



Russian Microfinance Center

THE LEGAL ENVIRONMENT FOR MICROFINANCE ACTIVITY IN RUSSIA

Analysis and Recommendations for Reform



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The Russian Microfinance Center (RMC) undertook this research of the legal environment for microfinance activity to identify issues that require amending the current normative regulation or adopting new normative acts.

The paper analyses provisions of the relevant Russian legislation¹ regulating microfinance activity; identifies some gaps, inconsistencies, and barriers to the development of microfinance; and looks at the practice of microfinance institutions (MFIs) in applying the laws and regulations. The paper is not designed to be a manual or a collection of practical advice. Some of the quoted case studies of Russian MFIs are not always perfect in all respects, and the author does not suggest that they may always be used as models to follow. These examples serve only to reflect the actual current practices of Russian MFIs.

Russian law does not have statutory definitions of *microfinance* or *microfinance institution*. Different sources define these concepts differently. In attempting to define microfinance, we can take into account either various aspects of microfinance relations or the object of these relations. Microfinance in a general sense includes not only the issue of loans, but also other financial and nonfinancial services offered to certain target groups, such as insurance, leasing, and consulting. Specific characteristics of microfinance operations include rapid delivery of financial services and unconventional types of loan security. Loan amounts and maturities differ depending on the region, the level of MFI development, and other factors. This paper does not cover the entire spectrum of microfinance activities; rather, it focuses on its most common aspect: making loans. Thus, for the purposes of this paper, we will define microfinance as making loans to small entrepreneurs (both individuals and organizations) that have limited access to bank credit because they require small amounts, have insufficient collateral, lack a credit history, or have other limitations. This paper uses the phrase *microfinance institutions* to refer to any organizations, established under any institutional and legal form, that engage in microfinance as the main purpose of their establishment and/or the main type of their actual operation.

The author of this paper is Natalia Burtseva, legal issues advisor of the Russian Microfinance Center; the research is part of the Russian Microfinance Sector Policy Initiative.

Timothy R. Lyman, program advisor, has made an invaluable contribution to this research. Mr. Lyman was involved in drafting the research plan, provided the description of the main principles of an enabling legal environment for microfinance activities, and helped to evaluate the research findings. Members of the Legal Experts Group, meeting in Moscow on February 17, 2003, and in Khabarovsk on June 4, 2003, contributed some additions and clarifications concerning the principles of policy reform and the description of enabling environment proposed by Mr. Lyman.

The managers and staff of MFIs in Volgograd, Voronezh, Yekaterinburg, Komsomolsk-on-Amur, Moscow, Nizhny Novgorod, St. Petersburg, and Smolensk, who generously shared their experience with the author, enriched the paper with their real-life examples of the application of laws and judicial practices.

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The RMC and the author look forward to your comments and recommendations; we will consider your views on our work, which seeks to improve the legal environment for microfinance activities in Russia.

This publication may be of interest to practitioners of Russian MFIs, Russian officials whose work involves SME support and social development, and workers of international and foreign organizations who support economic reforms and democracy in Russia.

¹ The normative acts analyzed are effective as of 17 June 2003.

Some acronyms used in the text:

- RF CC: the Civil Code of the Russian Federation
NDCO: non-bank credit organization, an institution that takes deposits and makes credit
NPO: noncommercial organization
RF TC: the Tax Code of the Russian Federation
MFI: microfinance institution
CB RF: the Central Bank of the Russian Federation (the Bank of Russia)

Translator's comment:

The Russian term *microfinansovye organizatsii* is translated using the generally established phrase *microfinance institutions*, or MFIs, rather than *microfinance organizations*.

CHAPTER 1

NORMATIVE REGULATION OF
MICROFINANCE ACTIVITY**The Hierarchy of Normative Acts**

The Constitution of the Russian Federation establishes the principles of legal regulation that form the foundation for all Russian legislation. The federal structure of the Russian state and the specific legislative powers of the subjects of the RF form the basis for the hierarchy of normative acts proclaimed in the RF Constitution. The hierarchy, as a means of organizing, aims to ensure the effectiveness of legislative regulation and avoid conflicting provisions between normative acts of different levels.

The RF Constitution has the highest legal power and is equally effective in all parts of the Russian Federation. Laws and other normative legal acts adopted at the federal level and in RF subjects are based on the RF Constitution; they cannot and must not conflict with it.²

Federal laws of the Russian Federation regulate the most significant, typical, and consistent public relations; they are effective all over the Russian territory. The Federal Assembly has exclusive power to adopt federal laws.³ Federal laws may be adopted as federal constitutional laws or federal laws, including codes—systems of normative legal acts regulating a certain sphere. For example, the Civil Code of the Russian Federation is a federal law that defines the respective legal situations of individual participants in civil transactions; the emergence of ownership and related rights and procedures for their enjoyment and enforcement; contractual and other obligations; and property and non-property relations based on equality, free will, and the independent property status of individuals.

Federal laws are adopted to regulate the issues of federal competence and the issues of joint competence between the Russian Federation and its subjects.

Federal laws cannot conflict with federal constitutional laws.⁴ Normally, codes contain a provision making it obligatory for all other normative legal acts applied to

the sphere regulated by the code to be consistent with this code. For example, Article 3 of the RF CC states that civil law norms established by other legislation must be consistent with the Civil Code. However, the RF Constitutional Court has reaffirmed on many occasions that, based on the provisions of Article 76 of the RF Constitution, no federal law, by force of Article 76 of the Constitution, has priority over another federal law. The choice and interpretation of provisions to be applied in a particular case lie with courts of general jurisdiction and commercial [arbitration] courts, rather than with the RF Constitutional Court. In particular, in its comment of February 3, 2000, the Constitutional Court ruled that the RF Constitution does not directly regulate the right to security of bank deposits and to enforcement of related obligations.⁵ This right emerges from Civil Code obligations of banks and other credit institutions, while the Civil Code regulation of the said relations allows for exceptions from general rules based on specific legal norms. Any apparent conflict between the RF CC and other federal laws regulating this sphere should be resolved in the application of these laws in specific instances, as the RF Constitution does not and cannot define the hierarchy of acts within one particular type, in this case, federal laws. To reiterate, no federal law, by force of Article 76 of the RF Constitution, has priority over another federal law.

The head of the Russian state, the President of the Russian Federation, issues decrees and orders within his sphere of competence. The President issues decrees on the basis of, and pursuant to, the RF Constitution and federal laws and the decrees cannot conflict with them; federal laws have priority over all other executive acts and regulations.

The Government of the Russian Federation issues resolutions and orders within its competence. Government resolutions and orders are executive acts adopted pursuant to the RF Constitution, federal laws, and presidential normative acts, and cannot conflict with them.

² Article 15 of the RF Constitution.

³ The Federal Assembly consists of two chambers, the Federation Council and the State Duma (Article 95 of the RF Constitution).

⁴ Article 76 of the RF Constitution.

⁵ In response to the request made by Pitkyarantsky city court in the Republic of Karelia to review the constitutionality of Article 26 of the Federal Law on insolvency (bankruptcy) of credit institutions.

Normally, resolutions contain generally applicable norms, while orders apply to a certain group of citizens. In addition, the Government develops and implements long-term thematic [*targeted*] programs, such as the Federal Program of SME support.

Federal executive authorities issue normative legal acts within their respective areas of competence and in forms defined by their statutes. Such normative legal acts are adopted pursuant to the RF Constitution, federal laws, presidential normative acts, and normative acts of the Russian Government. For example, the Ministry of Taxes and Levies, the Ministry of Finance, the State Customs Committee, and state extrabudgetary funds all issue orders, instructions, and guidelines pursuant to the Tax Code on matters that are not treated in legal acts; these documents are binding for their offices and departments.⁶

A normative legal act may be issued jointly by several federal executive agencies or by one agency in coordination with another, and in some cases, where a government ministry deals with more than one industry or sphere of activity, such acts may regulate interdepartmental relations among a number of agencies.

Outside the exclusive sphere of competence of the Russian Federation and the joint competence of the Russian Federation and RF subjects, the latter establish their own regional regulations in the same formats (laws, decrees, resolutions, orders, and the like).

Regional laws cannot conflict with federal laws that apply to federal or joint spheres of competence. Where such conflicts arise, federal legislation will prevail.⁷ This provision establishes the priority of federal legislation.

However, a normative act adopted by a subject of the Russian Federation in its sphere of competence as defined by Article 73 of the RF Constitution (that is, a sphere that lies outside federal and joint competence), has priority over federal laws.⁸

Local self-government is a system enabling local communities to make decisions concerning the ownership, use, and disposal of municipal property, and to address

other local issues. Local self-government bodies manage municipal property. They form, approve, and implement local budgets; establish local taxes; maintain public order; and so forth. Local self-government bodies and officials pass legal acts on matters within their competence. The charter of the municipality, in accordance with Russian law, determines the names and types of legal acts issued by local self-government, the elected and other official positions in the local self-government, their powers related to the adoption of such acts, and the procedure of their adoption and entering into force.⁹

Laws may delegate some functions of the state to local self-government bodies and provide the required financial and other material resources for their implementation. The state retains control over the delivery of the delegated tasks.¹⁰ Such functions include, for example, public health care, education, and urban development.

A perfect relationship between a law and a normative executive act requires coordination and avoidance of conflicts; an effective legal system must be unified and consistent.

The RF Central Bank exercises its functions and powers independently of other federal bodies, authorities of the RF subjects, or local self-government. It issues regulations on issues within its competence, as defined by the law on the central bank of the Russian Federation (the Bank of Russia).¹¹ These regulations are binding for the state authorities, local self-government bodies, all corporate legal entities, and individuals.

Federal Level of Regulation: Main Normative Acts Regulating Microfinance Activity

The Civil Code of the Russian Federation defines the status of legal entities, including consumer cooperatives, foundations, and associations (unions); it regulates contractual obligations, in particular loan and credit agreements.

The Tax Code of the Russian Federation establishes a system of federal taxes and levies and general principles of taxation in the Russian Federation, including forms and methods of tax control, liability for tax-related offences, and the procedure for appealing acts adopted by tax

⁶ The RF Tax Code, Article 4, Para 2.

⁷ Part 5, Article 76 of the RF Constitution.

⁸ Part 6, Article 76 of the RF Constitution.

⁹ Article 19 of the federal law *On general principles of organization of the local self-government in the Russian Federation*, No 154-FZ, August 28, 1995.

¹⁰ Article 132 of the RF Constitution.

¹¹ Federal law *On the Central Bank of the Russian Federation (the Bank of Russia)*, No 86-FZ, July 10, 2002.

authorities as well as making complaints against actions (or inaction) of officials.

Federal law No. 129-FZ, August 8, 2001 **On state registration of legal entities**, regulates the establishment, reorganization, and liquidation of legal entities, amendment of their charters and other statutory documents, and the procedure for maintaining the state register of legal entities.

Federal law No. 134-FZ, August 8, 2001, **On protecting the rights of legal entities and individual entrepreneurs in the exercise of state supervision/oversight**, is designed to protect legal entities and entrepreneurs in the context of supervision by executive authorities and their agencies and officials.

Federal law No. 128-FZ, August 8, 2001, **On licensing certain types of activities**, regulates relations between executive agencies, legal entities, and individual entrepreneurs in the context of licensing certain types of activities identified in a federally established list.

Federal law No. 117-FZ, August 7, 2001, **On citizen consumer credit cooperatives**, regulates the establishment, activities, reorganization, and liquidation of Consumer Credit cooperatives set up by private individuals who come together voluntarily to meet their need for mutual financial assistance.

Federal law No. 95-FZ, May 4, 1999, **On gratuitous aid (assistance) to the Russian Federation, on amending certain RF legal acts on taxes, and on establishing privileges on the payments to state nonbudgetary funds in connection with gratuitous aid (assistance) to the Russian Federation**, defines humanitarian aid and technical assistance and establishes criteria for entitlement to tax benefits in connection with such aid/assistance.

Federal law No. 97-FZ, July 11, 1997, **On consumer cooperation (consumer societies and their unions) in the Russian Federation**, defines the legal, economic, and social framework for the establishment and operation of consumer societies and their unions at different levels, pointing out that such structures are created for the satisfaction of material and other needs of their members. The law does not apply to credit cooperatives, but allows consumer societies to borrow from their members and other individuals, and to onlend to their members.

Federal law No. 7-FZ, January 12, 1996, **On noncommercial organizations**, defines the status as well as the procedures for the establishment, operation, reorganization, and liquidation of noncommercial organizations; the rights and responsibilities of their members; and the principles of their governance. This law does not apply to consumer cooperatives.

Federal law No. 193-FZ, December 8, 1995, **On agricultural cooperation** defines the legal framework for the establishment and operation of cooperatives formed by agricultural producers, including consumer cooperatives delivering saving and credit services to their members (credit cooperatives).

Federal law No. 88-FZ, June 14, 1995, **On state support of SME**, establishes the framework for state support and development of small businesses in Russia. In particular, it provides for the establishment of the federal SME support fund as well as the state and municipal SME support funds. The law also provides for the creation of non-governmental SME support funds and mutual credit societies by small entrepreneurs; but it does not define the institutional/legal form of such societies.

Decree of the Russian Government No. 1046, September 17, 1999, **On establishing the procedures for the registration of projects and programs of technical assistance, the issue of documents to certify funds, products, and services as technical assistance, and the supervision of its appropriate utilization**, regulates the following:

- Registration of technical assistance programs;
- Issue of certificates confirming that funds, products, or services are provided as technical assistance;
- Receipt and utilization of technical assistance; and
- Supervision of appropriate use of technical assistance [use for its intended purpose].

Issues that Require Improved Normative Regulation

Establishing federal legal norms that recognize the existence of microfinance at the federal level and that confirm its support by the state would allow local MFIs to save the effort and resources they currently spend defending their right to exist and would enable them to channel such effort and resources into their work for the public good.

Federal Level of Regulation: Some Relevant Normative Acts on Banks and Banking

Federal law No. 86-FZ, June 10, 2002, **On the Central Bank of the Russian Federation (the Bank of Russia)** defines the status, purposes, functions, and authority of the Central Bank of the Russian Federation (the Bank of Russia; CB RF).

Federal law No. 17-FZ, February 3, 1996, **On banks and banking**, gives statutory definitions of banks and other credit institutions and their associations; describes banking operations; establishes requirements for the documents which a credit institution must file at registration; and sets the amount of authorized [equity] capital and the governance procedures.

CB RF Regulation No. 153-Ī, September 21, 2001, **On specific characteristics of prudential regulation of non-bank credit institutions which perform deposit and credit transactions**, establishes procedures for regulating the activities of nonbank credit institutions which take deposits and issue credit.

CB RF Directive No. 474-U, December 31, 1998, **On the formation of authorized capital of credit institutions using in-kind assets**, defines circumstances that allow members (shareholders) of a credit institution to contribute in-kind assets, rather than money, to the institution's authorized capital.

Regulation No. 509, August 28, 1997, **On the organization of internal control in banks**, endorsed by CB RF Order of August 28, 1997, No. 02-372, establishes general guidelines for the exercise of internal control in all banks.

Federal Level of Regulation: Some Relevant Normative Acts on Currency Regulation

RF law No. 3615-1, October 9, 1992, **On currency regulation and control**, establishes guiding principles of foreign currency transactions in the Russian Federation; powers and functions of supervisory agencies; rights and responsibilities of individuals and legal entities related to the ownership, use, and disposal of foreign currency; and liability for violations of currency legislation.

CB RF Directive No. 1110-U, February 14, 2002, **On the use of certain Bank of Russia normative acts in the sphere of currency regulation and supervision**, lists the types of foreign currency transactions under credit/loan agreements that are not subject to restrictions, if supported by the required documents.

CB RF Instruction No. 7, June 29, 1992, **On the procedure for mandatory sale by enterprises, associations and organizations of a part of their earnings in foreign currency through authorized banks, and on foreign currency transactions in the Russian domestic market**, approved by CB RF Order No. 02-104, June 29, 1992, mandates the sale of a part of earnings in foreign currency and establishes the procedure.

Federal Level of Regulation: Some Relevant Normative Acts on Foreign Investments

Federal law No. 160-FZ, July 9, 1999, **On foreign investments in the Russian Federation**, establishes guarantees for foreign investors, protects their rights to investments and generated earnings and profits, and defines the rules for foreign investors operating in the Russian Federation.

CB RF Regulation No. 437, April 23, 1997, **On specifics of registration procedure for credit institutions with foreign investments and on prior authorization by the Bank of Russia of an increase of a credit institution's authorized capital through foreign contributions**, made effective by Bank of Russia Order No. 02-195, April 23, 1997, defines the details of registration requirements for credit institutions with foreign investments and the procedure for obtaining the Bank of Russia's prior authorization to increase equity capital by contributions from nonresidents. The definition of credit institutions with foreign investments for the purposes of this regulation includes Russian credit institutions with foreign participation in their equity capital, regardless of the share of foreign contribution.

