

The State of Microfinance Activity and Regulation in Russia

Mehnaz S. Safavian
Douglas H. Graham
Claudio Gonzalez-Vega
Dennis Whelan

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THE AUTHORS

Mehnaz S. Safavian is a Graduate Research Associate in the Department of Agricultural, Environmental, and Development Economics, The Ohio State University.

Douglas H. Graham and Claudio Gonzalez-Vega are Professors in the Department of Agricultural, Environmental, and Development Economics, The Ohio State University. Gonzalez-Vega is also Director of the Rural Finance Program at Ohio State.

Dennis Whelan is a Visiting Scholar at Dartmouth College, Department of Russian Studies, and a Partner at the Center for Russian Law in Moscow, Russia.

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Introduction

Worldwide, the emergence of microfinance institutions (MFIs) in developing countries has multiplied substantially over the past decade. A number of these institutions have been successful in providing credit and deposit services to the poor in low-income countries, facilitating poverty alleviation strategies, supporting micro and small businesses, and expanding the financial frontier to include hitherto excluded clienteles. Innovative lending technologies, new financial products, appropriate pricing, and a general understanding of the challenges and opportunities for the microfinance sector have contributed to their success and proliferation as well as to the recent global political and financial support they have attracted.

While MFIs are fairly common in most of the developing world, *i.e.* Africa, Asia, and Latin America, the transition economies of Central and Eastern Europe and the Newly Independent States remain a geographical frontier where microfinance is still nascent. In part, the paucity of institutions in this region stems from the former political climate, which made this market impenetrable until the early part of the 1990s. Also responsible for the limited microfinance activities in the region, however, is the fact that many of the successes and lessons learned from the extensive history of microfinance in more traditional developing countries have proven difficult to transfer to transition economies. This has been mostly a result of the incomplete and frequently inconsistent institutional environment found in these economies.

Perhaps nowhere are the difficulties of operating a microfinance institution more pronounced than in the Russian Federation. The legal and regulatory environment in Russia is particularly harsh. Taxation is often repressive, and the transaction costs of operation are high. In spite of these obstacles, the microfinance sector in Russia does exist, and it is slowly growing. This sector, however, is thin and fragmented. Up until now, MFIs in Russia have been individually struggling, at high cost, to circumvent common policy obstacles. Nevertheless, a consensus exists among these institutions that significant gains could emerge from a more transparent and cohesive sectoral initiative to improve the enabling environment for MFIs in this country.

The purpose of this paper is to describe the operating conditions for a select number of MFIs in Russia, with direct or indirect linkages to U.S. funding sources, and to underscore the challenges this environment poses for these institutions. By crystallizing a better understanding, not only of the problems, but also of some of the coping strategies that individual institutions have used to overcome them, we hope to broaden the knowledge about the MFI sector in Russia and to contribute to its healthy expansion. In particular, this paper focuses on the legal and regulatory constraints that limit the operations of MFIs and illustrates them using case studies from bilaterally-funded microfinance programs in Russia and with information collected through their head offices, field level practitioners, and various legal consultants.¹

¹ *Bilateral* funding refers to the transfer of donor funds from one country to another. One exception to the generalization about bilateral funding is the Russian Women's Microfinance Network (RWMN), affiliated with Women's World Banking, which receives the majority of its funding from the Ford Foundation and from monies raised by its domestic member institutions in Russia.

The paper is structured as follows. Section One provides an overview of the historical evolution of the MFI sector in Russia and describes the current state of microfinance activities in this country. Section Two offers a profile of constraints facing donor-funded MFIs, including registration, licensing, taxation, and legal and political obstacles. This section also provides a detailed description of possible legal forms of registration and evaluates their appropriateness for MFIs. Section Three highlights some MFI strategies undertaken to circumvent regulatory obstacles. Section Four follows with a brief synopsis of remaining legal and regulatory issues affecting the sector. Finally, Section Five reviews the *Best Practice* forms of MFI registration and setting up for lending. A summary with recommendations concludes the paper in Section Six.

Readers of this paper should be alert to the rapidly changing scenario of the legal and regulatory framework in Russia. This paper should be looked upon as a preliminary synthesis of research on the situation through February 2000.

1. EVOLUTION AND CURRENT STATUS OF THE MICROFINANCE SECTOR IN RUSSIA

1.1 Brief History of MFIs in Russia

The emergence of internationally supported MFIs in the Russian Federation dates from 1994, with the launching of the first of Opportunity International's organizations in Nizhny Novgorod. While some domestic MFIs existed in the Soviet era, it was only in the 1990s that the sector received a boost through the initiative of several international organizations in selected *oblasts* (administrative regions) in the country.

The operational philosophy, regulatory status, and market niches of the microfinance world can be divided into two distinct classes of operations. In Russia, microfinance activities occur either through the banking system (*i.e.*, *downscaling*) or alternatively through a grass-roots approach, operating as specialized credit programs through non-commercial organizations (*i.e.*, *upscaling*). For the former, the Law "On Banks and Banking" governs lending activity, while in the latter case the relevant legal framework is the Russian Civil Code.

This review highlights important features of the upscaling effort. In some respects, this effort has paralleled the downscaling initiative undertaken and financed by the European Bank for Reconstruction and Development (EBRD) from 1994-95, to reach a microenterprise clientele through the Russian banking system. Whereas the upscaling effort operates outside the banking industry, as an autonomous activity financed largely by bilateral donors (most notably USAID), the downscaling effort was concentrated within banks and was supported through a multilateral donor.²

The upscaling efforts have adopted either group or individual lending technologies and, in some cases, simultaneously both. In contrast, the downscaling efforts have focused exclusively on individual lending technologies, which are more amenable to banking practices, yet more innovative than those typically practiced by Russian banks. Both upscaling and downscaling approaches have represented fresh new ways to expand the frontier of finance in Russia. The upscaling MFI efforts have, however, generally reached further down the poverty ladder in the country than the downscaling efforts.

Finally, both approaches have struggled to adapt in the wake of the August 1998 currency crisis in Russia, which negatively affected their clientele. While recovery is evident in both instances, the EBRD downscaling effort has led to a far more daunting challenge of extracting the remaining sound clients from otherwise insolvent banks and of placing them in a new microenterprise bank. This institution has been under the temporary ownership and control of the EBRD itself jointly with other multilateral investor organizations. In contrast, the upscaling MFI movement generally experienced a temporary decline in loan numbers following the crisis, but by mid-1999 it had begun to recover its previous path of gradual growth.

² This is not strictly true. Opportunity International tried to lend through two middle-tier regional banks in Saratov in 1997. This effort failed, as both banks became insolvent, and bank channels were abandoned by Opportunity (Pitt, 1999). Emphasis in this paper on upscaling efforts does not imply any value judgement about the merits of either approach; rather, it responds to the more formidable regulatory constraints encountered in upscaling efforts.

Table 1: Institutional and Operational Features of Selected MFIs Operating in Russia as of October 1999

| | CCI-RISE | FINCA | Opportunity International | RWMN | Working Capital |
|--------------------------------------|--|--|---|--|---|
| Year Registered | 1995 | 1999 | 1994 | 1998 | 1998 |
| Registration of Parent Branch | N/A | Branch of International NGO | Russian Partner Agency of the American Public Corporation | Non-Commercial Organization | Branch of International NGO |
| Registration for Lending | Non-governmental Educational Institution | Social Organization for Mutual Development | Funds and Consumer Cooperatives | Funds | Channeled through State Fund for Small Business Support |
| Lending Methodology | Individual | Group | Group and Individual | Individual | Group |
| Monthly Interest Rates | 18% annual (dollar) | 5% | 8% | 8% Ruble 4% Dollar | 25% annual |
| Average Loan Term | 8-10 months | 3-4 months | 4 months | 1-3 months | 5 months |
| Average Loan Size | US\$5,000 | US\$620 | US\$725 | US\$550 | US\$1,300 |
| Oblast(s) where Located | Leningrad | Samara | Nizhny Novgorod; Rostov-on-Don; Saratov; Voronezh; Novgorod Lipetsk; Belgorod | Smolensk Vidnoe Kaluga Tver Kostroma | Khabarovsk |
| Number of Operating Units | 1 | 1 | 20 | 5 | 1 |
| Total Number of Borrowers | 17 | 203 | 1,442 | 362 | 240 |
| Technical Assistance | Yes | Yes | Yes | Yes | Yes |
| Number of Employees | 2 | 15 | 63 | 20 | 9 |
| Case Load per Loan Officer | 8 | 25 | 68 | 25 | 45 |
| Performance-based Staff Remuneration | No | Yes | Yes | No | Yes |

1.2 Status of MFIs in Russia

The remainder of this paper focuses on the upscaling microfinance sector, underscoring the predominant issues shaping its current evolution in the Russian Federation. The main microfinance institutions reviewed here are those sponsored by CCI-RISE, FINCA International, Opportunity International, Russian Women's Microfinance Network (RWMN), and Working Capital. These institutions are quite heterogeneous. They are spread throughout the Russian Federation, and they have adopted different organizational models, different lending technologies, and various forms of registration, as they attempt to operate under distinct oblast-specific policy environments. Table 1 provides an overview of their respective institutional and operational features as of October 1999.

1.3 Modes of Organization

There are several distinct patterns of organizational design among the five MFIs listed in Table 1. These modes of organization are mostly a function of the institutional structure of the sponsoring international organization, tailored to the peculiarities of each oblast/regional setting.

