

**General Recommendations on Microfinance Legislation for
Tajikistan
A Review of Selected Legal Vehicles, Key Issues,
Related Legislation to Amend, and Other Review Requirements**

National Bank of Tajikistan Team

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Introduction

At present the majority of the population of the Republic with low incomes who desire to develop their businesses and economic conditions have no access to traditional sources of financing granted by banks in the country. Development of microfinance institutions (MFIs) as one of the methods of poverty reduction and improvement of living standards of the population of the republic allows individuals to have access to sources of funds and other financial services, enhances the opportunities and independence of the poor, reduces unemployment, and creates new businesses.

During recent years, microfinance institutions in the form of non-government organizations (NGOs) have been developed in the country within projects financed by international organizations. However, the status and activity of these organizations has not received due attention in ongoing legislation. At present these organizations, as institutions rendering financial services, are registered with the offices of the Ministry of Justice. They are not within the sphere of regulation and supervision of the National Bank of Tajikistan (NBT).

The NBT has moved in the direction of supporting microfinance institutions within Non Bank Financial Organizations (NBFOs.) With this purpose, a number of normative acts were completed regulating the activity of NBFOs, but designed to deal with questions regarding the creation and operations of MFIs as NBFOs. However, this mechanism for MFI development in the form of NBFOs has not received sufficient attention to be fully developed.

Working on a statutory and normative structure allows us to eliminate the problems of the existing legislation and regulations governing microfinance operations. The focus of this task should be the creation of a framework for the formation and development of the microfinance services market, as well as creating conditions for MFI growth and competition.

We believe that the main direction in this work is the establishment of an effective system of law and regulation of MFIs with limited engagement by the government, minimizing the tax burden and responsibility of MFIs, with a provision for publicity on questions of settlements and supervision of the activities of these organizations.

The objective of the upcoming ADB project efforts on legislation for microfinance, as suggested by the team, is **the development of Acts and regulations as the basis for responsible growth of the microfinance services market in Tajikistan**. The team therefore considered the following four areas:

1. Alternative legal vehicles for this process;
2. Important areas to include, issues to consider, and steps to take to ensure the passage and effective implementation of such legislation;

3. Related issues to be dealt with in existing legislation and regulations for which there were both Russian and English versions;
4. Other legislation to review for potential impacts, where English versions were not available.

When considering these four areas, the team was cognizant of the following factors:

1. Tajikistan has a young financial market, and as such it is both shallow and relatively unsophisticated. Accordingly, a great deal of flexibility and care is needed to foster innovation and growth, and balance them with safety and soundness. Good statutes and normative acts can facilitate this process.
2. The microfinance sector has a number of unique aspects to it. These include:
 - a. Its attempt to deepen financial markets to serve microenterprises and poor households, a highly desirable social and economic objective;
 - b. Its low transactions sizes and high unit costs of service provision,
 - c. Its approach of physically taking banking services to clients in their homes and workplaces, rather than having clients come to a branch office;
 - d. The relatively undiversified and sometimes volatile nature of MFI credit and voluntary savings portfolios,
 - e. The fact that most MFIs begin as unregulated credit non-government organizations (NGOs), and may continue operating on a non-profit basis,
 - f. The fact that MFIs deal in savings and credit transactions with relatively low value in relation to the system as a whole -- and as a result are unlikely to have problems that cause broad systemic instability, and
 - g. The market risk posed within the microfinance sector itself when MFIs (especially large ones) are not properly managed and monitored.¹
3. The National Bank of Tajikistan, as financial markets regulator, has limited resources. Management of the microfinance market will be thus subject to a “light touch” with a prudential focus on those institutions which collect deposits from the public or are large enough to pose a risk of instability in the microfinance market.
4. Eight microfinance institutions already exist. These institutions are operating under international agreement. It is highly desirable that these institutions become long-term, sustainable Tajik organizations governed by domestic legislation, and that other microfinance institutions are encouraged to operate.
5. In discussions with stakeholders, they mentioned fear of unfair taxation, unduly complex registration and licensing requirements, unclear relationships with the banks, and passage of a law that is not be implemented as written as their most significant concerns.

¹ This list is adapted from Meagher, P and B. Wilkinson, Towards a market-friendly environment for microfinance—legal and regulatory reform in Zambia, Small Enterprise Development Journal, Winter 2000, p.2.

The team has produced this commentary and (separately) a logical framework analysis that incorporates and expands on the suggested objective. Additional notes from discussions, a presentation made on microfinance and legal issues, and examples of certain legislation and central bank recommendations regarding microfinance have also been collected. All materials have been made available in Russian and English for the convenience of the senior officials and others wishing to make use of them.

Successful implementation of legal reform in the microfinance sphere, in our mind, depends on the interactions and political dialogue in the process of preparation of the bill between lawmakers, corresponding ministries, and microfinance institutes.

