



ARMENIA MICRO ENTERPRISE DEVELOPMENT INITIATIVE

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**Analysis of the Legal Bases Enabling the Formalization of Armenian  
Microfinance Institutions as Licensed Credit Organizations  
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# Armenia Microenterprise Development Initiative

## Analysis of the Legal Bases Enabling the Formalization of Armenian Microfinance Institutions as Licensed Credit Organizations

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### I. Introduction

In late November 2004, the government of Armenia signed a Poverty Reduction Support Credit (PRSP) Agreement with the World Bank that incorporates conditionality relating to the microfinance enabling environment. The relevant paragraph states that “[i]n order to create a sound enabling environment for microfinance operations, the government is committed to strengthening the legal framework for their operations by encouraging MFIs to establish their lending arms as ‘credit organizations’ within the framework of the recently enacted legislation on Non-Bank Financial Intermediaries, under oversight of corresponding Central Bank regulations (viz. nos. 14 as amended and 15).”

Immediately following the signing of the PRSP Agreement, Armenia MEDI’s Chief of Party and Legal Advisors met separately with the World Bank’s Country Manager and representatives of Central Bank of Armenia (CBA) responsible for implementation of the microfinance-related conditionality. In both meetings, two separate categories of regulatory reform were discussed: (1) removal of obstacles that, under currently applicable legislation and normative acts, would hinder or prevent foreign and domestic nonprofit nongovernmental microfinance institutions (NGO MFIs) from formalizing their lending operations through the formation of a CBA-licensed commercial credit organization; and (2) creation of a ‘best practice’ regulatory regime that would apply to the MFIs’ credit organizations, once licensed by the CBA.

The World Bank and the CBA have accepted Armenia MEDI’s offer of assistance on both regulatory fronts. The second front essentially constitutes the continuation of ongoing efforts begun almost at the outset of the Armenia MEDI project (and which already bore fruit in the removal of prudential norms for credit organizations that do not intermediate publicly raised funds).<sup>1</sup> On the first front, however, work could not begin until the government made the decision whether MFIs should come under the regulatory jurisdiction of the Ministry of Finance or the Central Bank. Now that this decision has been made, work can begin to identify and propose a means around the legislative and regulatory obstacles in question.

This Report “*Analysis of the Legal Bases Enabling the Formalization of Armenian Microfinance Institutions as Licensed Credit Organizations*” outlines the specific practical and legal obstacles identified by the Armenia MEDI Legal Advisors. It is anticipated that this will constitute the start-point for discussions with the Central Bank and other interested parties about the optimal approach to removing the identified obstacles.

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<sup>1</sup> Although this topic is of interest to all microfinance institutions (MFIs) in Armenia and will continue to be an important priority of Armenia MEDI, it is not discussed further in this Report.

## II. Current scope of the microfinance sector and legal environment for microfinance institutions.

Microfinance activities in Armenia currently are limited to microlending carried out by: (1) NGO microlenders; (2) commercial microlenders licensed as credit organizations; and (3) licensed commercial banks.

The majority of NGO microlenders are formed as foundations or as branch or local operations of foreign NGOs pending formation of a local legal vehicle. Commercial microlenders are mainly formed as LLCs under the Law on Credit Organizations and are supervised by the Central Bank of Armenia. Commercial banks operate under the banking legislation and are also supervised by the Central Bank of Armenia.<sup>2</sup>

Microlending foundations operating in Armenia used to operate and conduct their lending activities based on the relevant provisions of the Civil Code. Two new laws – the Law on Credit Organizations (adopted on 29 May 2002) and the Law on Foundations (adopted on 26 December 2002) – have dramatically changed the legal environment for the microlending foundations.

The new Law on Foundations (LoF) supplements the provisions of the Civil Code relevant to foundations. Most provisions of the LoF represent basic good practice for foundation governance and do not present an operational challenge to microlending foundations. One particular requirement however, causes significant problems for microlending foundations. The LoF limits annual expenditures for administrative expenses to 20% of total expenses. For microlending foundations, compliance with the 20% ceiling on administrative expenses is absolutely unachievable given that virtually all operating expenses of a typical microlending foundation fall within the LoF definition of “administrative expense.”<sup>3</sup>

The Law on Credit Organizations (COL) has put in question the legality of lending activities of microlending foundations. The reach of COL is extremely broad, extending to any legal entity carrying out lending or crediting activities as a principal business and therefore on its face applies to microlending foundations as well. However, a foundation is not a permitted legal form for credit organizations. (The COL limits the legal form of a credit organization to limited liability companies (LLCs), joint stock companies (JSCs) and commercial and non-commercial cooperatives.) Therefore, microlending foundations do not have the option of obtaining a credit organization license directly.