Opportunity International (OI) has conducted lending operations through very diverse organizational forms and has drawn upon multiple sources of funding to carry out both individual and group loan programs. While the legal form that governs the administrative operations of the NGO is a Russian branch of the parent international NGO, the legal registration under which the lending operations are carried out usually takes advantage of the opportunities offered by various social organizations or consumer cooperatives (CCs).³ Moreover, OI often works with domestic partner non-commercial organizations, which enjoy varying degrees of autonomy from OI with respect to their funding and operations. The international NGO also plays an important role in providing technical assistance for all of its partners.

A second path followed by microfinance institutions, one similar in spirit to that followed by OI, is that of the Russian Women's Microfinance Network. RWNM, however, is not a branch of an international NGO. Instead, it is a local non-commercial partnership, and it acts as a mentor for domestic partner MFIs in Russia. RWNM provides training, technical assistance, policy support, and assistance in the mobilization of external funding for member organizations in the network.

In order to attain network membership status in the RWMN, a self-started, fledgling organization must pass through an initial screening process and be accepted into the network. Acceptance, however, is contingent on the ability to raise a minimum amount of its own capital.⁴ This initial capital is subsequently matched by RWMN. After a final evaluation period, in which the organization is judged for its ability to effectively administer a microfinance program, the network assists in securing additional donor or philanthropic funds to inject into the partner's capital base. This design is cost-effective, in part because of its reliance on the initiative of each domestic organization to mobilize its human and financial capital itself. Additionally, the grant funds that support the partner institutions after their acceptance into the network are tax-free if they come from established US NGO sources.

³ The distinctions between various forms of registration for administering credit programs will be clarified later in the paper.

⁴ Initial capital is usually in the range of US\$5,000.

The registration process for the RWMN network is simple, although none of the regulatory obstacles facing MFIs are circumvented via this route. The largest potential drawback for RWMN is the difficulty that the network may have in achieving large-scale operations for its partner institutions, given the obstacles that they face.

FINCA (Foundation for International Community Assistance) operates through a more integrated organizational structure, with a goal of creating a replication of the *village banking* methodology in Russia.⁵ The Samara project has been the first step in this direction.

As with OI, Working Capital, and CCI-Rise, the legal form that governs the administrative unit of FINCA Samara is a Russian branch of an international NGO, but credit operations are carried out via a *social organization for mutual development*. As FINCA's presence in Russia grows, it will likely continue along this course, with no intention of subsuming pre-existing domestic organizations into its operations.

A fourth type of organizational model found in Russia's MFI sector is the one used by Working Capital Russia (WCR). As with FINCA and OI, Working Capital's administrative unit is legally set up as a Russian branch of an international NGO. Unlike the other MFIs, however, WCR administers its loan program through a local Small Business Development Authority, which retails loans to its targeted clientele via a commercial bank window.⁶ Working Capital's mode of operation demonstrates the constraints of working within a *local* juridical setting. To the extent an NGO discovers high transaction costs or long delays in registering as an independent, autonomous unit, it may choose this organizational design to channel financial services (*i.e.*, loans) to its target clientele.⁷

Finally, the Center for Citizens' Initiatives (CCI) registered its lending activity in 1995. This is a Russian non-governmental educational institution. Its lending program is linked to a business incubator that offers services to businessmen and to a training unit for entrepreneurs, all of which operate out of a single office. CCI focuses on leasing and on relatively large individual loans, much larger than those loans characteristic of other MFI programs (Table 1). Given the difficulties its clients have recently faced in honoring repayments on foreign exchanged-indexed loans, following the August 1998 crisis, the program is preparing to discontinue its lending activities.

⁵ *Village banking* consists of individual loans generated through groups that meet regularly for loan disbursement and repayment and for the accumulation of member savings. FINCA is considering, however, the possibility of offering individual loans in the future in its Russian operation.

⁶ As will be elaborated later in the paper, only licensed banks and state and municipal development funds have a clear legal right to make loans in Russia. Other MFIs have circumvented this obstacle largely by exploiting articles in the Civil Code broad enough to suggest that member-based lending activity is not prohibited or by exploiting still-valid pre-Civil Code legislation from the late Soviet era, in combination with dialogue and courting of oblast authorities. In regions where the latter method is ineffective, MFIs may have to resort to less favorable tactics and work with a bank or state municipal fund, instead of around it.

⁷ A major benefit of using this downstream form of retailing microfinance loans is that it is exempt from the Value-Added Tax (VAT), a tax that generally represents a sizable fiscal burden for MFIs in Russia.

In summary, the legal modes of registration described above represent various organizational designs through which MFI lending operations are carried out in Russia. No one design appears to be uniformly superior to the others. Thus, the elusive concept of identifying a single, currently operating *prototype* institution is at best problematical under present circumstances.

The degree to which any given organizational form and mode of registration are appropriate for a particular MFI depends, in no small part, on the progressiveness of the local oblast authorities and on their built-in biases when interpreting and implementing the legal and regulatory framework for MFIs in these settings. The issue of which organizational design features would constitute an ideal prototype institution will be dealt with in the concluding section of the paper.

2. LEGAL, REGULATORY, AND OTHER FACTORS INFLUENCING MICROFINANCE ACTIVITIES

The number of constraints, degrees of difficulty, and high costs of market entry are usually unanticipated by international MFIs entering the Russian environment. Even those organizations with significant experience in the Newly Independent States (NIS), perhaps the closest relevant legal, political, and economic setting, report that they were unprepared for the obstacles they faced in setting up, maintaining, and expanding their microfinance activities in Russia. This section summarizes to a limited extent the most important of these issues.

2.1 Legal Framework

The legislative history pertaining to microfinance activity in Russia has been both dynamic and confusing in its evolution over the past decade. The regulatory framework within which credit organizations, including MFIs, work in the Russia Federation is at best ambiguous. On the one hand, credit organizations, including those sponsored by USAID, indisputably exist and issue loans. On the other, it appears that much of the lending activity of these organizations rests on an uncertain legal basis. A review of the applicable legislation helps explain the situation.

Before the last years of *perestroika*, there were no private businesses in the Soviet Union and, consequently, no business credit. The Civil Code of that period uses the term “*credit*” in a manner that makes it clear that the reference is only to *government* credit extended to *government* entities, not to loans extended to businesses or to individuals.⁸ To understand just how limited the notion of *credit* was as recently as 1984, one need only look at the *Encyclopedic Juridical Dictionary* of that year, where the only definition of *credit* is credit extended to consumers for installment purchases.⁹

The year 1988 saw the introduction of the Law "On Cooperation in the USSR." This law allowed limited private enterprise in the form of “*cooperatives*” --this word being an ideologically acceptable term for what was still essentially an ideologically unacceptable activity.¹⁰ Almost as soon as they had been created, however, the new forms of private enterprise were stifled by suffocating regulations and taxes. Still, the emergence, limited as it was, of private businesses led to the consequent demand for credit. Thus, the Law "On Cooperation" provides both for the extension of credit to cooperatives by existing banking institutions and the creation of new *cooperative banks*.¹¹

⁸ Civil Code of the RSFSR of 11 June 1964.

⁹ A. Ya. Sukharev, ed., *Iuridicheskii `Encyclopedicheskii Slovar`*, Moscow, “*Sovetskaia `Entsyklopediia`*,” 1984, p. 154.

¹⁰ Law of 26 May 1988 N 8998-XI, as amended through 19 June 1999. This law applied, in the context of the USSR, only to the RSFSR, that is, to the Russian Socialist Republic and not to the other republics and regions that, upon the dissolution of the USSR, became part of the Russian Federation – e.g., Chechnya, Karelia, Mordvinia, and many others. Only after the dissolution of the USSR in 1991 was the law extended to the whole of the new Russian Republic.

¹¹ Article 23(1-2) and Article 23(5).

On 27 April 1989, abuses by some of these new institutions led the Central Bank to issue a *Letter of Instruction* on limitations on the issuing of credit to any individual borrower.¹² In 1990 there followed the Law "On Banks and Banking," which provided for the creation of private banks and introduced regulations on the extension of what was by now clearly business credit.¹³ This law somewhat circularly defined *banks* and what it called *credit institutions* (a term still in use) as institutions with a license to carry out banking operations.

The banking system of the RSFSR was defined, in turn, as consisting of the Bank of Russia (the Central Bank), the Bank of Foreign Trade of the RSFSR, the RSFSR Savings Bank (*Sberbank*), and "commercial banks of various types" together with "other credit organizations" that had "a license to conduct banking operations." Finally, *banking operations* were defined as "the attraction of deposits and the extension of credit" (Art. 5). *Credit* itself, however, was nowhere explicitly defined.

On 12 December 1993, Russia adopted by referendum a new Constitution, which created today's Russian Federation, as well as a system of governmental and private relations radically different from anything that had existed since the Revolution of 1917. Basic to these new relations were guarantees of the right to hold property, including the means to production, and the right to engage in private enterprise.

The Constitution also declared that "the establishment of a legal basis for a unified market, namely financial, currency, credit, customs regulation, and monetary issuing institutions, the bases for price policy, and federal economic services, including federal banks, are exclusively a subject of federal, not regional or local, regulation." In principle, then, any regional or local legislation that purports to regulate credit activity is unconstitutional unless it is based on and authorized by prior explicit federal enabling legislation.

The federal enabling legislation of credit activities presupposed by the Constitution was, however, slow in coming. Except for the 1990 Law "On Banks and Banking," which, as repeatedly amended, continued in effect until superceded by 1996 amendments that effectively rewrote the entire law, there was little immediate implementation of credit-regulating legislation. In the meantime, a variety of quasi-legal institutions were set up, which purported to be purveyors of credit in one guise or another. Some of these were legitimate. Many were undoubtedly not, including those that operated the pyramid schemes that plagued the early market history of Russia and Eastern Europe under the guise of various *credit* machinations.