Competence of the RF Subjects and Local Self-Government in Regulating MFIs: Current Experience

Federal laws define the authority of RF subjects and local self-governments to regulate the activities of microfinance institutions as follows:

- Microfinance institutions cooperate with administrations of RF subjects and with local self-government bodies;
- Administrations of RF subjects and local self-governments support MFIs, in particular by funding their activities from different budgets to support specific approved programs and by creating privileges for MFIs in their access to information and resources; and
- Regional administrations and local self-governments are, however, not allowed to interfere with the MFI's business and finance operations unless a particular MFI was cofounded by regional executive authority or local

self-government (state and municipal SME support funds).

Competent executive authorities in the RF subjects and local self-government bodies are involved, in accordance with the law *On state support of SME*, in the establishment of state and municipal SME support funds. By virtue of their involvement, the RF Subject (or the local self-government authority) may, to a certain extent (depending on the powers the charter gives to founders), supervise the fund's activities and influence its decision making. The charter of the fund in question defines the specific powers involved in the respective authorities' participation. In some cases, regional or municipal authorities are directly involved in the fund's decision-making bodies; in other cases, they have virtually no influence on the fund's decisions, once it is established.

For example, municipalities in Voronezh Oblast, jointly with the State Fund for SME Support, establish municipal SME support funds that make loans to small businesses locally. The Oblast administration provides most of the funding to support municipal funds, but the municipality is also required to make a contribution, however small. According to the municipal fund charter, the Board of Trustees and the Director manage the fund. The founders designate the Director and Trustees of the fund at its establishment. Later on, the Board of Trustees may appoint or dismiss the Director; the Board itself approves changes in Board membership.

The federal law *On protecting the rights of legal entities and individual entrepreneurs in the exercise of state supervision/ oversight* defines the regional government's powers related to state supervision. By law, the highest regional authority (head of the highest executive body in a federal region) designates the regional executive agency empowered to exercise official state supervision and defines the structure, authority, functions, and procedures of such an agency.

Those Russian regions which are more active in developing their microfinance services run special programs to support credit cooperatives and SME development funds; in addition, local authorities initiate or cofound local structures that specifically support and coordinate microfinance activities.

For example, Volgograd Oblast, an area where many successful credit cooperatives operate, has a subprogram of

state support and regulation of consumer credit cooperatives in the Oblast in 2002-2006. This program aims to promote a sustainable and growing network of consumer credit cooperatives, to offer practical solutions to problems hindering the development of consumer credit cooperatives, and to improve existing mechanisms of state support. The funding of the program in 2002-2006 totals 269.1 million rubles. Most of the funding will be channeled into loan security, support of Consumer Credit cooperatives, and training programs for staff of credit cooperatives. The Head of Volgograd Oblast administration issued a decree establishing the Coordination Council for Consumer Credit Cooperatives Development. Members of the Coordination Council include the Oblast Administration officials, members of the Oblast Duma, the RF Central Bank office in the Oblast, associations of citizen consumer credit cooperatives, and rural credit cooperatives. The Coordination Council has a plan of action for 2003. This plan includes, in particular, the development of financial standards for citizen consumer credit cooperatives and an international conference.

In Volgograd Oblast, the local administration's Committee on Economy is the agency authorized to supervise and oversee cooperatives. As established by the Oblast law *On state supervision and oversight of consumer credit citizen cooperatives*, the Committee maintains a register of citizen consumer credit cooperatives operating in the Oblast.¹²

In Sverdlovsk Oblast, the local Center for Support of Entrepreneurship is the executive agency responsible for the implementation of state policies of SME support. In addition, the Microfinance Council was set up to facilitate the implementation of the microfinance program in the Oblast and to involve municipal SME Support Funds in decision making. Members of the Council are representatives of SME Support Funds and officials of the Center for Support of Entrepreneurship.

In Leningrad Oblast, the 2003-2005 SME support program includes, as one of its priorities, access to credit for small business. Some of the activities undertaken towards this goal include partial compensation of credit interest from the Oblast budget, and the design and approval in 2003 of a set of normative acts establishing a specialized financial agency in the Oblast, namely, a credit security guarantee fund. These activities are designed to support only conventional credit institutions, that is, banks. In

¹² Volgograd Oblast Law *On state supervision and oversight of Consumer Credit cooperatives of individuals*, No 706-OD, May 27, 2002.

addition, the program establishes other incentives for institutions that support small businesses, such as:

- Allocation of funds to municipalities, to be distributed as technical assistance to organizations that offer micro-finance services to small businesses;
- Development of a network of credit cooperatives; and
- Establishment of an oblast-based center of credit cooperatives offering information and consultation services and education and training of entrepreneurs in the field of mutual credit.

Issues that Require Improved Normative Regulation

State supervision of the activities of credit cooperatives at the level of RF subjects should guarantee the rights of MFIs and their borrowers, and promote the development of SME and MFIs.

LEGAL FORMS OF ORGANIZATIONS THAT ENGAGE IN MICROFINANCE ACTIVITIES

Diverse institutional forms make possible effective microfinance activities. These forms may be both commercial and noncommercial organizations—either licensed to perform certain financial transactions or not subject to licensing. This chapter looks at institutional forms of MFIs that are common in Russia. Although the MFIs mentioned below are those established as foundations, cooperatives, noncommercial partnerships, and the like, they may take any other institutional form provided by law; moreover, a multifunctional organization may undertake a microfinance operation as a part of its activities.

Noncommercial Organizations

The RF Civil Code (RF CC) mentions only five possible forms of nonprofit organizations: consumer cooperatives, social organizations, foundations, institutions, and associations. This list is not exhaustive, however, and allows the establishment of noncommercial organizations in other forms provided by law.¹³ A number of federal laws were based on this provision establishing new forms of noncommercial organizations and regulating the procedures for their establishment, activities, and liquidation.

Some forms of noncommercial organizations cannot be used to legalize a microfinance operation as the main activity. For example, law defines the purpose of *home owners' associations* as joint management and utilization of a condominium; ownership, use, and disposal—within legally established boundaries—of shared property.¹⁴ This institutional form cannot be used for microfinance.

Noncommercial organizations established under the federal law on noncommercial organizations are allowed to offer microfinance services as their main type of activities.¹⁵ The same applies to consumer cooperatives. The law on noncommercial organizations regulates the activities of noncommercial organizations established under the following legal forms:

- Foundations;
- State-controlled corporations;
- Noncommercial partnerships;
- Institutions;
- Autonomous noncommercial organizations; and
- Associations (unions).

Foundations¹⁶ are the most commonly used form of microfinance operations.

Four federal laws regulate the activities of consumer cooperatives engaging in microfinance activities. (See Figure 1 for an overview of their relationship.)

Each institutional form that MFIs use has its pros and cons. Moreover, the same characteristic may be an advantage in one situation, and a limitation in another. For example, a situation where the highest authority in the organization is an assembly of its members promotes democratic governance and inclusive decision making. However, getting a quorum can be a problem in organizations with a large membership and decisions voted by such an assembly may be unpredictable.

Cooperatives

The RF Civil Code (RF CC) contains only general requirements and restrictions related to the establishment and activities of consumer cooperatives, providing at the same time that specialized laws on credit cooperation, in accordance with the Civil Code, should establish the legal status of consumer cooperatives and rights and responsibilities of their members.¹⁷

Currently, microfinance institutions in the form of consumer cooperatives may use one of the following laws: *On agricultural cooperation*;¹⁸ *On consumer cooperation* (consumer societies and their unions) in the Russian Federation;¹⁹ *On citizen consumer credit cooperatives*;²⁰ or

¹³ RF CC Article 50, Para 3.

¹⁴ See Federal Law *On associations of home owners*, No 72-FZ, June 15, 1996.

¹⁵ Federal Law *On noncommercial organizations*, No 7-FZ, January 12, 1996.

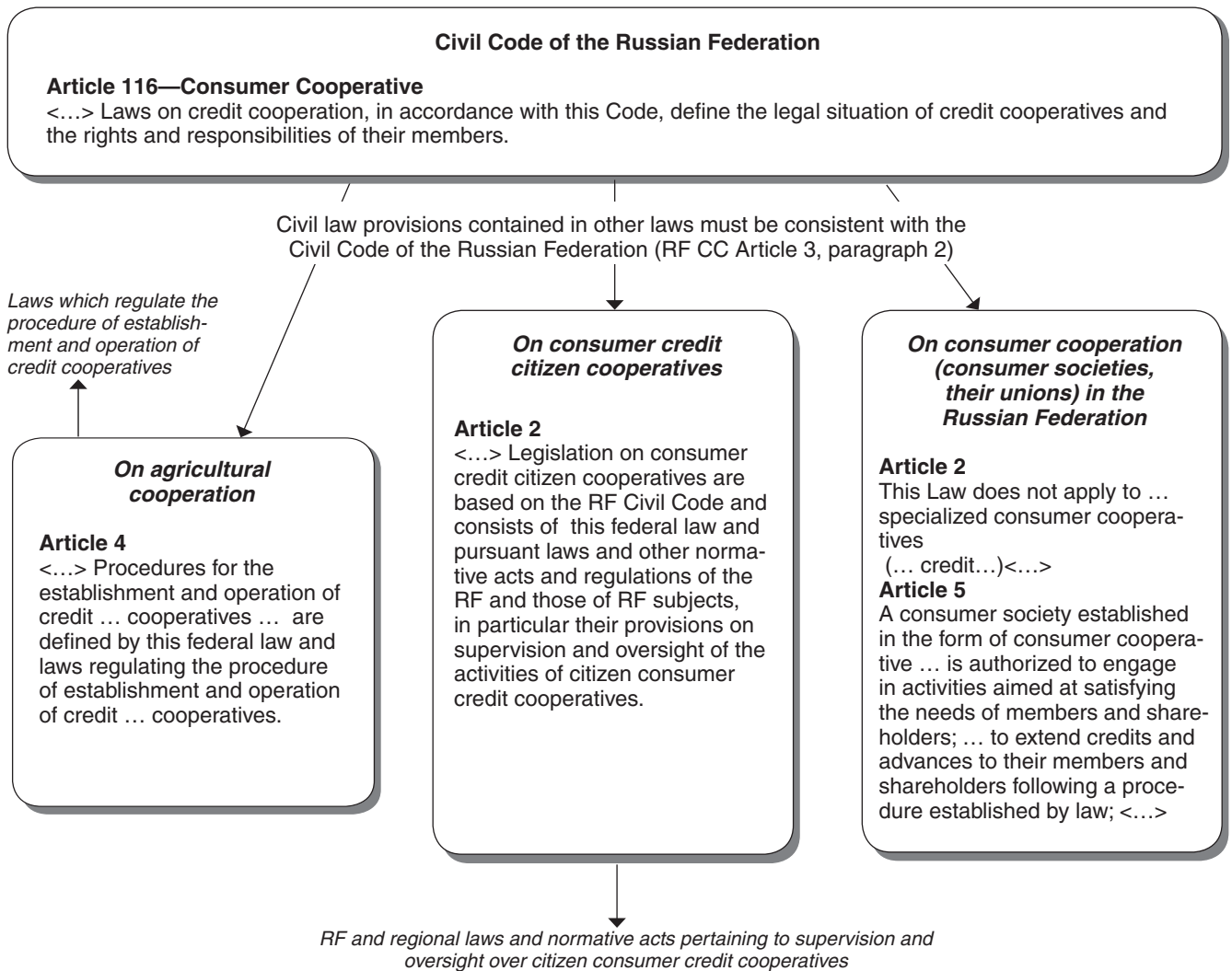
¹⁶ Some characteristics of such institutional forms as autonomous noncommercial organization, noncommercial partnership, and association, and some of the reasons why these forms are rarely used for microfinance, will be addressed in the section on *Mutual Credit Societies, Autonomous Noncommercial Organizations, Noncommercial Partnerships, Associations* below, in this chapter.

¹⁷ RF CC, Article 116.

¹⁸ Federal law *On agricultural cooperation*, No. 193-FZ, December 8, 1995.

¹⁹ Federal law *On consumer cooperation* (consumer societies, and their unions) in the Russian Federation, No. 97-FZ, July 11, 1997.

²⁰ Federal law *On consumer credit cooperative of individuals*, No. 117-FZ, August 7, 2001.

FIGURE 1: LEGAL REGULATION OF CONSUMER COOPERATIVES ENGAGING IN MICROFINANCE ACTIVITIES

just the provisions of Article 116 RF CC (see Figure 1).²¹ Each of these federal laws establishes principles, restrictions, and specific characteristics of the creation and operation of cooperatives as well as the rights and responsibilities of their members.²²

The law *On credit cooperation (credit societies and their unions) in the Russian Federation* does not regulate specialized credit cooperatives;²³ rather, it recognizes the right of consumer cooperatives to borrow from their shareholders and allows them to extend credit to shareholders.²⁴ As a result, a number of consumer societies established in strict

accordance with the purpose defined by law have come to have microfinance as their main activity.

There are differences of opinion in the Russian microfinance community concerning the fact that several laws regulate essentially the same relations in different ways. Some MF practitioners believe that having a choice makes it possible to meet the specific needs of each individual organization. For example, many founders of MFIs in the form of a consumer cooperative with individual and corporate membership choose the law *On consumer cooperation (consumer societies, and their unions) in the Russian Federation*. In such cases, they do not use the word credit

²¹ On April 24, 2002, the State Duma Decree No. 2701-III adopted, in the first reading, the federal bill On credit cooperation. As of this writing (June 17, 2002), the draft was under preparation for the second reading.

²² See Chapter 2, section on the hierarchy of normative acts.

²³ Article 2 of the federal law *On consumer cooperation (consumer societies, and their unions) in the Russian Federation* does not extend its application to include credit cooperatives and does not allow using the phrase *consumer cooperative* in relation to credit cooperatives.

²⁴ Article 5 of the federal law *On consumer cooperation (consumer societies, and their unions) in the Russian Federation* mentions, alongside other rights of a consumer society, its right to borrow from its members and shareholders and other individuals, and to extend credit and advances to its members.

in the name of their cooperative, but they engage actively in microfinance.

Others believe that the fewer laws there are, the better, and that new laws only add to the confusion. Indeed, following the adoption, in 2001, of the law *On citizen consumer credit cooperatives*, supervisory authorities in many Russian regions demanded that local credit cooperatives incorporated earlier under the law *On agricultural cooperation* amend their charters in accordance with the new law (in particular, by abandoning corporate membership), and that they reapply for registration. Some credit cooperatives complied, while others having access to a legal review were able to defend their right to continue their activities under the law *On agricultural cooperation*.

It should be noted that credit cooperatives established under the above-mentioned laws have different names. Further in this chapter, we will distinguish between different credit cooperatives based on the following:

- Credit cooperatives established under the law *On agricultural cooperation: rural consumer credit cooperatives*;
- Cooperatives established under the law *On consumer cooperation (consumer societies, and their unions) in the Russian Federation: Consumer Societies*;
- Credit cooperatives established under the law *On consumer credit cooperatives of citizens: citizen consumer credit cooperatives*; and
- Cooperatives established under the RF CC that are not subject to the restrictions established by other federal laws: consumer cooperatives.

We will use the term *credit cooperative* when discussing MFIs incorporated in any of these forms of consumer cooperatives.

Founders and Members

Russian laws for founders and members of credit cooperatives establish numerous and diverse requirements and

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restrictions. Looking at Table 1, you will see that fewer restrictions are imposed on the number and nature of founders and members of consumer cooperatives and consumer societies. Both individuals and legal entities may cofound consumer cooperatives and consumer societies. However, in most cases, credit cooperatives are established as citizen consumer credit cooperatives or as rural consumer credit cooperatives in rural areas. The main reason for this choice is that the laws *On citizen consumer credit cooperatives* and *On agricultural cooperation* specifically mention the possibility of functioning as a specialized *credit cooperative*.

Currently, only rural consumer credit cooperatives have a legally defined right to operate as a *credit cooperative* with individual and corporate membership. Citizen consumer credit cooperatives sometimes admit managers, owners, or founders of small enterprises as their individual members in order to comply with the legal restriction, while loans extended to such individuals are, in fact, used to fund the business.

For the first time in Russian law, in 1995, following the adoption of the law *On agricultural cooperation*, organizations were allowed to have two categories of members²⁵: members and associate members. Article 14 of the law *On agricultural cooperation* permits rural consumer credit cooperatives to have associate members, if provided for in their charters. In cooperatives, there are two fundamental differences between members and associate members:

- Associate members can vote; however, the number of voting associate members at a general meeting must not exceed 20 percent of all members. When the number of associate members exceeds the maximum established by the law *On agricultural cooperation* and the cooperative's charter, a separate meeting of associate members elects a number of representatives to vote at the general meeting; and
- If the cooperative is liquidated, associate members have the right to withdraw their shares and the announced outstanding dividends before payment is made to full members of the cooperative.

