



Support to the Development
of Small Entrepreneurship
SMERUS 9803

Microfinance in Russia

Policy Paper

April 2001

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List of abbreviations

ACDI	Agricultural Co-operative Development International
BRI	Bank Rakyat Indonesia
CC	Credit co-operative
CCI	Centre for Citizen Initiatives
CGAP	Consultative Group to Assist the Poor (World Bank Group)
CIDA	Canadian International Development Assistance
COPAC	Committee for the Promotion and Advancement of Co-operatives - Switzerland
CU	Credit Unions
DFID	Department for International Development (UK Government)
MLI	Micro-lending Institutions
EBRD	European Bank for Reconstruction and Development
FINCA	Foundation for International Community Assistance (Microfinance NGO US)
KKP	KKP Partners law firm (Moscow)
KREP	Kenya Rural Enterprise Programme
MCS	Society of Mutual Crediting of Small Business Entities
MFI	Micro Finance Institution (MLI, CU and CCs)
MSE	Micro and Small Enterprises
NACU	National Administration of Credit Unions in the US
NASCU	National Association of Savings and Credit Unions in the US
NBFI	Non-bank Financial Institutions
NIF	National Insurance Fund of NACU in the USA
OI	Opportunity International
RABO	RABO bank of the Netherlands
RCUL	Russian Credit Union League
RCC	Rural Credit Co-operatives
RCCDF	Rural Credit Co-operation Development Fund in Russia
RIS	Russian Initiatives for Self-employment
ROSCA	Rotating savings and Credit System
RC	Russian SME Resource Centre
RWMN	Russian Women Microfinance Network
SME	Small and Medium Enterprises
SMERUS	Support to the Development of Small Entrepreneurship – EC/Tacis project in Russia
SSEDF	Sakhalin Small Enterprise Development Fund
Tacis	European Union's Technical Assistance Programme for the Commonwealth of Independent States
TF	Task Force
USAID	United States Agency for International Development
VOCA	Volunteers Overseas Co-operative Assistance
WOCCU	World Council of Credit Unions

Note on documentation references:

[D-12] refers to document "D" page 12, in accordance to the documentation listing in appendix 1

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Author: Joost de la Rive Box, April 2001

Executive Summary

Importance of SME sector

Small and medium-sized enterprises (SMEs) play a crucial role in facing today's economic and social challenges and in creating employment. A strong entrepreneurial culture is essential for the future competitiveness of the Russian economy and for generating economic growth. SMEs can create many jobs within a short period of time, increase the tax base, add to the growth of national income, and may provide substitutes for imported goods. In modern economies, the SME sector is the most important "engine" of economic growth. Developing an enabling environment for SME development is hence crucial for both the SME sector and for the economy as a whole.

Aim of the study

The primary objective of the Tacis project SMERUS 9803 *Support to the Development of Small Entrepreneurship* is to strengthen the RF Ministry for Antimonopoly Policy and Support to Entrepreneurship (MAP) as an effective policy adviser. The sector policy study on microfinance in Russia has been carried out within the above framework. Purpose of the study is to provide an overview of microfinance in Russia, to review relevant experience abroad, to identify the current policy issues of microfinance development in Russia, and to recommend ways and means the Federal Government can address these issues, in order to create a more enabling environment.

The current draft report has been circulated among experts and MFIs and later has been discussed at the Task Force-3 (Access to Finance) meeting.

Role of the government at this stage of sector development

According to the estimates of the RC, in 2000 the sector as a whole served 13,100 clients with total disbursements estimated at Rub 1,170 million [A]. This clearly shows that the sector is still in embryonic state. Experience abroad shows that the Government at the early stages of sector development is involved in a promotion and advocacy capacity, rather than in a regulating capacity. In this respect a clear distinction must be made between enabling legislation and legislation aimed at regulation and supervision. The former is aimed at creating a legal and fiscal environment in which microfinance institutions can viably operate.

Based upon international experience, as a general rule it seems prudent not to rush a formal regulatory and supervisory framework until the sector has reached a level of maturity. Usually formal regulation of the microfinance industry is undertaken only when MFIs intend to become deposit-taking institutions, since this would bring them in the domain of banking legislation. It is therefore recommended that at this stage the government interventions focus on the creation of a microfinance-friendly climate, through enabling legislation and fiscal measures.

Mapping microfinance

In the microfinance delivery system broadly five types of institutions can be distinguished:

- Micro-lending Institutions (MLIs). These are specialised credit-only MFIs, that operate usually on a not-for-profit basis and are registered as NGO, Fund, co-operative or branch of a foreign NGO.
- Credit Unions; Membership organisations established with the aim of providing financial services to members, that are fully, or largely financed from the share capital and savings of its members. Usually they have no access to any external finance.
- Agricultural/rural credit co-operatives; these are membership organisations, just like credit unions, dealing predominantly with farmers and agriculture related rural businesses.
- Public Funds (Regional funds) operated under the auspices of the Regional government and wholly or largely financed from the regional budget.
- Commercial banks.

Since the SME finance through commercial banks is dealt with in a separate policy paper, the latter component is not included in the current study.

Based upon the experience of organisations working in the microfinance sector in Russia, five areas of concern can clearly be identified:

- lack of a policy framework
- ambiguity in federal legislation, creating uncertainty as to the legality of credit delivery by non-bank financial institutions
- unfavourable tax regime for microfinance providers and borrowers
- limited delivery capacity in the sector of micro finance and co-operative credit. the mechanism of replication and scaling up of operations is not functioning yet
- uncertain medium term funding perspective for institutions that are not fully self-financed

Below, for each of these factors the policy observations and recommendations are summarised.

Lack of policy framework

The Federal Programme of State Support to Entrepreneurship covers a wide array of intended support activities for Small and Medium Enterprises. Until now the Federal Government did not have a specific policy for micro-enterprises and microfinance institutions. In view of the emergence of this industry, it is desirable that on the federal level a policy framework is created, to guide the lower authorities in respect of microfinance operations. The policy framework recommended in this study deals with:

- government recognition of the sector
- creation and maintenance of a level playing field
- mandate for non-banking financial institutions to be involved in microfinance
- role of the government in sector development; creating an enabling environment
- the need for MFIs to be viable and financially sustainable
- freedom for the sector institutions to determine lending conditions
- protection of microfinance funds against erosion through inflation

Ambiguity in federal legislation in respect of microfinance

Microfinance institutions operating in Russia have been confronted with two fundamental questions in respect of legislation:

- Does current legislation provide sufficient sanction to the operations of MFIs?
- Are MFIs allowed to lend from borrowed funds, for instance from a line of credit provided by a donor?

Based upon legal scrutiny of available studies and documentation, it is concluded that micro-lending activities by non-commercial organisations are exempted from licensing requirements, and hence no specific legislation would be needed.

However, on the short run there seem to be two issues of enabling legislation that need to be addressed. The above conclusion is based upon the observation that the fact that MFIs are registered as non-profit organisations. This raises two related legal issues:

- The legislation on non-commercial organisations does not recognise micro-lending explicitly as a legitimate non-commercial activity. This implies that from a tax point of view, lending activities would be treated as commercial, thus attracting tax on interest income. It would therefore seem desirable to amend this legislation on non-commercial organisations in this respect.
- In the long run microfinance organisations may opt for commercial status, so as to be able to attract private capital. For this reason it is desirable that MFIs not involved in deposit taking, are exempt from licensing, irrespective of their legal structure.

It is recommended that the Federal authorities address these issues.

On the issue of lending from borrowed funds, it is concluded by legal experts that loans or lines of credit provided by national or international financial institutions, cannot be treated as bank deposits. Hence it appears that current legislation does not preclude borrowed funds for microfinance operations, provided the funds cannot be classified as deposit taking.

Credit unions and co-operatives suffer from a lack of clear recognition in civil legislation. In this field two different strategies have been proposed. The first strategy focuses on specific legislation for Credit unions. The second aims at a reform of civil legislation, to address the underlying deficiencies. Reportedly fresh efforts are undertaken in the State Duma to agree upon specific legislation for Credit Unions. A new draft Federal Law on credit co-operation has been developed by the Ministry of Agriculture and Food and is being passed through the Duma. It is recommended that a reputable international institution in this field, such as WOCCU be consulted, so as to make best use of international experience in respect of credit union legislation, regulation and supervision.

Unfavourable tax regime for microfinance providers and borrowers

Micro-lending institutions are confronted with a tax regime that puts them in an unfavourable position as compared to banks. If the Government acknowledges the development value of the industry, it would be prudent to ensure at least a level playing field. The following tax issues need to be addressed:

- *VAT on interest:* As of end 2000, VAT is payable by all MFIs, except those registered as a Fund. Both in the existing and in the new VAT law (Tax Code, Part 2), bank operations are exempted. It would seem justifiable to exempt all type of MFIs, not only those registered as a Fund, from VAT on interest revenue. It is recommended that this be taken up as part of the current tax review process.
- *Liability for Enterprise Profit Tax:* Currently all MFI operations that are funded through grants pay 30% tax on net revenue. This is considered the single biggest obstacle for achieving MFI financial viability. For example, it is estimated that out of a grant of USD 5 million, approximately USD 500,000 is payable in the form of profit tax. In view of the fact that the Federal Government gives high priority to microfinance development, it would seem fully justifiable for the government to wave profit tax for MFIs, since they retain their operating surpluses for the purpose of expanding loanable capital. There are two different strategies that could be followed to achieve this objective:
 - The first strategy is to better use the current provisions of the Tax Code. The new version of the Tax Code (Part 2) applies as a general rule that non-commercial organisations are not subject to income tax on income derived from the activities that are declared in the documents establishing the organisation as a non-commercial organisation. Unrelated business activities are subject to tax. As observed above, the problem for MFIs may be that microfinance is not considered an appropriate legal purpose of a non-commercial organisation. If the law on non-commercial organisations could be amended, as suggested above, MFIs would qualify for tax exemption.
 - The alternative strategy is to carve out a special exception in the Profit Tax law for MFIs.
- *Grants to MFIs:* Grants provided by the US to local MFIs is tax exempt, on the basis of a treaty and a special law. Grants from within Russia or from other countries (not USA) would be taxed. For development of the microfinance industry seed capital is of vital importance. In most countries seed capital has been generated in the form of grants from the government or donors. It is vital that this route is opened up, not only for US donor organisations, but also for donors from other countries.

Limited delivery capacity

Operators in the market report that development over the past years has been much slower than expected, due to the lack of an enabling environment and the differences in approach of regional and municipal authorities. Experiences in other countries of the region have shown that development of the microfinance can be much faster, provided that the environment is conducive.

In order to facilitate future growth of the industry, the following recommendations are made:

- *Harmonisation of the regulatory environment:* The laws and regulations of the regional governments in Russia vary widely. Harmonisation of these regulations may be desirable in certain instances, but it is envisaged that this will be a gradual process involving extensive exchange of information and expertise between the federal and regional authorities. It is considered desirable that a "clearing house" be created for information in respect of federal and regional legislation and regulations for financing of MSEs. The Federal Fund seems to be well placed to perform such function. By pursuing this clearinghouse function, the Federal Fund could promote the adoption of gradually more favourable legislation and regulation at the regional level.
- *Promotion of a second tier microfinance organisation in the private sector:* In the medium term, existing and new MFIs will require debt funding for their lending operations, as grant funding will

come to an end. It is recommended that MAP shall investigate, possibly with the assistance of one or more donors, the possibility to create a mechanism for wholesale financing of MFIs through debt and equity instruments. The logical entry point for such initiative is the source of funding; the government should engage in consultation with the major international finance institutions and donors on this issue. Once one or more possible funding partners have been identified, the formulation of the appropriate finance mechanism and institutional setting can be undertaken in collaboration with potential financiers.

- *Policy dialogue with the sector:* It is desirable that the government (MAP) engages in an active and sustained policy dialogue with the practitioners in the sector so as to create an enabling environment for the industry and eliminate undue administrative and fiscal obstacles. For this purpose the sector should be stimulated to constitute a mode of representation that can speak on behalf of the operators in the sector. Similarly the government (MAP) conducts semi-annual policy dialogue with donors and potential financiers of the sector, so as to discuss progress in sector development.
- *Creation of a liaison function within the Government:* In order to involve MAP in active consultation with the sector, and to steer support activities within the Government, it would be desirable that a unit is established within the DSSE of MAP to act as a liaison office on microfinance. This liaison office could well be seen as the institutionalisation of the current Task Force on Access to Finance, as far as the microfinance component is concerned.
- *Information Centre for microfinance:* The existing MFIs in Russia have found their way through the labyrinth of federal and regional regulations at great expense. In view of their funding base (provided by donors), they could afford lawyers and accountants to guide them. In order for replication mechanisms to work, it should become easier for new entrants on the market to engage in microfinance. For this reason it is desirable that documentation and studies on microfinance are collected and maintained at a central point, so as to make them available to interested parties. At the same time, an information centre could act as a source of information on current microfinance activity for the government, institutions operating in the sector and others. The Resource Centre (RC) could be mandated and requested to act as Information Centre for Microfinance.

1. Introduction

1.1 Framework of the SMERUS project

The general objective of the project is to develop a more favourable environment for Russian SMEs. Although the SME sector has witnessed a considerable growth, weaknesses in the fiscal and legal framework obstruct the development of the full potential of SMEs as a “motor” of economic growth. Support to the SME sector on the federal level is implemented by the RF Ministry for Antimonopoly Policy and Support of Entrepreneurship (MAP) and by the Federal Fund for Small Business Support. MAP is a pivotal policy maker in creating the overall business framework for SME development. The project has as objective to strengthen the MAP as an effective policy adviser and reinforce the framework of the Federal Programme of State Support to Small Enterprise. The overall project is also implemented in close collaboration with the Russian SME Resource Centre. The RC is a non-commercial foundation, established under Tacis, and performs research in SME development, provides policy advisory services and information support to the SME sector. The RC is strongly linked to MAP, and both are the principal counterparts of the project.