In response to these problems, on 10 August 1994, the High Commercial Court (VAS, from *Vysshiĭ Arbitrazhnyi Sud*) of the Russian Federation issued a *Letter of Instruction* that still carries the force of law.¹⁴ In brief, the letter states that any institution that grants loans – i.e., credit – on a *systematic basis* must have a banking license.

¹² Letter of the State Bank of the USSR of 27 April 1989 N 201 with changes of 11 October 1990 N 326 regarding "Rules Regulating the Activity of Commercial and Cooperative Banks."

¹³ Law "On Banks and Banking Activity in the USSR" (with amendments of 12 December 1991, 24 June and 13 December 1992).

¹⁴ Letter of the VAS RF [High Commercial Court (*Vysshiĭ Arbitrazhnyi Sud*) of the RF] of 10 August 1994 N S1-7/OP-555 "On various recommendations made at the session on judicial-*arbitrazh* practice." [Question:] 4. Is it necessary to receive a license for performing credit operations, if the monetary sums provided are from enterprises and organizations to other persons on the basis of return and payment? [Answer:] In accord with Articles 113 and 114 of the Bases of Civil Law [note: superceded by the Civil Code] on contracts of credit, a bank or other person engaged in entrepreneurial activity can provide credit at a percent interest certain, indicated in the contract. Banks and other credit organizations, created by proprietors for the performance of banking operations (which should be indicated in the charter of these

The distinction between the terms *loan* and *credit* is important in Russia. By definition, *credit* refers to the lending of funds mobilized from the public at large, usually in the form of deposits, and it is closely equivalent to the concept of financial intermediation. *Loans* refer to lending out of private or privately borrowed funds, and it may or may not include interest rates. In most countries, the former is a regulated activity, while the latter is not. The most detrimental aspect of this letter of instruction has been that it implied that *loans* issued on a regular basis were, in fact, *credit* and thus subject to Central Bank licensing requirements.

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 (*i.e.*, an individual) or to a legal person (a term that includes both incorporated entities as well as individuals registered as *private entrepreneurs*, a concept vaguely similar to that of an independent contractor in US law), is prohibited, unless the lender is a bank or a credit organization licensed by the Central Bank. This restriction would appear to prohibit the activities of credit unions, credit co-operatives, and microfinance institutions as they operate around the world, for current Central Bank requirements for securing a banking license are prohibitively time-consuming and expensive (see Section 2.4).

On the one hand, the reasoning is simple: lending at interest is a commercial activity; therefore, any organization that carries out lending at interest on a regular basis is by definition a *commercial* organization. However, the Law "On Banks and Banking" prohibits any commercial organization to engage in lending/credit activity unless it has a license from the Central Bank. On the other hand, an active system of microfinance institutions does currently exist, and it appears to operate with little regulatory interference—occasional clashes with the tax service excepted.¹⁵

institutions), must receive a license for occupation with said entrepreneurial activity in accord with Articles 1 and 11 of the RSFSR Law "On Banks and Banking Activity in the RSFSR." If the said institutions, in violations of the Charter, engage as entrepreneurial activity in the issuing of credit (regardless of the sources of the financial resources) at interest and conclude contracts of credit without receiving a license, such activity must be acknowledged as not in accord with the corresponding legislation, with all the consequences thereof flowing. When, however, an organization in accord with Article 113 of the Bases of Civil Law transfers to a borrower its free [available] funds per a contract of *loan*, and the latter obligates itself to return that sum and such activity is not otherwise forbidden by law and does to have a systematic character, then receipt of a license is not required, including the case of issuing the loan on the basis of paying specific interest rates.

¹⁵ Some consumer credit cooperatives, for example, have triumphed in collisions with the tax authorities. In a case against the "South Urals Credit Union of Consumers" of Cheliabinsk Oblast, for instance, the tax service demanded payment of VAT and "special taxes" based on interest charged on loans ("*ssuda*") extended by the co-op and also assessed fines and penalties for violations of the tax laws. The tax service based its position on the argument that since non-commercial organizations have the right to engage in entrepreneurial activity (as the consumer credit cooperative did, by issuing loans ("*ssuda*") and charging interest); therefore, they had turnover and were subject to VAT and "special taxes" based on interest charged. The consumer credit cooperative had no exemption for taxes, as it had no license to engage in banking activities. The consumer credit cooperative relied on its status as a non-commercial organization that extends credit ("*ssuda*") only to its own members and by definition is not engaging in entrepreneurial activity. Therefore, the interest charged to its shareholders is not subject to VAT and special taxes. The coop accumulated its resources on the basis of funds contributed by members as dues (*paevye взносы*) and on interest received as a result of activity allowed by its charter. The commercial (*arbitrazh*) court that heard the case decided in the consumer credit cooperative's favor. It rule that a banking license is needed only for bank deposit-loan (*ssudno-bankovskie*) activities aimed at securing income in the form of interest from unrelated parties, but it is not needed for "intra-union" credit extended to members, and that therefore no taxes were due.

In addition to the bilaterally-funded MFIs described earlier, other organizations that have no legal basis, such as credit unions and credit cooperatives, are active throughout the country and have lobbying groups actively pursuing avenues to get them legalized. How is it that MFI activities take place in what is ostensibly a regulatory framework rigidly and exclusively controlled by federal legislation and the Central Bank?

The answer lies partly in the permissive nature of the Civil Code, which effectively declares the legitimacy of contractual relations that are not explicitly forbidden.¹⁶ The remainder of the answer lies in the inventiveness of Russian lawyers and in the principle that where there is a need, there will be found a way. It appears clear from the history of credit-granting institutions that act without benefit of federal enabling legislation or a Central Bank license, that the demand for mutual credit organizations is great.

For example, microfinance institutions, credit unions, and consumer credit cooperatives are neither mentioned nor authorized in any currently operational legislation.¹⁷ The Civil Code recites an exclusive list of the possible forms of commercial organization, but it leaves open and undefined the number and kind of possible non-commercial organizations. It is into this undefined area that MFI-like institutions have slipped. Microfinance institutions, of any type, are nowhere explicitly forbidden by law, since lending is not in the list of activities requiring licensing according to recent legislation. The chief difficulty, however, lies in the uneven and uncertain application and enforcement of existing laws by the relevant local enforcement agencies.

2.2 Juridical Settings: Reform and Non -reform Oblasts

Another dimension influencing MFIs is the political configuration of the jurisdiction in which they operate. The decade of the 1990s saw the devolution of political and regulatory power to regional oblasts (*i.e.*, provinces). Although the regulatory frameworks that affects MFI activity are still established by federal authority (especially taxation), the rigor and spirit with which they are implemented at the local level can be influenced by the reform (or anti-reform) nature of local, municipal, and regional authorities. The most important aspect of the juridical setting is that regional governments can put forward a requirement for stricter provisions than those specified in the Civil Code. This practice is not strictly legal, since all activities not required to have licenses should, in theory, still be exempt from having to obtain licenses. In practice, however, the regional authorities can and do add additional requirements in an *ad hoc* manner.

¹⁶ The precise language is "[that are not] in contravention of the law of contracts." See Civil Code, Part I, Section I, Chapter 1, Article 1(2):

"Citizens (physical persons) and juridical persons shall obtain and realize their civil rights of their own will and in their own interest. They shall be free in the establishment of their rights and duties on the basis of contract and in determining any terms of contract not in contravention of the law of contract.

Civil rights may be restricted on the basis of federal law and only to the extent necessary to protect the bases of constitutional order, morals, health, the rights and legal interests of other persons, the defense of the country, and the security of the state."

¹⁷ There does exist legislation that authorizes and regulates the activity of *consumer cooperatives*. Consumer *credit* cooperatives have generally organized themselves, and claim their legitimacy, as a sub-form of this form of non-commercial organization, even though there exists no law or regulations that specifically authorize the existence of this sub-form. Conversely, there also exist no laws or regulations that specifically prohibit the existence of this sub-form. See the discussion immediately following.

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 unfavorable interpretations of the civil and tax codes and activities not well defined by legislation or decree become defined by the manner in which they are interpreted at various governmental levels.

Additionally, in Russia there is the possibility that discretionary power could be used retroactively. Thus, an institution can find itself being penalized for engaging in activities that were previously sanctioned or for a tax exemption offered under a prior regime. The perils of operating in such an environment are numerous. This type of environment translates into high transaction costs of operation, particularly in reference to the time, effort, and expense in courting or educating local officials and hiring lawyers to interpret the law and defend the MFI's interests.

Furthermore, no matter how secure the institution, it is always vulnerable to electoral changes in local and regional governments or to changes in the overall political climate. Thus, the type of lending activities and the autonomy of the institution and its network branches are always a function of the local and regional political setting.

2.3 Modes of Registration

When considering the several types of registration requirements to which MFIs are subject, two distinct issues arise. First, all non-commercial organizations must have a general registration that allows them to manage their administrative operations legally.¹⁸ Second, an additional form of registration is needed for a downstream or related institution to which an NGO can transfer grants for loans and to administer a credit program.

Regardless of the form of registration chosen, nearly all of the Russian MFIs worked with their local lawyers and local authorities from four to six months before they were in a sufficiently secure legal position to begin lending. This long delay was associated both with the initial registration of the branch of the international NGO and the subsequent registration of the local domestic organization to conduct lending operations.