Interestingly, to the best of our knowledge, credit cooperatives have not objected to associate membership as an undemocratic arrangement, regardless of the fact that some associate members may effectively be excluded from participating in decision making.

²⁵ Federal law *On agricultural cooperation*, No. 193-FZ, December 8, 1995.

TABLE 1. LEGAL REQUIREMENTS TO FOUNDERS AND MEMBERS OF CREDIT COOPERATIVES

	Founders and Members	Number of Founders	Number of Members	Nationality (country) of Founders and Members	Specific Requirements to Founders and Members	Associate Membership
Rural Consumer Credit Cooperative	Agricultural product producers: individuals age 16 and over, and/or legal entities. The charter may provide for membership of a number of persons who are not agricultural product producers. The law limits their number.	At least 15 individuals or 5 legal entities; a maximum of 2,000 individuals or 200 legal entities	At least 15 individuals or 5 legal entities; a maximum of 2,000 individuals or 200 legal entities	No restrictions	Members must be involved in the cooperative's economic activities. The charter may establish additional membership requirements	Associate members do not have to be involved in the cooperative's economic activity; they contribute their shares and receive dividends. If the number of associate members reaches a certain level defined by law and by the charter, they may participate in the general meeting of members through their representatives.
Consumer Societies	Individuals age 16 or older and/or legal entities	At least 5 individuals and/or 3 legal entities	No restrictions	No restrictions	Members and founders are usually linked by location.	None
Consumer Credit Cooperative	Individuals aged 16 or older	Between 15 and 2,000 individuals	Between 15 and 2,000 individuals	No restrictions	May be based on any type of community of individuals, including residence, occupation or profession, and so forth.	None
Credit Cooperative	Individuals aged 16 or older and/or legal entities	At least 2 individuals and legal entities	No restrictions	No restrictions	None	None

Virtually all rural credit cooperatives have associate members as well as full members.²⁶

In June 2003, Article 4 of the law *On agricultural cooperation* was amended by a provision stating that a corporate member of the cooperative may have more than one vote at a general meeting, if so provided by the cooperative's charter.

Issues that Require Improved Normative Regulation

For continued development of microfinance, a law is needed which would allow establishing credit cooperatives with corporate members. The legislation regulating credit cooperatives should be brought into a consistent system.

Establishment and Operation: Permitted Goals

From the perspective of permitted goals of establishment and operation, credit cooperatives may offer the most appropriate institutional form for microfinance activity. In most cases, the legislation states clearly and directly that credit cooperatives are established to meet the needs of their members, namely, to give and receive mutual financial assistance. However, different laws describe the activities authorized for credit cooperatives with varying degrees of clarity and detail.

When analyzing the data presented in Table 2, we need to be aware of the following:

²⁶ Many other credit cooperatives also use associated membership to a certain extent. For example, one consumer credit cooperative of individuals extends associate membership to shareholders with outstanding loans. They are restricted in their voting on issues concerning the cooperative's financial policy. The restriction is designed to protect the interests of other members and shareholders and the cooperative itself. In all other matters, associate members enjoy the same voting rights as others, depending on the amount of their shares or savings.

1. A credit cooperative enjoys all the rights accorded by law to all legal entities and to all noncommercial organizations, and also the rights given to it by a specific law.
2. If the specific law prohibits certain types of transactions, this restriction is in addition to those that apply to all legal entities or to all noncommercial organizations.

For example, provisions regulating consumer cooperatives and citizen consumer credit cooperatives say nothing about whether these organizations may borrow funds to meet their needs; in effect, this means that laws do not prohibit borrowing. Similarly, the RF Civil Code (RF CC) does not restrict borrowing regardless of the borrower's institutional form or the proposed use of the borrowed funds, unless the use of the funds is specifically stated in the loan agreement. Consequently, consumer cooperatives and citizen consumer credit cooperatives have the right to borrow, because this right is given to all legal entities. Therefore, the reaffirmation in a special law of a provision applying to all legal entities does not enhance rights that already exist. It is sometimes desirable, however, to reaffirm a provision to simplify practical application. For many regional organizations that do not have access to specialized legal services, the only way to prove they are allowed to engage in certain activities may be to clearly indicate a line in the law, and state, "This is a law about our organization. It states we may do this."

Specialized laws establish the following additional rights for certain types of credit cooperatives:

- Rural consumer credit cooperatives may save its members' money. The law does not, however, say what exactly is involved in *saving the members' money*. Nevertheless, given the generally accepted meaning of the phrase, the cooperative may keep its members' savings for the purpose of their accumulation.
- Citizen consumer credit cooperatives may, subject to an agreement, accept member savings as a contribution to a mutual credit fund used to onlend to cooperative members. The cooperative does not own private savings of the members, which are not subject to its obligations.
- Consumer societies and rural consumer credit cooperatives may extend credit to their members. Unfortunately, specialized laws fail to explain the meaning of *credit* for the purposes of these laws. The defini-

tion of credit given in Chapter 42, *Loan and Credit*, of the RF CC may not be used for purposes of these laws because the RF CC limits the range of lenders to banks and other credit institutions, which do not include consumer societies and rural consumer credit cooperatives.²⁷

Additional restrictions, as compared to those established for other cooperatives, are imposed only on citizen consumer credit cooperatives and rural consumer credit cooperatives and prohibit certain transactions with its members and nonmembers, individuals or organizations. In summary, we can conclude the following about the ability of citizen consumer credit cooperatives and rural consumer credit cooperatives to borrow and lend: (1) citizen consumer credit cooperatives have the same right as any other legal entity to borrow from individuals or organizations; (2) rural consumer credit cooperatives cannot borrow from individuals who are not members; and (3) both can lend only to their members.

Sometimes the question is raised whether a credit cooperative may offer its members other financial services, such as money transfers on their request, for example for payment of rent or taxes. The answer is clear for consumer cooperatives, consumer societies, and rural consumer credit cooperatives: the cooperative owns member shares, admission fees, and other contributions and keeps them in its bank accounts. A cooperative may not transfer payments on behalf of its members from its own funds. It becomes more complicated with citizen consumer credit cooperatives, which may keep member savings in its bank accounts without owning the money. Strictly speaking, where the agreement between the cooperative and its member signed upon receipt of the savings provides for the possibility of money transfers on behalf of the member, tax authorities or other recipients of payments cannot refuse to accept them. However, two problems may arise:

1. There may be technical difficulties in making payment orders (since the name of the cooperative rather than

Issues that Require Improved Normative Regulation

For continued development of microfinance, a law is needed which would allow for the establishment of credit cooperatives with corporate members. The legislation regulating credit cooperatives should be brought into a consistent system.

²⁷ See Chapter 4, Lending and Loan Security, for a comparison between a loan agreement and a credit agreement.

TABLE 2. REGULATION OF ATTRACTION OF FUNDS FROM COOPERATIVE MEMBERS

Consumer Co-op.	Allowed: Not Allowed:	(1) Combining shared property contributions of members No indication of direct prohibitions
Consumer Societies	Allowed: Not Allowed:	(1) Combining shared property contributions of members; (2) receiving admittance fees; (3) borrowing from members and other non-member individuals No indication of direct prohibitions
Rural Consumer Credit Co-op.	Allowed: Not Allowed:	(1) Combining shares contributed by members; (2) preserving members' money; (3) borrowing from members, associate members, credit institutions, and other organizations No indication of direct prohibitions
Consumer Credit Co-op. of Citizens	Allowed: Not Allowed:	(1) Receipt of member shares; (2) receipt of member savings by agreement No indication of direct prohibitions

REGULATION OF THE PROVISION OF SERVICES, INCLUDING FINANCIAL, TO COOPERATIVE MEMBERS

Consumer Co-op.	Allowed: Not Allowed:	No No indication of direct prohibitions
Consumer Societies	Allowed: Not Allowed:	(1) Engage in activities to meet the needs of shareholders; (2) provide loans to shareholders according to procedures established in the charter No indication of direct prohibitions
Rural Consumer Credit Co-op.	Allowed: Not Allowed:	(1) Provide credits and advances to members of cooperative (1) Loans to non-members (individuals or legal entities)
Consumer Credit Co-op. of Citizens	Allowed: Not Allowed:	(1) Loans to members; (2) conclusion of underwriting (guarantee) contracts at the request of, and on behalf of, its members; (3) provide consultation to its members (1) Loans to individuals who are not members of the cooperative; (2) commercial loans to businesses when the sum of the loan would exceed 50 percent of the total mutual financial assistance fund; (3) loans to legal entities; (4) acting as a guarantor on behalf of members or third parties

of the individual on whose behalf the payment is made would be indicated in the *payer* field of the payment form); and

- Since this activity is very similar to a banking operation (for example, maintaining bank accounts), it could be considered illegal without a license.

Issues that Require Improved Normative Regulation

Legislation regulating credit cooperatives should be brought into a consistent system

Management

The RF Civil Code does not establish general principles of governance and management for consumer cooperatives because they are generally understood. The provisions of specialized laws are generally consistent with the basic principles of the cooperative movement and they always

include democratic governance: one member-one vote, regardless of share amount.²⁸ This formal definition of equality does not always hold true in practice. Those members who can affect the organization's sustainability (for example, by withdrawing their share) have greater influence on decision making. To ensure effective equality, any individual share in citizen consumer credit cooperatives may not, by law, exceed 10 percent of the sum total of shares.

In citizen consumer credit cooperatives, the assembly of members is the highest governing body. In consumer societies and rural consumer credit cooperatives, either the general assembly of shareholders or the general assembly of their representatives may be the highest authority. Each law establishes specific quorum requirements for the general assembly: for citizen consumer credit cooperatives, at least 70 percent of members; for consumer societies, at least 50 percent of the members or 75 percent of the representatives; for rural consumer credit cooperatives, at least 25 percent of the members or 50 percent of the representatives.

²⁸ As mentioned earlier, in June 2003, a provision amending Article 4 of the law *On agricultural cooperation* stated that a corporate member of the cooperative may have more than one vote at a general meeting, if so provided by the cooperative's charter.

Citizen consumer credit cooperatives with a significant membership (more than 1,000) find it challenging both to secure space for their general assemblies and to ensure a quorum, because when a cooperative operates smoothly, without scandal or risk of collapse, most members are not interested in becoming involved in its management.

Special laws regulating citizen consumer credit cooperatives, rural consumer credit cooperatives, and consumer societies contain separate chapters with fairly detailed descriptions of the governing bodies required for each of these cooperatives. The descriptions cover the exclusive competences of the highest governing bodies and the quorum necessary for approving decisions. Each of these cooperatives must have a board. Whereas for a citizen consumer credit cooperative, the board is a governing body that manages the cooperative's operation between meetings of the member general assemblies, in rural consumer credit cooperatives and consumer societies the board is an executive body. The authority to resolve any issues whose resolution is not defined by law or by the charter as belonging to a higher authority in the hierarchy is included in the powers of the board and other executive bodies.

To varying extents, each specialized law indicates the need (or absence of need) for including members or shareholders in governance and management bodies. The law governing rural consumer credit cooperatives clearly states that members of the board must be members of the cooperative; however, it says nothing about the membership of the executive body. The law on consumer societies requires that the chairperson and members of the society council be chosen from shareholders with practical experience of credit cooperation, but it does not extend this requirement to members of the board. The law on citizen consumer credit cooperatives indicates that the Director need not be a member of the cooperative, so we may assume that other governance and management bodies should be composed of cooperative members only.

Sources of Asset Formation

In addition to using funding sources accessible to foundations, credit cooperatives may also accept shares, admittance fees, and other contributions from their members.²⁹ It would appear that credit cooperatives have more sources of funding available; however, most credit cooperatives underutilize these sources and receive the bulk of their funding from membership fees—a source common to all cooperatives.

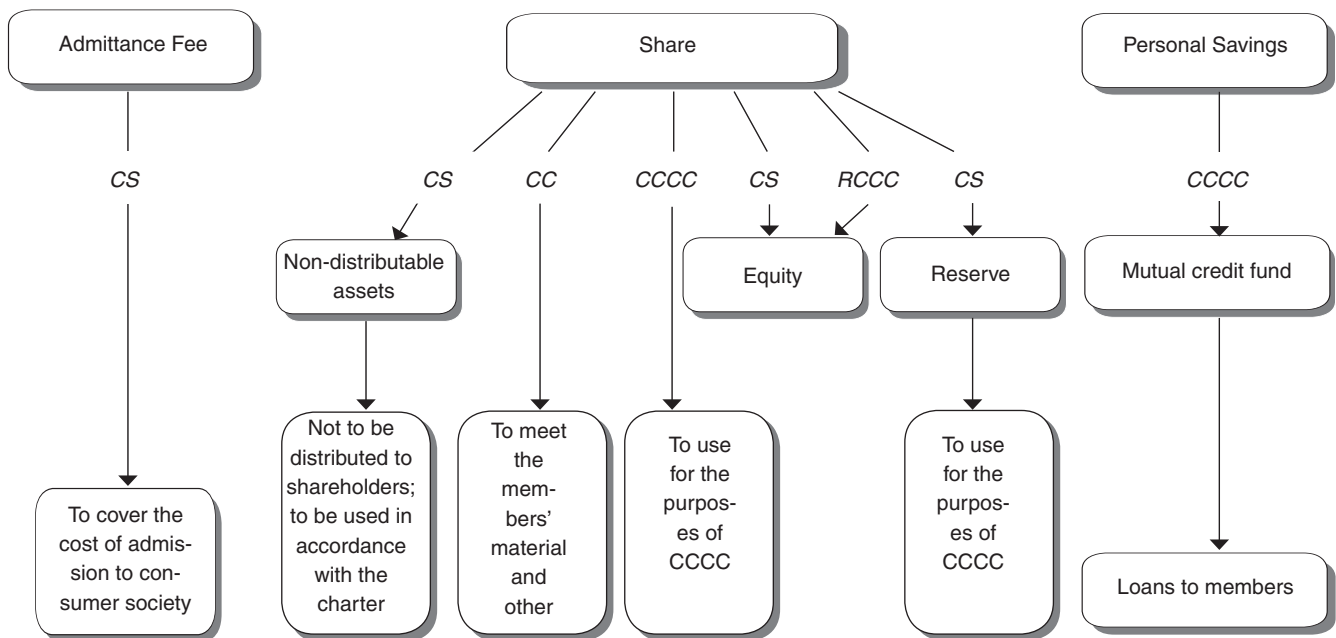
As mentioned, any legal entity may borrow from members and shareholders and from other individuals or organizations, whether or not a specialized law mentions this possibility expressly. However, the law restricts the scope of persons from whom rural consumer credit cooperatives may borrow by excluding individual nonmembers.

Credit cooperatives—unlike other MFIs, that may independently decide how to use their funds (subject to their stated goals and the purpose of funding, if so designated)—are limited in various respects in their use of admittance fees and other fees, as well as member savings (see Figure 2):

- Consumer societies may use admittance fees only to cover the costs of admitting a new member to the cooperative. They may not add admittance fees to the share fund and they do not return them if the member leaves the society. Since, from an accounting perspective, it is extremely difficult, if at all possible, to determine the exact cost of admitting a new member to a cooperative, this legal restriction on their use makes such fees less attractive to cooperatives.
- Personal savings in citizen consumer credit cooperatives may not be used for any purposes other than onlending to members. The cooperative does not own members' personal savings, as opposed to other contributions. While the savings may be used for the indicated purpose, these funds are not subject to any of the cooperative's obligations.³⁰ Previously, civil law did not contain provisions for the transfer of funds for use by another person or entity. Thus far, there have been no cases of judicial settlement of a dispute involving a debtor organization having part of its assets formed through borrowing from its members and, consequently, not subject to lien enforcement.
- Member shares represent the part of funding which credit cooperatives may use at their discretion to the greatest extent. The credit cooperative may use member shares to fund the its operation as stated in its charter, to form various reserves, and to cover losses. The legal provision that allows members of citizen consumer credit cooperatives to withdraw their share's value upon exit from the cooperative is rarely implemented. Every cooperative has assets essential to its operation, and cooperatives will do whatever they can to keep them. By law, rural consumer credit cooperatives and consumer societies may retain a portion of shares as nondistributable funds. To do so, these types of cooperatives should provide for the formation and use of nondistributable funds in their charters.

²⁹ See Chapter 4, section on grant-based finding of noncommercial organizations, for details of obtaining grants for cooperatives.