Legal Vehicle

The team reviewed a number of options when considering the best way to create a legal framework for microfinance. These included:

1. A regulation on microfinance issued under the Law on the National Bank of Tajikistan;
2. Amendments to either the Law on Banks and Banking or the Law on the National Bank of Tajikistan;
3. A new Law on Non-Bank Financial Institutions, under which microfinance would be a part and credit unions would also be included;
4. A regulation on microfinance to be followed by a Law on Microfinance Institutions; and
5. A new Law on Microfinance Institutions.

After a great deal of debate on these options, Item 5 was deemed the most appropriate mechanism. The reasons why include:

1. Certain clauses in the Civil Code require establishment of statute to govern rules.
2. Statutes have a superior position in law.
3. Regulations are not public documents at this time. This, plus the relative ease by which they can be changed, does not provide confidence to actual or potential investors – whether donors or commercial – about the stability and support for the microfinance market intended by the government.
4. ADB will require this statute to be fast-tracked, eliminating the need for an interim regulation.
5. The burden on the existing two financial sector statutes is currently very high in terms of regulatory development. At this juncture, development of a set of key laws to govern second tier financial institutions, commercial credit, and other specialized financial institutions seems a sensible approach to financial market development, and it is consistent with international best practice.

We consider that it is necessary to work out a separate law on microfinance. Adoption of a law rather than regulation allows formalization of the status and activities of organizations implementing business activities in the financial market. This choice allows a more smooth and painless transition of ongoing NGOs into a formal status as MFIs. Furthermore, the adoption of law instead of regulation allows the NBT to initiate the adoption of amendments to related legislation required for the development of microfinance within the country. It is necessary to note the essential differences in the status and juridical force between laws and regulations, and to ensure a descriptive law is adopted to allow development of corresponding normative acts.

Accordingly it is the team's recommendation that a new statute be drafted with the NBT directing this process. The process for legal development has been laid out in the logical framework; assuming that the President would agree to directly sponsor the bill to speed up the development and passage of the law.

The draft bill should be worked out on the basis of study and analysis of existing microfinance international practice and examples of legislation on microfinance, with the purpose of choosing a suitable example to work with, giving due regard to the experience and errors of other countries. A selected example can then be used as a framework, and revised with due regard to the political, social and economic conditions of Tajikistan, and its own legislation. The bill should conform to NGOs rendering financial services to the population now and having experience in this regard.

We consider that it is advisable to conduct working and informal meetings with representatives of interested ministries and departments in the process of working out the legal and regulatory foundation of the bill. We will draw up general directions and discuss and eliminate differences, if any, on MFIs. This will provide a higher quality, more detailed approach in working out microfinance legislation as well as accelerating its adoption time.

Special consideration should be given to informing the public about the drafting of legislation on microfinance, and to encouraging their input, particularly existing NGOs working on microfinance and their clients.

Important Issues to Consider and Items to Include in the Microfinance Drafting Process

General principles:

1. The law must fit in with and be harmonized with other laws.
2. It must be flexible and visionary, anticipating market growth and innovation.
3. It must be practical and implementable without high cost.
4. There must be clear space for supporting regulation.
5. The law should be descriptive (what), not prescriptive (how.)
6. The law should have as sections: Background describing why the law is important and needed, Definitions of key words, Description of the market including generally what services will be provided, by whom, to whom; Define regulator; Describe things specifically permitted or forbidden (depending on usual legal practices in other laws)
7. While the law is being drafted, think about what the regulations will likely look like.
8. There must be inbuilt guarantees that the law will be implemented as intended, similar in spirit to such provisions in the Foreign Investments Act.
9. The anticipated key stakeholders are Justice, the Tax Committee, Finance, the Office of the President (both economic and legal departments), and the existing MFIs. Other interested parties may be donors and commercial banks who may engage with MFIs as wholesale lenders or holders of savings deposits.
10. One of the problems of consulting with stakeholders on legal drafts is the relative inexperience and lack of understanding of financial law within Tajikistan. This causes meetings and discussions on the topic to tend to be unfruitful and unfocused. For this reason, the team proposes tight attention on internationally accepted practice, an acceptance that the parent agency (in this case NBT with the President's approval) will sent the priority of work and choices, and a focus on how the law will actually work in practice here in Tajikistan.
11. Supervision according to a simplified scheme may be foreseen for microfinance organizations as non-commercial organizations, particularly those that do not take deposits from the public.

Specific areas of law/regulation:

12. Possibly provide registration and licensing as a single process, passing information on approved registrations to the Ministry of Justice. Registration is as a legal person, with licensing as a financial institution for life, subject to compliance with license requirements (periodic reporting, with additional financial requirements for those with savings/very large MFIs.)
13. Special provisions to existing MFIs to make licensing simple. Registration and licensing should be together at the NBT. Current MFIs should only have to be licensed by the NBT, and if they wish to add services, they should have a streamlined re-registration process.