The initial registration process of the international affiliate is time-consuming and expensive; it can take up to six months to complete. While, in theory, this process can be completed within the span of two to three weeks, first-time entrants with little knowledge of the system may experience long delays in obtaining the necessary paperwork. Anecdotes abound regarding bureaucratic delays, the amount of verified documentation required, the necessary efforts to educate the local authorities about the institution, and the high costs of screening and hiring lawyers to negotiate the labyrinth of Russian law.

¹⁸ According to the Russian Civil Code, a non-commercial organization may be created to pursue social, philanthropic, cultural, educational, scientific and managerial goals, to protect the health of the population, develop physical culture and sports, satisfy spiritual and other non-material needs of the citizens, settle arguments and conflicts, or render legal help and for other purposes that generate social benefits. Non-commercial organizations may undertake profitable activities, but these are limited to serving the social aims for which the organization was founded. Non-commercial organizations are legally prohibited from distributing net revenues to members, directors, or other insiders. In this sense, property rights over the organization are severely attenuated, as members do not have the right to share in the results of the operation (Christie, 1996; Evseyeva *et. al*, 1999). That is, residual claimants for the financial outcome of the organization are not well defined.

The remainder of this section focuses, however, on the registration of the lending program itself, as this seems to be an even more formidable constraint to the expansion of microfinance in Russia.

Without exception, therefore, all MFIs have consulted local lawyers to determine the most appropriate registration mode for their activities, given that there is no standard or uniform legal form for private, non-profit lending organizations. The actual or potential modes of registration for MFIs reviewed in this paper are:

1. Credit Unions (CUs) and Consumer Credit Cooperatives (CCCs)
2. Consumer Cooperatives (CCs)
3. Social Organizations for Mutual Development
4. Private Funds
5. State Funds and Mutual Credit Societies (MCSs)
6. Non-commercial partnerships (NCPs).

2.3.1 Consumer Credit Cooperatives and Credit Unions

Consumer credit cooperatives and credit unions have had a checkered history in Soviet and post-Soviet Russia. Many of these organizations suffer from a generally unfavorable image due to their perceived role in dubious financial activities in the past. Currently, they have no full legal base for operations (Evseyeva *et al.*, 1999). In spite of the lack of a robust, unambiguous legal base, there were more than 200 functioning organizations that were registered as either credit unions or credit cooperatives until the August 1998 crisis. These organizations were engaged in lending at significantly higher interest rates than those charged by banks, but with a much higher loan turnover in this market niche.¹⁹ Additionally, they enjoyed an exemption from placing obligatory reserves with the Central Bank of the Russian Federation. Instead, they were allowed to entrust the management of their own resources to a bank or to another credit organization. They were not subject to restrictions on the size, periodicity, and contributions of their members (Evseyeva *et al.*, 1999).

For several years, the Federal Duma has been considering provisions to regulate the activity of credit unions/cooperatives.²⁰ In 1998, however, a special law was vetoed by then President Yeltsin. This veto was based on the opinion that the law conflicted directly with the Law “On Banks and Banking Activities,” which requires credit organizations to obtain a charter or license from the Central Bank if they engage in lending activities based on mobilized deposits.²¹ Even if this law had been passed, however, it would have only allowed for loans made to physical but not legal persons. This prohibition would block the use of this source of funds for many types of small businesses that are often registered as juridical persons (Evseyeva *et al.*, 1999).

¹⁹ Members of credit cooperatives could usually obtain loans after a short application process that ranged from between three to seven days (Evseyeva, 1999).

²⁰ In the proposed legislation, two distinct forms of credit cooperatives were addressed, “rural credit cooperatives” and “consumer credit cooperatives.” The distinction between the two is not a subject of this paper.

²¹ Additional grounds on which the law was rejected focused on the distinction between a cooperative and a union. A consumer credit cooperative is considered a separate juridical person, while a union is an association of juridical persons. The lack of clarity between these two juridical forms mixed into one law was considered unacceptable (Evseyeva *et al.*, 1999).

More recently, a second draft law on credit unions/cooperatives was vetoed by Acting President Putin in early 2000. There is still the expectation, however, that the new Law on Consumer Credit Cooperatives and Credit Unions will eventually be passed, in some form, in the near to medium term. Thus, credit unions may be alternative organizational designs for the MFI community to consider. Credit Unions (CUs) have a number of advantages with respect to microfinance activities. CUs have a long history of addressing the forgotten half of the financial market—savings and deposit facilities. This feature is notably absent from the current MFI structure in Russia.

Credit unions exhibit, nevertheless, some organizational deficiencies. Among these shortcomings are the poor incentives for internal control stemming from the one person-one vote governance rule, which removes incentives for members to monitor opportunistic behavior by the management and constrain growth. Allowing for voting rights commensurate with share contributions would induce key stakeholders to more effectively monitor management. It would appear, however, that all non-commercial organizations and/or associations created on the basis of the Civil Code in principle reflect this organizational deficiency.

Additionally, CUs have little or no experience in a group lending methodology, so they would be a poor organizational choice for MFIs that characteristically use group lending to reach poorer clientele. Furthermore, an important clientele for CUs are salaried employees, who constitute a different target group from that of the MFI community. The focus on employees rather than microentrepreneurs also invokes the issue of ensuring repayment in the Russian labor market, characterized by a high incidence of wage arrears.

Finally, membership in Credit Unions is restricted to physical persons. Legal entities are proscribed from membership in these organizations, effectively excluding many small businesses registered as some form of juridical person.

2.3.2 Consumer Cooperatives

Consumer cooperatives (CCs) are a more general form of Russian non-commercial organization.²² They are considered voluntary associations of citizens who join together as members. The cooperative is created to carry out a particular restricted purpose, emphasizing the socio-economic welfare of members. In the past, this was linked to accumulation of funds for housing for the members. Members of CCs meet in annual meetings to elect officers and a board and to establish cooperative goals and operating procedures. A principal drawback to this form of organization is its unlimited liability. At least in theory, each member faces unlimited liability for the obligations of the entire cooperative, making it a serious risk for members of this organization. This, however, may create stronger incentives for internal control.

The tradition of unlimited liability stems from the German cooperative movement of the 19th century, which wanted to inculcate diligent member monitoring of management. While unlimited liability is also common to some credit cooperative organizations in Western Europe, there has rarely been an instance in these settings where legal action taken against the personal property of members has been triggered by a cooperative failure.

²² Note the absence of the word “*credit*.” A consumer cooperative is different in legal form from a consumer credit cooperative. The former is a legitimate form of non-commercial organization, while the latter currently has no legal basis under Russian law. This is an important distinction.

This action is even less likely to occur in a membership structure made up of poor, low-income participants, since in practice it is both politically and administratively difficult to carry out such actions. However, the passive stance of creditors (and more importantly, of government authorities and courts) could quickly change into a pro-active strategy to take members to court if one or a few members are known to have substantial assets available for seizure.

As long as the MFI sponsor is itself the major donor (creditor) to a consumer cooperative, the danger posed by unlimited liability is mitigated. If and when the sponsor disappears from the scene in the future and the domestic CC becomes autonomous, unlimited liability may become a more serious threat. Unlimited liability could also constrain growth by preventing diversification of the sources of funding for the cooperative, such as borrowing from banks.

Another drawback to this organizational design is the one-person-one-vote rule, which makes the organization vulnerable to numerical borrower dominance in annual meetings. A principal sponsor or stakeholder in these organizations could easily be outvoted by a large number of borrower-members.

To resolve this dilemma, one MFI sponsor has temporarily overcome this deficiency by inducing member-borrowers to sign over their proxy votes to the organization for a set period of time (2-3 years, for example) as a condition for receiving their loans. This contractual mechanism creates a temporary majority for voting commensurate with sponsor contributions. In the end, this one-person-one-vote rule does constitute an organizational weakness that requires an additional contractual initiative to deal with the problem.

One of the strengths of consumer cooperatives, in direct contrast to the organizational design of credit unions, is a membership structure that allows for juridical as well as physical persons to be members. Indeed, it was this feature that allowed the MFI sponsor denoted above (*i.e.*, a juridical person) to design the innovative contractual mechanism in question. If juridical persons had not been allowed to be members, this sponsor would not have been able to create and employ this contractual vehicle to protect the use of its grant monies.

2.3.3 Social Organizations for Mutual Development

Social Organizations for Mutual Development (SOMD) represent another organizational form for microfinance institutions. The legal base for these social organizations falls under the Civil Code section “About Social Unions.” That is, SOMD are considered to be mutual societies or associations. These social organizations incorporate the one-person-one-vote rule and are thus potentially vulnerable to the borrower-dominance scenario described above. A social organization is a non-profit entity, based on volunteer fees and other funds not prohibited by law. Only grant income or own-income can be used for lending purposes. As with other forms of non-commercial organizations, the distribution of profits to members and loans to third parties are prohibited by law. These organizations are not free to liquidate their own assets. They do enjoy, however, limited liability.

In practice, member-based SOMDs come in two forms: those with a restricted member base and those with an extended member base. The former consist of a limited number of members such as the founding members of the parent NGO plus a few local collaborators, while the latter include all the client borrowers in the program. This latter form is subject to the same governance problems mentioned earlier for credit unions, since votes at the annual meeting follow a one-person-one-vote rule. Since juridical persons cannot be members, it is not possible to devise an innovative proxy sign-over contract as described earlier for consumer cooperatives.

2.3.4 Private Funds/Foundations

A foundation or a fund in Russia is a non-commercial, non-mutual organization with no member-clients, set up to pursue social, philanthropic, and other socially beneficial aims.²³ Funds must have a board of trustees that supervises all financial activities and decisions made by the management of the fund. Both juridical and physical persons can be founders, and the governance structure of a fund allows for a sponsor organization to maintain a strong voice in the decision-making process, since the founders appoint the board of trustees, determine their term of service, and the criteria for reappointment.