³⁰ Article 14, paragraph 3 of the federal law *On consumer credit cooperatives of individuals*, No. 117-FZ, of August 7, 2001.

FIGURE 2. USE OF FUNDS CONTRIBUTED BY CREDIT COOPERATIVE MEMBERS

Registration, Reporting, and Supervision

Credit cooperatives acquire the rights and responsibilities of legal entities following their registration. Laws regulating the activities of credit cooperatives do not impose any additional restrictions on the procedures of registration, reporting, or supervision of credit cooperatives as compared to other legal entities. Credit cooperatives pursue their main activities without a special authorization (license).

Cooperatives report to government authorities under the same procedures as other legal entities. Law establishes the reporting schedule. Cooperatives maintain accounting records, lists of members, minutes of meetings, and other internal documents in accordance with rules established by law and their own policies and procedures.

Credit cooperatives are obliged to form an audit commission (a supervisory board in rural consumer credit cooperatives). The audit commission (supervisory board) supervises the activities of the cooperative and its various bodies. Law does not establish any requirements about board members' qualifications, but cooperatives themselves may establish them in their charter or by internal acts.

As compared to other laws, the law *On agricultural cooperation* establishes additional requirements concerning the

procedure of supervision of rural consumer credit cooperatives: each cooperative must be a member of an audit union established specifically to audit member cooperatives and to offer them audit-related services. In the event of noncompliance, the cooperative is subject to liquidation by court.³¹

Citizen consumer credit cooperatives have the right, but not the obligation, to establish self-regulation bodies—associations of legal entities. Such self-regulation bodies may have the following authority:

- The appropriate federal executive agency may request them to monitor citizen consumer credit cooperatives to determine their compliance with law;
- They may appeal to an appropriate federal executive agency and to other authorities to report violations or hindrances to the activities of cooperatives; and
- They may represent the interests and defend the rights of cooperative members and unions in courts and arbitration.

As stated above, RF subjects also have a certain degree of control over the activities of cooperatives.³² For instance, according to the Volgograd Oblast law *On state supervision and oversight of citizen consumer credit cooperatives*, No. 706-OD, of May 27, 2002, the Volgograd Oblast

³¹ Article 31 of the law *On agricultural cooperation*, No. 193-FZ, December 8, 1995.

³² See Chapter 1, section on regulation at the level of RF subjects.

Economic Committee conducts comprehensive and thematic reviews of consumer credit cooperatives to determine their compliance with the law, as well as reviews prompted by the appeals of shareholders, government agencies, or social organizations.³³ Based on the findings of such reviews, the Economic Committee provides recommendations to cooperatives concerning the correction of deficiencies and supervises the implementation of corrective action.

Prudential Supervision and Financial Performance Standards of Cooperatives³⁴

By law, citizen consumer credit cooperatives and rural consumer credit cooperatives must establish financial performance standards either through their charter or a decision of the general assembly. The following financial performance standards and ratios are obligatory:

- For consumer credit cooperatives:
 - The amount of member shares and personal savings;
 - The cooperative's assets and total liabilities; and
 - The amount of reserves and the mutual financial assistance fund.
- For rural consumer credit cooperatives:
 - The amounts of shares and reserves;
 - The cooperative's own capital and assets on its balance sheet;
 - Balance sheet assets and current liabilities;
 - Maximum loan made to an individual borrower and the cooperative's assets; and
 - Current balance of the mutual financial assistance fund (which must not exceed 50 percent of its total amount).

Prudential standards established by Russian law for credit institutions do not apply to credit cooperatives.

To ensure their financial sustainability, credit cooperatives sometimes develop their own standards based on banking

limits and restrictions established by the Russian Central Bank. Credit cooperatives cannot apply directly some of the norms established for banks. For example, credit cooperatives cannot observe minimum authorized capital requirements, because credit cooperatives are established as consumer cooperatives, which are noncommercial organizations without authorized capital.

When making decisions concerning their reserves, credit cooperatives are aware of the fact that the tax code does not allow MFIs—as distinct from banks—to create reserve provisions for loan losses accumulated due to nonpayment of interest.

Issues that Require Improved Normative Regulation

The issue of prudential regulation of credit cooperatives requires careful consideration by the state and the microfinance community.

Foundations³⁵

As mentioned, foundations may be established under the law on noncommercial organizations. In addition, it is possible to establish a *social foundation* under the law on *social associations*.³⁶ In principle, there is no difference between a foundation and a social foundation. Very often, founders and managers are not sure to which category their own foundation belongs. This duplication results from the almost simultaneous adoption of two different laws regulating certain types of noncommercial organizations; they came only six months apart. Foundations established under the law on noncommercial organizations are more common. One reason is that while registration takes at least a month for a *social foundation*, it takes no more than five days for a foundation. The longer procedure comes from the fact that after a federal or local justice authority makes the decision to register an association, the tax authority should include it in the state register of legal entities.

³³ Volgograd Oblast law *On state supervision and oversight of Consumer credit cooperatives of individuals*, No. 706-OD, May 27, 2002.

³⁴ Prudential supervision involves a set of limits and restrictions imposed on financial institutions aimed at ensuring the stability of the financial system and protecting depositors. It is not always possible to draw a clear boundary between prudential and non-prudential regulation. Sometimes, the same provision may serve both prudential and nonprudential purposes. Prudential regulation provisions include: maximum risk limits for financial institutions, reserve provisions to ensure liquidity and to cover possible losses, and other requirements where noncompliance may affect the organization's financial situation or the reliability of assessment of its financial operation. According to Article 56 of the federal law *On the Central Bank of the Russian Federation (the Bank of Russia)*, the RF CB is an agency of banking regulation and banking supervision. The main purposes of banking regulation and supervision are to ensure stability of Russia's banking system and to protect the interests of depositors and creditors.

³⁵ The Russian term *fond* can be translated both as *fund* and *foundation*. In this paper, *foundation*, in most cases, indicates a certain institutional and legal format, while *fund* refers to specific institutions, such as SME Support Fund, Pension Fund, and so on.

³⁶ Federal law *On social associations*, No. 82-FZ, May 19, 1995.

A characteristic distinctive of foundations is a more complicated liquidation procedure as compared to other non-commercial organizations: they cannot be liquidated by an act of their founders or governing bodies. Only the court can undertake their liquidation, based on an application by concerned individuals, and only in the following cases:

- The foundation's assets are insufficient for attaining its goals and it is unrealistic to expect it to obtain the required additional assets;
- The foundation's goals cannot be attained, and it is impossible to change them; and
- The foundation deviates from its goals stated in its charter.³⁷

We will address the law and practice related to foundations established under the law on noncommercial organizations later in this report.

Issues that Require Improved Normative Regulation

There is a need to systematize the legislation regulating the activities of noncommercial organizations.

Founders

There are no legal restrictions concerning the founders of such organizations; they may be established by individuals and/or legal entities, Russian nationals or foreign citizens, Russian or foreign organizations. There may be any numbers of founders or just one founder—individual or organization.

The Russian Federation, RF subjects, and municipalities acting on the same terms and with the same rights as other founders may cofound foundations. Government agencies or local self-government bodies will act on behalf of such founders, where appropriate.³⁸ The section of this paper entitled *State and municipal SME support funds* will look at the details of establishing and operating foundations cofounded by the state or municipalities.

Foundations, like other noncommercial organizations, do not have authorized [equity] capital. Since no minimum

capital is required, it is possible to launch a foundation without any assets whatsoever. Thus, the founders' role may be limited to their attending the founding meeting; they are not required to make any property contribution to the newly established foundation. The founders are not responsible for the foundation's obligations; likewise, the foundation is not responsible for those of its founders. The founders have no property rights in relation to the foundation: they cannot receive any part of the foundation's profits or claim the property they have contributed to the foundation.

Founders may include provisions in the charter allowing them to participate directly in the management of the foundation throughout its existence. Where founders do not want direct control over the foundation's activities, but wish to retain their links with the organization, they may provide for their membership on the Board of Trustees, that is, the supervisory body of a foundation. Some founders withdraw from any participation in the foundation immediately after its incorporation. In such case, the charter and other founding documents contain provisions allowing the foundation's governing body to renew and change its membership through an internal procedure.

Establishment and Operation: Permitted Goals

The foundation is legally defined as a noncommercial organization, that is, an organization that cannot pursue the generation of profit as its main goal and cannot distribute profit to its members. Noncommercial organizations are allowed to engage in a business operation only to the extent that it promotes the goals for which they were created, and the operation is consistent with these goals.³⁹ Certain types of activities require a license; law defines the list of such activities.

A foundation is a legal entity with certain rights and obligations related to its chartered activity. Foundations may be established for social, charitable, cultural, educational, and other purposes that serve the public.

The law does not expressly mention microfinance as an activity permitted to foundations. However, microfinance can be defined as an activity that meets social needs and serves the public good by supporting small business, developing entrepreneurship, creating jobs, decreasing social tension, and improving living standards.

³⁷ Article 18, paragraph 2, federal law On noncommercial organizations, No. 7-FZ, January 12, 1996.

³⁸ RF CC Articles 124, 125.

³⁹ Business [entrepreneurial] operations are defined as independent activities undertaken at one's own risk and aimed at the generation of profit through the use of property, sale of products, or delivery of services by individuals registered for such purposes following an appropriate legal procedure (RF CC Article 2, paragraph 1).

At the early stages of microfinance in Russia a question commonly asked was whether lending requires a license when it is the main activity of an organization. MFIs have successfully defended the right to deliver their services without a license. Foundations rightly argue that according to the law *On banks and banking*,⁴⁰ the activity of investment (use) of funds should be considered a banking activity and subject to licensing only when the activity involves the use of funds which have been attracted as deposits (on-demand and timed) from individuals or legal entities.⁴¹

Issues that Require Improved Normative Regulation

Legal provisions at the federal level are needed to secure state support for the provision of microfinance services through organizations established under various institutional and legal formats.

Management

Russian law has very liberal rules about governing bodies in a foundation; there are virtually no restrictions. It is established that the foundation charter should define the governance and management procedures.⁴²

A charter may provide for collective or individual governance. The membership of a governing body may be designated by founders or regulated through an internal procedure. The charter may provide for a simple management system, where all decision making is delegated to a single body, or for a complex, multitiered management structure.

Where a foundation has more than one governing body, the law defines the following decisions as the exclusive authority of the highest body:

- Amending the charter;
- Defining priority areas of activity, principles of generation, and use of assets;
- Establishing and dismissing executive bodies; and
- Reorganizing a foundation.

If permitted by the founding documents, the highest authority may delegate to a permanent executive body

approval of the annual report, balance sheet, and financial plan; decisions related to the establishment of branches and representative offices; and participation in other organizations.

In addition to management bodies, a foundation is required to have a Board of Trustees. The charter defines its procedures.

The Board of Trustees supervises the foundation's activities, decision making and implementation, the use of funds, and compliance with legislation. The Board of Trustees works free of charge; its members are volunteers.

The above provisions allow founders to establish governing bodies that suit the foundation's purposes and allow it to operate in the most efficient way. In reality, however, founders do not always know how to use this opportunity. For example, it is common for foundations to establish decision-making procedures that are totally dependent on the founders. In the case of one or two founders, individual or corporate, decision making may be blocked because of an adversity, such as the liquidation of a corporate founder, the death of an individual, or other reasons which prevent a founder from involvement.

As a way out of such situations, the law provides the possibility to amend the charter through a judicial procedure. The Board of Trustees or any other body of the foundation may apply to a court in such cases.⁴³

Sources of Assets

Microfinance institutions established in the form of foundations have the following sources of funding available to them:

- Interest earned on loans;
- Technical or humanitarian assistance received from other organizations or individuals and used for designated purposes, grants, donations, and charitable contributions;
- Revenues generated by entrepreneurial activities and services, such as consulting or training;
- Revenues not related to the sale of goods or services, that is, from lease of property or from currency exchange rate fluctuations;⁴⁴

⁴⁰ Federal law *On banks and banking*, No. 17-FZ, February 3, 1996.

⁴¹ See Chapter 2, section on banks and other credit institutions, for details.

⁴² Article 29 of federal law *On noncommercial organizations*, No. 7-FZ, January 12, 1996.

⁴³ RF CC Article 119, paragraph 1.

⁴⁴ See Chapter 4 for treatment of the issues of taxation.

- Borrowed funds;⁴⁵ and
- Credit received from Russian or foreign banks.

Since under Russian law foundations are organizations without membership, they cannot use membership fees as a source of funding.

Access to credit is problematic for most foundations, because they cannot provide the security (collateral) required by banks. Some MFIs use grants received in foreign currency from international or foreign organizations as collateral. Special funds providing security guarantees might effectively address the problem of access to credit. Russian laws do not expressly prohibit the establishment of such funds, but they do not provide for their establishment either.

Recently, Russian legislation on currency regulation and supervision has gone through significant changes. In the past a special authorization from the Russian Central Bank was required to obtain a credit in foreign currency for more than 180 days; currently there are no restrictions of such borrowing. According to the recent directives of the Russian Central Bank, Russian legal entities may perform foreign currency transactions under credit agreements (loan agreements) with foreigners without restrictions, subject to the provision of documents required by CB RF normative acts.⁴⁶ The amended normative regulation may open up new sources of funding for Russian MFIs.

Given the above, grants by international and foreign organizations remain the most important source of assets for foundations (and largely the only source of funding for new foundations). At later stages, foundations develop a

Issues that Require Improved Normative Regulation

There is a need to study carefully the issue of creating normative provisions for the establishment of special funds providing security guarantees.

sustainable income generated by their main microfinance operation, that is, interest on loans.

Registration, Reporting, and Supervision

A foundation is considered as incorporated and granted the status of a legal entity as of the moment of its registration with government authorities in accordance with the law on state registration of legal entities.⁴⁷ The law does not establish any advantages or more complicated procedures for the registration of foundations as compared to other types of organizations. Foundations are registered with local tax authorities at the location of their permanent executive body; the procedure is completed within five days of the filing of application and founding documents.

Like any other noncommercial organization, a foundation keeps accounting records and files statistics reports following standard procedures established by Russian laws. Foundations report on activities to statistics agencies, tax authorities, its founders, and others, as prescribed by law and its charter and founding documents.

The amount and composition of a foundation's income; information about its assets, expenditures, number and positions of its staff, and the amount of their remuneration; and the use of volunteers in the foundation's activities is public information and may not be considered a commercial secret.

Foundations must publish annual reports on the use of their assets, and since 2001, they must perform annual audits of their records and financial reports.⁴⁸

The last two requirements can be an excessive burden for emerging foundations, which do not have sufficient resources of their own and cannot spend their grant funds for these purposes.

⁴⁵ When asked whether lending from borrowed funds should be regarded as banking activity, some practitioners--experts and officials--answer that "lending from one's own funds is not banking activity." This answer is evasive, to say the least, because for purposes of financial reporting, funds borrowed under a loan agreement are not considered the organization's own funds, while according to civil law, money handed over by the lender become the borrower's property. (Article 807 RF CC). See Chapter 3, section on loans and credit, for more details.

⁴⁶ CB RF Directive, *On the application of some Bank of Russia normative acts in the sphere of currency regulation and supervision*, February 14, 2002, No. 1110-U.

⁴⁷ Federal law *On state registration of legal entities*, No. 129-FZ, August 8, 2001.

⁴⁸ Article 7 of the federal law *On auditing*, No. 119-FZ, August 7, 2001.

There are no specific legal requirements concerning the supervision of foundations engaging in microfinance as their main type of activity.

State and Municipal SME Support Funds

Legal foundations for the establishment and operation of state and municipal funds are stipulated in the federal law *On state support of SME in the Russian Federation*.⁴⁹

Currently, 77 of 89 RF subjects have established oblast or republic-based SME support funds. It is realistic to consider the process of establishing SME support funds as close to completion. However, municipal SME support funds are currently number fewer than 200 and they have not been created in all municipalities; their creation continues.

Founders

As follows from the names of state and municipal funds, state and municipal authorities are involved in their establishment.

By law, their respective share in the charter capital must be at least 50 percent. This requirement, cannot be met, however, as these funds, being noncommercial organizations, do not have charter capital. Rather than share in the capital, the number of founders can determine the government's participation. In this case, a 50-50 percent division of the charter capital would be comparable to two cofounders establishing an organization. With this assumption, state funds with one or more founders coestablished by executive authorities in RF subjects meet the legal requirement. Most SME support funds that are currently operating have one founder, the appropriate executive authority in the region.

Municipal funds do not always observe the principle of having two cofounders. Very often, in addition to local self-government, founders include Oblast-based SME support funds, small business development centers, business incubators, and so forth. Moreover, material contribution of local authorities is often symbolic rather than real and does not make any tangible difference to the fund's total assets. However, funds cofounded by local self-government automatically receive the status of municipal fund at their registration.