The organisation of activities of the project is structured around six Task Forces

- 1 Monitoring and Analysis
- 2 Fiscal and Tax Policy and Accounting
- 3 Access to Finance
- 4 Legislation and Administrative Barriers
- 5 Business Development Services and Training
- 6 Access to Markets and Public Relations

The Ministry has nominated a chairperson for each of the Task Forces. Logical candidates were the heads of units within the Department for State Support to Entrepreneurship (DSSE). Three members of the resident project team have been nominated to serve as secretaries for six Task Forces. Each Task Force was composed of a core group of around six-eight members including two-three from MAP, one-two from the RC, one-two EU experts. Specific attention was given to establishing and strengthening contacts with ongoing projects dealing with the topics selected through the Task Forces. The aim is to create synergy through involvement of experts of other projects in the Task Forces and to avoid duplication of efforts. Meetings of Task Forces take place on average once per two months. Additional work meetings related to project work in progress are conducted when and if needed.

Each of the Task Forces has elaborated a work-plan till the end of the project. According to the work-plan of the Task Force-3 (Access to Finance), the project experts must develop four policy papers for MAP. This is the first policy paper. Three others will analyse and develop recommendations on leasing, venture capital and investment funds, including guarantee arrangements. All policy papers will be produced during the year 2001.

On 14th February 2000 President Putin signed Decree 121 “On the Federal Programme of State Support to Small Entrepreneurship in the Russian Federation in 2000-2001”. This Decree highlights the priority the Government gives to MSE development. Two components in the programme are particularly relevant; section II on Development of Progressive Financial Technologies and section VI on International Co-operation in the field of small enterprise. While the above decree outlines the broad framework of government policy, the current report aims to address on particular segment, the financing of micro enterprises.

1.2 Purpose of the study

The sector policy study on microfinance in Russia has been carried out within the above framework. Purpose of the study is to compile relevant documentation on microfinance in Russia, to discuss policy issues of microfinance development with the parties involved, and to recommend ways and means the Federal Government can create a more enabling environment for microfinance.

A number of specialised studies on the microfinance sector in Russia have been conducted by the

Russian SME Resource Centre, FINCA and KKP Partners law firm. Together they provide a good basis for policy assessment. A list of all documents used for this paper has been attached as Appendix 1. Special reference is made to the following documents:

- Analysis of Microfinance Supply and Demand on Russia's Market – by the Russian SME Resource Centre for FINCA International
- Financial Technologies in Small Business by the Russian SME Resource Centre
- Improvement of the Policy and Regulatory Framework, Small and Medium Enterprise Development Moscow 2000, KKP Partners
- The State of Microfinance Activity and Regulation in Russia - FINCA 2000, Mehnaz S. Savian ea

Apart from documentation study, the consultants have interviewed all prominent players on the microfinance market as well as the government officials involved.

The current paper focuses on the main policy dimensions, and refers for detailed analysis to the underlying materials. The purpose of a policy study is to assist the government to define its position of the subject, and to identify possible areas of intervention. In order to do this, the study addresses questions such as:

- What is the current status of the sector, and what are the obstacles for its development?
- What is the outlook, and what can be learned from experience elsewhere?
- What should be the government strategy in respect to microfinance development?
- What action on the side of the government is required in the coming three to five years?
- How can the process of continued policy formulation be structured, and how can sector institutions be involved?

1.3 The case for microfinance; core questions for sector policy

Microenterprises form the lowest bracket of entrepreneurial activity in society. For the large number of entrepreneurs, a micro enterprise is their entry point in the world of business. This entry point can be a formally registered shop, but equally informally executed sale of agricultural produce. Every modality of self-employment, both in cities and in rural areas can be considered a microenterprise. When people get employment, and some tangible investments are made, a small business is in the making. Micro enterprises are the breeding ground for entrepreneurship. In Russian society, which has been dominated for most generations in the last century by the concept of state care, the transition of citizens towards a market economy, towards self-reliance, is more than just an economic development. It is a socio-cultural process of change, which touches upon core human values and convictions. For more and more Russian families, the transition from a secure job or government support scheme, towards the establishment of some kind of micro-enterprise, is becoming a day to day reality. With job opportunities getting more and more scarce, micro-entrepreneurs are rapidly becoming a substantial segment of working people in Russia. And they are not taken care of. Micro enterprise support is still in its infancy in Russia, so the large majority of micro-entrepreneurs in Russia has to somehow struggle on their own. Which is not easy.

Looking at the figures in this report will help to appreciate this fact. Microfinance is done by pioneers; institutions that open up new finance markets in areas that were not served before. These institutions have to clear the ground, which obviously makes the going slow. Now that some passable tracks have been created, the question is how to make them passable for others and how to rapidly expand the outreach. It is not the role of the government to act as entrepreneur in these new markets. But the government can play a vital role in encouraging the parties that do, in removing the obstacles imposed by lack of appropriate legislation or discriminating taxation, and by promoting new and larger scale financing in this sector.

Microfinance is not just another business sector. It is a business with social objectives; it operates on the borderline social development and commercial activity. This is the justification for the Government and donors alike to allocate funds to the sector and to promote its development. Microfinance is widely recognised as an effective instrument to create employment, to breed entrepreneurship, to facilitate market orientation and to combat poverty. It is an instrument that helps to empower people who are willing to take their fate in their own hands, and not rely on other to take care of them. Micro

entrepreneurs do not expect gifts or favours, but they do expect to be treated as actors in the economy, just as their larger scale counterparts are. All they expect are business services, provided in a businesslike manner. When this is offered, international experience has shown that micro-entrepreneurs are a reliable client. Not only that. They are the types of client that have the potential, by virtue of their numbers, to change the make up of society.

Do microfinance institutions have a role to play next to commercial banks, or are they merely competing for the same clients? It is generally recognised that MFIs are providing services complementary to commercial banks, thus strengthening the entire financial system. The conditions of commercial banks can often not be met by micro entrepreneurs (especially collateral requirements). Lack of access is also determined by proximity of services; MFIs tend to have a potential for greater outreach in the rural areas, especially membership based MFIs (credit unions and credit co-operatives). Microfinance institutions deal with small sized financial transactions that are not attractive to commercial banks. MFIs have developed special delivery methodologies that allow delivery if these small financial transactions to be cost effective and low risk. Thus, MFIs fill in the gaps that commercial banks cannot serve. MFIs can even strengthen the commercial banking system, since they effectively mobilise savings for depositing with commercial banks. Moreover, successful MFIs generate successful entrepreneurs that graduate to small or medium scale businesses. Every successful micro-entrepreneur is a potential client for the commercial bank. For this reason commercial banks sometimes support MFIs through loans or share capital. They merely invest in future business.

1.4 What is microfinance? Some concepts and definitions

Microfinance is the sector of activity that provides financial services to microenterprises. Microfinance institutions (MFIs) typically do this by mobilising savings, by providing credit, by organising group activities geared towards the financial requirements of members, or any combination of these. It is remarkable that in literature, both in Russia and abroad, few definitions of microenterprise can be found. The reason is that effort to define microenterprise tend to be all-inclusive, in order to cover the multitude of forms that small and often starting entrepreneurs, have to operate a business activity.

The following definition reflects this characteristic:

“Microfinance refers to small-scale financial services for both credit and deposits - that are provided to people who farm or herd; operate small or microenterprises where goods are produced, recycled, repaired, or traded; provide services; work for wages or commissions; gain income from renting out small amounts of land, vehicles, draft animals, or machinery and tools, and to other individuals and local groups in developing economies, in both rural and urban areas”¹.

In many countries the difference boundary between microfinance and other forms of SME finance is drawn by defining a maximum amount for the loan to ultimate clients that can still be considered “micro”. The smallness of the loan clearly is a distinguishing feature of microfinance. Any “ceiling” is quite arbitrary however; no universal standard exists. In developing countries often a ceiling of USD 500 is quoted (in practice often increased to USD 1,000 or higher), and in the industrialised countries levels of USD 5,000 or DM 10,000 are usually considered micro-loans. It would be desirable that such standard is defined for Russia also. A national microfinance conference or summit would be a good opportunity to do so.

A very relevant difference between microfinance and “formal” finance is that the former includes clients without business track record (start up), clients without credit history and without registered collateral. Microfinance also emphasises the need for promotion and advocacy, encouraging clients to access finance services, who would normally look at themselves as being “uncreditworthy”. Especially women are thus stimulated to take up entrepreneurial activity in their own right.

The term "Microfinance Institution" (MFI) is used for any organisation that provides microfinance in accordance to the above definition. This very simple definition of MFIs implies that it includes organisations such as agricultural co-operatives, which may have other functions as well. The implication is that in this report the focus is on all institutions that perform a microfinance *function*,

¹ This definition is a slightly amended version of one provided by Marguerite Robinson in Strategic Issues in Microfinance, 1998.

rather than limiting ourselves to institutions that do nothing but microfinance.

In the context of this report a further distinction is made between:

- Micro-lending Institutions (MLIs); i.e. specialised credit-only MFIs, which are externally funded.
- Credit Unions; Membership organisations established with the aim of providing financial services to members, that are fully, or largely financed from the share capital and savings of its members. Usually they have no access to any external finance.
- Agricultural/rural credit co-operatives; these are membership organisations, just like credit unions, dealing predominantly with farmers and agriculture related rural businesses.
- Public funds for SME support, operated under the auspices of the government and wholly or largely financed from the government budget (federal, regional, municipal).

Commercial Banks can and do provide microfinance but, for the purpose of this report, they are not included in the term "Microfinance Institution" (MFI). The special MSE programmes of commercial banks will be dealt with in a separate policy paper to be produced by Tacis SMERUS 9803 project.

For the same reason, the current study focuses on policy issues related to micro finance providers, not on the specific problems of small or micro entrepreneurs. It is envisaged that this aspect is dealt with in a separate Task Force on SME Monitoring and Analysis.

2. Institutional map of the microfinance sector

2.1 Types of institutions involved in microfinance

In line with the above conceptual framework, the microfinance delivery system is described in terms of three broad categories:

- Micro-lending Institutions (MLIs). These are MFIs that are established with the assistance of donor programmes, focusing mostly on micro-credit delivery. They have NGO status and are fully or largely externally financed.
- Credit Unions and credit co-operatives. Membership organisations established with the aim of providing financial services to its members, that are fully, or largely financed from the share capital and savings of its members. Usually they have no access to any external finance.
- Public Funds (Regional funds), operated under the auspices of the Regional government and wholly or largely financed from the regional budget.

And finally:

- Commercial banks.

The Russian Small Business Fund EBRD providing loans to Russian commercial banks is essentially a "scaling down" approach. A methodology has been developed to allow banks to operate with SME clients in a viable manner. This programme covers the higher brackets of the MSE market. Since the SME finance through commercial banks is dealt with in a separate policy paper, this component is not covered in the current study.

The major differences between the Micro-lending Institutions (MLIs) and credit co-operatives are shown in the table below:

Table 2.1 Comparison of Micro-lending Institutions and Credit Co-operatives

	Microlending Institutions	Credit Cooperatives
Relationship with borrower	Lending to clients	Membership organisations
Legal form	NGO type registration	Operating under co-operative law
Main service	Microcredit is the main product, externally funded	Savings-based microfinance
Groupsize	Groups are small (five-thirty)	Co-operatives can be big (up to 1,000 members)
Group mobilisation	Active mobilisation by the MLI	CUs or CCs are self-mobilised
Savings	Not allowed to take deposits from clients. Savings can be pledged as cash collateral, but cannot be used for on-lending	Taking share capital contributions and member deposits
Funding source	Externally funded (donors)	Internally funded (member contributions)

Each of these two strands of microfinance is described below in more detail.

2.2 Micro-lending Institutions

2.2.1 Characteristics

The MLIs operating in Russia utilise both individual lending and solidarity group-lending methodologies. The common denominator of these programmes is that appropriate lending techniques are used for micro and small entrepreneurs, creating access for small clients that have no access to regular bank credit. Lack of access is created by a variety of factors such as lack of hard collateral, lack of credit history or the small size of the transaction (not considered cost effective for the bank). MFIs have developed specialised financial technologies to overcome these problems. Alternative security is created either through mutual guaranties (solidarity group lending) or alternative collateral (like household utensils).

According to the study "Analysis of Microfinance Supply and Demand on Russia's Market", there are currently over 20 specialised microfinance institutions operating in Russia. The combined disbursements are estimated at Rub 1,171 million, and combined clientele some 13,100 (these figures include data from commercial banks). This shows that, for a sector that has been in development now for five years, growth has been rather slow. As a consequence committed funding may not even be exhausted as per budget targets. Each of the institutions in the sector is still operating on a relatively small scale, in which economies of scale cannot yet be fully achieved. One indicator is the number of clients per loan-officer, which on average is still well below generally accepted targets. Substantial scaling up is a precondition for the creation of efficient and viable MFIs. This is the challenge for the next decade.

The main providers of microfinance are:

- Opportunity International
- FINCA
- RWMN
- ACDI/VOCA
- Counterpart International

The microfinance institutions in this category have two basic characteristics. First, the institutions are all recently established. Due to the relatively small size of operations, the cost per Rouble lent is high. While a number of them is reportedly already operationally sustainable, this needs not be a permanent feature. Scaling up is necessary, and requires more elaborate accounting, information and control systems. Secondly, these MFIs have developed specialised methodologies. In most cases these methodologies will require fine-tuning and adaptation to the peculiar circumstances in the region. The sector is still in the early stage of the learning curve. Inevitably at this stage, there are risks and relative inefficiencies that only gradually will be brought under control. Network structures, such as FORA and RWMN, help institutions identify imminent problems at an early stage.

2.2.2 Overview of institutions

Fund Opportunity Russia (FORA)

FORA was established by Opportunity International and its Russian Partners in July 2000. Since 1993, Opportunity International has helped to develop Russian microfinance organizations and adapt lending methodologies to the needs of the Russian market. FORA (Fund Opportunity Russia) has been established on the experience of Opportunity International Russia Partners; and, from the consolidation of four of the five of those partners. Its mission is to be a leading microfinance organisation in Russia providing quality services to entrepreneurs with a desire to develop their businesses and without collateral.

FORA is a national organisation and operates in nine regions (oblasts) of European Russia (Belgorod, Lipetsk, Nizhny Novgorod, Novgorod the Great, Rostov-on-Don, Saratov, St. Petersburg, Tambov, and Voronezh). The headquarters of the foundation are located in Nizhny Novgorod. As of January 2001, Opportunity International's partners have provided 8,287 loans funds since inception of the programme in 1995. Funding for Opportunity International's programme in Russia has come from USAID, DFID (UK Know How Fund), UNHCR, the Eurasia Foundation and Charles S. Mott Foundation.