One drawback to this legal form is that founders have no right to withdraw contributions they have made to the foundation; hence, once invested in the fund, property and assets cannot be withdrawn by their original owners. Furthermore, a fund can only be liquidated by a court decision once the purpose for which it was created disappears.

2.3.5 State Funds and Mutual Credit Societies

There are two forms of credit organizations that have explicit federal authorization for existence through the federal law “On the State Support of Small Entrepreneurship in the Russian Federation” (Evseyeva *et al.*, 1999).²⁴ This law provides the basic enabling legislation for these entities, which are specifically allowed to issue loans to small business without the licensing requirements required of other “credit organizations.”

The first of these forms is a “State Fund in Support of Small Business.” These State Funds are juridical entities organized as non-commercial organizations. They may exist at the federal, regional, and municipal level. State Funds receive funding from a variety of sources but, in any case, the charter capital committed by a state entity must not be less than 50 percent. While state and municipal funds have the explicit legislative right to grant preferential and short-term loans to small businesses without obtaining licenses for banking activity, they are only authorized to provide credit that, according to the terms of the law, is supposed to be advanced at *advantageous* rates of interest.²⁵

²³ In Russia, the juridical concepts of “*fund*”, “fund to support entrepreneurship”, and “social development fund” are not synonymous. Note that “funds” and “social development funds” are forms of non-commercial organizations, the latter being a mutual organization, while the former is not. Funds to Support Entrepreneurship are more broad and can be set up as a variety of non-commercial organizations, including institutions, funds, or associations (Evseyeva *et al.* 1999).

²⁴ Federal law of 14 June 1995, N 88-FZ, “On State Support of Small Entrepreneurship in the Russian Federation,” with amendments to 31 July 1998.

²⁵ The law explicitly states that crediting of small business entities is done on advantageous terms with compensation of the relative difference to credit organizations at the expense of the funds of the Small Business Support Funds. At the same time, credit organizations that provide credits to small businesses on advantageous terms shall themselves enjoy advantages pursuant to laws of the Russian Federation and the subjects of the Russian Federation. Furthermore, Small Business Support Funds shall have the right to compensate credit organizations in full or in part for their losses incurred in crediting small businesses on advantageous terms. The amount, timing, and conditions of compensation shall be established by contract between the credit organization and the Fund. Elsewhere, (Article 8 (3)), the law states that State and Municipal Funds can themselves give “advantageous credits, no-interest loans (*ssuda*), and short-term loans (*zaem*)” without a bank license and/or that they can act as guarantors for credits extended by other credit organizations.

The State Funds are explicitly exempted from both the restrictions on lending in the Law “On Banks and Banking” and the value-added tax on interest earnings. While not always enforced for MFIs that use the State Fund as an intermediary, the potentially enforceable “advantageous interest rate” requirement is contrary to the *best practice* microfinance principle that emphasizes cost-covering rates of interest. In the end, each MFI will have to weigh whether the uncontested right to lend plus the exemption from the value-added tax on interest earnings more than offsets the potential requirement to lend at “advantageous” interest rates.

The second potentially useful vehicle for MFI activities authorized by the federal law is a private non-commercial organization defined in Article 12 of the above law as a *Society of Mutual Crediting of Small Business Entities* (hereafter, *Mutual Credit Society or MCS*).

MCSs are granted the following powers:

1. *to accumulate temporarily free (available) funds of participants of the said societies to provide them with financial assistance;*
2. *to be free from keeping obligatory reserves with the Central Bank Russia;*
3. *to trust the administration of their own resources to a depositary bank or other credit organization;*
4. *to determine by themselves the amount, periodicity, and order of paying deposits (dues) by the participants in said societies as well as the maximum limits, time periods, and conditions for providing members with financial help; and*
5. *to provide financial resources to physical or juridical persons who are members of the organizations (but to no one who is not a member).*

There are a number of issues that remain unclear, however, with respect to the actual operation of these Mutual Credit Societies for MFI purposes. Though the federal law does not require MCSs to issue credit at advantageous interest rates, the only examples of regional enabling legislation based on the federal law that we have been able to find insert a requirement that credit be issued on advantageous terms. In a similar manner, though the federal enabling legislation absolves MCSs from the requirement to keep reserves with the Central Bank, at least one of the regional laws implementing the federal legislation makes explicit mention of the requirement for a Central Bank license.²⁶

For MFIs that have been impeded in their attempts to set up their own lending program or that are particularly risk-averse to regulatory uncertainty, State Funds or MCSs can be used as an apparently uncontested channel to administer a credit program. Of course, there may be some problems with State Funds in working through a government channel. Nonetheless, this method does constitute a possible option to avoid registration problems and to avoid the regulatory ambiguity surrounding all other organizational forms. Some of the principal drawbacks may include the loss of some control over the terms and conditions of the loan contracts, such as the requirement to incorporate subsidized interest rates, or undue government influence over the number and type of clients participating in the program. It appears that potential obstacles to these organizational forms primarily emerge in regional legislation or implementation of the program at the local level.

²⁶ That of Saratov, see Appendix II.

2.3.6 Non-Commercial Partnerships

Non-commercial partnerships (NCPs) represent another possible registration form. Pursuant to Article 8 of the Federal Law on Non-Commercial Organizations, members of non-commercial partnerships can be either physical or juridical persons, and juridical persons can be domestic or foreign. In addition, NCP partners have important legal rights, including limited liability and the right to withdraw their share in the partnership (including at the time when assets are liquidated). Furthermore, members generally serve on the collegial board and can shape the management structure to their interests. Therefore, it would appear that foreign sponsors can exercise control of management and operations of NCPs.

While, in principle, this form of registration has several positive features of organizational design, less is known about this option in practice. No institution among the current community of MFIs reviewed here has experimented with this form of registration. Hence, it is not clear what regulatory response this type of registration for lending would elicit from the authorities.

2.4 The Banking Sector

The Law “On Banks and Banking” explicitly limits the authorization for financial intermediation to banks licensed under a charter that brings them under the regulation and supervision of the Central Bank, unless they are otherwise authorized to lend by federal law as in, for example, the Federal Law of 14 June 1995, N 88-FZ, “On State Support of Small Entrepreneurship.” Furthermore, a legal entity engaging in banking activities without a license can be fined and the Bank of Russia has the right to take up its potential liquidation before the *arbitrazh* court (Pyle, 1999).

Microfinance institutions that have contemplated obtaining a banking license have been quickly dissuaded from doing so. The formation of a chartered financial intermediary is time consuming, expensive, and the outcome is unpredictable. Licensing by the Central Bank of Russia requires a large amount of documentation, which must be presented to decentralized authorities. This lengthy process is further hindered when the peculiarity of credit organizations with foreign equity is introduced into the scenario. Obtaining and verifying all of the materials for simple registration is estimated to be a yearlong process (Tokar, 1999).

Additionally, as a result of the enforcement of the Law “On Banks and Banking Activities,” stringent requirements for minimum authorized capital have been introduced. Newly created credit institutions, with the exception of subsidiaries of foreign banks, were required to have a minimum equity capital equivalent to five million US dollars as of January 1, 1999.²⁷ 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. The MFI would obviously lose much of its autonomy under these restrictions. These high costs, together with the loss of autonomy to the Central Bank, currently make it unfeasible and unjustifiable for MFIs to register as banks, given the scope of their activities.

²⁷ This minimum equity capital is a legitimate requirement to ensure that banks, in addition to other reserves, have sufficient resources to cover the deposits of all physical persons. Unfortunately, reserves deposited with the Central Bank in practice quickly lose real value through inflation.

In addition to the exclusive legal authority to intermediate funds from the public enjoyed by the commercial banking sector, banks, up until recently, have enjoyed another advantage over MFIs through their preferential tax treatment. Microfinance institutions registered as non-commercial organizations are subject to a 20 percent value-added tax on interest earnings, from which the banking sector is explicitly exempt. Some recent initiatives for legislative changes have introduced an exemption from the VAT for those non-commercial organizations set up as funds/foundations. However, MFIs licensed through other organizational forms would not enjoy this privilege.²⁸

The lack of authority for the provision of savings and deposit services represents an additional obstacle for microfinance institutions in the context of the Russian regulatory environment. It is the general consensus of the MFI community that the mobilization of member-only deposits will continue to be prohibited in the short and medium term. While the regulatory authorities in other countries tend not to intervene so long as savings are mobilized from members only, this is not the case in Russia, where even member-only savings facilities are likely to attract additional regulatory attention.

One alternative for MFIs is to establish an earmarked account for voluntary savings with a regulated financial institution, where each member is assigned a shadow account. In Russia, however, this would be problematic for two reasons. First, borrowers have little faith in the banking system, particularly after the August 1998 crisis, and they may refuse to participate in any activities that involve placing their assets with Russian banks.²⁹ Second, there is a direct link in Russia between the fiscal regime, which presides over taxation and public finance, and the banking sector. The tax authorities use bank accounts to verify and enforce tax and fiscal compliance, subjecting borrowers or account-holders to additional undesired tax scrutiny.

2.5 Taxation

For purposes of discussion, the question of taxation is broken down into two distinct issues. MFIs in Russia are concerned with both their tax liability for the initial grant money from the international sponsor as well as with the relatively high taxes levied on the operations of all non-commercial organizations.