Issues that Require Improved Normative Regulation

The law on state support of SME in the Russian Federation needs to be improved.

Establishment and Operation: Permitted Goals

The purpose of state and municipal funds is to finance programs, projects, and events that promote SME development. The law lists eight main objectives of SME funds, including making loans to implement de-monopolization programs and refocusing production to promote competition and fill local markets with consumer products.

The objectives and functions of each individual state or municipal fund are determined in their charters, which have to be approved by regional or municipal authorities. Many, although not all, state and municipal funds run SME lending programs.

State and municipal funds started their lending operations at approximately the same time as other foundations that run lending programs as the main focus of their work. Nevertheless, as opposed to other funds, their operations did not draw nearly as much attention and did not cause concern with the supervising authorities. Possible reasons are, first, the fact that these funds were established by authorities, or at least with their involvement; and second, that the law specifically gives state and municipal funds the right to extend discounted credit, interest-free subsidies, and short-term loans to SME without the need for a banking license.⁵⁰

Management

The procedure for their establishment does not differ from those of other foundations. Everything said above about governance procedures in other types of foundations also applies to municipal and state funds.

Sometimes, Boards of Trustees and the Director govern state and municipal funds. Strictly speaking, the Board of Trustees is a supervisory, rather than governing, body, as established by the Civil Code and the federal law on voluntary associations; in particular, it oversees decisions made by other bodies.⁵¹

⁴⁹ Federal law *On state support of SME in the Russian Federation*, No. 88-FZ, June 14, 1995.

⁵⁰ Article 8, federal law *On state support of SME in the Russian Federation*, No. 88-FZ, June 14, 1995.

⁵¹ Article 7, paragraph 3, federal law *On noncommercial organizations*, No. 7-FZ, January 12, 1996.

In that case, the Board of Trustees is the body that combines the functions of the highest governing body and the supervisory body, with the following functions:

- Reviews and determines the main directions of the fund's activities, principles of generation, use, and disposal of its property;
- Amends the charter;
- Approves annual reports and annual balance sheets;
- Approves the budget and any amendments to the budget;
- Approves the payroll and the number and positions of staff;
- Makes the decision to set up branches and open representative offices;
- Makes the decision to reorganize the fund;
- Makes the decision to start liquidation proceedings in court;
- Designates an independent auditor and hears and approves audit reports;
- Reviews and makes decisions on the findings of annual internal and external audits;
- Approves the procedure for selecting SME programs and projects to be funded;
- Makes the decision to participate in business partnerships and societies, and in noncommercial organizations; and
- Implements other functions involved in the supervision of the fund's executive bodies.

The Director is in charge of the day-to-day management of the fund in accordance with the charter; the Director reports to the Board of Trustees.

When founders wish to continue to be in control of the activities of the fund after its establishment, they provide in the charter for their right to approve the Trustees and to appoint the Director. In some other cases, their involvement is limited to the initial establishment of the Board of Trustees, whereupon all changes of its membership and the appointment of the Director are effected by the Board itself.

Ironically, there is no direct relation between the amount of government or municipal funding and the involvement of such authorities in its management. The regional government's position on this issue seems to play a more important role.

Sources of Assets

State and municipal funds may use the same sources as other foundations to generate income, but access to government funding is of special relevance to them.

Government funding usually comes in the form of subventions⁵² and subsidies.⁵³ Regional and local subventions and subsidies are based on specific government programs, regional laws, or decisions of local self-government.⁵⁴

Unfortunately, the provisions and decisions are not always implemented; it is not infrequent for allocated funding not to be delivered, or not to be delivered in full.

State and municipal funds keep the proceeds from interest on loans, leasing of property, and revenues generated by other activities, and use them to pursue goals and objectives permitted to them by the law on state support of SME in the Russian Federation and by their charters.

Registration, Reporting, Supervision

State and municipal funds follow the same registration procedures as other foundations. In addition to reporting requirements legally established for all funds, the receipt and use of government funding requires the respective part of the budget to be endorsed by the government agency which disbursed the funding; it also involves additional reporting on the use of government funds. According to the RF Budget Code, regional and municipal finance authorities supervise the use of government funding, in particular its consistency with the designated purpose.

Mutual Credit Societies, Autonomous Noncommercial Organizations, Noncommercial Partnerships, Associations

One of the effects of the adoption of the law *On state support of SME* was the emergence of a new type of MFIs, namely, small business mutual credit societies. The law allows setting up such societies for the purpose of accumulating the participants' contributions as a way of offering financial assistance to those members who are currently in need.⁵⁵ The law does not define or describe the institutional and legal format for mutual credit or guarantee societies, so depending on their founders (members), they are established either as citizen consumer credit cooperatives or as consumer societies. Consequently, the legal implications for mutual credit societies will be determined by their respective institutional form.

⁵² Subvention is free and gratuitous funding from the state budget provided for specific designated purposes.

⁵³ Subsidy is matched funding from the state budget provided for designated purposes.

⁵⁴ See *Budget Code of the Russian Federation*, No. 145-FZ, July 31, 1998.

⁵⁵ Article 12, federal law *On state support of SME in the Russian Federation*, No. 88-FZ, June 14, 1995.

Sometimes, though not very often, MFIs are established as autonomous noncommercial organizations or noncommercial partnerships. These forms are very convenient for microfinance operations. The fact that MFIs rarely use autonomous noncommercial organization as an institutional form is hard to explain; prejudices or stereotypes may be the only reason.

There are virtually no provisions specific to autonomous noncommercial organizations except some restrictions of employees' membership in the governance: paid staff cannot make up more than one-third of the membership of the highest collective governing body in an autonomous noncommercial organization. Autonomous noncommercial organizations do not have members; they can be founded by any number of individuals and/or legal entities. The law describes their goals in very broad terms, so microfinance may well be their main area of activity. Autonomous noncommercial organizations may use the same sources of funding as foundations, except receiving donations.⁵⁶ They are not required to publish annual reports or to have annual audits.

Noncommercial partnerships are membership-based noncommercial organizations. Individuals and/or legal entities establish them for the pursuit of socially beneficial purposes; therefore, microfinance may be one of such purposes. Like any membership-based organization, its highest governing body is a general meeting of members. Its registration, reporting, and supervision of its operation do not have any specific requirements, as compared to other organizations. This institutional form may be of interest to founders who plan to make important material contributions to the organization's assets. By law, unless otherwise established by its charter or other founding documents, a member of the partnership may withdraw its share of the property or its worth, except membership fees.

Russian law defines associations (or unions) as institutional forms with corporate membership only.⁵⁷ There may be associations of commercial organizations or associations of noncommercial organizations. The possibility of establishing an association of commercial organizations—small businesses—for delivering microfinance services seems doubtful for economic reasons and because of the Civil Code requirement: if members decide that the association will engage in entrepreneurial activities (which

may include commercial lending), this association must transform into a business partnership; alternatively, it may establish, or participate in, such a partnership or society for these purposes.

Branches of International or Foreign Organizations

International and foreign organizations can assist in the development of microfinance in Russia not only by supporting Russian MFIs established with or without their participation, but also by opening their branches and representative offices in Russia.

A representative office has fewer rights than a branch. A representative office only represents and protects the rights of the organization that established it. A branch of a foreign or international organization may perform all or some of the functions of the main organization, including representative functions.

Representative offices and branches operate on the basis of provisions approved by their corporate founders. Relevant governing bodies of their corporate founder—a foreign or international organization—appoint managers of representative offices and branches. Therefore, a foreign (international) organization may determine and change at its discretion the types and spheres of operation of its branch (representative office).

Branches and representative offices of foreign (international) MFIs may use the same sources for their assets as Russian MFIs, including loan interest, proceeds from business operations, other income not related to sales, borrowed funds, credit, and donated property. In addition, they may have property contributed by their corporate founder, a foreign or international organization.

Branches and representative offices established in Russia are recorded in the Unified State Registry for a period of up to three years; the record is based on permission to open a branch (representative office) which, in turn, is based on the documents submitted by the corporate founder. When the term of permission expires, it may be extended.

The amount and schedule of reporting to government agencies and supervision of the activities of branches and representative offices of foreign organizations depend on

⁵⁶ Article 582 of the Russian Civil Code does not mention autonomous noncommercial organizations among those that are allowed to receive donations.

⁵⁷ Article 121, RF CC.

the type of their corporate founder and the scope of powers of the branch or representative office.

Commercial Organizations

As opposed to noncommercial organizations, which may be established in forms provided by the Civil Code and other federal laws, commercial organizations may be established only in those institutional forms that are enumerated in the Civil Code. Figure 3 shows their diversity.

Given that commercial organizations, with the sole exception of unitary enterprises,⁵⁸ are allowed to engage in any activity which is not expressly prohibited by law,⁵⁹ one would not expect any problems with legalizing a microfinance operation as a commercial company.⁶⁰

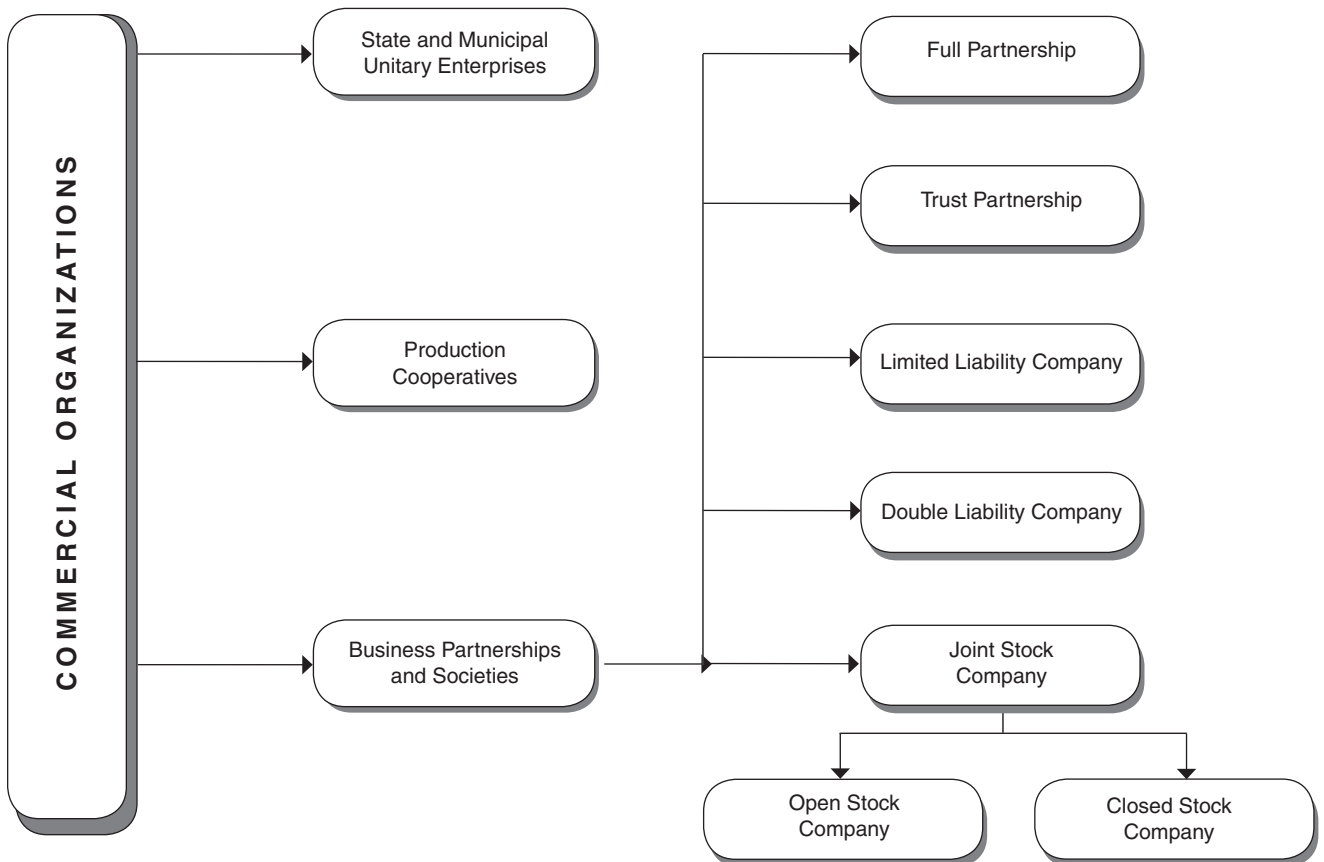
However, Russian microfinance sector practitioners are cautious about establishing a commercial organization with the main purpose of delivering microfinance services

without a banking license. Although the idea of setting up a *commercial MFI* has re-emerged from time to time, we do not know of any example of such a project being implemented. There are two main reasons why no *commercial MFIs* have been set up:

1. Microfinance requires specialized skills and generates, on average, lower revenues than many other operations; and
2. Commercial MFIs will probably have to fight for their right to lend without a banking license, just as their noncommercial colleagues had to do.

Given the above, and the fact that commercial organizations do not have access to some important sources of funding such as membership fees, donations, targeted support of their chartered activities—as well as the fact that international donors are not inclined to make grants or provide technical assistance to commercial companies—it

FIGURE 3. FORMS OF COMMERCIAL ORGANIZATIONS



⁵⁸ Only state and municipal enterprises may be established as unitary enterprises. The assets of a unitary enterprise remain state or municipal property used by the enterprise, but not owned by it. The RF CC and by the federal law on state and municipal unitary enterprises establishes the legal status of unitary enterprises. The scope and purpose of operation of unitary enterprises are defined in the charter (Article 113 RF CC).

⁵⁹ RF CC Article 49.

⁶⁰ The same provision applies here, that certain types of activities listed in the law may be performed only by authorized (licensed) legal entities.

is easy to understand why currently, in Russia, there are no commercial organizations engaging in microfinance as their main activity.

Certain characteristics of state and municipal unitary enterprises make this institutional form attractive for microfinance operations.

- Unitary enterprises are set up, in particular, to meet social needs;⁶¹
- Since unitary enterprises are established by an act of the authorized state agency or local self-government body, endorsing the objective and goals of the operation stated in its charter, we can safely assume that microfinance operations performed by this type of company will not trigger too many reviews or judicial proceedings; and
- Unitary enterprises have access to an additional funding source; they stand a much better chance of receiving subventions, subsidies, and credit from the state budget than other commercial companies.

We should also mention those provisions regulating unitary enterprise that may hinder their microfinance operations. Article 8 of the law *On state and municipal unitary enterprises* says that unitary enterprises may not, without the property owner's consent, perform transactions that involve lending. This provision may be interpreted as a requirement to obtain consent on each particular loan, which makes microfinance services impossible. Alternatively, it may be interpreted as a requirement to obtain a general consent specifying the amounts, maturities, clients, and so on, which makes microfinance services possible.

Banks and Other Credit Institutions

According to Russian legislation, credit institutions are incorporated as economic unions.⁶² Credit institutions have the right to perform banking operations as authorized by special licenses issued by the RF Central Bank.⁶³ The list of banking operations is determined by the law *On banks and banking*. Credit institutions include banks and nonbank credit institutions.

Banks have an exclusive right to perform the following banking operations: accepting deposits from individuals and legal entities; placing [investing] such deposits on its own behalf and at its own expense; and opening and maintaining bank accounts for individuals and legal entities.

The law does not differentiate between general and specialized banks; it does not establish special procedures for banks that deal with certain categories of clients or perform certain operations. The types of banking operations that a specific bank may perform depend on the combination of licenses it has obtained, which may vary from bank to bank.

Nonbank credit institutions are allowed to perform certain banking operations as established by the RF CB. Currently, nonbank credit institutions may perform cash clearing operations, organize collecting procedures, and engage in deposit and credit operations (nonbank credit and deposit organizations [NDCO]).

The full official name of a credit institution must indicate the type of operation, by mentioning whether it is a bank or a nonbank credit organization, and its institutional and legal form. Credit institutions may add to this required information; for example, KMB Bank's formal name—Commercial Bank for Small Business Credit (closed stock company)—also indicates the target group of clients, that is, small business. The formal name of Sberbank—Joint Stock Savings Bank of the Russian Federation (open stock company)—indicates that the bank takes deposits (captures savings) and operates over the entire Russian territory.

The normative acts which specifically regulate banking are the federal law on banks and banking,⁶⁴ the federal law on the Central Bank of the Russian Federation (Bank of Russia),⁶⁵ and acts issued by the RF CB as part of its statutory function of banking regulation and supervision within its sphere of competence.

The forms of credit institutions that may be used to deliver microfinance services are banks and NDCO.⁶⁶

⁶¹ Article 8, paragraph 4, federal law *On state and municipal unitary enterprises*, No. 161-FZ, November 14, 2002.