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<sup>2</sup> Of these three groups, microlending foundations and a single foreign NGO constitute a significant proportion of the entire microlending sector, as measured both by portfolio outstanding and number of active clients. Given that these are the institutions facing an immediate issue of legality under the COL (and, for the foundations, the LoF), as discussed below, this Report addresses only practical and legal issues related to their ‘transformation’ into licensed credit organizations, also as discussed below. For the one foreign NGO engaged in microlending in Armenia, the legal and practical issues will be very similar to those affecting the Armenian microlending foundations (although the LoF will not be an issue and it is also possible that some tax issues of potential concern to the microlending foundations may not be applicable due to the application of bilateral agreements).

<sup>3</sup> Administrative expenses are defined under the LoF (Art. 8, clause 9) as expenses for the management of a foundation, wages of the foundation employees and compensation of the members of governing bodies of foundation.

Although the CBA so far has not expressed an interest in enforcement activity against microlending foundations (based on the fact that those operating currently are lending only out of donor funds and retained earnings), the legality of their operations still can be challenged. Moreover, senior CBA personnel have clearly indicated to the Armenia MEDI Legal Advisors that they are supportive of regulatory changes that will permit microlending foundations to formalize their operations as credit organizations through a so-called ‘transformation’ transaction (described below). It is unlikely, therefore, that the CBA will continue indefinitely to tolerate lending activity as a principal activity by foundations once the legal and regulatory preconditions for a ‘transformation’ have been put in place.

### **III. ‘Transforming’ an NGO into a licensed formal financial institution.**

In other countries where there also exist legal and regulatory barriers to NGOs being licensed or otherwise registered as formal financial institutions, NGOs have succeeded in accomplishing the same practical result indirectly, through a transaction known colloquially in the microfinance world as a ‘transformation.’ This type of transaction is not, in fact, a transformation in a technical legal sense (where an existing legal entity of one legal form simply takes on the character and regulatory treatment of another legal form), but is rather an exchange transaction, in which the existing NGO trades the property involved with its lending operations (most importantly, its loan portfolio) for shares in a commercial legal entity that can be licensed as a formal financial institution.

The legal and practical issues raised by such a transaction with respect to the operation of the NGO after the transaction almost always involve questions of first impression in most countries, given that few organizations have ever attempted a similar transaction. This is the case in Armenia. The novel legal and practical issues can be divided into two general categories: (1) issues flowing from the ‘transforming’ microlender’s status as an NGO (in the Armenian case, a foundation); and (2) issues flowing from the practical and legal aspects of the exchange transaction itself and the requirements for licensing the commercial legal entity as a formal financial institution (in the Armenian case, a CBA-licensed credit organization).

### **IV. Issues flowing from the ‘transforming’ microlender’s status as a foundation.**

Armenian microlending foundations contemplating such a ‘transformation’ transaction face four basic questions flowing from their status as foundations: (1) whether, under the Civil Code and LoF, they are permitted to hold shares of and conduct business activity through a commercial credit organization; (2) whether they are permitted to form the types of commercial legal entities that can be licensed as credit organizations; (3) whether, after the exchange transaction is completed, they are permitted to exist with essentially all their property tied up in a single commercial asset – their shares in the licensed credit organization; and (4) whether the 20% limitation on administrative expenses is likely to remain an impediment to their operations after the exchange transaction is completed.

a. Business activity of a foundation

Under the Civil Code and the LoF, foundations are defined as noncommercial organizations, established based on voluntary contributions of property of citizens and (or) legal persons to pursue social, charitable, cultural, educational, scientific, public health, environmental or other public benefit goals. Foundations do not have members or owners.

Although foundations must have noncommercial goals, they can engage in entrepreneurial activities. The relevant provisions of the Civil Code and the LoF stipulate that foundations may carry out entrepreneurial activities only if such activities serve the accomplishment of the goals of the foundation. Foundations may engage in entrepreneurial activities and may create commercial organizations or participate in them.

If the foundation carries out entrepreneurial activities directly without creating a commercial entity it can carry out only the types of activities which are mentioned in the charter of the foundation.

b. Permissibility of formation of (or investment in) a credit organization by a foundation

As stated above, the COL provides that credit organizations may be founded in the legal form of an LLC, JSC or a cooperative. The COL does not stipulate any limitations as to types and legal forms of *founders* or owners of the credit organizations. Therefore, each legal type of the credit organization (LLC, JSC or cooperative) may be founded by the persons stipulated by the respective special laws, i.e. Law on LLCs, Law on JSCs or the provisions of the Civil Code governing cooperatives.