FORA offers two different loan products to their clients: individual loans and Trust Bank loans. Trust

Bank loans are group loans. Group loans provide an effective way of reaching low-income microentrepreneurs that have the need and capacity to borrow but lack conventional (physical) collateral. FORA's Trust Bank methodology is based upon the experience of the Opportunity Network with group lending since 1991 and in Russia since 1995. Members of Trust Bank groups mutually guarantee each others' loans and the peer pressure from other group members acts as an effective control on repayment. Through its experience in Russia, FORA has found that the optimal group size consists of four-seven members and no groups have been larger than seven members. Trust Bank loans is also a cost effective way of providing loans for FORA and increases the loan handling capacity of each loan officer.

The majority of clients are in trading and 70% of all clients are women. The maximum loan size is USD 3,500. The average loan size is USD 840. The annual interest rate is between 48-70%. Loan repayment is reported as 98.25% (1.75% portfolio in arrears over one day) and the portfolio at risk is reported as 2.53% (over one day). The total portfolio outstanding as at December 31st 2000 was USD 1.3 million.

FINCA - Samara Regional Microcredit Programme

The Foundation for International Community Assistance (FINCA) started the Samara microcredit programme in 1999 with funding from USAID. FINCA applies a group lending approach to microfinance, referred to as village banking. Village banking groups in Samara consist of five to ten neighbours, who come together to guarantee one another's loans, to administer group lending and saving activities, and to provide mutual support. Currently the programme serves 600 clients (88% of them women) and the loan portfolio is USD 570,000. Groups meet weekly and loans are provided without collateral. Loan repayment is 96%.

Russian Women's Microfinance Network (RWMN)

The RWMN was established in 1998 with a grant from Ford Foundation, with the aim to support the development of women-focused microfinance institutions throughout Russia. There are four partner MFIs in the network:

- Kaluga Fund "Microloan" in Kaluga Region; disbursement of USD 467,000 in 917 loans
- "Women Initiatives" in Moscow Region; disbursement of USD 137,000 in 125 loans
- Fund for Support of Women Entrepreneurs in Tver Region; disbursement of USD 164,000 in 212 loans
- Fund for Support of Women Entrepreneurs in Kostroma Region; disbursement of USD 149,000 in 219 loans

The RWMN organisations use individual loan methodology with collateral. The average loan term is two months, and the interest charged is 8% per month. Currently the network serves a total of 625 clients, out of which 70% are women. The ceiling for the first loan is USD 500.

Mobilising Agricultural Credit (MAC) Programme of ACDI/VOCA

ACDI/VOCA is a private non-profit development organisation in the US with roots in the agricultural co-operative movement. It is administering the MAC programme on the basis of a three-year grant of USAID. ACDI/VOCA works in partnership with the Rural Credit Co-operation Development Fund (RCCDF) in implementing the programme. The RCCDF is a private Russian non-profit organisation that promotes the Development of rural credit co-operatives in Russia through information dissemination, workshops and advocacy.

Sakhalin Small Enterprise Development Foundation (SSEDF)

ACDI/VOCA is developing a micro-finance institution capable of providing loans to micro- and small-scale entrepreneurs in the Sakhalin Oblast. This MFI will be named the Sakhalin Small Enterprise Development Fund (SSEDF). It is envisaged that peer-group lending methods will be used, for micro-start-up enterprises, but also for existing MSE's that currently lack access to finance. The project budget is USD 4.4 million.

Counterpart Enterprise Foundation (CEF)

Counterpart International implements the Khabarovsk Regional Microlending Programme. It provided loans to 1,200 micro-entrepreneurs. The target is a portfolio of USD 600,000.

An overview of the current state of the main programmes is given in table 2.2 below:

Table 2.2 Overview of MFIs operating in Russia

MFI	Funding source and conditions	Regions	Current portfolio and number of clients
Russian Women's Microfinance Network	Grant from Ford Foundation Onlending to partners	Kaluga - Oct.1998 Moscow - June 1999 Tver - Nov.1999 Kostroma - Oct.1999 Kazan - June 2000	USD 586,000 2,535 clients average loan USD 500 98% recovery Interest 60-96%
FINCA	Grant from USAID	Samara - June 99	USD 570,000 600 clients
Opportunity/FORA Vozmozhnost Suprichastnost Novy-Soyuz Perspektiva Doveriye	Grant from USAID	Nizhny Novgorod Rostov Voronesh Novgorod Oblast Saratov	2,300 clients USD 1.3 million
ACDI/VOCA	Grant from USAID	Yuzhno-Sakhalinsk	-
Counterpart International Microlending Programme	Grant from USAID	Khabarovsk	USD 600,000 1,200 clients

Other programmes

The Centre for Citizen Initiatives/Russian Initiatives for Self-employment (CCI/RISE) started in 1995 with the execution of a MSE development programme in St. Petersburg. The focus of the programme is on training, but it includes a small credit component. The programme disbursed USD 291,000 in 106 loans.

The Small Business Incubator in Volkhov was set up in March 1995. The incubator has established a unique leasing service for SME in the Leningrad Oblast. The aim is that the leasing programme will make the incubator financially self sustainable. Over 60 SME got access to leasing finance for a total amount of USD 600,000.

The Siberian International Microfinance Association (SIMA) is a US registered NGO, aiming to create MFIs in Irkutsk, Novosibirsk, Yakutia and Gorno-Altai. It started in March 2000, and is still in the process of establishing its operations in Russia.

2.2.3 Observations - Development issues

Achievements

Based upon the information provided by the current MFIs a number of observations can be made:

- Loan repayment performance is reportedly very good. All programmes appear to have met high performance standards, which proves that the methodology applied works under the local circumstances of the regions in which they operate.
- The level growth has been much lower than anticipated and the absolute volume of clientele and portfolio are still very low. Relative to other countries in the region, progress in Russia has been slow. For example, FINCA Kyrgyzstan alone achieved an outreach of over 13,000 borrowers after

four years of operation. The current levels of operation do not safeguard a viable microfinance industry. A major effort for scaling up of operations needs to be undertaken. This requires a more enabling environment, in which MFIs can operate efficiently and expand their branches and field operations in accordance to demand. It also requires more funding. While current funding is not yet fully absorbed, it is foreseen that substantial additional funding is required in the medium term.

- The RWMN has demonstrated that microfinance on the basis of commercial funding is achievable. It also showed that the commercial bank financing their lending operations is willing to do so beyond the level of guarantees backed up by liquid deposits. This shows that the operation has achieved credibility in the perception of the bank, which is an important step forward.
- The lending rates are relatively high due to inflation, high level of taxation and the generally complicated regulatory environment. For trading activities and for the most profitable activities in other sectors, this turns out not to be an impediment. However in certain sub-sectors of micro enterprise, such as manufacturing and agriculture, high rates could be prohibitive. The high rates partly reflect the fact that the sector has not been able yet to benefit from economies of scale. Through scaling up of operations can lower lending rates become feasible. This is crucially important in order to serve the full spectrum of microenterprises in Russia.

Legislation

The study State of Microfinance Regulation in Russia stresses the great difficulties that MFIs have experienced in order to get registered and obtain a legal basis for their operations. Several problems have been experienced by MFIs going through this process:

The first problem is that relevant legislation is not consistent and therefore open to interpretation. The above study states:

"To this day, it has been the position of most legal practitioners in the area of banking law that any activity which involves the systematic extension of loans, whether to a physical person or to a legal person, is prohibited unless the lender is a bank or a credit organisation licensed by the Central Bank. This restriction would appear to prohibit the activities of credit unions, credit co-operatives and microfinance institutions. On the other hand, an active system of microfinance institutions does currently exist, and it appears to operate with little regulatory interference" [D-11].

With good lawyers all MFIs have been able to register in the area of operation. The problem is that the authority to lend, on the basis of current legislation, cannot be considered incontestable.

Another problem is that regional governments can put forward requirement for stricter provisions than those specified in the Civil Code. According to the said study this requirement is not strictly legal, since all activities not required to have licences should be exempt from having to obtain licences. In practice however, the regional authorities can and do add additional requirements in an ad hoc manner [D-12]. The study concludes:

"Because of the discretionary power of the local authorities, regulation of the activities engaged in by MFIs is always open to subjective interpretation. Even in the most progressive regions, these institutions are vulnerable to unfavourable interpretations of the civil and tax codes and activities not well defined by legislation or decree becomes defined by the manner in which they are interpreted at various governmental levels".

As a consequence of these problems microfinance has been slow to get off the ground, and expenditure involved in legal services have been disproportionate.

The RWMN, later joined by OI, initiated an amendment in legislation, which would sanction lending activities organised as a legal Fund. The legislative strategy set out was to supplement the State Fund legal statute with consideration on private Funds (Federal Law "On Introducing Changes and Additions to the Federal Law "On State Support of Small Entrepreneurship in the Russian Federation"). Since the legislation on State Funds probably the most solid legal status for non-bank credit activities in Russia, this would have provided a strong legal basis for MFIs registered as private funds. However, in the end, after approval in the State Duma, Acting President Putin vetoed this amendment. The veto opinion² argued: "It should be observed that Federal Laws do not make it compulsory to receive a licence for

2 Letter of 3 January 2000 of the Acting President Vladimir V. Putin addressed to the Chairman of the State Duma of the Russian Federation Gennadiy N. Seleznev.

loan disbursement activity". It was concluded by RWMN that since the Russian Government and the President are united in their opinion, it could be considered that any ambiguity on the issue had been eliminated. MFIs already have the right to lend according to the Civil Code, and hence no specific legislation was necessary to sanction their status. However, according to the above legal study, it is still unclear how contestable this opinion is [D-24].

Related to this, is the question whether MFIs are allowed to lend from borrowed funds, for instance from a line of credit provided by a donor. The experience of RWMN partners suggests that borrowed funds received by MFIs are treated as deposits by taxation authorities, and interest paid on these funds as interest on deposits, and thus that activity is considered to be a banking activity that would require a licence³. The current understanding of MFIs operating in Russia is that they can lend from their own (grant-based) funds, but they cannot lend borrowed funds.

Tax regime

MFIs are subject to a multitude of taxes, which together create a heavy tax burden. Most important are the VAT on interest revenue and the profit tax. MFIs registered as non-commercial organisations also incur payroll withholding taxes, along with property taxes and various local and municipal taxes.

The study "State of Microfinance Activity and Regulation in Russia" lists the principal tax obligations of MFIs as follows:

Table 2.3 Principal Tax Obligations for MFIs*

Tax	Base	Rate for non-commercial organisations (%)
VAT on interest revenue	Gross Revenue	20%
Profit tax	Net Revenue	30%
VAT on goods and services related to business activities	Value of goods or service	15%**
Wage/employment taxes	Total wage bill	38%
Local taxes	Wage bill	3%
Property tax	Property value	2%

* All figures are as of 2000

**This figure seems to be a mistake, the correct one 20%.

The following observations can be made in respect to the tax regime:

- Banks are exempted of 20% VAT tax on interest. MFIs in general were not, with the exception of MFIs registered as a Fund (i.e. foundation). Under the new Tax Code all MFIs are exempted from VAT on interest⁴.
- This eliminated an element of tax discrimination against MFIs that are not registered as funds.
- Profit tax is charged on taxable net revenue. In order to calculate taxable net revenue not all expenditures are accepted as tax-deductible expenses, and hence taxable net revenue usually is considerably higher than commercial net revenue. It depends upon the skill of local MFI tax consultants in consultation with local tax authorities, what constitute tax-deductible expenditures. It should be noted that MFIs use after tax profits to augment their capital. If the capital reservations are insufficient to compensate for inflation, the MFI capital gets eroded.
- Grants provided by the foreign donor to local MFIs are tax-exempt according to the special law⁵. Grants from within Russia would be taxed. This would pose a serious problem in attracting capital for microfinance from inside Russia.

3 Microfinance - Quarterly Bulletin RWMN - No1 2000

4 Article 149-3-15 of the Tax Code

5 The Gore-Primakov Commission through a bilateral treaty, allowed US grant money to pass through tax free to local MFIs. This was legalised through the adoption of Federal Law number 95 of 4th May 1999.

- Donations to MFI's from Russian organisations are only partly tax deductible for them. It is desirable that donations to MFIs should be fully tax deductible.

In 1999 the Russian Women's Microfinance Network, together with Opportunity International have addressed the issue of VAT on interest revenue, contained in the Federal Law "On Introducing Changes to the Russian Federation Law on Value Added Tax". As a result of this activity, changes have been introduced (in Art. 5 point e), which resulted in exemption of VAT on interest earned for foundations for the support of small entrepreneurship that provide short-term loans. This was a major step forward, but it was expected that this privilege would be lost in the Part 2 of the Tax Code. Actually, interest payments remained VAT-exempt according to the methodical recommendations issued by the Ministry of Taxation.

Funding of Micro-lending Institutions

The current situation is that the MLI's are funded with donor grants. The advantage of grant aid is that institutions are capitalised and that the high expenses can be met of opening a new market, experimenting new approaches and establishing the legal and administrative framework. Without substantial grant funding none of the initiatives in respect of microcredit would have been possible. Grant funding is a normal feature in the early stage of microfinance development.

Grant funding has drawbacks too. It is in essence an unsustainable form of financing. Every grant comes to an end". Even when that end is not yet near, it is wise to think what happens after grant termination. Secondly, international experience shows that there is a danger of institutions becoming grant dependent, rather than self-reliant. Somehow the moment of full cost recovery is postponed and postponed. Thirdly, there is a risk of market distortions. If some operators in the sector receive grants, whereas others pay the full cost of capital, obviously the playing field is not level. Those receiving grants would be able to offer credit more cheaply than those paying the full price of capital. This way, institutions that already meet conditions of financial sustainability could suffer from unfair competition by those MFIs that are not. This would be counter productive for sector development. Finally, grant funding is usually applicable only for NGO type of MFIs, since donors find it hard to provide grants to private commercial enterprises. For these reasons, it is generally felt that grant funding to MFIs should be minimised as soon as possible, and that funds for on-lending should be provided in the form of loans or lines of credit.