⁶² Figure 3 presents the place of business societies in the Russian system of legal entities.

⁶³ Article 1, federal law *On banks and banking*, No. 17-FZ, February 3, 1996.

⁶⁴ Federal law *On banks and banking*, No. 17-FZ, February 3, 1996.

⁶⁵ Federal law *On the Central Bank of the Russian Federation (Bank of Russia)*, No. 86-FZ, July 10, 2002.

⁶⁶ This paper deals only with the formal possibility of delivering microfinance services, with no regard as to the feasibility of such an operation in each particular case.

Banks

Founders

Both individuals and legal entities may establish a credit institution, provided there are no legal restrictions on their participation in credit institutions.⁶⁷ For example, unitary enterprises may not be founders of credit institutions.⁶⁸ A noncommercial organization may participate in the establishment of a credit organization unless laws regulating this type of organization forbid it from participating in business societies.⁶⁹ If a credit organization with foreign investments is established, prior permission is needed for this particular foreign organization to participate in the establishment of a Russian credit organization.⁷⁰

Credit institutions established as an economic union may have only one founder. A joint stock company may not be founded solely by another commercial entity consisting of one individual. The number of founders in a closed stock company and a limited liability company may not exceed 50.⁷¹

A legal entity—the founder of a credit institution—must be financially sustainable; it must have sufficient resources to contribute to the newly formed credit institution’s charter capital; it must have been operational for at least three years and must have met its obligations before the federal and regional budgets for the previous three years. Procedures and criteria for assessing financial sustainability of corporate founders of credit institutions are described in RF CB normative acts; the Central Bank may request any information from a credit institution or its founders concerning the financial situation and activities of any entity or individual that may directly or indirectly influence the decision making of a credit institution or its founders.

RF CB has control over the concentration of a credit institution’s stock; an individual or group wishing to acquire more than 5 percent of a credit institution’s stock must notify RF CB, while a purchase of more than 20 percent requires prior authorization from RF CB.

The founders of a bank may not divest themselves within three years of its incorporation.

Establishment and Operation: Permitted Goals

Banks may be licensed to perform banking operations. The law defines the following transactions as banking operations:

1. Capturing deposits from individuals and legal entities (both demand and timed deposits);
2. Investing deposits received from individuals and legal entities, on its own behalf and at its own cost;
3. Opening and maintaining bank accounts for individuals and legal entities;
4. Performing cash clearing operations on behalf of individuals and legal entities, including correspondent banks, on their bank accounts;
5. Collecting cash, bills, payment, and clearing documents; delivering cash services for individuals and legal entities;
6. Purchasing and selling of foreign currency in cash and clearing operations;
7. Attracting and investing deposits of precious metals;
8. Providing bank guarantees; and
9. Performing money transfers on behalf of individuals without opening bank accounts (except postal money orders).

In addition to licensed banking operations, a bank may perform other transactions consistent with Russian law, in particular:

- Guarantee third parties’ obligations; and
- Exercise trust management of funds and other assets under agreements with individuals or legal entities.

Credit institutions are not allowed to engage in production, trade, and insurance.

⁶⁷ RF CB Instruction on the application of federal laws regulating the incorporation of credit institutions and the issue of banking licenses, No. 75-I, July 23, 1998.

⁶⁸ Article 6, federal law *On state and municipal unitary enterprises*, No. 161-FZ, November 14, 2002.

⁶⁹ See Chapter 5, The possibility of transformation and participation in the establishment and activities of other organizations.

⁷⁰ See CB RF regulation of the specifics of the establishment of credit organizations with foreign investments and the procedure for obtaining a prior permission from the Bank of Russia for increasing the equity capital of an established credit organization through foreign contributions No. 437, April 23, 1997.

⁷¹ Article 10, federal law *On joint stock companies*, No. 208-FZ, December 26, 1995

The types of banking operations permitted to a particular bank are indicated in its license. A newly formed bank may obtain the following licenses:

- License to perform banking operations in rubles, without attracting deposits from individuals;
- License to perform banking operations in rubles and foreign currency, without attracting deposits from individuals; and
- License to attract and invest deposits of precious metals.

A bank wishing to expand its scope of operation may obtain the following banking licenses:

- License to perform banking operations in rubles and foreign currency, without attracting deposits from individuals;
- License to attract and invest deposits of precious metals;
- License to accept deposits in rubles from individuals; and
- License to accept deposits in rubles and foreign currency from individuals.

A general license may be issued to a bank already licensed to perform all types of banking operations in rubles and foreign currency, provided it meets the RF CB capitalization requirements.

A bank with a general license may open branches abroad, following an established procedure, and/or purchase shares (stock) in equity capital of foreign credit institutions.

Management

In 2001, the law *On banks and banking* was amended by an article on credit institutions' governing bodies; under the amendment, governing bodies of credit institutions include, alongside a general meeting of its founders (members), a Board of Directors (Supervisory Board), an individual executive authority (executive officer), and a collective executive authority.

The executive officer and vice-executives, members of the collective executive body (hereinafter, executives), and the chief accountant of the credit institution are not allowed to take any official positions in other credit institutions or insurance companies, professional stock market operators, leasing companies, or affiliates of the said credit institution.

Candidates to the Board of Directors (Supervisory Board), a credit institution's executive positions, the chief accountant, and the deputy chief accountant in the credit institution must meet qualification requirements established in federal laws and pursuant to normative acts of the RF CB.

Sources of Assets

Undoubtedly, banks have more funding sources available to them than the MFIs discussed above.

First, the bank's equity formed at its establishment makes credit and loans readily available to banks.⁷³

Second, a bank may capture deposits from individuals and legal entities and invest them on its behalf and at its cost. On February 1, 2003, Russian credit institutions held a total of 2,164,716.4 million rubles (about US\$70,000 million).

Other funding sources available to MFIs are open to banks as well, such as revenues generated by consulting and information services and by the leasing of property (in addition to other property, banks can lease special secure spaces and safes for keeping documents and valuables).

Incorporation, Reporting, Supervision

Banks are incorporated under the law *On state registration of legal entities*, subject to special procedures established by the law *On banks and banking for credit institutions*.

The registration procedure breaks down into the following stages:

1. RF CB issues a decision allowing for the registration of the bank.
2. The registering authority files the information on the newly founded bank in the Unified State Register of Legal Entities.

⁷² RF CB Instruction *On the application of federal laws regulating the incorporation of credit institutions and the issue of banking licenses*, No. 75-I, July 23, 1998.

⁷³ According to RF CB Directive *On equity requirements of newly founded credit institutions, capitalization requirements of banks applying for a general license, and credit institutions applying for transformation from a non-banking credit institution into a bank*, No. 586-U, June 24, 1999, minimum equity requirement of a new bank, except affiliates of foreign banks, is the equivalent of 5 million euros.

3. The founders pay the bank's charter capital.
4. The founders obtain a license to perform banking operations.

The decision to register a bank and issue banking licenses or to decline the application must be made within six months of the submission of all documents required by the law *On banks and banking*.

Following the RF CB decision to incorporate a bank, the registering authority must, within five days of receiving the information from RF CB, file it in the Unified State Register of Legal Entities.

Then the RF CB notifies the founders that they must pay 100 percent of the bank's charter capital within a month.

The RF CB issues a banking license within three days after it receives the proof of payment. The license indicates the authorized banking operations. The banking license has no time limit.

According to the law *On the Central Bank of the Russian Federation (Bank of Russia)*, the Committee of Banking Supervision, which cuts across RF CB departments, ensures banking regulation and oversight to ensure banking sector stability and protect depositors and creditors.

RF CB establishes binding rules for banking operations, accounting, and reporting, internal control procedures, format of accounting and statistics reports, and other reports required by federal laws. Banks are obliged to undertake annual audits of their accounting books and financial reports.

Prudential Supervision⁷⁴

RF CB established sanctions to be applied to credit institutions for violations of prudential standards as well as the procedures for applying such sanctions.

Prudential standards are defined as the following norms established by the RF CB:

- Maximum risks allowed to credit institutions;
- Allowances to ensure credit institutions' liquidity and to cover possible loss; and
- Requirements which, if ignored, may affect negatively the financial situation of a credit institution or the possibility of an adequate assessment of its financial performance, including requirements related to bookkeeping and accounting, reporting, and publishing reports in the press (in some cases defined by federal laws); requirements related to providing audit reports and to registration, licensing, and extension of activities of credit institutions.⁷⁵

The central RF CB office and its local divisions apply sanctions to credit institutions in cases and following procedures defined by federal laws and instructions; these measures may be preventive or compulsory.

To ensure its financial soundness, the bank is obliged to:

- Establish internal control procedures to ensure an adequate level of stability, corresponding to the nature and scope of its operation;
- Meet standards established by the RF CB, according to the law *On the RF Central Bank (the Bank of Russia)*; and
- Create reserves following the procedures and in amounts established by the RF CB.

The RF CB may establish the following standards:

- Minimum equity requirement for new credit institutions; capitalization requirements for existing credit institutions, allowing them to open affiliates and/or branches outside Russia; converting from a nonbank credit organization into a bank, or becoming an affiliate of a foreign bank;⁷⁶
- Maximum in-kind share in the equity of a credit institution;
- Maximum risk per borrower or group of related borrowers;⁷⁷

⁷⁴ See Footnote 34.

⁷⁵ Instruction No. 59 *On sanctions to be applied to credit institutions for violations of prudential standards* approved by RF CB order No. 02-139, March 31, 1997.

⁷⁶ See RF CB Directive *On equity requirements of newly founded credit institutions, capitalization requirements of banks applying for a general license, and credit institutions applying for transformation from a non-banking credit institution into a bank*, No. 586-U, June 24, 1999.

- Maximum limit of major credit risks;⁷⁸
- Liquidity requirements;⁷⁹
- Capitalization requirements;⁸⁰
- Financial risks related to currency exchange rate, interest, and so on;
- Risk reserve requirements;
- Norms related to the use of a credit institution's own capital to purchase stock or shares in other companies;⁸¹ and
- Maximum total of credit and guarantees that may be extended by a credit organization (banking group) to its shareholders.⁸²

Nonbank Credit Institutions Performing Deposit and Credit Operations

The Russian Central Bank, as authorized by the law *On banks and banking*, establishes procedures for nonbank credit institutions and banking operations permitted to them. The Rules of Prudential Regulation of nonbank credit institutions with clearing functions and collection organizations, endorsed by the RF CB in 1997, does not allow these organizations to capture and invest deposits.⁸³ Therefore, clearing nonbank credit institutions and collecting organizations cannot engage in microfinance operations.

The third type of nonbank credit organization provided for by a RF CB regulation in 2001 is a nonbank credit organization engaging in deposit and credit operations (NDCO).⁸⁴

Several leading MFIs in Russia are interested in the prospect of delivering microfinance services through an NDCO and they research the possibility of establishing this type of nonbank credit organization. As of this writing, no NDCOs exist in Russia, so it is impossible to analyze their experience. We can only look at the possibilities the legislation provides.

Founders

Everything said about founders of credit institutions in the section on banks applies both to founders of banks and to founders of nonbank credit institutions, including NDCOs.

Some of the rules established for banks do not apply to non-bank credit institutions, including NDCOs. For example, the provision of the law *On banks and banking*, which prohibits founders from divesting or withdrawing all or part of their equity share for the first three years of operation, does not apply to nonbank credit institutions.

There are no requirements or restrictions concerning founders of NDCOs and other nonbank credit institutions in addition to those established for founders of credit institutions in general.

Establishment and Operation: Permitted Goals

The RF CB allows NDCOs to conduct the following banking operations:

- To capture timed deposits from legal entities;
- To invest deposits on their own behalf and at their own cost; and
- To purchase and sell foreign currency (only clearing, no cash).

Notably, NDCOs are not permitted to capture demand deposits from legal entities. On the one hand, deposits that cannot be withdrawn before a certain moment increase the financial soundness of a credit institution. But on the other hand, demand deposits would attract more customers and, consequently, additional funds for NDCO. Although the parties to a time deposit agreement, that is, an NDCO and its customer, may both decide to terminate it or to change the time of repayment, this agreement nevertheless does not offer the same advantages as a demand deposit agreement; it makes time deposits less attractive to clients.

⁷⁸ Ibid.

⁷⁹ Ibid.

⁸⁰ Ibid.

⁸¹ Ibid.

⁸² Ibid.

⁸³ *Rules of prudential regulation of nonbank credit institutions which perform cash clearing operations, and collecting organizations*, endorsed by RF CB Order No. 02-390, September 8, 1997.

⁸⁴ *Rules of prudential regulation of nonbank credit institutions that perform deposit and credit operations*, No. 153-P, September 21, 2001.

The regulation on NDCOs does not allow this credit institution to perform banking operations in addition to those mentioned above. In particular, an NDCO cannot open and maintain bank accounts for individuals and legal entities, perform clearing operations on their behalf, and attract deposits from individuals.

NDCOs may operate in Russia only; they are not allowed to open branches and affiliates outside Russia.⁸⁵

All transactions other than banking are regulated in the same way for all credit institutions, both banks and non-bank, according to the law *On banks and banking*.

Management

Governance and management procedures as well as requirements to members of governing bodies are the same for NDCOs and banks. They are established by the laws *On Banks and Banking*, *On the Central Bank of the Russian Federation (Bank of Russia)* and pursuant normative acts of the RF CB.

Sources of Assets

As a credit organization, an NDCO must form equity in the amount established by the RF CB normative acts. Currently, charter capital nonbank credit institutions must be at least 500,000 euros, one-tenth that of a new bank.⁸⁶ Therefore, given an NDCO's ability to collateralize borrowed funds with its own assets, its chances of borrowing are somewhere between those of nonlicensed MFIs and banks.

Similarly, an NDCO is between these two types of institutions in relation to deposits. While banks are authorized to attract on-demand as well as timed deposits from individuals and legal entities, and non-licensed MFIs are not allowed to capture deposits, NDCOs are limited to timed deposits from legal entities. It is difficult to assess legal entities' interest in making timed deposits with NDCOs.

In addition to receiving loans and credit, and attracting deposits, NDCOs have available to them other sources of funding open to all commercial organizations, with restrictions established for credit institutions.

⁸⁵ Ibid., paragraph 1.4.

⁸⁶ See RF CB Directive *On equity requirements of newly founded credit institutions, capitalization requirements of banks applying for a general license, and credit institutions applying for transformation from a non-banking credit institution into a bank*, No. 586-U, June 24, 1999.

⁸⁷ *Rules of prudential regulation of non-bank credit institutions which perform deposit and credit operation*, No. 153-P, September 21, 2001.

⁸⁸ See Footnote 34.

⁸⁹ Regulation *On specifics of prudential regulation of non-bank credit institutions which perform deposit and credit operations*, No.153-P, September 21, 2001.

⁹⁰ See Bank of Russia Regulation *On the organization of internal control in banks*, No. 509, September 28, 1997.

Incorporation, Reporting, Supervision

The law establishes the same procedures of incorporation, reporting, and supervision for all credit institutions, both banks and nonbanks. Therefore, all relevant rules described in the section on banks apply to NDCOs.

Supervision over NDCO activities is exercised by RF CB local institutions, following the same procedures that apply to banks, subject to certain specifics of NDCO prudential regulation.

Prudential Supervision⁸⁸

The Central Bank established the following standards for NDCOs aimed at reducing their risks:

- Minimum charter capital;
- Minimum capitalization;
- Current liquidity;
- Long-term liquidity;
- Maximum risk per borrower or per group of related borrowers;
- Maximum total of major credit risks;
- Maximum total of credit and guarantees which may be extended by an NDCO to its shareholders;
- Maximum total of credit and guarantees which may be extended by an NDCO to its insiders; credit and guarantees;
- Maximum total of credit and loans extended to its insiders; guarantees extended for their benefit;
- Norms related to the use of an NDCO's own capital to purchase stock or shares in other companies;
- Maximum amount of an NDCO's own funds invested in shares of a single legal entity; and
- Maximum risk of an NDCO's own obligations.

As a way to regulate currency exchange risk exposure, limits are imposed on open currency positions; to regulate credit risks, NDCOs must establish loan loss reserves and other reserves prescribed by the RF CB. NDCOs must also organize internal control in accordance with RF CB requirements in order to protect investors and ensure financial soundness corresponding to the nature and scope of the operations.⁹⁰

LENDING AND LOAN SECURITY

Loans and Credit

Civil law, that is, the RF Civil Code and pursuant other federal laws regulate contractual obligations based on equality, autonomous will, and independent property status of the parties, including obligations arising from a loan agreement or a credit agreement. The RF CC defines a Loan Agreement and a Credit Agreement as different agreements, although in some cases the same provisions regulate them. Table 3 presents some characteristics of a loan and a credit.⁹¹

Parties. In addition to the RF CC, other federal laws may establish specific restrictions for borrowers. For example, as has been mentioned, the law regulating citizen consumer credit cooperatives allows lending only to members of the credit cooperative.⁹²

The lender (creditor) may wish to restrict the range of borrowers to ensure designated use or repayment, or for other purposes. For example, a SME support fund may establish in its by-laws that it only lends to SMEs.