14. No restrictions on foreign ownership. Currently it is 65% maximum, but this requirement is being amended for banks and NBFIs, so it can also apply to MFIs.
15. Determine what will happen if an NGO MFI undergoes voluntary or involuntary closure. This could affect donor contributions, especially if they believe an NGO can be force-closed and the assets revert to the State.
16. Branching should be unlimited and no advance approvals required for this.
17. Safety and security requirements for cash handling applying to banks should not apply to MFIs.
18. Manager and accountant qualification requirements for banks must not be applied to MFIs. Potentially a tiered system of qualifications should be put in place.
19. The team strongly suggests that consideration of a depositors protection fund be made. In draft microfinance legislation currently under consideration in Pakistan, 5% of net surplus per year in each MFI must be deposited into a central-bank administered fund for this purpose. This can be used as an example.

Commentaries on Selected Existing Legislation

Commentary on the Tax Code

All MFIs and government officials the team consulted felt that changes and adaptations in this area were the most important to be worked on first. A proper balance is vital between the keen interests of the government to alleviate poverty and deepen financial service provision, and the proper payment of taxes due to the State from those who are able to pay them.

As the tax legislation generally accompanies the annual budget, timing of proposed Tax Code changes may need to be proposed in September/October for easiest consideration. This should be checked.

General Issues:

1. The definition of a charitable organization is very narrow and does not agree with that in the Civil Code. Additionally, the Tax Code does not recognize that some markets may develop with both for-profit and non-profit institutions. Thus the team suggests for legal consistency that the Civil Code and Tax Code be harmonized to define non-profit institutions in the same manner, with the same wording to treat non-profit microfinance institutions. The team also suggests that non-profit MFIs be explicitly treated as non-taxable for institutional income-tax purposes. We recognize that the Tax Office may object to this. Our arguments are as follows. First, non-profit MFIs are currently paying no tax as international agreement-governed institutions, so there will be no government revenue losses. Second, they are playing a critical role in poverty alleviation, which is a charitable purpose. Third, no individuals are profiting from their operations in the manner

defined as commercial, since all surplus is added to loanable funds. Fourth, individual employee income and social taxes will be paid, so there are no unfair advantages for these institutions vis-à-vis commercial institutions. Fifth, efforts to ensure tax responsibility by clients (see below) can increase tax revenues.

2. Clients of MFIs tend to be individuals who live below the poverty line. Access to loan funds enables them to undertake income-generating activities that help the family to eat, pay for basic needs, and improve their standard of living. Accordingly at this time it seems very unlikely that clients are paying income taxes. For those who expect to continue with agricultural production, this is unlikely to be a problem as such activities are exempt from taxation. However, for those undertaking other kinds of income generation activities, the potential requirement to pay taxes is a significant problem. Business licensing is expensive, time consuming, and complex. In the absence of such arrangements, a 30% tax rate can be assumed. Additionally, abuses by the tax authorities are possible.

The team suggests two alternatives:

1. Accept that clients of the microfinance institutions are under the poverty line, and that it is in the public interest to enable them to earn and spend additional funds in order to support their families. Accordingly, allow a blanket exemption for those under the poverty line from income tax on activities funded by microfinance loans.
2. Gradually and reasonably incorporate clients into the tax structure. Allow a two-year period from licensing of the MFI for its clients to prepare to be taxed. After that period, allow the MFI to issue a special business license for one year within their loan agreement to any client under the poverty line, for the activities funded by the loan issued to the client. A fee of 5 somoni will be charged and provided to the Tax Ministry for this service, as a proxy for the imputed tax valuation. Once clients cross the poverty line they will be encouraged to register their businesses formally, and to pay the simplified business tax.

Specific Articles requiring amendment:

1. Articles 11 and 20 on charitable institutions require amendment to bring them into harmony with the Civil Code and to take account of the unique aspects of non-profit microfinance institutions.
2. Article 27 should be modified to more carefully define financial services and income in accordance with the Articles above.
3. Article 83 holds financial institutions accountable for getting tax numbers on their clients. This is unreasonable for microfinance institutions working with isolated rural

clients. The team leader advised that this provision is in the process of being removed.