The study on Microfinance Regulation makes observation in respect to the prospect of MFIs graduating to bank status. It observes that this requires currently USD 5 million minimum equity capital and that the Central Bank of Russia controls all licensing and supervises changes and amendments to the founding documents of financial institutions as well as the composition of partners and the candidates nominated as senior executives and chief accountants. It concludes; These high costs, together with the loss of autonomy to the Central Bank, currently makes it unfeasible and unjustifiable for MFIs to register as banks, given the scope of their activities. If the deposit collection from the local market is not possible, due to inability to obtain bank status in the foreseeable future, the question is how are these programmes going to continue their expansion after grant termination?

Non-financial services

All current MFIs receive considerable technical assistance to establish and expand their operations. This TA is provided by the foreign parent organisation or by consultants. At this stage of development the availability of non-financial services are vital for capacity building, for product development and for creating effective methodologies for microfinance. In view of the close relations that Russian MFIs maintain with their network partners, currently the demand for non-financial services can adequately be met. However, if in future, larger scale replication is envisaged with many new entrants on the market, a local capacity needs to be created to provide the type of technical support and training currently supplied from abroad.

2.2.4 Policy recommendations

Funding

The category of specialised MFIs are currently all donor financed. On the short term their finance requirements seem to be amply served. Only one MFI expressed an interest in a line of credit right now. It is expected however that in two or three years, more MFIs will be interested in loanable funds. It is therefore considered justified to explore mechanisms for the provision of loan finance to MFIs so as to safeguard sustainable growth of lending operations.

Legislation

No specific recommendations have been brought forward in the above quoted legal study for changes in legislation. Within the three main networks, partners are sufficiently guided. But new entrants in the sector will face the same hurdles. Moreover, the continuing uncertainty does not serve as an incentive to mobilise more funding. It was therefore recommended that legal advice be obtained on the matter from a reputable law firm on:

- The status of the veto opinion in respect to amendments to the 'state fund for small business support' legal statute. Does it provide sufficient sanction to the current operations of MFIs?
- Are MFIs allowed to lend from borrowed funds, for instance from a line of credit provided by a donor?

In paragraph 4.4 below the findings of a legal expert are presented.

Having discussed the policy paper, Task Force-3 members came to the joint opinion that no special Federal Law on Microfinance is needed, because the sector is too young. However, some methodical recommendations clarifying open questions are needed.

Tax regime

In view of the above observations, the following improvements in the tax regime for MFIs would seem desirable:

- to create a tax incentive for institutions that retain profits for the purpose of expanding loanable funds for the purpose of microfinance
- not only grants from foreign donors, but all grants provided to NGO type of MFIs should be tax exempt

International experience has amply shown that tax measures are very effective instruments to achieve improved sector performance. This however is not likely to happen, unless the government has adopted a consistent strategy for microfinance promotion.

2.3 Credit Unions and credit co-operatives

2.3.1 Characteristics

Credit co-operatives are membership organisations established with the aim of providing financial services to its members that are fully, or largely financed from the share capital and savings of its members. In Russia various types of credit co-operatives have developed identified with different characteristics. A distinction needs to be made between:

- credit unions
- agricultural and rural credit co-operatives
- mutual credit societies

A **credit union** is an association of individuals united according to their place of residence, occupation or employment with the aim of providing mutual support to the members of the union. In accordance to current rules of credit unions, only natural persons can be members. Legal entities are excluded from membership and hence cannot receive loans either. Loans are provided to credit union members on the basis of appropriate sureties such as a co-members guarantee, future salary or on the basis of the members credit history (A13).

Agricultural credit co-operatives differ with credit unions mainly in terms of eligible membership. Their founders and members can be individuals **and** legal entities. This difference is important, because it means that agricultural co-operatives can lend directly to registered business or farms, while credit union lend only to individuals. The members are farmers and agricultural entrepreneurs.

Mutual credit societies are special institutions operating in the sphere of saving and lending services. Being non-commercial organisations and rendering services to their members only mutual credit

societies provide taking personal savings and lending. Though credit society activity is similar to banking, they radically differ as the first one is not oriented on receiving of profit. The income received as a result of lending is allocated among members of credit society pro rata. All expenses related to credit society's operations are covered by its members (by additional dues). Operating like this credit society receives no profit on its main activity as a non - commercial organisation.

2.3.2 Overview of institutions

According to the RC study there are an estimated 1,200 organisations in Russia operating as credit unions. Not all of them meet the classic credit union requirement however. This diversity reflects the lack of legislation for this type of co-operatives. Credit Unions are registered in different legal forms. The preferred option is registration as a consumer co-operative, or -less frequently as non-commercial partnership or public fund. None of these forms fully meet the practical requirements however.

In 1994 a number of credit unions that formed the nucleus of the co-operative movement established the Russian Credit Union League. The RC study [B] shows that to date there are 51 credit unions within the League with a total of over 21 thousand members. Part of the credit unions is organised through regional associations. Four out of seven existing associations are also members of the League.

The table shows that growth of member Credit Unions has been gradual, with 10-11% annually, while growth of shareholders was considerably higher (21.6%). Disbursements even grew on average with 49% annually over the past five years. The average loan-size is Rub 2,300 or USD 80, which shows that credit unions serve the lower brackets of the micro-finance market. About 5% of the members of the CU League are entrepreneurs (they are CU members as individuals) [A-14]. Loan-sizes for the CU member-entrepreneurs are considerably higher than the average; they vary from Rub 50,000 up to Rub 200,000. While the maximum loan term is one year, the average loan duration for entrepreneurs is about three months, which means that loans are used primarily for working capital. The average annual interest is 45-48% annually.

Table 2.4 Development indicators for the Credit Union League

	1996	1997	1998	1999	2000
Nr. of credit unions	34	36	36	47	51
Nr. of shareholders	9,590	14,700	16,100	17,710	21,000
Loan disbursement Rub'000	9,659	11,835	18,462	22,708	47,698
Average loan size Rub	1,007	805	1,147	1,282	2,271
CU assets Rub'000	11,905	17,496	20,104	26,500	61,804
CU savings	8,947	10,942	17,071	19,932	44,991
Average Savings per shareholder	933	744	1,060	1,108	2,142

There is considerable differentiation in size of credit unions. The nine largest Credit Unions have an average of 1,580 members, while the starting and small CUs have an average of 30-40 members. It is noteworthy that the interest rate charged in the largest CUs is 36%, while the smaller CU charge 48%. This shows the impact of economies of scale, with lower transaction cost for the bigger CUs.

The RC assessment indicates that the Credit Union League comprises the largest, most successful and most promising Credit Unions. It estimates that the asset base of the credit unions that are not associated to the League is approximately five-six times that of the League. Based upon this assessment, the total volume of loans provided by CUs is estimated between Rub 23 million and 125 million. Loans provided to micro-entrepreneurs are estimated at about half this level.

The Canadian Credit Union organisation Desjardin executes a second five-year support programme for Credit Unions in Moscow, Volgograd and four other regions, covering up to 26 Oblasts. The programme

started in 1993 and lasts until 2004. The programme's beneficiaries are the Russian Credit Union League (RCUL), the Union of Rural Credit Unions, the Association of Consumer CUs in Volgograd and the Association of Agricultural CUs in Volgograd, as well as other regional associations of credit unions. The programme is funded by CIDA.

The Resource Centre has undertaken an extensive study on Credit Unions, presented as part of the 'Financial Technologies' report (see Appendix 1 – B).

Apart from Credit Unions, over the past five years also a new breed of agricultural credit co-operatives has developed in various regions (e.g. Volgograd, Saratov and Tumen oblast). They serve the needs of farmers and rural dwellers, which have even less access to means of finance than people in the cities. Individuals who are members of agricultural co-operatives in most cases are private entrepreneurs, and only part of them (approximately one third) is formally registered as individual entrepreneurs. These co-operatives provide loans primarily for entrepreneurial, not for personal purposes. Most of the rural credit co-operatives are joined into the Union of Rural (Agricultural) Credit Co-operatives, which now comprises of 91 members. The RC conducted research in 1999 in Volgograd Oblast, which provides some insight in the characteristics of the co-operatives.

Table 2.5 Characteristics of co-operatives

- Average number of members per co-operative	40
- Average number of loans per co-operative	25
- Average loan size	9800
- Average loan term	three month
- Average loan repayment rate	96%
- Number of members 1999	3640
- Volume of loan disbursements	Rub 22.3 million

Both technical and financial assistance to the agricultural co-operatives is made available through the ACDI/VOCA programme, financed by USAID. ACDI/VOCA has been active in Russia since 1992. Currently, there are three offices in Saratov, Moscow, and Khabarovsk. ACDI/VOCA is administering the two-year Mobilising Agricultural Credit (MAC) Program funded by the U.S. Agency for International Development to develop and support a credit fund for credit co-operatives. The project aims to establish and support a self-sustaining fund for financing agricultural credit co-operatives, to promote a favourable legislative environment for agricultural co-operatives, and to support the establishment of a network of user-owned democratically managed co-operative financial institutions. Also in the co-operative sector the volume of activity is still very small in relation to population and size of the country. Neighbouring countries with much smaller population, have achieved considerably higher growth of the co-operative credit sector. In Poland total assets of the Credit Unions amount to USD 40 million compared to USD 2.3 million for Russia. A brief review of relevant international experience shows the great potential for co-operative credit, which, in some countries has become a major feature in the financial landscape.

2.3.3 Development policy issues

Why is it that development of co-operative credit in Russia has been slow? What are the obstacles for development of the sector? What measures can be conceived to remove these obstacles? The research that would be needed to answer these questions thoroughly, is yet to be carried out. However, from the existing studies, and consultation with some players in the field, a number of factors can readily be identified:

- lack of recognition on the policy level of the importance of co-operative credit for development of MSEs and small farmers
- lack of appropriate legislation
- limited organisational capacity on all levels of the co-operative movement, and insufficiently developed supervision and self-regulation
- unfavourable tax regime for microfinance providers

Legislation on co-operative credit

Legislation in Russia on co-operative credit is of a recent date. The body of law on this subject has been developed during the past five years. In view of the fact that specific legislation on credit co-operatives is lacking in Russia, organisations involved in this activity have to resort to legislation intended for other organisations and activities. The relevant legislation on the federal level is basically contained in the following documents:

- The Civil Code
- The Federal Law "On Protection of Competition in the Financial Services Markets" (No 117 of June 1999)
- The Federal Law "On State Support to Small Entrepreneurship" (June 1995, No 88-FZ)
- The Federal Law "On Banks and Bank Activities" (No 17-FZ of December 1996)
- The Federal Law "On Agricultural Co-operation" (No 193-FZ of 1995)

For agricultural co-operatives specific legislation has been in place and currently this legislation is updated. Major legislative problems do arise however for credit unions. Currently they are registered either as a consumer co-operative or as a non-commercial partnership, but none of these forms are entirely adequate. They have to be used because specific legislation on credit unions is lacking. The form of consumer co-operative is clearly not adequate for lending activities targeting (micro-) entrepreneurs, which makes the current business lending vulnerable for legal challenge. Similarly, the Law on Agricultural Co-operation is not adequate for credit unions that operate fully or mainly in urban areas, with membership that have no ties to agriculture. Credit Unions have been able to operate only in those regions where specific accommodating regional legislation has been created.

Other policy issues

It is generally recognised that there is a great need for capacity building in the co-operative sector. The industry is still in infancy stage and both the co-operatives and their umbrella organisations are young institutions with limited staff and experience. A lot can be gained from exploiting experience obtained in other countries with conditions similar to Russia, through exchange visits, training and consultancy. Credit co-operatives face four major challenges (N-7):

- **Credit Union Governance:** Boards dominated by volunteer non-professionals can be very responsive to local community social issues but fail to have the financial and business expertise required for a financial institution. Clear rules, by laws, supervisory regulations, training and good guidelines are necessary ingredients to ensure good governance.
- **Delinquency:** Credit co-operatives run the risk of high delinquency rates when they are not very well organised and skills for proper credit administration are lacking. Proper procedures for borrower screening, credit risk assessment, and collection practices are necessary to prevent delinquency. One requirement for microfinance is that the risk analysis moves away from a simple multiple of shares to solid repayment analysis.
- **Business Orientation and Innovation:** A healthy co-operative movement requires viable and financially sustainable institutions. The transition from purely consumptive credit in some credit unions towards financing of micro enterprises, requires a businesslike approach of the management. Training and guidance is needed to help credit unions establish market-level interest rate pricing for savings and credit products, mobilisation of savings, updating of procedures, strengthening of financial monitoring and reporting and the improvement of planning.
- **Lack of external supervision or supportive regulatory environment;** credit co-operatives in Russia are not subject to external supervision. Long-term development of the sector is not possible without the establishment of prudential supervision rules, policy guidelines, operational and governance regulations and monitoring and examination systems. Self-regulation of the sector would require the ability of the (national) associations to enforce prudential discipline related to loan loss provisions, institutional capital, liquidity management and management.

For this reason in many countries technical assistance projects have been executed to help build the capacity of sector institutions on the national and regional level. The government has a role to play in facilitating that such capacity development programmes are undertaken.

Funding of Credit Union lending operations

The credit union movement provides an effective savings-based and self-sustainable approach to microfinance that has proven its worth world-wide. What most distinguishes credit unions from other non-bank financial institutions is the ability to mobilise member savings, usually by means of share capital contributions. These funds can then be invested in rural production, housing, microenterprise and small business loans. It follows that Credit Unions are basically self-financing. Once an enabling environment is created for the credit union movement, through legislation and capacity building, funding mobilisation goes hand in hand with expanded membership and credit delivery. External funding for specific microfinance activities may or may not be needed, depending upon the willingness of credit unions to invest in microenterprise. International experience has shown that some external funding may help to "prime the pump" for microfinance, in situations that loans are normally given for consumptive purposes only. Financing of microenterprise requires a basic expertise in assessment of small business or farming ventures, which may not be available. In such cases, external funding, together with some basis training and capacity building, may help to pave the way for increased business lending

2.4 Regional funds

In accordance with the Federal Law "On State Support to Small Entrepreneurship in the Russian Federation" of June 1995, the Federal Fund for Small Business Support (called hereinafter the Federal Fund) is a state non-profit organisation. The institution is mandated to implement financial instruments of federal policy, in the field of state support of small business in the Russian Federation. The Fund is located in Moscow.