The Gore-Primakov Commission, through a bilateral treaty, allowed U.S. grant money to pass through tax free to local MFIs. Until recently, this convenient arrangement for U.S. grants had not been formally sanctioned by legislation. This issue was addressed, however, through the adoption of Federal Law Number 95, dated May 4, 1999, which codified this tax exemption.³⁰

²⁸ In the past, some MFIs had chosen to circumvent the VAT by charging fees rather than explicit interest rates. This is not a good practice, and they resort to this mechanism less today. One should note, however, that small businesses are allowed to deduct interest payments from their taxable income but cannot do so with respect to a fee payment to a non-commercial organization thus, *de facto*, making the banking sector more competitive.

²⁹ In this regard it is notable that a recent World Bank study found that the most prominent banks in the survey were severely undercapitalized and recommended revoking their licenses. They found that total liabilities of the surveyed banks were Rb348 against Rb137 in assets (Euromoney, 1999).

³⁰ This law is titled “On Gratuitous Aid to the Russian Federation and Amending Certain Legislative Acts of the Russian Federation on Taxes and on Introducing Privileges on Payments into State Nonbudgetary Funds Relating to the Provision of Gratuitous Aid to the Russian Federation.”

Currently, MFIs launched or supported through the initiative of U.S. NGOs benefit from a tax exemption on all U.S.-originated grant funds passed on to the local institutions (*e.g.*, social organizations, consumer cooperatives) established (or, if already existing, then supported) by them.³¹ It is pertinent to point out that grants from Russian MFIs are not tax exempt. This restriction stems from the recent problematic history of some Russian MFIs having been used by gray market operators to avoid taxes and to engage in capital flight.

All MFIs face a significant tax burden on their operations. Microfinance institutions registered as non-commercial organizations incur payroll withholding taxes, contributions to so-called "non-budget" funds (pension fund, unemployment fund, social insurance fund, and the obligatory medical insurance fund for their employees), along with property taxes and various local and municipal taxes. In addition, MFIs that charge interest rates on their loans may be subject to a 20 percent value-added tax on interest earnings and also incur a 30 percent tax on net profits. Table 2 summarizes the types and rates of taxation to which Russian MFIs are subject.

Table 2: Principal Tax Obligations for MFIs

| Tax | Base | Rate for Non-Commercial Organizations (Percentage) |
|--|------------------------------|---|
| VAT on interest revenue | Gross Revenue | 20 |
| Profit tax | Net Revenue | 30 |
| VAT on goods and services related to business activities | Value of the Good or Service | 15 |
| Wage/Employee taxes | Total Wage Bill | 38 |
| Local taxes | Wage Bill | 3 |
| Property tax | Property Value | 2 |

It is important to note that banks are exempt from the value-added tax, in contrast to any MFI that is not registered as a state fund. Banks pay a profit tax of up to 41 percent on net revenue, while MFIs pay approximately 30 percent on profits.³² There is clearly an element of tax discrimination against MFIs that are not registered as funds, in that they are subject to both profit and value added taxation.

Finally, in addition to problems of direct taxation, it is worth noting that current tax regulations curtail charitable donations to the non-profit community. For example, banks and businesses can only claim 3-7 percent of their profits as tax-free charitable donations; they must pay taxes on the remaining profits. The net effect is that banks and businesses avoid claiming charitable contributions because it is a signal for higher profits and makes their own tax status more transparent (Christie, 1996). This statute directly limits the mobilization of domestic donor funds, a potentially important funding source for MFIs that work directly with domestic partner institutions, such as OI and RWMN.

³¹ Not only must grant money originate in the U.S., but the U.S. NGO itself has to be "well established," meaning that it must have been registered for a minimum of ten years in the U.S. before it is eligible for tax-exempt status in Russia.

³² Banks are subject to a profit tax ranging from 15 to 41 percent. The tax rate depends on the type of charter they have and the type of activities they engage in.

3. COPING STRATEGIES TO IMPROVE AND PROTECT MICROFINANCE ACTIVITY

Several initiatives undertaken by MFIs to cope with these regulatory challenges are listed below.

3.1 Use of Local Boards to Mitigate Regulatory Uncertainty

The use of local influential board members can, to a certain extent, aid an MFI in securing an informal endorsement or approval of both its legal status as well as permissible activities by the local authorities. Carefully selected local officials, business people, and local professionals of integrity can draw upon their own valuable social and political networks to intercede quietly on behalf of the MFI, if it experiences unusually high or arbitrary transactions costs in dealing with tax or local officials.

Eventually, it is precisely such a local board that could inherit the local organization, once it has matured into a sustainable operation and the international NGO branch disappears or becomes a minor player in the organization. This evolution could take a long time in the current conditions in Russia and, more importantly, could be subject to periodic setbacks, given the economic and political instability characteristic of the country. The sooner a civil society can be more durably established in Russia, the quicker the institutional evolution described above can occur.

3.2 Maintaining a Dialogue with the Regional Branch of the Central Bank

Some institutions have tried to pre-empt negative regulatory interest on the part of the Central Bank authorities by initiating an informal dialogue with them. In part, this dialogue serves as a courtesy in informing the authorities about the MFI activities. At the same time, however, this dialogue can be a useful means of emphasizing both the philanthropic and benign nature of their lending programs.³³ Moreover, educating the regional Central Bank authorities can provide an informal shield for the MFI. Indeed, one organization was able to secure a legal document from the Central Bank, which in fact sanctioned their regional lending activities. While it is always somewhat risky to intentionally draw attention to unregulated MFI activity, it is in any case likely that local and regional authorities would become quickly appraised of the presence and purpose of the microfinance organization.

3.3 Advocacy at the Federal Level

By far the most ambitious and effective strategy to date has been the effort undertaken by the Microfinance Working Group in engaging in advocacy efforts with the Federal Duma. The purpose has been to promote a conducive legal environment for microfinance in Russia.

³³ Benign, in this sense, refers to the source of MFIs funds, which are not linked to deposits from the public and pose little risk for either the banking sector or the public at large.

This advocacy effort was originally undertaken by the Russian Women's Microfinance Network, and Opportunity International later joined it. These two organizations initially researched the existence of legislative niches that supported the legality of their lending activities. When it became apparent that niche legislation would only provide moderate support for their activities, RWMN and OI developed the more challenging and ambitious strategy of introducing new legislation that would sanction the lending activities of certain organizational forms.

The recent legislative initiatives regarding the supplement to the State Fund legal statute with considerations on *private* funds instilled a degree of legitimization to microfinance (microlending) in an unexpected manner. This legislation was originally designed to create a niche statute that would allow for one particular organizational type (*i.e.*, private funds) to explicitly engage in lending and be exempt from the value-added tax on interest earnings. This legislation would have represented uneven progress along the path towards creating a more sound enabling environment for microfinance in Russia, by creating more favorable treatment to MFIs registered as a private funds compared to those registered in other MFI forms.

In the end, after its approval in the Federal Duma, Acting President Putin vetoed this legislation. The veto opinion, however, argued that MFIs already had the right to lend (to issue *zaem*) according to the Civil Code; hence, no specific legislation was necessary to codify their status. It is still unclear how contestable this opinion is, in light of the existing 1994 Letter of Instruction of the Supreme Court of Arbitrage discussed above.

However, it is arguable that the initiative indeed instigated a presidential sanction in favor of MFI lending for any organizational type, thereby creating a leveled and more transparent playing field for microfinance activity in Russia. This is essential for MFIs to enjoy an equal opportunity to experiment with innovations consistent with their organizational and lending philosophies and their own comparative advantages.

4. OTHER ISSUES

The central focus of this paper has been to document and clarify regulatory issues as they pertain to MFI activity in Russia. Some conclusions and recommendations have emerged (see the final section of the paper). We were unable to sufficiently investigate, however, several other issues that have been suggested by our review. As such, these issues remain unexplored. Nevertheless, we feel that it would be useful to highlight some of these issues as illustrative questions for further discussion and clarification.

4.1 Long-Term Growth in an Adverse Regulatory Environment

The prohibition on legally lending or mobilizing savings deposits, together with exigent tax obligations, has clearly stymied the growth of MFIs in Russia and will likely continue to do so in the future. Russian MFIs that can only rely upon grants and interest earnings for their lending operations that face significant tax burdens will continually have difficulties in achieving enough scale (outreach) and/or sustainability.

It is notable that five credit institutions, the most experienced, with over five years of operational history, are collectively reaching fewer than 2,300 borrowers in Russia (Table 1). This is a telling statistic, particularly when contrasted with MFI outreach in much poorer countries. For example, FINCA-Kyrgyzstan alone achieved an outreach of over 13,000 borrowers after four years of operations. Similarly, PRODEM in Bolivia was reaching over 20,000 borrowers after five years of operation, and it was able to transform itself into a licensed financial intermediary, to reach almost 100,000 clients in the following three years.

These institutions, however, operate in a world where the legality of lending is not contested, registration and licensing requirements are minimal, and tax burdens are largely negligible.³⁴ The limited scale of Russian MFIs is not a fair reflection of the diligent and skilled efforts on the part of Russian practitioners in reaching their target population. It is, in fact, a reflection of the operational difficulties, fiscal obligations, and limitations on capital sources that prevail in the Russian regulatory environment.

Commensurate with the development of a more enabling environment for MFIs, long-term growth in a country the size of Russia will depend largely on the capacity of these institutions to develop a broad network, such as typically seen in the credit union movement in other developing countries. This network would consist of a central financing facility, which could transfer resources between surplus and deficit units as well as providing backstopping support in the form of Management Information Systems training, accounting, and auditing. The legal form of the organization best suited to allow for this type of national networking has not been tested in the current regulatory setting.