According to the Law on LLCs, individuals and legal entities (as well as the Republic of Armenia and communities) can be founders or participants of an LLC. The Law also provides that an LLC may be founded by a single individual or legal entity. The Law on JSCs also contains similar provisions. The provisions of the Civil Code on cooperatives provide that the cooperative is a union of the citizens and legal entities on the basis of membership with the purpose of satisfying the material and other needs of the participants.

Therefore, a foundation may be a founder (and owner) of a credit organization in any form, whether an LLC, a JSC or a cooperative.

c. Permissibility of a foundation having a single investment asset

In some countries, foundations face a legal or regulatory requirement that they hold their property in a diversified portfolio, to avoid excessive risk concentration (although there is likely to be an exception for an asset or assets that contribute directly to the furtherance of the foundation's mission). In Armenia, there are no legal or regulatory provisions directly on point. There is no specific provision in the LoF that explicitly states that a foundation may exist for the sole purpose of holding equity in a single commercial company, but at the same time the LoF does not contain any limitation on this. Therefore it can be assumed that the LoF permits a foundation to exist for the sole purpose of holding equity in a credit organization.<sup>4</sup> However, since the main purpose of the foundation must be noncommercial, any dividends received by it from a credit organization in which it owns shares must be used for its statutory social purposes.

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<sup>4</sup> A senior official of Ministry of Justice has confirmed this interpretation to MEDI Legal Advisors.

d. 20% limitation on administrative expenses

Whether the LoF's 20% limitation on administrative expense will constitute a legal or practical burden for an Armenian microlending foundation after it has exchanged its portfolio for shares in a credit organization depends upon the foundation's planned activities and mode of operation thereafter. Bearing in mind that the foundation will not be permitted to continue direct lending activities, experience from other countries would suggest two possible activities and modes of operation: (1) becoming a grantmaking foundation (using dividends paid by the credit organization); or (2) switching over to some sort of direct support organization for low-income persons and entrepreneurs (typically providing or facilitating the provision of business development services).<sup>5</sup>

In the first case, there is no reason to believe that the administrative expenses of a grantmaking foundation that formerly existed as a microlending foundation would be higher than those of grantmaking foundations generally. Accordingly, for foundations that choose this path, the 20% administrative expense limitation should not constitute a problem. However, for organizations wishing to become involved in BDS, the 20% limitation can be expected to pose the same problem it poses for the microlending foundations currently.

**V. Issues flowing from the practical and legal aspects of the exchange transaction itself and the requirements for licensing the credit organization.**

There are two principal sets of practical and legal issues relating to the exchange transaction itself and the requirements for licensing the commercial legal entity as a credit organization. The first set flows from the COL and regulations thereunder; the second set flows from the Armenian Tax Code.

Analysis of the COL and its implementing regulations suggests only one significant impediment to the formation of (or investment in) a credit organization by a microlending foundation, relating to the type of property that may be used to capitalize a credit organization. Unfortunately, on the taxation front, there are a significantly greater number of issues and some potentially troubling ambiguities.

a. Restriction on capitalizing a credit organization with non-cash assets

As discussed, typically the 'transformation' of a lending NGO into a commercial entity would happen through the contribution by the lending NGO of its loan portfolio to a commercial entity in exchange for the shares of the commercial entity. However, this is not currently possible under Armenian law due to the requirement of CBA Regulation N 14 (applicable to all credit organizations), according to which the statutory capital of the credit organization can be paid only in cash. This means that the microlending foundation cannot contribute its loan portfolio or any other noncash assets as the statutory capital of the credit organization.

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<sup>5</sup> The foundation may also choose to dissolve after the 'transformation.' However, in this case the credit organization shares held by the foundation, according to the LoF, shall be either distributed for the satisfaction of the creditors' claims or, if left after the satisfaction of creditors' claims, for the accomplishment of the foundation's goals. In case it is not possible to distribute the shares for the accomplishment of the foundation's goals, those shares will be transferred to the state.

This limitation makes the ‘transformation’ transaction practically unworkable, because the foundation would either have to stop providing loans and contribute cash after all loans are repaid (which would cause irreversible damages to the foundation since it would lose its clientele in the process) or it would have to pay in the statutory capital over a long period of time by contributing small amounts (which would be an extremely inefficient, and probably economically unviable, solution).