Item concerned. A loan may involve money or other property defined according to its typical characteristics; the definition by typical characteristics is necessary, because the borrower does not return the same objects at loan maturity, but returns other objects of the same type and quality as defined by the agreement.

A credit agreement may involve only a specific amount of money.

Effective date. Knowing when obligations arise under a loan or credit agreement is important. Most civil law con-

TABLE 3. COMPARISON BETWEEN A LOAN AGREEMENT AND A CREDIT AGREEMENT

	Loan Agreement	Credit Agreement
Parties	RF CC does not establish any specific requirements or restrictions for either lenders or borrowers (Article 807, RF CC). Anyone can be a party to a loan agreement, whether individual or organization, Russian or non-Russian (unless otherwise established by other federal laws).	A bank or another credit institution can issue credit (act as creditor). A credit institution is a legal entity licensed to perform banking operations (Article 1 of federal law <i>On banks and banking</i> No. 17-FZ of February 3, 1996). There are no specific requirements or limitations for the borrower (Article 819, RF CC).
Item(s) concerned	Money or other property defined according to its typical characteristics may be borrowed under a loan agreement (Article 807, RF CC).	Only money can be borrowed under a credit agreement (Article 819, RF CC).
Effective date	A loan agreement is effective as of the moment of transfer of money or other property between the lender and the borrower (Article 807 RF CC).	A credit agreement is effective as of the moment the parties confirm in writing their consent to enter into the agreement (Articles 433, 434, and 819, RF CC).
Format	Where the lender is a legal entity, a loan agreement must be executed in writing (Article 808, RF CC).	A credit agreement must always be executed in writing (Article 820, RF CC).
Interest	The lender has the right to charge interest on the loan, according to the terms and conditions stated in the loan agreement. If the agreement does not establish the interest rate, its amount is determined by general rules provided in the RF CC. A loan of money made by a legal entity will be interest-free if this is explicitly stated in the agreement (Article 809, RF CC).	The creditor has the right to charge interest, according to terms and conditions stated in the credit agreement. If the agreement does not establish the interest rate, its amount is determined by general rules provided in the RF CC (Articles 819, 809, RF CC).
Designated use	A loan agreement may specify how the loan must be used (Article 814, RF CC).	A credit agreement may specify how the credit must be used (Articles 814, 819, and 821, RF CC).

⁹¹ This chapter does not discuss or refer to budget credit or other credit regulated by the RF Budget Code (federal law No. 145-FZ, July 31, 1998).

⁹² See Chapter 3, section on cooperatives.

tracts are consensual, that is, reaching an agreement and formalizing it as required is sufficient for rights and obligations to arise; a credit agreement is consensual. In contrast, a loan agreement becomes effective at the moment of actual transfer of money or property (real agreement).

The parties cannot change the effective date established by law and grant rights or impose obligations on a party to the agreement before the agreement becomes effective. For example, under a loan agreement, the borrower's obligation to pay interest arises after the actual transfer of the money, even if the agreement says that interest is accrued immediately after the parties sign it.

Under a credit agreement, its signing by the parties gives rise to the rights and obligations, so this agreement may obligate the borrower to pay interest even before the actual transfer of money takes place.

Interest rates. The lender is free to choose whether it will charge interest or provide a free loan. A loan agreement involving a loan of money and at least one legal entity, even if it does not establish the amount of interest, is assumed to be interest-based. If the parties wish the loan to be free, they must explicitly state this in the loan agreement.

If a loan or credit agreement does not establish the interest rate, its amount is determined by general rules in the RF CC.⁹³

Effective Russian laws do not establish maximum limits on loan or credit interest rates; some indirect regulation is achieved through the restriction of the amount of interest the borrower may report as an expense for taxation purposes.⁹⁴

Designated use. If a loan is made on condition that the borrower use the money for specific purposes [designated use], the borrower must make it possible for the lender to monitor the use of the loan. If the designated use requirements are not met, the lender may demand an early repayment of the loan, principle and accrued interest, unless otherwise provided by the agreement. The RF CC provisions regulating designated use of loans also apply to credit agreements. In addition, given the consensual nature of credit agreements, the creditor may refuse to

disburse any additional amounts to the borrower, should the latter fail to meet designated use requirements.

In certain cases it is easy to confuse a loan with a credit, when they share characteristics. For example, if money is handed over by the lender to the borrower at the same time that an agreement is signed establishing maturity and interest rate, these characteristics alone are insufficient to determine whether it is a loan agreement or a credit agreement.

Therefore, the RF CC provisions regulating loan and credit agreements do not give a definitive answer to the most common question asked in Russia at the establishment of an MFI, namely: is a legal entity allowed to lend money to borrowers, on a regular basis, and charge interest (that is, engage in a microfinance operation) without a special license?

We need to refer to laws on licensing and laws on banking, in addition to the RF CC, for a sound answer.

1. Federal laws define the types of activities that require licensing.

1. The relevant federal laws do not mention anywhere that lending requires a license, regardless of the frequency of such lending, or the fact that this may be the main activity or the only activity of a legal entity.
2. Credit institutions require a license to perform banking operations. Their licenses say which banking operations are allowed them and specify the currency of transactions. Liability arises even from a single act of performing operations without a license and from a single breach of licensing requirements.

2. The law *On banks and banking* defines the following operations as banking operations and, therefore, subject to licensing.

1. Capturing deposits from individuals and legal entities (both demand and timed deposits).⁹⁵
2. Investing deposits received from individuals and legal entities, on its own behalf and at its own cost.
3. Opening and maintaining bank accounts for individuals and legal entities.
4. Performing cash clearing operations on behalf of individuals and legal entities, including correspondent banks, on their bank accounts.

⁹³ Article 809, RF CC.

⁹⁴ Interest accrued on debt obligations may be reported as an expense only if the amount is not substantially different from the average debt interest rate over the same quarter. See Articles 265, 269, RF Tax Code.

⁹⁵ A bank deposit agreement says that one party (the bank) accepts a deposit from, or on behalf of, the other party (depositor) and undertakes to repay this amount, plus accrued interest in a manner stated in the agreement. A bank deposit may be repaid on demand (demand deposit) or after a certain period of time (time deposit).

5. Collecting cash, bills, payment, and clearing documents; delivering cash services for individuals and legal entities.
6. Purchasing and selling foreign currency in cash and clearing operations.
7. Attracting and investing deposits of precious metals.
8. Offering bank guarantees.
9. Making money transfers on behalf of individuals without opening bank accounts (except postal money orders).

The list is exhaustive and cannot be interpreted to include other transactions, that is, according to paragraph 2 of the list, a banking license is required only if deposits are invested (or used to make loans and credit, in particular).

We can conclude from the above that the way to distinguish between licensed activities and those not subject to licensing is to look at the source of the money they subsequently invest or onlend:

- If an organization onlends (makes either loans or credit and charges an interest) from deposits, it engages in a banking operation that requires a license and can be performed only by credit institutions.
- If an organization onlends (while charging interest) from any funds other than deposits, this activity has all the characteristics of making loans (in particular, it should be a real, rather than consensual, agreement); it is not considered a banking operation, and may be performed by any legal entity without a license.

Therefore, the answer to the question of whether a legal entity in Russia is allowed to provide microfinance services without a license will be as follows:

1. Yes, it is allowed to do so if it lends from any funds other than deposits captured from individuals or legal entities. Such lending should be formalized under a loan agreement (with or without interest).
2. No, it is not allowed to lend without a license if it captures individual or corporate deposits and uses (onlends) them as a source of funds from which to onlend. An organization which has a license for this type of banking operations may formalize its lending under a loan or credit agreement.

Paperwork Involved in Lending and Repaying Loans

Where the lender is a legal entity, a loan agreement must be executed in writing; it may be one document jointly signed by parties, or an exchange of documents through a medium allowing certitude that the party to the agreement issued the document.

If the parties fail to execute their loan agreement in writing, they cannot use witness testimonies to support their case, should a dispute arise; however, they are free to refer to documents and other evidence (such as a receipt signed by the borrower or other written confirmation of the amount of money that the lender has made available to the borrower).

The repayment of the loan principal and interest is made through a bank transfer to the MFI's account or in cash. In both cases, the repayment is recorded in accounting books.

As a rule, MFIs do not have problems with paperwork involved in the processing and repayment of loans.

Loan Security

The right choice of collateral is an important step toward financial soundness and sustainable development, whether you are a noncommercial MFI or a credit institution lending to SME under a banking license. The challenge for any institution is to choose the type of collateral which, on the one hand, does not discourage a potential borrower from seeking a loan and, on the other hand, provides the lender with adequate security.

Licensed credit institutions establish their collateral demands taking into account its value and other characteristics, with regard to loan loss reserve requirements.⁹⁶ Credit risks are classified on the basis of analysis of actual circumstances, according to formalized criteria and following applicable RF CB rules. The higher the risk of default, the greater should be the amount of loan loss reserve. For the purposes of credit risk assessment, the RF CB recognizes loans as secure if the collateral meets all of the following criteria:

- Its current market value is sufficient to compensate the bank for the entire amount of principal and interest under the agreement (if the loan is extended for a period exceeding one year, the amount of interest due in the year, to date), and all possible costs involved in enforcing the loan on collateral; and

⁹⁶ See RF CB Instruction On the procedure for the formation and use of loan loss reserve, No. 62a, June 30, 1997.

- All security instruments are executed in such a manner as to allow a maximum of 150 days for the bank to be able to realize upon the collateral, following the date when such recourse is necessary, which is no later than on the 30th day of the borrower's default on either principal or interest payment.

Loans guaranteed by the Russian Government, governments of the RF subjects, by the RF CB, by governments, and central banks of countries in the *group of developed countries*, and by promissory notes issued by these actors are considered secure.

Most SME and individual entrepreneurs cannot provide collateral sufficient for a secure loan, and this is the main barrier restricting SME access to bank credit in Russia.

MFI established as noncommercial organizations are not prudentially regulated under Russian law. Therefore, MFIs develop and offer collateral or loan security options to their borrowers, providing sufficient security to the lender while being accessible to the borrower. Depending on the market demand and supply, loan portfolio, and other factors, the types of collateral and criteria for assessing its quality may change. Most often, noncommercial MFIs use penalties, collateral, and/or guarantors to secure loans. Of equal or even greater importance is MFIs' policy of preventing delinquent borrowers from further access to loans.⁹⁷

MFI accept pledges of business assets and personal property of the borrower. Many MFIs accept pledges of property belonging to third parties. A pledge of property is documented according to the same rules as applied in credit institutions, but the method of value assessment and the required amounts are different.⁹⁸ Noncommercial organizations may accept a pledge of property with a relatively low market value, but of great value to a specific borrower as being essential for his or her own well-being or the success of his or her business.

Both credit institutions and noncommercial MFIs accept third party guarantees as security. The problem for SME is that those who provide guarantees, like the borrower him or herself, may not have sufficient assets to secure

a loan. MFIs assess the guarantors' reliability by looking at whether they are responsible and consistent in meeting their obligations. Like the borrowers, providers of guarantees value their relationship with the MFI as a potential source of loans for themselves.

Many MFIs have adopted a policy of group loans. Under a group loan, each borrower in a group (3-15 members, depending on the situation) obtains a loan and guarantees all other loans in the group. This arrangement works well with small loans, when individual borrowers do not own sufficient assets to secure a loan; members of the group know each other well and have similar business interests, but operate individual businesses independently of each other.⁹⁹

Issues that Require Improved Normative Regulation

Support the initiative and participate in discussion of the bills On mutual guarantees and On credit bureaus with the purpose of presenting and protecting the interests of MFIs.

Security Instruments

Russian legal requirements regarding the formalization of security instruments are reasonable, fair, and practical.

There may be a separate security agreement or a security clause in the general loan agreement. Normally, MFIs do not have problems with formalizing their security instruments. Notarization and legalization costs involved in securing a pledge of real estate are well justified, given that real estate is pledged as security when the loan amount is substantial.

The Possibility of Enforcing the Lien on the Collateral

Most Russian MFIs believe that chances of collecting the debt are higher with a lower investment of time and effort through an amicable out-of-court settlement rather than through a judicial procedure. Therefore, they tend to rely more on their communication skills and the knowledge of human psychology in working with delinquent borrowers and guarantors, rather than on their knowledge of judicial and enforcement procedures.

⁹⁷ According to Article 330, RF CC, forfeit (fine, penalty) is defined as a legal or contract amount of money to be paid by the debtor to the creditor in the event of default on an obligation, including a failure to repay loan principal or interest at maturity.

⁹⁸ Notarized or legalized (registered with state agents), as required in some cases.

⁹⁹ *Small* is a subjective estimate that may vary, according to circumstances, between 3,000 and 30,000 rubles.

Nevertheless, in some cases when all other attempts to collect the debt fail, the institution has to take the matter to court. MFIs may take action in a general jurisdiction court or a commercial [arbitration] court in order to collect the loan principal and accrued interest. The law does not prevent MFIs from using judicial remedies, and they do so with reasonable success.

Problems arise when the judgment in favor of an MFI has to be enforced. Many MFIs believe that a failure to enforce judicial decisions is not a problem of law, but a problem of court bailiffs' performance. Where officials are committed to enforcing a judgment, they find a way to collect debts; but where their commitment is low, they fail.

TAXATION OF MICROFINANCE ACTIVITIES

Legal provisions on MFI taxation may be the most important factor for the survival and growth of microfinance institutions. The scope of this paper does not allow a detailed analysis of taxation-related issues. Given that a range of organizations in diverse institutional forms deliver microfinance, their activities and relations with borrowers differ. This chapter, therefore, will look at some general problems organizations encounter in the context of lending to small business and obtaining funds for such lending.

Grant-based Funding of Noncommercial Organizations

The recent history of noncommercial organizations in Russia is quite short; the noncommercial sector in post-communist society emerged in 1990-1993, with support from foreign and international donors. The word *grant* became an integral part of the noncommercial sector vocabulary. Grants were understood as gratuitous assistance offered by foreign and international organizations,

TABLE 4. COMPARISON AMONG DIFFERENT TYPES OF GRATUITOUS SUPPORT OF NONCOMMERCIAL ACTIVITIES

Type of NCO Support	Donors of Funds and other Donated Assets	Recipients	Purpose	Other Requirements
Technical assistance ¹⁰⁰	Foreign governments, their federal or municipal authorities, international and foreign institutions or noncommercial organizations, and individuals.	Any NCO	Delivering support in the implementation of economic and social reforms and disarmament as part of projects and programs.	The project or program must be registered following a special procedure established by the Russian Government. They must have a certificate, that is, a document certifying funds, goods, works, or services as technical assistance; the certificate must be executed and issued as regulated by the Russian Government. ¹⁰¹
Humanitarian aid ¹⁰²	Foreign governments, their federal or municipal authorities, international and foreign institutions, or noncommercial organizations.	Any NCO	Delivering medical and social aid to low-income people, socially vulnerable people, victims of natural disasters and other emergencies. Relief operations following natural disasters and other emergencies.	A document certifying funds, goods, works, or services as technical assistance is required; the certificate must be executed and issued as regulated by the Russian Government. ¹⁰³
Grant	Noncommercial organizations, including international and foreign organizations and associations; individuals. ¹⁰⁴	Any NCO	Implementation of programs in the spheres of education, art, culture, environment, and research programs as designated by the grantor.	Grantors, international or foreign organizations, must be included in the list of organizations whose grants to Russian recipients are tax exempt; the Russian Government approves the list. ¹⁰⁵

¹⁰⁰ See federal law *On gratuitous aid (assistance) to the RF, on amending certain RF legal acts on taxes, and on establishing privileges on dues to state non-budgetary funds in connection with gratuitous aid (assistance) to the RF*, No. 95-FZ, May 4, 1999.

¹⁰¹ See the *Procedure of registration of projects and programs of technical assistance; the issue of documents certifying funds, goods, works or services as technical assistance, and supervision over its designated use, approved by the RF Government*, No. 1046, September 17, 1999.

¹⁰² See federal law *On gratuitous aid (assistance) to the RF, on amending certain RF legal acts on taxes, and on establishing privileges on dues to state non-budgetary funds in connection with gratuitous aid (assistance) to the RF*, No. 95-FZ, May 4, 1999.

¹⁰³ See the *Procedure for delivering humanitarian aid (assistance) to the Russian Federation, endorsed by the RF Government Resolution*, No. 1335, December 4, 1999.