³⁴ For example, FINCA-Kyrgyzstan is not a registered legal entity because of a bilateral agreement between the U.S. and Kyrgyzstan and is therefore exempt from all federal and local taxes (Cooling, 1999).

4.2 Competition versus Cooperation amongst the MFI Community

Given the large geographical size of the country and the commensurately large population of potential clients, the advantages of sharing information amongst MFIs should outweigh any competitive incentives to withhold proprietary or new information or strategic perceptions, since MFIs have been largely operating in separate, segmented regions. Donor funding is limited, however, and competition amongst MFIs for this external funding is keen. Thus, the MFIs understandably protect their organizational breakthroughs on registration and operations, in which they have laboriously invested. In short, they may feel uncomfortable about sharing information on too many of their operational innovations.

The trade-off between information sharing for the common good of the MFI community versus the competitive advantage that individual MFIs legitimately feel are their proprietary rights is an ever-present issue. The costs and benefits of these competing incentives must be calculated individually within the MFI itself and collectively amongst the MFI Policy Working Group concerned with lowering the costs of the regulatory burden for MFIs in Russia. Improvements in the regulatory framework are a public good and justify some donor involvement.

4.3 The importance of Legal Professionals

Legal professionals play an instrumental role in assisting MFIs in registering and in addressing tax questions. However, some MFIs have mentioned that many lawyers are unprepared to search for the most appropriate niche statutes, given both the local regulatory environment and the particular goals and needs of the institution. Thus, it is unclear how germane some of the legal advice that they receive is. This is not a trivial point, given that many lawyers do not have experience in setting up a non-commercial organization for lending purposes.

It is extremely important to consider all forms of domestic non-commercial organization through which lending activities can take place. When these issues are insufficiently explored, the potential arises for a less than appropriate registration form based on incomplete information. Explicitly trying to select and train a handful of lawyers in microfinance topics, organizational form, and similar topics would be a sound investment strategy to make the lawyers more cognizant of the non-commercial organization world that they are advising.

5. THE ISSUE OF THE “BEST PRACTICE” FORM OF MFI REGISTRATION

The diversity and heterogeneity of the legal forms typified by various MFIs in Russia has led to a search for a prototype or *best practice* legal form of MFI registration. In addition to the desirable attributes of organizational design described below, the effectiveness of any legal form for a MFI will also depend on the reform nature of the oblast where it operates and on the record of discretionary regulatory interpretations on tax and licensing questions in each oblast. These oblast-specific regulatory opportunities and constraints must always be kept in mind in determining the costs and benefits of registering in one organizational form versus another.

Nevertheless, one can list the properties and attributes of enabling legal and regulatory requirements, on the one hand, and features of organizational design, on the other hand, which can play an important role in facilitating the emergence of a *best practice* organization. In general, a well-designed national regulatory environment, on the one hand, and well-designed ground level organizations, on the other hand, are both essential to enhance the growth of MFIs. Important elements at each level are outlined below, with their status in Russia denoted in parentheses.

5.1 National Regulatory Enabling Environment for MFIs: Desirable Features

Any conducive regulatory environment should include a number of desirable features. Among these desired attributes are the:

- Legal right to engage in lending [not allowed in Russia for credit activity based upon deposits from the public at large without a charter issued by the Central Bank, but it appears to be allowed for loans (*zaem*) based on private grants and own funds].
- Freedom to charge cost-covering interest/fees and to set other terms and conditions on loan contracts [Exists in Russia].
- Freedom for member-based MFIs to mobilize savings from its members [Not allowed in Russia].
- Freedom to distribute dividends to shareholders [Not allowed in Russia].³⁵

5.2 Important Properties of Organizational Design

Listed below are important features of organizational design for non-commercial microfinance organizations. These features contribute to the outreach and sustainability of the organization and are typically related to the ownership and governance structure.

³⁵ The most contentious issue would likely be permitting the distribution of dividends to shareholders in member-based cooperatives. Although this is quite common in many *non-profit* cooperative organizations in the West, it would clearly challenge the spirit of non-profit, non-commercial organization articles in the current legislation in Russia.

Desired attributes of organizational design are:

- To allow for principal stakeholders to maintain a high degree of internal control of the organization. This control could stem from either a mechanism that ensures voting rights in MFIs commensurate with shares or grant contributions or from a governance structure that allows for the sponsor to actively shape and define activities and select board members of the MFI. The latter would appear more feasible in the Russian non-commercial organization setting.
- Institutions free to liquidate their own assets (including undisbursed grant monies, equipment, and the like) once tax obligations and creditors have been satisfied.
- Limited liability for members in member-based MFIs.
- Minimal tax liability.
- Uncontestable right to lend.
- To allow juridical persons (legal entities) to be members in cooperatives and social funds and borrowers in all MFIs.
- Freedom to charge cost-covering interest rates.

These characteristics of organizational design fall into two principal dimensions. One dimension is the degree to which principal sponsors have a controlling voice in the operations. Another dimension includes attributes that facilitate the effective operation of the organization. The difficulties of unambiguously ranking registration types will become apparent after reviewing the findings in Table 3 and Figure 1 below.

Table 3: Summation of Selected Attributes of Registration Modes (by Rank Order)

| NCO | Elements of Control | | | | Elements to Facilitate Operations | | | | |
|--------------------------------|---------------------|---------------------------|------------|-------------|-----------------------------------|---------------------------------|---|--------------------------------|-------------|
| | Stakeholder Control | Residual claims on assets | Ltd. Liab. | Total Score | VAT Exempt | Uncontestable authority to lend | Can make loans to juridical persons (7) | No interest rate restrict. (8) | Total Score |
| | (1) | (2) | (3) | (4) | (5) | (6) | | | (9) |
| 1. Non-Commercial Partnerships | 1 | 1 | 1 | 3 | 0 | 0.5 | 1 | 1 | 2.5 |
| 2. Private Funds | 1 | 0 | 1 | 2 | 0.5 | 0.5 | 1 | 1 | 3 |
| 3. Consumer Cooperative | 1 | 1 | 0 | 2 | 0 | 0.5 | 1 | 1 | 2.5 |
| 4. State Funds/MCS | 0 | 0 | 1 | 1 | 1 | 1 | 1 | 0 | 3 |
| 5. Social Organization | 0 | 0 | 1 | 1 | 0 | 0.5 | 0 | 1 | 1.5 |
| 6. CUs & CCCs | 0 | 0 | 1 | 1 | 0 | 0 | 0 | 1 | 1 |

The individual scores in Table 3 range from zero (no functional attribute) to one-half (partial functioning attribute), to one (fully functional attribute). A few words of clarification are in order to explain the partial scores in the table.

While a law exempting Funds from the VAT was recently passed, it is not clear whether this exemption is only for the benefit of state funds or whether private funds will also be allowed to qualify for this exemption. The partial score for private funds (0.5) is listed to reflect this uncertainty in column five.

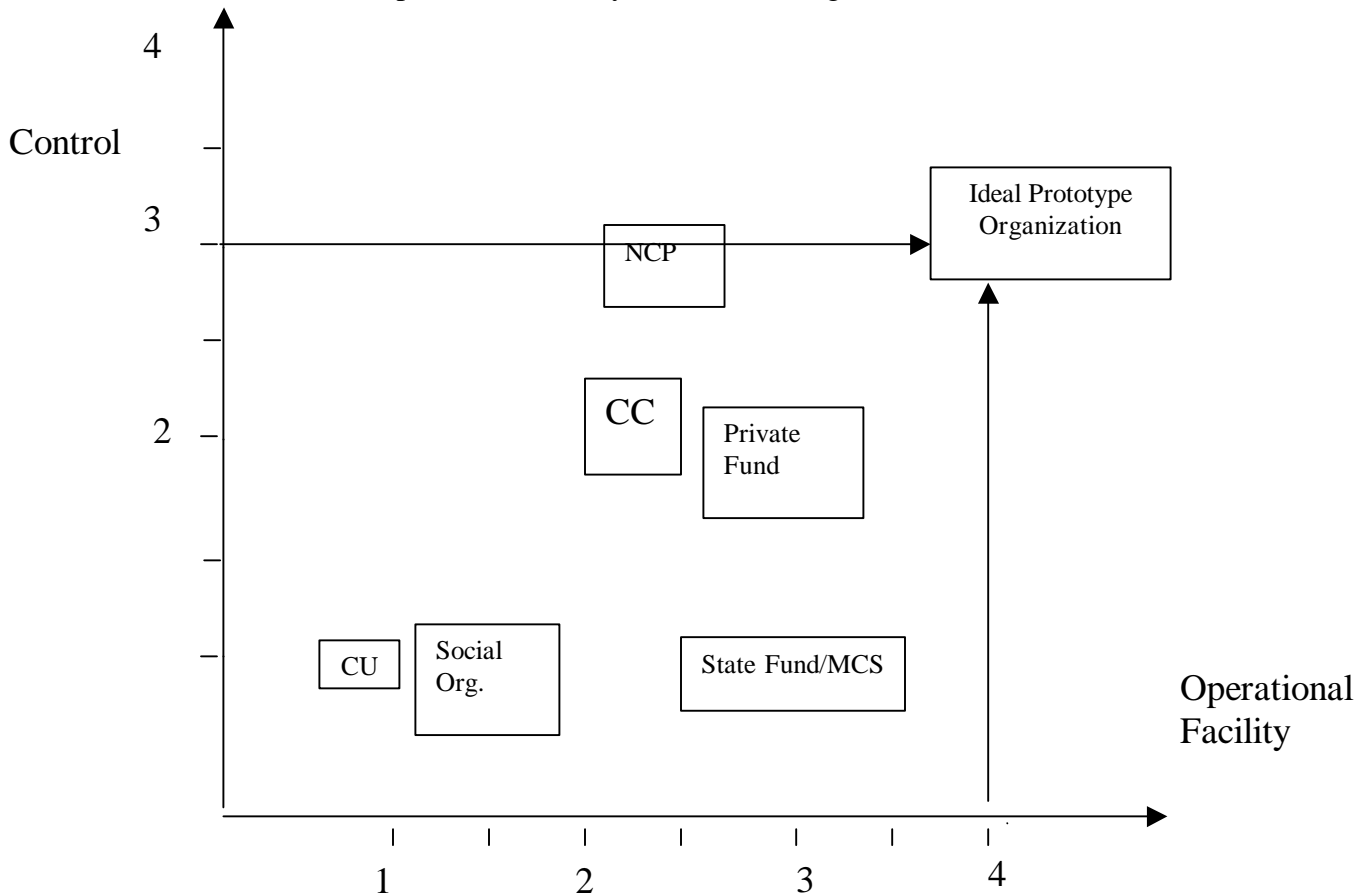
Finally, all MFIs enjoy a right to lend (*i.e.*, issue *zaem*) based on the Civil Code. Acting President Putin's recently issued opinion following his veto of the Private Funds Supplement to the Law on State Funds confirms this right. This opinion, however, could still possibly be challenged in court, on the basis of the earlier Supreme Court of Arbitrage's 1994 Letter of Instruction. In short, MFIs may not have a completely uncontested authority to lend, such as that enjoyed by State Funds. Hence, partial scores are listed for all MFIs except State Funds, for which the score is one in column six.