4. Article 129 provides for exemptions from institutional income taxation; non-profit MFIs should be included on this list.
5. Article 134 only allows interest payment deductions of up to 125% of the NBT interbank rate. Microfinance institutions may borrow wholesale funds to retail to their clients, for which the interest payments will be a very substantial cost. It is virtually certain that these rates will be over the limitation. This should be revised to allow the full interest costs to be deductible for any institution.
6. Article 135 only allows banks to deduct 80% of bad debt reserves. However, if they collect on bad debts after writing them off, they must pay tax on 100% of that revenue. The team leader advised that this provision is in the process of being revised, and the team advises that it should be 100% deduction to be consistent with taxation of the post-writeoff collection tax rate.
7. Articles 263 and 274 provide exemptions for land tax and road use tax for charitable institutions. Consistent with the changes suggested in Article 129 and Articles 11 and 20, non-profit microfinance institutions should be added here.
8. Article 278: The team feels that small for-profit microfinance institutions operating as small businesses should be able to use the simplified tax system. We consider circumstances such as small pawnbrokers or money lenders to be appropriate candidates for this, and would ask for the simplified system to be applicable to them rather than having a blanket exemption from this option for all financial service providers.

Commentary on the Civil Code

The team reviewed Parts One and Two of the revised Civil Code. It was felt that no changes would be required to enable the operation of microfinance institutions. However, Part 3 is under development now and should be reviewed before introduction to the Majlisi Oli.

The team recognized that the provision in Article 51 for registration of all legal entities by the Ministry of Justice might be an issue. It is the NBT's view that the safety and soundness of the financial system would be compromised if financial institutions were not registered by the NBT, a view shared by the IMF, World Bank, and other international agencies. Therefore this issue was left to higher authorities to address. The team has assumed that microfinance institutions in existence at the time of passage of the law will be licensed by the NBT, while their existing registrations will be accepted. New microfinance institutions will be required to be registered and licensed by the NBT.

Existing MFIs wishing more complex structures can go through an expedited and simplified re-registration system with the NBT at a later date.

Commentary on the Law on Banks and Banking Activities

General Issue:

In this and the law on the National Bank of Tajikistan, the terms bank, non-bank financial institution, and credit institution are used. They are not defined in either statute. As a result, it is unclear whether the stated rules apply to banks OR other institutions, or whether in some portions of these two laws the clauses apply to banks AND NBFIs and credit institutions. As a result, in order to have the microfinance legislation clear, it will need to define all of these institutions and delineate microfinance institutions within this set of structures.

Specific Articles requiring amendment:

1. Article 5 bans deposit-taking from any non-regulated banking activities. If microfinance institutions are to be allowed to take any form of deposits, even from their members, this Article will have to be amended accordingly.
2. Article 7 bans advertising of any banking services by non-registered banking institutions. As a list of banking services is included in the statute which includes lending, transfers, and savings services, this Article will need to be amended to allow advertising of services only by financial institutions duly licensed to perform such services by the NBT.
3. Article 17 on licensing is unclear on whether it applies both to banks and non-banks. It should be clarified to ensure it applies only to banks and NBFIs not covered under other statutes.
4. Article 44 does not allow banks or non-bank financial institutions to provide insurance services. It may be very important for microfinance clients to be able to get insurance services, and thus MFI operation as an agent or broker for an insurance company seems reasonable and practical. The Article should be amended to so allow financial institutions, with the permission of the NBT.

Comments on the Law for the National Bank of the Republic of Tajikistan

General Issue:

As above, under the Law on Banks and Banking Activities. See recommendations.

1. The team suggests that once the microfinance bill is drafted, the Law for the National Bank should be reviewed to ensure harmony between the two laws and any necessary changes in the latter Law should be suggested at that time.
2. An Article should be added which provides the power to the National Bank of Tajikistan to engage in small pilot projects to support financial innovation. Such projects should operate no longer than five years, with the purpose of encouraging innovations to increase access to financial services by the citizens of Tajikistan.

Specific Articles requiring amendment:

1. Article 4 should be amended to add microfinance institutions and other relevant financial sector institutions providing certain financial services to the population.
2. Article 48 governs fines. If MFIs have no or small authorized minimum capital, their fines will also be small. The team recommends that this be amended to add “or as by statute” to enable fines to be placed in the MFI legislation for them.

List of Statutes and Normative Acts for Additional Review Before MFI Bill is Finalized

Note: these were areas where, in discussion, issues emerged within the team that indicated the importance of review. Other areas, particularly in normative acts, may also be important. It is strongly recommended that all normative acts receive some review and reference to the drafting process.

Statutes:

Labour Code, to determine effects of rules on MFI staff and field operations
Law on Joint Stock Societies, to determine effects on MFI institutional structures
Law on Non Government Institutions, to determine effects on MFI institutional structures, particularly where assets revert to on closure
Law on Insurance, to determine if there are limits on MFIs as brokers or agents
Law on Consumer Protection, to see effects on and use of systems by MFI clients
Law on Anti-Monopoly, to see if MFI consumer protection falls under this agency
Civil Code Part 3, still under development, for relevant provisions

Normative Acts:

Regulation on risk classification of credits
Regulation on payments/settlements system
Regulation on inspections of banks
Instruction #100 on bank registration