The Federal Fund is responsible for the implementation of financial components of the Federal Program for State Support of Small Business, participation in financing of regional (interregional) programs as well as projects and measures directed to small business support and development, including measures implemented by the Russian Federation's Ministry for Antimonopoly Policy and Support to Entrepreneurship.

The Federal Fund has a network of regional funds in over 70 regions of Russia. However, since the Federal Fund is a minor shareholder in the majority of regional funds, the latter are dependent more on the respective regional authorities, which provide funds for their operations. As far as microfinance is concerned, the currently applied scheme is simple. The Federal Fund lends to regional funds the money received from the federal budget to support entrepreneurship. Normally it is done under a tender procedure.

The Federal Fund has undertaken an evaluation of the microfinance programmes implemented in 1999-2000 by ten regional funds, which operate in Smolenskaya, Sverdlovskaya, Orlovskaya, Novgorodskaya, Kaluzhskaya Oblasts, Republics Marii-El, Khakassiya, Tatarstan and Kareliya. The report shows that during 1999-2000 the selected regional funds provided 3,684 loans at (on average) 4% per month interest rate, and their volume accounted for almost Rub 60.2 million. In terms of number of loans and funds disbursed, the most advanced Regional Funds are Non-commercial Women Credit Co-operative 'Sodeistvie' in Smolenskaya Oblast and Centre for Assistance to Entrepreneurship under the Government of Sverdlovsk Oblast.

The changing role of Regional Funds

It has been observed that the scope of activities and the success of regional funds in addressing the needs of MSE in their regions vary widely. In the early stage of development of a market-oriented economy, government interventions may still be aimed at sectors in the market that are not or inadequately being served. MSE finance at this moment could be considered such area. However, business financing is an activity that will have to be performed in the private sector, with the Government gradually withdrawing to its role as regulator and facilitator. Also Regional Funds will face this dilemma in the coming decade. Regional Funds will have to revisit their intervention strategy for the MSE sector, and see in which segment an effective contribution can be made that private sector institutions do not, or do not yet serve. Experience world-wide suggest that the role of the government in the financial sector tends to move away from acting as direct provider of finance to a supporting role of private sector institutions. Government finance could be made available indirectly to providers of financial services, or the Government could establish a loan guarantee mechanism for MSE finance. This could facilitate lending of banks to MFIs or co-operatives.

2.5 Donor programmes

The main donors in the microfinance sector are USAID, Ford Foundation, DFID and CIDA.

USAID

- Khabarovsk Regional Microfinance Programme (Counterpart International)
- Samara Regional Micro Lending Programme (FINCA)
- Sakhalin Regional Micro Lending Programme (ACDI VOCA)
- Mobilising Agricultural Credit Program (ACDI VOCA)
- Tomsk Regional Microfinance Programme (FINCA)
- Russian Initiative for Self Employment (RISE)
- Fund Opportunity Russia (Opportunity International)

Ford Foundation:

- Russian Women's Microfinance Network

DFID

FORA (Opportunity International) for developing microfinance activities

CIDA

- The Canadian Credit Union organisation Desjardin executes a second five-year support programme for Credit Unions in Moscow, Volgograd and four other regions, covering up to 26 Oblasts. The programme started in 1993 and lasts until 2004. The programme's beneficiaries are the Russian Credit Union League (RCUL), the Union of Rural Credit Unions, the Association of Consumer CUs in Volgograd and the Association of Agricultural CUs in Volgograd, as well as other regional associations of credit unions. The programme is funded by CIDA.

3. Brief overview of relevant international experience

3.1 Phases of development in the microfinance sector

Distinct characteristics of microfinance

Microfinance is a relatively young phenomenon. It developed over the past 30 years, starting in the densely populated countries of Asia and spreading to Latin America and Africa. Well-known examples are the Grameen bank in Bangladesh, with over two million borrowing clients, the Bank Rakyat Indonesia (BRI) with 1.89 million borrowers and the BancoSol in Bolivia with 62,000 borrowing clients. Both the Grameen Bank and Banco Sol developed out of grant funded microfinance projects. These are examples of the fact that "scaling up" of microfinance can succeed. Most microfinance institutions around the world are smaller. The key test for success is not the absolute size, but the question whether the institution has reached an economically viable mode and scale of operations.

Five characteristics distinguish microfinance institutions from traditional finance institutions:

- *Client base:* MFIs target low-income people who operate their business in the informal sector or the lower bracket of the formal economy.
- *Lending methodology:* Traditional banking is collateral based and requires lengthy application procedures. MFIs use information-based or character based lending methodologies, often together with systems of mutual guarantees within peer groups. MFIs "bring the bank to the people"; they mobilise and organise groups that perform some or most of the retail lending functions (e.g. village banks).
- *Administrative costs:* Microlending is labour intensive. Transaction costs are typically 10-21% of loan portfolio, which is high in comparison to commercial banks (operating typically at 4-6%). MFIs have to charge interest rates above the rates of commercial banks, in order to cover cost.
- *Portfolio characteristics:* MFIs make small and short-term loans, a high proportion of them going to women. Application procedures are simple and fast. Clients are visited by the loan officer. One loan officer can manage as much as 400 clients at a given time. Through volume, economies of scale are attained.
- *Governance:* Organisation structures of MFIs tend to follow a common pattern; a set of small outlets that do the frontline work, linked by a superstructure that provides financial, management and technical support. Similar to franchising, institutions develop a basic module and then replicate it.

Twenty years ago it was hard to envision where the multitude of microfinance initiatives around the globe would lead. Now that in many countries microfinance institutions have become established actors in the financial sector, it is clearer to see the pattern of development and the challenges they faced. The development can be analysed in terms of four key challenges⁶. "Each of these challenges involves overcoming a traditional belief prevalent through the years among bankers and development credit practitioners: (1) that poor people do not repay loans, (2) that they cannot pay interest rates high enough to cover the costs of their loans, (3) that MFIs can not be run on commercial funding sources and (4) that microfinance can never be profitable enough to attract private, commercially motivated equity investment. The first challenge that MFIs face is loan repayment. Due to the pioneering work done by institutions like Grameen Bank in Bangladesh and Accion in Latin America, it could be demonstrated that repayment rates of over 95% were quite achievable. This has now been confirmed by many microfinance the world over. Not that it is easy to achieve this type performance. It requires well-developed and tested methodology, procedures, credit administration and internal auditing, together with the staff development to implement it all. For this reason there is merit in working with technologies that have proven their strength, not with standing the need of making adjustments for local circumstances.

⁶ Ranking Services for the Poor: Managing for Financial Success - An expanded and revised guidebook for microfinance institutions - Robert Peck Christen.

The second challenge that MFIs face is cost recovery. While pilot operations of microfinance institutions are usually grant financed, the financiers usually put strict condition as to the period in which the operation has to become self sustainable. Whether this is achieved depends on two three factors: (a) is the lending methodology sufficiently efficient? (b) is the scale of operation expanding sufficiently fast to reduce the fixed overhead expenditure to an acceptable level and (c) is the interest charged sufficient to cover an efficient operation ? By the mid 1980s there was an intense debate among leading MFIs and donors and governments, about the need to charge rates of interest that covered cost, or at least were positive in real terms and in line with local financial markets. By the end of the decade virtually all successful microfinance programmes were charging interest rates that were at least as high as bank rates in the local economy, and most multilateral and bilateral agencies had accepted market rates as necessary and desirable. More recently consensus has been reached within the donor community that MFIs have to aim at full cost recovery, which implies that rates may be considerably higher than markets rates, in order to reach the fast majority of potential clientele.

By the end of the 1980s the leading MFIs had achieved rudimentary operational viability. An MFI is called operationally sustainable when it is able to cover all operating expenses from operating income. They had proven that they could make loans with very high recovery rates and that borrowers were able and willing to pay the cost of delivering credit. This led to a great increase of cheap donor funding. However, the leading MFIs realised that this would not last long, and that donor funding would soon fall short of meeting the demand.

The next challenge was to achieve financial sustainability, which means that operating income is not only covering operational expenses, but also adequate to cover the real cost of capital employed. The leading Asian and Latin American MFIs were the first to mobilise saving deposits for the purpose of microlending. In 1992 BRI had mobilised USD 2 billion in savings from 10 million poor households. The increased willingness of private commercial banks to lend their own resources to MFIs in excess to the value of any real guarantees, marks the credibility that the industry has gained, and it demonstrates legitimacy beyond the development aid sector. The utilisation of deposits for onlending raises the issue of prudential regulation and supervision of the microfinance industry, which is discussed below. Institutions that are moving towards financial self-sufficiency can also benefit from other debt financing instruments, such as issuing bonds or lines of credit from national or international agencies. The types of debt financing may help to bridge the process leading to full reliance upon local deposits.

The fourth challenge is attracting private, for profit equity investment. When MFIs have achieved a level of scale and profitability comparable to commercial banks, it reaches a point where private capital must be attracted in order to leverage the institution's liabilities. This inevitably requires a structure of private ownership, and hence requires the restructuring of NGO-type of organisations. The transition in 1990 of PRODEM in Bolivia to BancoSol, a licensed commercial bank.

The historical process of microfinance development over the last 30 years, also reflects the stages that every successful MFI will encounter. The table below contains an overview of the stages of development of a successful microfinance institution. It distinguishes four major stages related to the type of financing, with the approximate time required⁷:

Table 3.1 Stage in development of successful MFIs

Stage in development	Years
1. Subsidy dependence: financing through grants; Working towards operational self sufficiency	three-five
2. Mixed cost of funds; financing partly by loans Working towards financial self sufficiency	three-five
3. Financially sustainable institution Working towards credibility as a commercially viable finance institution, able to attract deposits	three-five
4. Solid financial institution; able to attract national and international investors	-

⁷ The time indication refers to average historical figures. Cases exist in which MFIs shorten the period, e.g. when they are able to charge exceptionally high interest rates to cover initial inefficiencies.

The table shows very clearly that the institutions require substantial time to reach a stage of maturity. This observation is important determining the appropriate timing for the establishment of formal licensing, prudential supervision and supervision of MFIs.

Best practice principles

During the past two decades gradually a high degree of consensus has developed about some basic principles:

- Subsidised lending, at interest to end users below market rate of interest is harmful to the long-term development perspective of the sector. Subsidised loans tend to be misallocated and subsidised lending schemes are not sustainable. Thus the development of viable operations on a large scale could get frustrated.
- Microfinance is a business. Despite the fact that it pursues social objectives, it must be conducted in a businesslike manner. By proper business planning MFIs must be able to achieve full cost recovery within a reasonable period of time (i.e. operational sustainability).
- Determination of the rate of interest charged to clients is a business decision of the MFI that should not be influenced/dictated by the government or financiers.
- Donors should generally aim to maintain a level playing field, and reduce or refrain from the use of grants, where other MFIs have to borrow their loan funds.

Sources of expertise that can be drawn upon

Most relevant experience of leading MFIs is well documented and freely available. Reference is made to the documents list and to the listing of relevant web-sites (Appendix 2).

3.2 Regulation of Microfinance

In recent years regulation of microfinance has become a hot issue, discussed in many countries by forums of MFIs, government representatives and donor institutions. CGAP, the microfinance programme of the World Bank, has described the current debate in a recent paper called "the Rush to Regulate". The paper arrives at four rather straightforward conclusions;

- that credit-only MFIs should generally not be subject to prudential regulation and supervision
- that small community-based MFIs should not be prohibited from deposit taking
- that the push to create special regulatory windows for MFIs in most countries is premature right now, running too far ahead of the organic development of the local microfinance industry
- that self-regulation, by MFI controlled federations is highly unlikely to be effective

Based on this conclusion, the authors argue that the future of microfinance lies in a licensed setting, but that the timing is crucial. Regulations will be useless, or worse, if they cannot be enforced. The core of the argument is that, if the central bank would have to supervise a multitude of small MFIs throughout the country, the cost for the central bank in terms of money, manpower, and possible the neglect of other important duties, would make it highly unlikely that supervision in the early stages is effective. Secondly, the authors argue that in case of an industry at the early stage of development, with credit-only NGOs and small community based MFIs, prudential regulation is not really necessary.

A distinction needs to be made prudential and non-prudential regulation. Some requirements are non-prudential, because they do not involve the financial authority in vouching for the soundness of the "regulated" institution. Examples of these requirements would be external audits, or the requirement to provide portfolio data for statistical purposes. Prudential regulation and supervision of financial intermediaries involves definition of detailed standards for financial structure, accounting policies etc. Enforcing these standards require much more intensive reporting and on-site visits, that go much beyond the scope of normal financial statement audits.

Three issues are particularly relevant to the situation in Russia (a) the legality of conducting microfinance in general, (b) the status of credit-only MFIs and (c) the status of community based MFIs.

"Illegal microcredit": In many countries it is illegal for NGOs to offer credit, because this activity is not specifically authorised in laws under which the NGOs function. Many MFIs continue to operate in such

situations, simply because the law is not enforced. Most Latin American MFIs developed in precisely this situation until recent years. If the uncertainty is perceived by NGOs as unworkable, a legal solution may have to be worked out. But the issue may be addressed without the whole structure of prudential legislation. An appropriate solution could be found in amending the law authorising NGOs so as to explicitly include credit as a permissible activity.

"Credit-only MFIs": Most MFIs that operate as NGOs do not operate savings accounts of their clients, notwithstanding the fact that they may require cash collateral to be pledged as part security for the loan. The CGAP study argues: "Neither of the classical justifications for prudential regulation apply with much force to such obligatory deposits. (1) They are really just part of the loan contract, and most of the MFIs clients are in a net debtor position most of the time, so the risk to them in the case of MFI failure is relatively low. (2) Compulsory deposits pose no significant risk to the country's financial system, not only because their amount is small but also because the restrictions on withdrawal of these deposits greatly reduces the risk of a run on them." [K-10]. Thus it is concluded that as long as MFIs do not opt to become deposit-taking institutions, there are no compelling reasons to subject them to prudential regulation and supervision.

