans, as of 1 January 2005, %***



To compare: in conventional credit institutions with 20 mln. rubles or less in assets, i.e. institutions comparable in size to MFIs, on 1 January 2004, the delinquency to outstanding loans ratio was 1.5% for loans made to enterprises and organizations, and 0.7% for loans made to natural persons.0,7%[9].

In half of the market operators, delinquency rates did not change over the past year.

One private fund and credit consumer cooperative of citizens out of two were able to increase their repayment rate by 54 pp and 16 pp, respectively. In contrast, agricultural consumer cooperatives, state funds, and consumer societies experienced a minor increase of delinquencies. However, we should remember that their delinquency rates were low to start with.

Regardless of their high repayment rates, in 2004, most MFIs (71% of the respondents) made an allowance for loan loss. The fact that they provide for a loan loss reserve on their balance sheet shows that MFIs' policies seek to improve their sustainability and follow high standards of operational reliability and predictability. It is of particular relevance to MFIs registered as consumer cooperatives that experience a relatively high delinquency rate. They provided a loan loss reserve in more than 85% of cases across all cooperative types. State funds made such reserves only in 24% of cases, regardless of their relatively high delinquency rates.

A new Law on Credit Histories effective since 1 June 2005 will allow MFIs to improve their sustainability and portfolio quality even further. By this law, non-profit MFIs are allowed to contribute to credit histories and to participate in the work of credit bureaus.

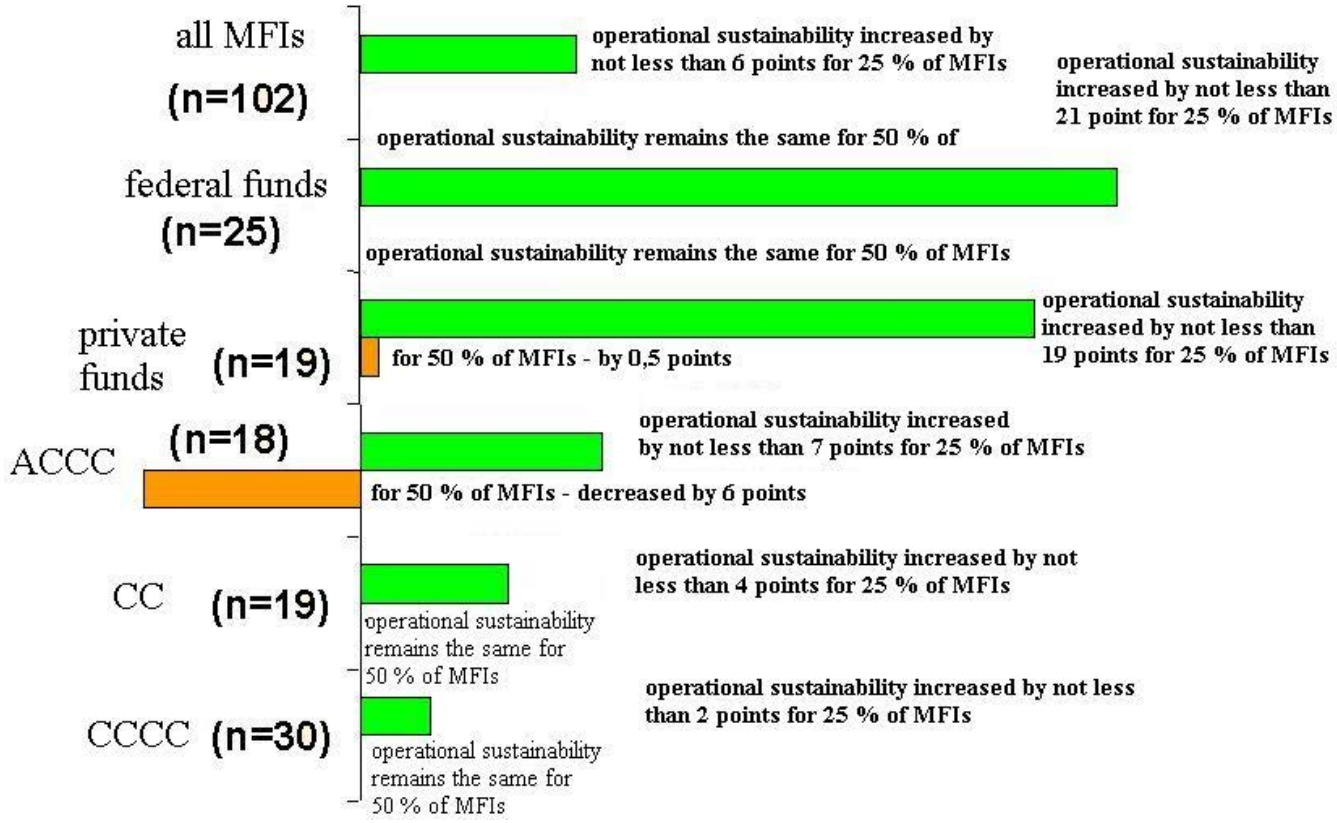
Profitability

In addition to high repayment rates and low portfolio at risk, Russian MFIs are fairly profitable.

Across all MFI types, operational revenues cover operational costs by 123% at the average. In 2004, the most profitable of the surveyed MFIs were credit cooperatives (consumer societies) and private MFIs (with operational sustainability rates of 147% and 144%, respectively). This indicator was the lowest – 114% - in state funds in our sample. However, when we looked at the dynamics of operational sustainability in comparable MFI types - i.e. in institutions included in the 2003-2004 monitoring survey, state funds appeared to be the ones with the highest dynamics of this indicator - 25% achieved an increase of operational sustainability of 21 pp., whereas the average growth rate across the sector was 6 pp. (Diagram 31).

[8] Loan delinquency to loan portfolio ratio, i.e. outstanding loan debt.
[9] Bulletin of Banking Statistics, №2 (129), the Central Bank of the Russian Federation, Moscow 2004.

Diagram 31 ***Operational sustainability dynamics, 2004 as compared to 2003, /in respective institutions/***



Correlation analysis supported a statistically significant correlation between the institution's assets, loan portfolio and loan amounts. The higher were these parameters, the higher was the institution's profitability. While operational sustainability was not sensitive to loan interest rates, it was fairly sensitive to minimum deposit interest rates established by the institution: sustainability rates were higher with lower deposit interest rates.

Notably, we found no correlation between the average loan size and profitability: an institution can be profitable even lending to smallest customers, provided a sufficient scale of operations.

****

Although the Russian microfinance market is still young and faces a number of unsolved problems, its growth rates and prospects are encouraging. As of end-2004, the market grew by 1.3 to -1.8 times, measured by various indicators. There are a number of objective reasons that allow us to predict its further growth, and the main such reasons are three:

- Tremendous unmet demand for microfinance;
- High efficiency of microfinance; and
- Comprehensive state support of the microfinance development.