- b. Tax treatment of the exchange of the loan portfolio in return for the shares of the credit organization and/or the transfer/assignment of the loan portfolio to the credit organization

Assuming there is an amendment to CBA Regulation N 14 to permit noncash statutory capital, there are still a variety of tax issues regarding the exchange of a loan portfolio for shares of a credit organization that could make such transactions economically unfeasible even if they are legally feasible.<sup>6</sup>

- i. Tax treatment of the purchase of shares

A transaction involving the exchange of a loan portfolio for the shares in a credit organization will generally be considered as a tax-free transaction under the Armenian tax laws, provided there is a fair valuation of the loan portfolio contributed to the statutory capital.

- ii. Possible profit tax issues

The only significant profit tax issue associated with the transfer of a loan portfolio in exchange for shares seems to be the impossibility of deducting from taxable income the loan interest accrued, but not actually received, by the foundation before the transfer.

- iii. Possible VAT issues<sup>7</sup>

Due to the requirements of the Civil Code, the transfer of a loan portfolio in exchange for shares may also need to be formalized as an assignment of claim (a type of civil contract). Although it is assumed that such an assignment of claim will not be considered separately from the share purchase transaction (and therefore will not be subject to VAT), this is not absolutely clear under the Law on VAT.

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<sup>6</sup> Experience from other countries in which ‘transformations’ from NGO microlender into commercial legal entity have taken place (through an exchange of a loan portfolio for shares) suggests that it is impossible to predict all the possible issues that aggressive tax authorities may raise. The following discussion should therefore be understood as a preliminary analysis of these issues.

<sup>7</sup> According to the Law on VAT a reorganization transaction is exempt from VAT. However, as already mentioned, the direct reorganization (or legal transformation) of foundations into credit organizations is not legally possible. A ‘transformation’ transaction through the founding of a credit organization and the exchange of the foundation’s loan portfolio for shares may trigger some VAT-related issues.

## **VI. Recommendations for changes in laws and regulations to remove the legal obstacles for formalization of microlending foundations as credit organizations.**

- a. Amend CBA Regulation N 14 to make it possible to pay statutory capital (at least above the required minimum capital) with noncash assets.

The current regulation provides for required minimum capital as one of the prudential norms applicable to credit organizations. However, the provision describing the order of payment of the statutory capital refers to the “statutory capital” and not the “minimum statutory capital.” Assuming that CBA would still like to require credit organizations to have some cash at the time of starting their operations, it seems reasonable to state that the “minimum” required statutory capital should be paid in cash, but to permit the remaining amount contributed in excess of the minimum required statutory capital to be paid in noncash assets. The CBA may also want to consider limiting the types of noncash assets, to exclude the possibility of misuse of this provision.

- b. Amend relevant provisions of the tax laws to make the transfer of the loan portfolio and its exchange for shares of the credit organization a tax-free transaction.

An amendment to the Law on VAT may be considered to make clear that an assignment of claim in cases when it is linked to the purchase of shares is exempt from VAT.

An amendment to the Profit Tax Law may be considered to make sure that there is no double taxation of loan interest in case of an exchange of a loan (as part of a portfolio) in return for shares.

- c. Amend LoF to permit an exception to the 20% limitation on administrative expenses in the case of operating foundations.

An amendment to LoF may be considered to permit an exemption or to provide a different limit for operating, nongrantmaking foundations.

## **ANNEX A**

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### Main Legal and Practical Steps Required for a Microlending Foundation to 'Transform' Through the Exchange of its Loan Portfolio for Shares in a Licensed Credit Organization

- Step 1
- Revise the statutory documentation of the foundation, if necessary, to provide that the foundation may form or invest in a credit organization
  - modify the scope of activities of the foundation, if necessary, given that after the creation of the credit organization the foundation will not be directly engaged in the lending activities.
- Step 2
- make a decision to found (or invest in) a credit organization,
  - if founding (as opposed to investing in) a credit organization,
    - approve the charter and other documents that require approval of the founder of the credit organization,
    - appoint the management bodies (CEO, Board of Directors, etc.) of the credit organization.
- Step 3
- if founding a credit organization,
    - prepare and file all other legal documents necessary for registration and licensing of the credit organization,
    - take other necessary actions to comply with the requirements for registration and licensing (qualification of managers, technical and security requirements for the place of operation, etc.)
- Step 4
- if founding a credit organization, take other actions to enable the operation of the credit organizations (registration with tax, social security authorities, obtaining seal, etc.)
- Step 5
- transfer employees (all or some, depending on what activities the foundation will engage in after transfer of the loan portfolio) to the credit organization.
- Step 6
- formalize the assignment of the loan and security interests, if necessary,
  - notify the borrowers of the assignment of the loans and the change in the lender's identity.