We have given a score of zero for the credit unions' right to lend, in light of the fact that they currently have no legal basis to exist under the Russian Civil Code. In spite of two recent attempts to pass laws sanctioning their activity, this lack of clear legal status has been reinforced by two successive presidential vetoes of these laws. Figure 1 plots the summed total of the three elements of control on the vertical axis, and the four elements facilitating operations on the horizontal axis. Any position (point) in the graph represents, therefore, the combination of a score concerning control of the organization and a score related to operational advantages.

The trade-offs between control and operational attributes can be visually noted in the figure. Some organizations score well with respect to control attributes (ranking higher on the vertical axis), while others score better with respect to operational attributes (located further right on the horizontal axis). One can also compare the scored location of particular MFIs in Figure 1 to the location of the ideal *prototype* score (*i.e.*, an organizational type that would obtain the maximum score of 3 for control and 4 for operational advantages).

Non-commercial partnerships and private funds are on the actual *best practice frontier* shown in Figure 1 and thereby stand out as the preferred registration modes when using these combined attribute ranking criteria. The rest of the organizations fall inside this frontier, at varying distances.

Figure 1: Trade-Off Between Attributes of Control and Operational Facility for Selected Organizational Forms



Private funds and non-commercial partnerships allow for borrowers to be juridical entities. In these organizations, MFI sponsors, either foreign or domestic, can exercise reasonable voting control and can thereby protect their grant interests through stronger governance structures. Additionally, the members of these two organizational types enjoy limited liability, while private funds may benefit from an exemption to the VAT on interest earnings in the future.

The other organizational modes exhibit one or more limitations in their design. While CCs allow for loans to juridical persons, have some indirect governance control over voting rights, and enjoy residual claims on assets, their members do suffer from the risk of unlimited liability. State funds and Mutual Credit Societies benefit from the strongest uncontested authority to lend and a well-established exemption from the VAT. They can be subject, however, to interest rate controls and other political intrusions. They may not be the most cost-efficient arrangement for retailing funds because of the complications that may arise from working through government channels. These retailing arrangements may work well in one oblast but not in another. Both social organizations and credit unions, because of their one-person-one-vote rule, can leave the sponsor grant monies hostage to borrower domination. Furthermore, they exclude juridical persons from their pool of borrowers, which would compromise their outreach to small enterprises registered as legal entities.

It should be noted that the attributes denoted in Table 3 all carry equal weights. Some practitioners, however, might feel strongly about weighting some attributes more heavily than others. Differentially weighting certain features (such as the VAT tax exemption, voting rights, or loans to juridical persons) could result in a reshuffling of the MFI rankings and locations in Figure 1. Furthermore, microfinance organizations have their own organizational philosophies, and these preferences may weight some attributes more heavily than others. Finally the degree to which local oblast registration and regulatory tolerance are relatively amenable or difficult for one institutional form versus another will also play an important role in the registration decision.

Therefore, the ranking above is not more than a generalized guideline in light of the attributes chosen for discussion. ***The actual registration choice in the real world will depend heavily on the relative costs and benefits practitioners face in exploiting opportunities or addressing regulatory constraints in oblast-specific settings.*** The wisest strategy for a potential MFI licensee would be to hire several local lawyers to explore the most effective organizational form for that oblast from among the top four organizational designs identified here.

6. RECOMMENDATIONS

The review of the issues in this paper and the MFI experience with registration, taxation, and other regulatory questions in Russia leads to the following set of recommendations about compliance in the short term and about reform in the medium term:

- Carry out a thorough and continuing legal review of the various forms of registration and licensing discussed in this report, considering both legislation and enforcement aspects. In light of the continuing advocacy efforts to improve the enabling environment for microfinance organizations in Russia, it is important to have some forum that allows the community to keep abreast of these efforts and of the regulatory changes generated by these efforts.
- Undertake a comparative study of legal and regulatory environments between the Russian Federation, on the one hand, and selected environments in the Near Abroad and Eastern Europe, on the other, to evaluate how these different environments impact the growth of microfinance activity and what policy frameworks appear to be more conducive to a healthy expansion of microfinance.
- Continue to support advocacy strategies through the Federal Duma focusing, in the near term, on possibilities to improve the MFI enabling environment. These efforts should focus on reducing or eliminating tax and other forms of discrimination between and amongst different MFI organizational designs.
- Maintain informal contact with regional representatives of the Central Bank in selected oblasts where MFIs operate. Direct advocacy with the Moscow Central Bank officials should be postponed, however, until a MFI has matured into a larger operation with a strong performance record.
- Maintain a continuing dialogue among MFI practitioners to strengthen advocacy efforts. To accomplish this, it is recommended that a coordinating office be established to facilitate information flows and strategy discussions in an efficient manner. These flows should take place periodically, through regularly programmed meetings, and continually, through informal dialogues via an Internet discussion group.
- Recognize that constraints on micro and small entrepreneurs (MSEs) are important factors that affect the health of MFI loan portfolios. Local MFI practitioners and loan officers should remain informed about changing tax and regulatory actions affecting their clientele and, where feasible, use representatives on their local boards to interact with relevant officials to reduce any arbitrary or counterproductive actions.
- Consider undertaking a survey of a newer generation of MFI borrowers to determine if the oblast-specific legal and regulatory environment in Samara has improved or deteriorated from the previous year and evaluate the impact of changes in the environment on the growth and profitability of MSE borrowers.

7. CONCLUSIONS

The foregoing review underscores the continuing uncertainty surrounding the legal status of microfinance institutions in Russia. This review has highlighted ambiguities in legal frameworks and contradictions between the Russian Civil Code and Federal statutes governing banking activities. This underlying tension has stemmed from contradictions between the Civil Code, which does not restrict the legal range of permissible activities for non-commercial organizations and other private entities, and the Letter of Instruction issued by the Supreme Court of Arbitrage, which effectively puts private lending under the jurisdiction of the Law “On Banks and Banking.” Until very recently, this contradiction had left the microfinance sector to operate in an ambiguous and uncertain legal and policy environment, making it potentially vulnerable to regulatory discretion in the interpretation of the legal basis for lending activities.

One of the focuses of this paper has been the identification and evaluation of relevant organizational properties for effectively functioning MFIs. This evaluation resulted in ranking non-commercial partnerships and private funds as the most desirable modes of registration, followed by consumer cooperatives, state funds, and mutual credit societies. The paper also pointed out, however, that other weighting criteria could be brought to bear on the attributes selected for the analysis.

In the long run, MFIs that reach large scale in lending will likely have to face the challenge of formalizing their activities through the Central Bank, as grant monies dry up and the need for savings and deposit mobilization increases. This challenge highlights the need for a long run advocacy strategy that can induce the passage of a law that facilitates the establishment of a formal non-bank sector. The ideal law would allow for non-bank financial intermediaries to acquire less expensive charters than those associated with commercial banks, provided that these institutions offer a more restricted range of financial services.³⁶

Non-bank institutions play a valuable role in supplying a limited range of financial services in practically all developed countries and a number of developing countries, broadening the financial frontier for those usually excluded from bank finance. Hopefully, the institutional learning curve will rise in the financial services industry in Russia to allow this broadening of the country’s financial markets.

³⁶ A more limited range of financial services would imply that the organizations would not engage in financial intermediation. This type of organization could be a credit-only MFI or would offer savings services to members only.

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LIST OF ACRONYMS

CC: Consumer Cooperative
CCI: Center for Citizens' Initiatives
CU: Credit Union
CCC: Consumer Credit Cooperative
EBRD: European Bank for Reconstruction and Development
FINCA: Foundation for International Community Assistance
MFI: Microfinance Institution
NCO: Non-commercial organization
NCP: Non-commercial partnership
OI: Opportunity International
RWMN: Russian Women's Microfinance Network
SOMD: Social Organization for Mutual Development
WCR: Working Capital Russia