Small community based MFIs: Most countries have many completely informal financial service providers such as moneylenders and ROSCAs. It is generally accepted that prudential regulation of these actors is impossible for practical reasons. Moving up the scale, one finds mutual credit organisations, co-operatives, building societies etc. The small size and large numbers of such organisations make effective oversight difficult and prohibitively costly. They seldom pose any risk to the country's financial system. On the other hand, the community-based ownership will make internal supervision and social control more effective. The CGAP study states: "In our view it is a serious mistake to prohibit deposit taking by community-based organisations just because they are too small or remote to be supervised effectively." And thus it concludes that small community-based MFIs should not be prohibited from deposit taking.

The fundamental problem is whether a country has MFIs that are mature enough for licensing. Shortage of licensable MFIs is the binding constraint for growth of microfinance, rather than the absence of a tailor made regulation system.

3.3 Credit unions and credit co-operatives

The co-operative movement

The history of credit co-operatives goes back to the late 19th century. Interestingly, today's dichotomy of rural/agricultural credit co-operatives and predominantly urban credit unions, is rooted in the early developments of that era in Germany and Austria. F. W. Raiffeisen started the first farm credit associations¹. The system became widely adopted and was known as the Raiffeisen system. Simultaneously Herman Schulze established a system of Loan associations. While there were certain features in common (like the principle of one man - one vote), there were also differences. The Raiffeisen model was based on Christian ideals, targeted at the rural population (mostly farmers) and membership was limited on the basis of a parish. The loan associations were based upon pragmatic considerations, targeting the city population (workers and craftsmen) with a system of open membership.

Raiffeisen formulated a set of principles that largely remained the foundation for the co-operative movement to follow:

- unlimited liability of the association members
- strict localisation of association's operations within one community
- commitment to belong to only one credit co-operative
- non-remunerability of management
- predominant application of profit to form specialised coop development funds
- credits are used exclusively for production purposes

The model rapidly spread across Europe including Russia. In the early 20th century a modified version of the European co-operative model was imported and further developed in the USA. The Farm Credit System was set up in 1916, at a time that commercial bank credits were virtually inaccessible to

farmers. A co-operative structure was built around 12 Federal land banks. The government provided USD 125 million in start up funds for the Farm Credit System. Both in Europe and the USA, the co-operative credit institutions have been very successful. Today's leading co-operative banks, such as the Raiffeisen Bank in Germany, the Credit Agricole in France, the RABO Bank in the Netherlands and the Farm Credit System in the USA, are among the 20 largest commercial banks in terms of equity and size of operations.

Credit unions

The credit union movement has mostly been developing in North America since the beginning of the 20th century. Again, historic developments explain the differences that still exists today within the credit union movement, with the US model being distinguished from the Desjardins model of Canada, and the models used in Ireland and the UK⁸.

In the US the first act on credit unions entered into force in 1906 in Massachusetts. Rapid spread all over the US forced federal legislation in 1935. It took nearly 60 years to form a special federal regulatory body. In 1970 the National Administration of Credit Unions (NACU) was formed, as well as a national fund for insuring the investments in credit unions (NIF). The NACU performs three main functions, safety and soundness regulation, management of the NIF and implementation of methodological, financial and administrative support programmes for credit unions.

In about the same period a parallel movement developed in Canada [C-75-78]. Popular cash funds were founded by journalist and philanthropist Alfonse Desjardin for Quebec citizens. The shareholders were (unlike in the USA) small craftsmen, farmers and traders, because there few workers among the shareholders. So from the very start there was a demand for small commercial loans. During the second and third quarters of the century, the movement created a system of self-regulation, standardisation and centralisation. Thus, from the early 1920s a system of regular mandatory cash fund inspections were introduced. In 1963 a law on cash funds provided obligatory membership of cash funds in regional federations (in the USA no credit union was obliged to join in the league). In 1971 the Quebec law on Desjardins Federation assigned to it the rights of a self-regulating body in relation to regional federations. The process was completed in 1980 with the formation of the Reserve Fund Corporation - an institution for mandatory insurance of deposits. The Desjardin movement is the leading financial institution in Quebec. It renders services to virtually every citizen of the province, issuing 36% of consumer loans, 46% of mortgages for housing, 25% of commercial loans and 50% of agricultural loans. It mobilises about 45% of all savings deposits.

These two examples show the strength of the credit union concept, able to survive and compete within the framework of a modern financial sector. The World Council of Credit Unions (WOCCU) has members in 82 countries, organised in 37,700 credit unions, which serve a total of over 100 million members (1999 figures). The saving base amounts to over USD 400 billion, financing loans outstanding to the tune of USD 314 billion. Since 1980 WOCCU has implemented more than 100 substantive regional and country level development projects. It has a special technical assistance program to strengthen credit union systems, to develop and guide national support organisations, as well as developing and implementing legislation conducive to credit union growth.

On such support project was carried out in Poland, to assist in building up a credit union system after the fall of communism. Considering that no credit unions had operated in Poland since before World War II, the credit union network had to be built up from the ground. In 1992 the project established a National Association of Savings and Credit Unions (NASCU) and created a Central Finance Facility, a Stabilisation Fund and an Insurance Company. In 1998, six years later, 220 credit unions were registered, with 268,700 members, who jointly saved the amount of USD 138 million. Out of these savings a loan portfolio of USD 112 million was financed, with a loan delinquency of 0.74%. The total cost of the technical assistance project, financed by USAID, was USD 3.9 million. For every dollar spent, over 40 USD were generated. Assets of USD 158 million render the Polish credit union system the fourth largest financial network in the country.

Apart from WOCCU, there are numerous organisations that can provide technical assistance.

8 An extensive analysis of the credit union systems in the USA, Canada, Ireland and UK can be found in "Improvement of the Policy and Regulatory Framework, Small and Medium Enterprise Development" - Moscow, September 2000, KKP Partners

3.4 Comparison between credit co-operatives and micro-lending institutions

Within the co-operative movement in various countries different modalities have developed within the overall framework and philosophy of mutual savings and credit. While historically clear distinctions could be made between agricultural co-operatives, providing credit mainly for businesses and farms, and credit unions providing credit mostly consumer credit, even this distinction no longer holds. Credit unions have increasingly discovered that credit can be provided to members for business purposes, and thus they become effective microfinance providers. The opposite has also happened. Microfinance organisations are increasing borrowing technology from the credit union movement. The various village banking models attest to that. What has been happening is a process of **methodology diffusion** between MFIs, credit unions and banks [P-2]. In the drive for market share and niche, institutions have simply borrowed the best of each other's practices. Village banking is a good example. FINCA originally established village banks as pre-co-operatives or quasi credit unions to fill a niche for poor women it felt that credit unions were no longer reaching. The village banking model was subsequently adopted by a multitude of MFIs around the globe. KREP, the leading MFI that transformed from an NGO to become a commercial bank, has now established a subsidiary non-profit organisation to mobilise self reliant microfinance associations, using the credit union concept. A study on this subject concludes that "Instead of separate evolution of co-operative, credit union, PVO/NGO and banking approaches, over the years an active **process of hybridisation** is under way. This includes not only the dissemination of methodologies, but also the creation of entirely new approaches combining PVO microfinance and co-operatives." This process is likely to continue, and it has implications for the legislative and regulatory framework of the sector. Whatever legislation is adopted, it is important that it does not stifle the creativity of microfinance providers.

4. Towards an enabling environment

4.1 Problems that need to be addressed - opportunities yet to be captured

Considering the relevant experience abroad, especially the development of micro finance and credit unions in neighbouring transition countries, the question is why development in Russia has lagged behind. Based upon the experience of organisations working in these sectors in Russia, five factors can clearly be identified:

1. Lack of a clear policy on federal level to guide regional authorities in respect of microfinance and co-operative credit for development of MSEs and small farmers.
2. Ambiguity in federal legislation, creating uncertainty as to the legality of credit delivery by non-bank financial intermediaries.
3. Unfavourable tax regime for microfinance providers and borrowers.
4. Limited delivery capacity in the sector of micro finance and co-operative credit. The mechanism of replication and scaling up of operations is not functioning yet.
5. Uncertain medium term funding perspective for institutions that are not fully self-reliant from a point of view of resource mobilisation.

Below each of these factors will be addressed from a perspective of enabling environment. The experience abroad has shown that once the environment for MFIs and credit co-operatives is conducive rather than obstructive, the private sector will exploit the opportunities and the sector will blossom on its own strength. In order to realise this potential, the most obvious obstacles on this route have to be cleared.

It should be noted that equally important is the creation of an enabling environment at micro enterprise level. This subject will be dealt with separately (Task Force on MSE monitoring) and hence is not elaborated here. A clear example of a discriminatory measure in respect to micro-entrepreneurs is the treatment of interest. While interest on loans from commercial banks (accessible mainly for small/medium enterprises) is deductible for tax purposes, interest paid on MFI credit is not recognised as a tax-deductible expense.

4.2 Government policy on microfinance

Through the Law "On the State Support to Small Entrepreneurship in the Russian Federation", and through the specific provisions in the Federal Programme of State Support to Small Entrepreneurship in the Russian Federation in 2000-2001, the Government has clearly expressed the importance attached to the sector. The Federal Programme refers specifically to "progressive financial technologies", for the first time microfinance being one of them.

While it is generally understood that the government should not become a market player in its own right in this sector, it is vitally important that the government's stand on the development of the sector is well formulated and widely publicised. If a branch of an MFI, a new agricultural co-operative, or a credit union, attempts to get established in one of the regions of Russia, the attitude and approach of the regional authorities makes all the difference. Some regions are ahead of developments on the federal level, and they pass special legislation in order to pave the road for non-bank financial institutions such as credit unions or agricultural co-operatives. In other regions or municipalities microfinance institutions may face a total lack of support. The purpose of a federal policy on microfinance is to guide all levels of government on the strategy in this sector, and the main principles that need to be considered in decision making. Policy makers at the lower level, will find it easier to deal with microfinance once the strategy on federal level is clear. For this reason it is desirable that a federal policy be formulated or at least measures of microfinance development elaborated in the Federal Programme of State Support to Entrepreneurship for 2002-2004.

Federal policy in respect to microfinance should be based upon a number of guiding principles:

1. The government recognises the prospects of the microfinance sector for employment creation, entrepreneurship development and promotion of private business initiative. It aims to create an environment that allows non-bank providers of financial and non-financial services to microenterprises and small farmers to operate profitably and sustainably.
2. It is the policy of the Government to create and maintain a level playing field for all actors in the microfinance market, in order to ensure fair competition.
3. The Government will act as a facilitator of development by the private sector institutions rather than performing financing functions directly. Wherever government bodies are currently involved in direct funding, this function should be limited to areas not served by private sector organisations. Government bodies should not obstruct the development of viable private sector institutions, by offering services to ultimate clients at subsidised rates of interest.
4. Microfinance should be delivered at a sustainable basis. This means that interest income should allow the institution involved to cover the full cost of financial services provided.
5. The government allows non-banking financial institutions to operate with credit delivery methodologies of their own choice, provided these services are legitimate and in the interest of their clients. It recognises that it is in the interest of the development of effective credit delivery in Russia that various methods and models are practised, so as to allow the most efficient and effective models to be replicated on a large scale.
6. The Government will not prescribe the rate of interest to be charged to clients. It recognises that lending rates depend upon many factors that are specific for the sector served, the methods used and the area of operation. Microfinance institutions should charge the interest rates that allow it to operate viably and sustainably, thus facilitating expansion of operations and maintenance of the real value of its capital.
7. Microfinance institutions should be able to hedge against the erosive effect of inflation on its capital. The government will look at measures to assist MFIs to perform this function, or remove obstacles that stand in the way of such policy.
8. The government recognises the potential of Credit Unions to serve the financial needs of ordinary citizens that hardly have access to bank credit. Credit Unions act as effective financial intermediaries to mobilise savings and to render small credits in time of need. Credit Unions have proven in other countries to be effective delivery mechanisms for micro-enterprise finance. Experience in the region has shown the great potential. Long term development of the sector is not possible however without the establishment of prudential supervision rules, policy guidelines, operational and governance regulations and monitoring and examination systems. Self-regulation of the sector would require the ability of the (national) associations to enforce prudential discipline related to loan loss provisions, institutional capital, liquidity management and management.
9. The government will not interfere in the operations of microfinance institutions. Lending operations are to be conducted in a businesslike manner, without favour or advantage to any particular client. Microfinance should not be perceived by the public as quasi government support, as this tends to erode credit discipline.

4.3 Harmonisation of the regulatory framework

The laws and regulations of the regional governments in Russia vary widely. Harmonisation of these regulations may be desirable in certain instances, but it is envisaged that this will be a gradual process involving extensive exchange of information and expertise between the federal and regional authorities. It is considered desirable that a "clearing house" be created for information in respect of federal and regional legislation and regulations for financing of MSEs. The Federal Fund is well placed to perform such function, in view of the fact that it maintains working contacts with the Regional Funds. The Regional funds, by their very nature, are well informed about the specific legislation in the region for MSE financing. Regional Funds should be assisted to strengthen their expertise in this regard by staff

training and workshops. Lateral learning can be achieved by sharing expertise of representatives of different regional funds, together with expertise mobilised by the Federal Fund. By pursuing this clearinghouse function, the Federal Fund could promote the adoption of gradually more favourable legislation and regulation at the regional level.

4.4 Regulatory framework for micro-lending institutions

4.4.1 Core questions to be addressed

In 2.2.4 it was concluded that two legal issues need to be addressed:

- The status of the veto opinion in respect to amendments to the legal statute of 'state fund for small business support'. Does it provide sufficient sanction to the current operations of MFIs?
- Are MFIs allowed to lend from borrowed funds, for instance from a line of credit provided by a donor?

Based upon analysis of the case by a legal expert, the following observations can be made.

4.4.2 Status of the veto opinion

- Federal Law No 88 of 14 June 1995 "On State Support to Small Entrepreneurship in the Russian Federation" (further FL On Small Business) states in article 8 (Funds for the support to small entrepreneurship) that "*State and municipal funds for the support to small entrepreneurship have the right to provide to subjects of small entrepreneurship preferred credits, interest-free loans⁹ and short-term loans without the need to obtain a license for banking activities*". The amendment approved by the Duma, but then vetoed by the Acting President of Russia, would have extended this privilege to non-state, non-municipal funds.
- From the documents reviewed it seems that the Acting President considered unnecessary the introduction of this amendment, since "*It should be observed that Federal Laws do not make it compulsory to receive a license for loan disbursement activity*". The question, thus, is whether this official opinion of the executive branch of power creates sufficient ground for the lending activities of private funds and other MFIs.
- The Civil Code states clearly that under credit contracts only banks and other credit organisations can provide credit to borrowers¹⁰. Federal Law No 395-1 of 2 December 1990, "On Banks and Banking Activity" (further FL on Banks) defines credit organisations as "*those legal entities which, seeking to make profit as the basic purpose of their activity, have the right, on the basis of a license issued by the Central Bank of Russia, to implement the banking operations provided in this Federal Law*"¹¹. This implies, actually, not only that for the provision of credit to third parties a license is required, but also that any organisation engaged in such activity must be a commercial organisation, since legal entities seeking as the to make profit as the main purpose of their activity are commercial organisations, in the definition given by article 50 of the Civil Code. This is another ground to exclude MFIs from credit activity, since they usually act in the form of non-commercial organisations.
- If excluded from credit activity in the sense of the Civil Code and banking legislation, MFIs must have a clear ground to be able to engage in (systematic) loan disbursement to third parties, including legal entities. From the definition of the contract of loan in article 807 of the Civil Code¹², there are no subjective limitations as to the parties of loan contracts; they can include natural persons and legal entities without further requirements. The actual question, then, is whether the systematic disbursement of loans is also license-free.

9 Here the contract of loan is in the sense of the *dogovor ssudi* of article 689 of the Civil Code, which is the same as the contract of uncompensated use.

10 See article 819 of the Civil Code, "The credit contract" (*kreditnii dogovor*).

11 See article 1 of this Federal Law.

12 "Under the contract of loan, one party (the lender) transfers to the ownership of the other party (the borrower) money or other things determined by generic characteristics, and the borrower is obligated to return to the lender the same amount of money (the amount of the loan) or an equal quantity of other things received by it of the same type and quality...".

- It seems logical to think that the license-free right of state and municipal funds to provide credit and disburse loans to subjects of small entrepreneurship relates to more than a sporadic, non-systematic kind of activity. This interpretation is supported by the tasks which FL On Small Business entrusts to such funds (see point 1 of article 8). Therefore, if it has been considered unnecessary to amend article 8 because “*Federal Laws do not make it compulsory to receive a license for loan disbursement activity*”, it seems to mean actually a systematic activity¹³.
- If the Acting President expressed this opinion in his letter to the State Duma, what value does it have in support of the lending activities of MFIs in Russia? The authentic interpretation of laws and regulations is a prerogative of the body that issued such norm. Therefore, the interpretation made by the executive branch of power of a law or a set of laws is basically a unilateral, non-binding interpretation. It could be binding for the executive branch of power itself, that is, the Presidential Administration, the Government, Agencies, etc., unless it were clearly against the Law, to which all branches of power are bound. The Letter of Instruction of the High Arbitration Court has a recommendation character, and applies to the cases under the jurisdiction of the so-called *arbitrazh* courts, state commercial courts which deal with private law disputes where at least one of the parties is an entrepreneur. This Letter implies that loan disbursement as a regular activity is considered to be a banking operation, which requires the relevant license from the Central Bank of Russia.
- However, it should be kept in mind that the Letter was issued before Parts One and Two of the Civil Code had been adopted. What the Letter stresses is that the granting of credits as a business activity is a form of banking operation and thus subject to licensing. It could be judged that the reference to systematic loan disbursement is made in the sense of having loan disbursement as a business activity, this activity being undertaken with the main purpose of making profit. Article 2 in Part One of the Civil Code establishes that “*Civil legislation shall regulate relations between persons effectuating entrepreneurial activity or with the participation thereof, proceeding from the fact that autonomous activity effectuated at one’s own risk directed towards the systematic obtaining of profit from the use of property, the sale of goods, the fulfilment of work, or the rendering of services by persons registered in this capacity in the procedure established by law shall be entrepreneurial*”. Article 50 of the Civil Code precisely establishes that the systematic making of profit is the basic characteristic of commercial organisations, in other words it could be said that commercial organisations, unlike non-commercial organisations, are basically engaged in entrepreneurial/business activity. Non-commercial organisations “*may effectuate entrepreneurial activity only insofar as this serves the attainment of the purposes for which they have been created and corresponds to such purposes*”. So it could be argued that for MFIs acting in the form of non-commercial organisations, the systematic disbursement of loans is not directed at a systematic obtaining of profit, and thus is not to be classified as entrepreneurial activity. Even if it can be classified as entrepreneurial activity, it is an activity that just serves the attainment of the purposes for which they have been created and corresponds to such purposes, that is, lending of funds to small businesses as a way to support the development of such businesses.

Conclusion

Based upon legal scrutiny of available studies and documentation, it could be concluded that micro-lending activities by non-commercial organisations are exempted from licensing requirements, and hence no specific legislation would be needed. Based upon international experience, as a general rule it seems prudent not to rush a formal regulatory and supervisory framework until the sector has reached a level of maturity. Formal regulation of the microfinance industry need to be undertaken only when industry (i.e. MFIs) express the wish to become deposit-taking institutions, since this would bring them under jurisdiction of banking legislation¹⁴.

However, on the short run there seem to be two issues of enabling legislation that need to be addressed. The above conclusion is based upon the observation that the fact that MFIs are registered as non-profit organisations. This raises two related legal issues:

- The law on Legislation on non-commercial organisations does not recognise microlending

13 This is an actual supposition, because we lack the original of the Russian text of the veto and the subsequent letter addressed by the Deputy Chairman of the State Duma to the Russian Women’s Microfinance Network.

14 Moreover, in its 1994 version, Federal Law on Banks did explicitly include credit activities among banking activities subject to licensing, and in the Civil Code there was not a clear subjective distinction of the parties in credit agreements, on the one side, and loan agreements, on the other side. Currently that subjective distinction is explicit and credit and loan agreements are separately regulated in the Civil Code.

explicitly as a legitimate non-commercial activity. This implies that from a tax point of view, lending activities would be treated as commercial, thus attracting tax on interest income. It would therefore seem desirable to amend the law on Legislation on non-commercial organisations in this respect.

- In the long run microfinance organisations may opt for commercial status, so as to be able to attract private capital. For this reason it is desirable that MFIs not involved in deposit taking, are exempt from licensing, irrespective of their legal structure.

It is recommended that the Federal authorities address these issues.

4.4.3 Lending from borrowed funds

If MFIs are involved in systematic loan disbursement, the question arises whether this is still possible if they lend funds borrowed from third parties, mainly international donors, as is usually the case.

It is considered desirable that MFI are authorised to lend from borrowed funds, especially when these loans are obtained through lines of credit from donors. The legislator is obviously concerned with safety of depositor's monies, if these were to be used for lending purposes. However, when donors or international financial institutions provide funds in the form of (concessional) loans, with the explicit understanding that they be used for the purpose of micro-lending, the integrity of the financial transaction need not to be questioned. Hence, in order to finance long term growth, MFIs should be allowed to borrow for the purpose of their microfinance activities.

- The problem is formulated in Bulletin N° 1 '00 of the Russian Women's Microfinance Network, and amounts to considering whether in a situation that a Russian MFI uses funds borrowed from a (international) lender to on-lend to Russian borrowers, and pays interest to its lender, a bank deposit relation arises between the lender and the MFI; with the subsequent requirement that the MFI obtain the relevant bank license. If this is the interpretation made by Russian tax authorities, it places MFIs in a difficult position.
- Two observation can be made in this respect. First; the Federal Law On Banks defines credit organisations as legal entities the main aim of whose activity is making profit. This coincides with the definition given by the Civil Code for commercial organisations. It follows, then, that in order to become credit organisations, all MFIs should act in the form of commercial organisations (Joint-Stock Companies, Limited Liability Companies, Full Partnerships, Limited Partnerships, etc.).
- Secondly, one has to look at the nature of the lender-MFI relationship. It is hard not to agree with the arguments given in the Bulletin, that the (international) lender-MFI relationship amounts to a loan contract in the sense of the Russian Civil Code. Moreover, the provisions on special-purpose loans contained in article 814 of the Civil Code guarantee the lender's right to control the use of funds lent under special conditions. The Civil Code does not prohibit special-purpose loans with the obligation to pay interest to the lender, and if a loan contract is drafted in such a way that it fully complies with the provisions of the Civil Code in Section 1 of Chapter 2, it is hard to argue that this is a bank deposit contract from the civil law point of view.

Conclusion

On the issue of lending from borrowed funds, it is concluded that loans or lines of credit provided by national or international financial institutions, cannot be treated as bank deposits. Hence it appears that current legislation does not rule out lending from borrowed funds, provided the funds cannot be classified as deposit taking. Yet, in the current situation not all MFIs feel invulnerable for legal challenge on this matter and hence it is considered desirable that MFIs are specifically authorised by means of legislation, to lend from borrowed funds.

4.4.4 Information centre

In view of the complexities of legislation, entry into the sector for smaller Russian organisations is not easy. It would help if existing studies on these matters would be brought to a central point that could act as an information centre. It should be investigated whether an existing institution, such as the SME Resource Centre or the Federal Fund could perform this function.

In order to operate the reference centre, the organisation concerned should actively collect and maintain all relevant documents, and involve themselves in policy forums of the sector. The information centre could also build up a database of consultants and lawyers with expertise in the sector.

4.5 Tax regime for micro-lending institutions

Fiscal policy has proven to be an effective instrument to stimulate MSE finance. Micro-lending institutions are confronted however with a tax regime that puts them in an *unfavourable* position as compared to banks, as banks exempted from VAT on interest revenue. As the Government acknowledges the development value of the microfinance industry, it would be prudent to ensure at least a level playing field. The following tax issues need to be addressed:

- *VAT on interest:* VAT on interest used to be payable by all MFIs, except those registered as a Fund. In the newly approved Part 2 of the Tax Code, however, all loans are VAT exempt and hence the disadvantage of MFIs vis-à-vis banks is a thing of the past.
- *Liability for Enterprise Profit tax:* Currently all MFI operations that are funded through grants pay 30% tax on net revenue. This is considered the single biggest obstacle for achieving MFI financial viability. For example, it is estimated that out of a grant of USD 5 million, approximately USD 500,000 is payable in the form of profit tax. In view of the fact that the Federal Government gives high priority to microfinance development, it would seem fully justifiable for the government to wave profit tax for MFIs, since they retain their operating surpluses for the purpose of expanding loanable capital. There are two different strategies that could be followed to achieve this objective.
- The first strategy is to better use the current provisions of the Tax code. The new version of the Tax Code (Part 2) applies as a general rule that non-commercial organisations are not subject to income tax on income derived from the activities that are declared in the documents establishing the organisation as a non-commercial organisation. Unrelated business activities are subject to tax. As observed above, the problem for MFIs may be that microfinance is not considered an appropriate legal purpose of a non-commercial organisation. If the law on non-commercial organisations could be amended, as suggested above, MFIs would qualify for tax exemption.
- The alternative strategy is to carve out a special exception in the Profit Tax law for MFIs.
- Grants to MFIs: Grants provided by international donors to local MFIs is tax exempt, on the basis of a treaty and a special law. Grants from within Russia would be taxed however. For development of the microfinance industry seed capital is of vital importance. In most countries seed capital has been generated in the form of grants from the government or private (charitable) institutions. It is vital that this route is opened up.

4.6 Credit Unions

4.6.1 Legislation for Credit Unions

Legal studies point to the fact that in order to accommodate the practice of co-operative credit properly, a legal package on non-commercial co-operative credit organisation would have to be created. This would require a review of current legislation, starting with proper definitions of legal terms (for instance defining "mutual activity" as a form of economic activity) and ensuring consistency between the above mentioned laws. Moreover a new Federal Law on Credit Unions should be adopted. However, even without a new package, progress could be reached by incorporating amendments in existing laws. Specific recommendations to this end have been formulated (C-117).

The report on the State of Micro Finance Activity and Regulation in Russia shows that there are two major legal obstacles for credit co-operatives in Russia. First of all credit unions currently have no legal basis. Two attempts to pass a Federal Law "On Credit Consumer Co-operatives" in the Duma have failed. The first time was in December 1995, then in January 1997 (both times vetoed by then President Yeltsin), and the third time it was in early 2000 (vetoed by then Acting President Putin). According to the Credit Union League, in November 2000 the Reconciliation Commission started discussion of next version of the draft law, taking into account the President's comments. The second problem is that even if the law would have passed, it would allow only for providing loans to physical persons, not to legal persons. This would effectively bar CUs still from providing loans to small business that are often registered as legal entities (E-p14).

Credit Unions have proven to be effective vehicles for microfinance in other countries. Usually their membership consists largely of employees, rather than micro-entrepreneurs. However, in practice loans can be granted through a salaried person to a family member in business. This channel has proven to be rather effective since the family member guarantees with his/her income the debt servicing of the micro-entrepreneur. If this method is practised, it could well be that the above observed legal restriction on lending to legal entities does not arise. But this would have to be confirmed by legal experts. When a line of credit is made available to a credit union in the framework of a micro finance programme, usually the precondition is that the funds can be used only for business applications. It seems that this channel has great potential for rapid replication and scaling up of microfinance activity, provided that, apart from member shares and savings, external lines of credit could be made available.

Another interesting option is that the people who intend to form a credit union for the purpose of micro finance, are advised to use the legal form that is already authorised by the Federal Law as a "Society of Mutual Crediting of Small Business Entities" (MCS). This legal form seems to allow all activities that credit unions normally undertake, since MCSs are granted to accumulate funds from participants and provide (lend) financial resources to physical and/or juridical persons, although it is not fully clear whether they are licence-free in relation to the latest point (systematic issue of loans to legal entities). If the legal obstacles to Credit Unions can be overcome, it is envisaged that the demand for loanable funds for micro-enterprise lending could increase substantially.

It is envisaged that successful legislation would free the way for very rapid expansion. This will require not only capacity building within the credit unions, but also the creation of transparent accounts and perhaps even a form of supervision. It is necessary that local consultancy and training expertise is built up, to deal with the capacity building demands. It is good practice that international consultants and trainers collaborate in their assignments with local experts, so as to enhance local capacity in this field. The Ministry could stimulate this, in consultation with donors.

4.6.2 Policy recommendations

The first priority now seems to be a professional review of the legislation prepared on the subject. For this reason the following action is proposed:

- Translation of the draft legislation on Federal level, together with a sample of legislation developed on the regional level.
- Consultation with WOCCU, the World Council of Credit Unions, on desirable improvements.
- Instruction to Russian Law firm to review the law, in light of the reason for rejection by the Dumb and comments made by WOCCU. The lawyers should also advise whether the existing Mutual Credit Societies law could provide an appropriate legal cover. Finally legal advice must be given on possible coping strategies, pending formal legislation, and to what extent this allows or precludes credit delivery through CUs in the intermediate period. This assignment is to be contracted out to a Russian law firm that has experience in this sector. The Lawyers will propose the legislative strategy to be pursued.

If the outcome of the legal study is positive, a feasibility study should be undertaken on the possibility to use existing credit unions as intermediaries for microfinance. This is a separate project activity, for which donor funding is yet to be identified. Terms of Reference for such study can be provided by the Tacis project.

4.7 Funding requirements of the sector

In as far as the funding mechanisms are concerned, a clear distinction needs to be made between the two main strands of microfinance; (a) the specialised microlending institutions are established with the assistance of donor funds, and (b) the credit unions and credit co-operatives, that are fully, or largely financed from the share capital and savings of its members. Usually they have no access to any external finance. Below the funding perspective for both is briefly reviewed.

In the short term the availability of funding for microfinance (loanable funds) seems not to be a constraining factor. For the dedicated MFIs currently operating in the country, substantive grant funding is available, while the credit unions lack funds for non-financial services (capacity building), not for

financial services. In the medium term (two or three years from now) a need will arise for sustainable funding on the basis of loans. This applies mainly to the MFI sub-sector, but may extend to the Credit Unions and co-operatives. By this time a funding gap is expected to arise, especially when current grant funding arrangements would dry up. Even if this would not be the case, donor policy is likely to shift towards loan funds rather than sole reliance upon grants.

5. Scope for specific interventions

5.1 Policy dialogue with the MFIs

It is desirable that the Government engages in an active and sustained policy dialogue with the practitioners in the sector so as to create an enabling environment for the industry and eliminate undue legal, administrative and fiscal obstacles. For this purpose the sector should be stimulated to constitute a mode of representation that can speak on behalf of the operators in the sector. In many countries for this purpose Associations of microfinance institutions have been established. As long as no formal association exists, an informal representation such as the Microfinance Policy Working group of MFI network organisations (OI, FINCA, RWMN, ACDI VOCA and Counterpart International), provides a good opportunity to conduct this policy dialogue. Chances for efficient sector development are best when the Government is responsive in its dealings with the sector.

The Federal Fund has the expertise and manpower capable of addressing the legal and regulatory issues the sector is facing. It is envisaged that the Federal Fund could play a facilitating role on the side of the Government. If eventually a second tier financing mechanism were to be established in the private sector, this institution could also perform an advocacy function.

The microfinance sector in Russia is an infant industry; it is still in the early stages of development. The industry itself will have to develop its effectiveness and scale of operation, in order to become a credible and viable component of the financial sector in Russia. While the Government now starts to see the merit of the sector, the Government should be restrained in prescribing or limiting modes of operations, as the sector will require experimentation to find the most efficient modalities of credit delivery.

5.2 Policy consultation with donors

It is desirable that the MAP conducts semi-annual policy dialogue with donors and potential financiers of the sector, so as to discuss progress in sector development. Moreover this forum could be utilised to agree on the means of implementation of the medium term strategy for development of the sector, and "best practice" standards for interventions in the sector. In the framework of CGAP such standards have been agreed upon by the donor community, and all that needs to be done is to translate these general guidelines into specific guidelines for Russia.

5.3 Statement of Policy

It is desirable that the Federal Government makes a clear statement of policy intent in respect of the microfinance sector, possibly by means of a periodical microfinance sector policy paper. It could be of great help of microfinance practitioners in their consultations with regional authorities, and could guide and encourage actors within and outside the Government to work towards a more enabling environment.

This policy statement could deal with elements such as:

- The government's recognition of the importance of micro enterprise development for the employment, economic growth and creation of entrepreneurship potential. Microfinance, whether delivered by specialised MFIs, credit co-operatives or commercial banks, is to be promoted.
- The government is in full support of the development of a micro finance industry in the private sector. The role of the government is to enable the sector to work, not to control or direct its operations.
- Promotion of expanded delivery capacity and replication of proven technologies. While the Government does not have a promotion body for microfinance, it can help the sector expansion through a campaign of advocacy and awareness at lower administrative levels.

- The government to review legislation and supporting regulations, for specialised MFIs and Credit Unions, so as to facilitate their operations.
- It will create a favourable tax regime for financial intermediaries and eliminate fiscal obstacles for the development of the industry.
- It will allow international donors to fund the sector institutions in accordance to internationally agreed best practices.

5.4 Enabling legislation

In respect to legislation, a clear distinction needs to be made between the three main strands of microfinance in the country; i.e. MFIs, Rural Credit Cooperatives and Credit Unions.

For MFIs it is desirable that the current status of MFIs operating as a fund is formally confirmed. A statement of the Federal Government's Ministry (e.g. the Ministry of Justice) or Arbitration Court in this respect could facilitate the registration of new MFIs in the regions.

Based upon the newly proposed Federal Law on Credit Co-operation, it is envisaged that the legal framework for this mode of microfinance is adequate. However, also in this sub-sector, providers of microfinance like ACDI/VOCA are hampered by the type of fiscal obstacles as observed above for MFIs in general.

Most urgent at this stage is the legislation in respect to credit unions, as a legal basis for their operations is currently lacking. The history of this piece of legislation is not very fortunate, since it has been rejected already twice in the State Duma. Reportedly a fresh attempt for legislation is currently undertaken. If this would fail, it is suggested that a professional review of the draft legislation is done by a law firm conversant with the sector, and that a legislative strategy is worked out. A wealth of international expertise on legislative issues is available through organisations like WOCCU or COPAC. Subsequently the Ministry could liaise with the sector (institutions and international donors) on how best to implement this strategy. It is envisaged that in order to succeed with legislation, special effort needs to be done in terms of publicity and information dissemination about the need for orderly development of credit unions. It is envisaged that the Federal Fund could perform a facilitating role in overcoming the administrative hurdles on the way.

5.5 Creation of a second tier lending mechanism for microfinance

As described above, it is envisaged that in the short-medium term (2003-2004) a funding gap may arise, provided that planned microfinance activities expand in accordance to plan. Apart from the current institutions, new organisations will enter the field, which will require finance for lending operations. It is considered desirable that MAP investigates the possibility to create a mechanism for wholesale financing of MFIs in Russia.

Justification

In the overview of international experience the stages of development of the sector institutions have been highlighted. It was concluded that historically MFIs require a period of approximately 15 years to mature from subsidy dependence to full financial viability. What applies for individual institutions, also applies to the sector as a whole. Time is required to develop appropriate and efficient delivery mechanisms, to scale up operations and to reduce the operating expenditures to a level of optimum efficiency and competitiveness. This takes time. The most crucial step for the microfinance industry is to gain sufficient credibility so as to convince the public and the regulatory authorities that it is safe to use client deposits for on-lending. This step will open up local savings resources for financing of micro-credit operations. While this is the ultimate objective for the sector, it is only realistic to recognise the fact that this is not realised in the short term. For this reason, it is necessary to create a 'bridging mechanism', that allows the industry to move efficiently from the present state of subsidy/grant dependency, to a state of full financial viability.

A number of specific observations can be made for Russia:

- Current MFIs are highly unlikely to transform into a commercial bank within the medium term (five to ten years). In fact the FINCA study considers this step currently "unfeasible and unjustifiable". This means that these institutions are not able to collect deposits and hence will remain dependent upon external funding for the foreseeable future.
- From a point of view of sector strategy, it would not be sound to assume future grant funding to match the financing gap of the sector. Grant funding will not be able to match a rapidly growing demand for microfinance services in a potential fast market like Russia. Moreover, donor policy for microfinance moves in the direction of loan-financing, rather than grants.
- Grant funding can create market distortions, especially if it is available to some NGOs, where others are operating commercially. It is a basis for replicable solutions only to the extent that similar grant funding is available to other new entrants in the market.
- The existence of a credible second tier (apex) finance mechanism can mobilise international funding that would otherwise not be available.

Functions of a second tier mechanism

Generally for microfinance apex mechanisms two functions are distinguished: (a) as financial intermediary and (b) as developer of the market. The role as financial intermediary is important, as argued above, in the development stage of MFIs. It provides the bridge between grant funding and commercial capital. Often this is done by means of term loans with a rate of interest that compares favourably to the market rates. A degree of concessionality in the interest rate assists the industry to reach operational sustainability sooner, and to apply interest rates affordable to the end user. The concessionality should be limited however, so as not to retard the growth of MFIs towards maturity, or endanger the sustainability of the mechanism itself. Apart from debt financing, an apex mechanism could also provide (quasi-) equity instruments. The apex organisations would mobilise funding from the government or international financial institutions and donors. One of the functions is transform these funds in terms of risk perception (loan size, terms to maturity, timing of disbursement and interest rate) into a product that is appropriate for the retailing MFIs. While it can be expected that the specialised micro-lending institutions would be its main market, also credit unions and credit co-operatives could augment their resources for the purpose of microfinance.

The market development function refers to a number of non-financial services and activities that an apex institution could perform. These functions can include capacity building of MFIs, transfer or exchange of technology, development of loan tracking systems and reporting standards, advocacy and consultation with the authorities on issues of sector development.

A recent study executed for CGAP¹⁵ concludes that the two functions may well be conflicting. In order to avoid this, a clear focus on the financial intermediary role may well be preferred. The report warns against a number of problems that have affected apex institutions abroad. To mention a few:

- government ownership of the apex is to be avoided – it should be organised in the private sector
- a sufficiently large and well established microfinance market already exists
- the domestic apex organisation has the will and the credibility needed to enforce contracts
- the degree of interest rate subsidy is not excessive
- existing lending technologies have been developed by local leaders of the microfinance industry, and there is a second echelon of MFIs that can adopt those technologies with the assistance from the apex and the innovative leaders in the industry

The last condition appears to be particularly relevant for Russia. Until now there is a handful of leading MFIs with foreign funding, but it would be difficult for local MFIs to replicate what the leading institutions are doing. Thus, an apex mechanism could play a vital role in the replication of microfinance throughout Russia.

Operational options

A wholesale financing mechanism for MFIs can take many forms. It is not even necessary to create a new institution, since a wholesale financing mechanism could well be implemented by an existing financial institution. For the purpose of Russia a number of options might be considered:

Reference is made to "Microfinance Apex Mechanisms: Review of the evidence and policy recommendations, by Claudio Gonzalez-Vega, for CGAP – August 1998.

- Competitive bidding for a Fund Management contract by commercial banks (for a specified period of time). This is usually a short-term contract (e.g. for two years, renewable), but it can also be awarded for a longer period (e.g. 5 years).
- Creation of a Trust Fund with an existing commercial bank. Based upon the Trust agreement and a set of specific policies and procedures, the bank manages the Trust Fund. This can be a long-term arrangement, or even a permanent arrangement.
- Creation of a new Trust Fund, operating on a non-profit basis. The management of this legal entity can be executed by its own staff or it could be sub-contracted to an existing institution with expertise in the sector.
- Creation of private commercial financial intermediary, able to attract private shareholders and institutional shareholding.

The last two options can also be combined, when the non-profit Trust fund, establishes a subsidiary company limited by shares, to serve the purpose of attracting private capital.

Follow up and design

The logical entry points for investigations of the feasibility of a wholesale finance mechanism are the supply and demand side of the equation. The history of apex institutions shows that at the inception there was always an identified source of finance. This is critical, not only because it is the most critical factor in the feasibility analysis, but also because one or more major financiers will have specific conditions for participation that need to be taken into account. As far as the demand is concerned, some observations have been made in chapter 2. It was concluded that MFIs have expressed interest, and that a finance gap has been identified for the period 2002–2004. A pre-identification study for this project should start with a confirmation of the actual demand, and identification of possible funding sources. Once one or more possible funding partners have been identified, the formulation of the appropriate finance mechanism and institutional setting can be undertaken in collaboration.

It is recommended that MAP shall execute a pre-identification study as a first step towards project design and appraisal.

5.6 Information Centre for Micro Finance

Currently the RC performs research in the field of MSE development. Since mid-January 2001 it has been busy with the survey of current microfinance supply in Russia. Information was gathered from MFIs operating in 62 regions of Russia. A special database with qualitative and quantitative information on the types of operating MFIs was developed using the SPSS-Statistics software. In order to analyse the activities of MFIs and assess the resources provided by them to small businesses, a series of selected indicators were produced. The analysis of gathered and processed information provided a clear picture about the state of affairs with microfinance supply in Russia. It will facilitate identification of further directions and techniques in developing this financial instrument for small business support. The draft Report was completed in early April 2001 and distributed at the Task Force-3 meeting.

As a logical follow up to the current studies, an existing institution such as the Resource Centre (RC) could be mandated and requested to act as Information Centre for Microfinance. All reports and studies should be readily available to local and foreign organisations that are (potentially) active in this field. This could include a database of MFIs, consultants, trainers, lawyers and accountants.

Appendix 1

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- S: Guidelines for the Analysis of Policies and Programmes for Small and Medium Enterprise Development, A. Tolentino, ILO, September 2000
- T: The Micro Finance Summit Report, February 1997
- U: From Margin to Mainstream: The Regulation and Supervision of Microfinance, Rachel Rock and Maria Otero, Accion International, January 1997

Appendix 2.

Relevant web-sites on microfinance

www.cgap.org
www.villagebanking.org
www.opportunity.org
www.info.usaid.gov/pubs
www.mip.org
www.woccu.org
www.womensworldbanking.org
www.microcreditsummit.org
www.accion.org
www.grameen-info.org
www.agecon.ag.ohio-state.edu/ruralfinance/publications.htm
www.pactpub.com
www.undp.org/sum
www.gdra.org/icm
www.myriada.org