¹⁰⁴ See Article 251, RF TC

¹⁰⁵ See the list of foreign and international organizations whose grants to Russian recipients are tax exempt, endorsed by the RF Government Resolution No. 923, December 24, 2002.

TABLE 4 (CONTINUED)

Type of NCO Support	Donors of Funds and other Donated Assets	Recipients	Purpose	Other Requirements
Donation ¹⁰⁶	No restrictions.	Medical, educational, social, and similar institutions and services; charitable organizations, research, and training facilities, foundations, museums, and other cultural organizations; voluntary and religious organizations.	General public good. Donors may designate specific use of their donations.	No authorization or endorsement is necessary for accepting a donation.
Contribution towards charitable purposes ¹⁰⁷	No restrictions.	Any NCO	Delivering social support and protection, including aid to the poor, social rehabilitation of the unemployed, persons with disabilities, and others who need help in realizing their rights and legitimate interests for reasons of physical or intellectual ability or because of other circumstances; delivering aid to victims of natural disasters, ecological, industrial, and other catastrophes; social, ethnic, religious conflicts, and political repression; to refugees and forced migrants; and any other purposes listed in Article 2, federal law No. 135-FZ.	Individuals and legal entities may freely engage in charitable activities based on the principle of voluntary involvement and choose its purposes among those established by federal law No. 135-FZ.

in the form of money or in-kind assets, to support chartered activities of a noncommercial organization. Profit tax law effective at that time allowed noncommercial organizations to exempt such assets from taxable revenues, although the law does not use the term *grant*. Before 2001, when Chapter 25 of the Tax Code, Corporate Profit Tax, was introduced, both tax authorities and noncommercial organizations understood and used the term in a broader sense, applying it to any property received by a noncommercial organization and used for its noncommercial purposes. A weakness of this approach was a lack of clear differentiation between noncommercial and profit-generating activities; many judicial disputes between noncommercial organizations and tax agencies emerged from the confusion.

The designers of RF Tax Code Chapter 25 on Corporate Profit Tax found an easy solution by avoiding the words *commercial/profit-generating and*

noncommercial/noncommercial altogether, with the only two exceptions being Articles 321 and 321.1 regulating state budget-funded institutions, the RF CB, ARCO (Agency for Restructuring of Credit Organizations,) and the federal postal service. The effective version of the RF Tax Code chapter on corporate profit tax contains a detailed and exhaustive list of funds and other assets exempt from profit tax. In particular, noncommercial organizations do not include in their tax base the following types of assets donated by other organizations or individuals and utilized for designated purposes:

- Technical assistance or humanitarian aid;
- Grants;
- Donations; and
- Property contributed towards charitable purposes.

Related federal laws define each of the listed types of support. Table 4 shows some of the criteria a recipient

¹⁰⁶ See Article 582 RF CC.

¹⁰⁷ See federal law *On charitable activities and charitable organizations*, No. 135-FZ, August 11, 1995.

must meet to be entitled to tax exemption and other tax benefits.

As Table 4 shows, effective legislation has established a narrow definition of a grant, as opposed to its former meaning. A list of international and foreign grantors has been established, and only five possible areas for using a grant have been specified.

Recipients of technical assistance are entitled to the greatest tax advantages in relation to corporate profit tax, VAT, corporate property tax, and customs duties. In addition, the law does not restrict the types of recipients of technical assistance (they may include foundations, cooperatives, and even commercial companies); its purpose of delivering support in the implementation of economic and social reforms is broad enough to cover microfinance institutions. On the other hand, a broad interpretation of purpose, combined with a requirement to obtain individual certificates, leaves plenty of room for abuse by authorities; this affects both donors and recipients of technical assistance.

The easiest way to support noncommercial organizations, one that does not require any authorization, is donating funds or other assets for generally beneficial purposes which, again, cover microfinance institutions. Unfortunately, the Civil Code limits the list of noncommercial recipients of donations by certain institutional and legal forms; these do not include consumer cooperatives, noncommercial partnerships, autonomous noncommercial organizations, and associations.

Any microfinance institution registered as a noncommercial organization may be entitled to tax benefits associated with a charitable donation. No special authorizations or certificates are required, provided that the related documents (the charter of the microfinance institution, the agreement on the transfer of property to support charitable activity, the decisions to make loans, the information about borrowers, and so forth), and the activity itself, meet the following criteria:

1. They must be altruistic, that is, services must be delivered free of charge or on favorable terms as compared to other financial institutions (for example, without collateral), while any proceeds generated by the operation must not be distributed among founders, participants, or members of the MFI.

2. The goals of the activity must be consistent with those listed in Article 2 of the federal law *On charitable activity and charitable organizations*. For example, an organization making loans to unemployed women to enable them to start their own business meets the statutory definition of a charitable activity.

Issues that Require Improved Normative Regulation

Unjustified and discriminatory restrictions and administrative barriers on the socially beneficial activities of noncommercial organizations should be removed.

Profit Tax

By law, all Russian organizations pay corporate profit tax. Corporate profit tax is levied on revenues minus expenses as defined in Chapter 25 of the Tax Code.

The law regulates the amount of tax base by indicating for different types of organizations, as well as different operations, how income and expenses must be reported. For example, an organization may reduce its taxable base for profit tax by deducting its expenses for establishing reserves for problem debts. However, in most cases MFIs cannot use this formal right, because, in accordance with the Russian Tax Code, the amount of reserve must be determined on the basis of the amount and maturity of the problem debts, which include debts meeting two requirements:¹⁰⁸

1. Debts that have not been repaid by the time stated in the agreement; and
2. Debts that are not secured by a collateral, warranty, or bank guarantee.

One method of establishing tax benefits for certain categories of taxpayers is to make additional expenses deductible from their tax base. For example, banks—as opposed to unlicensed microfinance institutions—may report the amounts used to form reserves for outstanding interest as their nonoperational expense deductible from the tax base.¹⁰⁹

Another method of reducing the tax burden is to establish tax-deductible types of income. We mentioned some types of tax-deductible assets of noncommercial organizations earlier.¹¹⁰ Membership fees and shares contributed to MFIs

¹⁰⁸ Paragraphs 1, 4, Article 266, RF Tax Code.

¹⁰⁹ Article 266, RF TC.

¹¹⁰ See Chapter 5, section on non-recoverable funding of noncommercial activities.

TABLE 5. ADVANTAGES AND DISADVANTAGES OF DIFFERENT METHODS OF REPORTING LOAN

	Advantages	Disadvantages
Income is reported as interest received on loans	<ol style="list-style-type: none"> 1. Documents reflect the actual situation and the organization's finances. 2. In the event of the borrower's default, the organization may collect outstanding interest through a judicial procedure. 	<ol style="list-style-type: none"> 1. More complicated accounting and reporting of expenses incurred through lending. 2. Additional tax burden for borrowers, because they cannot claim the entire amount of interest as expenses to lower their tax base.
All or part of income is reported as fee for consultation services or for administrative expenses incurred by MFI in connection with lending	<ol style="list-style-type: none"> 1. It is possible to report material expenses, personnel costs, and so on, as deductible from tax base. 2. The borrowers can report the cost of consultations as their expense. 3. In the event of the borrower's failure to pay for consultations the organization may collect the payment through a judicial procedure. 	<ol style="list-style-type: none"> 1. Documents do not reflect the actual situation and the organization's finances. 2. The borrowers are misled about the actual cost of the borrowed funds.
All or part of income is reported as membership fees or contributions (for organizations with membership)	<ol style="list-style-type: none"> 1. Members' fees and contributions are tax-deductible for MFIs. 	<ol style="list-style-type: none"> 1. Documents do not reflect the actual situation and the organization's finances. 2. Outside regulatory bodies may find the payment of members' fees and contributions to be fictitious transactions, with all this implies. 3. There is no possibility to collect members' fees and contributions through judicial proceedings. 4. The borrowers are misled about the actual cost of the borrowed funds. 5. The borrowers cannot claim members' fees and contributions as an expense to lower their tax base.

with membership (cooperatives, noncommercial partnerships, and associations) are also tax-deductible.

Issues often arise around profit tax in connection with income generated by lending.

MFIs use different methods to report income generated through their main activity, that is, lending. The following methods are common:

- All income is reported as interest received on loans;
- All or part of income is reported as a fee for consultation services or for administrative expenses incurred by MFI in connection with lending; and

- All or part of income is reported as membership fees or contributions (for organizations with membership).

Each of these methods has its advantages and disadvantages. Some of their characteristics are listed in Table 5.

In most cases, MFIs report as a fee for consultation services or as members' fees and contributions the portion of their interest income that is in excess of the Central Bank rate by 10 percent, because borrowers may report interest as an expense only within limits established by the tax law.¹¹¹

MFIs established as noncommercial organizations may use their profits to support their operation, including their loan portfolio, only after all taxes are paid. This rule

¹¹¹ Article 265, paragraph 1, subparagraph 2; paragraph 2, Article 346.16, Article 269, RF TC.

applies to all nongovernmental noncommercial organizations, regardless of the social value of their operation.¹¹²

Microfinance operations legalized as commercial companies with a banking license are sometimes at an advantage as compared to unlicensed MFIs. For example, Article 292 of the RF Tax Code regulates the rules for determining expenses related to the establishment of bank reserves, or, as has been mentioned, banks may report amounts used to form reserves for outstanding interest as their nonoperational expense deductible from the tax base.

Issues that Require Improved Normative Regulation

Laws on taxation should be improved to remove restrictions imposed depending on the form of organization.

Value Added Tax

Effective since 2001, RF Tax Code chapter 21, Value Added Tax, resolved an issue of crucial importance to microfinance institutions; now lending is not taxable under VAT, regardless of the lender organization.

It often happens that legislators find solutions and create new problems at the same time. The procedure of tax exemption of goods (services) delivered as technical assistance makes it impossible to apply this provision of the Tax Code. For a recipient of technical assistance to purchase goods VAT-free, the supplier (distributor) of goods must submit documents certifying VAT-free status to tax authorities. Under such circumstances, suppliers are interested in delivering goods (services) under technical assis-

tance programs only if the amount is very high, or the demand for the goods (services) is low, or the price is excessive.

Therefore, recipients of technical assistance, including MFIs, are in a difficult situation: on the one hand, donors insist that goods (services) be purchased VAT-free; on the other hand, suppliers refuse to cooperate.

A microfinance institution attempted to claim the 20-percent VAT it had paid when purchasing goods under a technical assistance program. The MFI supported its claim before a commercial (arbitration) court by submitting letters from suppliers who refused to sell goods VAT-free; the arbitration court of first appeal satisfied the claim and obliged tax authorities to refund the VAT paid by the MFI.

Problems emerge also because the delivery of goods or services is taxable even when the goods or services are provided free of charge.¹¹³ For example, if an MFI delivers a training seminar which is free for the participants, the organizers must pay VAT for the service anyway; in this case the amount of tax is based on model fees as provided by the Tax Code.¹¹⁴ Even the Tax Ministry admits that taxation of free services offered by noncommercial organizations is absurd; they have not tried to amend the law, however. In fact, nobody complies with this rule, and both the RF TC and tax inspectors are quite tolerant about such violations.

Issues that Require Improved Normative Regulation

A taxpayer must have a realistic possibility to use a lawfully established right.

¹¹² Many microfinance institutions find their tax burden excessive and approach the issue of tax exemption as crucial for their viability and sustainability. Consumer cooperatives of individuals are especially persistent in defending their interests. The following are the arguments a consumer cooperative presented in court to support its position that interest income received by credit cooperatives of individuals should not be taxable:

1. A credit cooperative is incorporated as a noncommercial organization; its exclusive purpose is meeting the need of its members to give and receive financial assistance, consequently, a cooperative does not seek to generate income through its operation. Interest on loans is a way to support the cooperative's operation; it is not an indicator of entrepreneurial activity.
2. Only members of the cooperatives may use its financial services as part of mutual financial assistance.
3. Risks are distributed among members as their joint subsidiary liability.
4. Only individuals may become members of the cooperative. By depositing their personal savings and contributing shares to the mutual assistance fund, they receive income as compensation for the use of their personal savings and as cooperative payments on shares. Fees paid by members-borrowers under loan agreements generate this income.
5. Given the above, the individual member him or herself is the party to tax relations that arise from the receipt of interest by the cooperative. Members' income received as cooperative payments and other payments provided by the charter are already subject to individual income tax. Additional tax liabilities imposed on this income by making it subject to taxation of corporate entrepreneurial activity constitutes double taxation and excessive tax burden for individuals.

¹¹³ Article 146, paragraph 1, subparagraph 1, RF TC.

¹¹⁴ Article 154, paragraph 2, RF TC.

The Use of Simplified Taxation Regime

The use of a simplified taxation system makes a difference for small microfinance institutions and their customers; it makes the organizations' bookkeeping and tax accounting easier and reduces their tax burden.

Taxpayers that have adopted a simplified system of taxation record their transactions in the book of income and expenses. The format of this book and the procedure of keeping records in it allow entrepreneurs to do their own accounting without any specialized skills.¹¹⁵

In accordance with chapter 26.2, RF TC, certain organizations may choose to adopt a simplified system of taxation; such organizations include those whose earnings, cost of amortized assets, number of employees, and some other indicators are below a certain level. Individual entrepreneurs who engage in certain types of operations and with a limited number of employees may also adopt this system. Where a simplified system is used, the Corporate Profit Tax (Individual Income Tax), Value Added Tax, Sales Tax, Unified Social Tax, and Property Tax are replaced by a single tax.

Taxpayers who adopt a simplified system may choose one of two possible bases for taxation: either income, or income minus expenses. When income is chosen as the taxable base, the rate is 6 percent; when income minus expenses is taxable, the rate is 15 percent.

Most taxpayers choose income as the base. MFIs then do not have to worry about reporting their cost of administration as an expense (when they receive interest on loans), while customers of microfinance institutions do not have to worry about reporting interest paid on loans, shareholder contributions, membership and other fees paid to MFIs to which they belong.

Unfortunately, starting on January 1, 2005, all taxpayers that have adopted a simplified system of taxation under chapter 26.2 of the Tax Code will be obliged to pay the tax on their income minus expense, without the other option.¹¹⁶

When chapter 26.2 of the Tax Code was debated in parliament in July 2002, the legislators were under pressure to adopt it as soon as possible; as a natural result of its hasty adoption, the law came out with many defects. On December 31, 2002, immediately before chapter 26.2 came into force, it had to be substantially amended. Some of the amendments had important implications for anyone wishing to adopt a simplified system of taxation. For example, the law in its version of July 24, 2002 did not allow reporting as expenses (when income minus expenses is chosen as base) the sum total of taxes and dues paid under Russian laws and the amounts paid for goods intended for further distribution, while the December 31 version allowed deducting these expenses from the base.

Some problems became apparent with the application of the simplified taxation system. For example, organizations "with a 25 percent participation of other organizations" are not allowed to use the simplified system of taxation. The law does not explain the meaning of "25 percent participation," so some tax agencies interpreted it to mean that noncommercial organizations with fewer than four founders may not use the simplified taxation system. Other tax agencies have argued that noncommercial organizations do not have equity, so they may use a simplified taxation regime regardless of the number of founders.

The Russian Ministry of Taxes and Levies has been monitoring the application of RF TC chapter 26.2, Simplified System of Taxation; based on the findings, the Ministry plans to initiate amendments to the law before the end of 2003. In particular, it proposes to expand the range of taxpayers permitted to adopt the simplified system of taxation; it also intends to clarify the procedure for recording expenses and to correct some technical errors.

Issues that Require Improved Normative Regulation

Provisions regulating the use of a simplified taxation system must be improved.

¹¹⁵ See Order of MTL RF *Establishing the format of income and expenses book of organizations and individual entrepreneurs that use a simplified taxation system, and the method of keeping records in the book of income and expenses by such taxpayers*, No. BG-3-22/606, October 28, 2002.

¹¹⁶ Article 6, federal law *On amending Part 2 of the RF Tax Code and certain other laws of the Russian Federation, and on the annulment of certain RF laws on taxes and levies*, No. 104-FZ, July 24, 2002.

THE POSSIBILITY OF TRANSFORMING AND PARTICIPATING IN THE ESTABLISHMENT AND OPERATION OF OTHER ORGANIZATIONS

At a certain stage of their development, many MFIs consider the possibility of transforming into commercial organizations, of participating in the establishment and operation of other organizations, including credit institutions. In some cases, such transformation or participation brings in more funding for their microfinance operation.

Transformation from Noncommercial to Commercial

Each time a legal entity transforms into a different type of legal entity (that is, changes its institutional and legal form), the new institution takes over all rights and responsibilities of the reorganized legal entity, according to the terms and conditions of the Act of Transfer. The Act of Transfer must contain provisions extending to the new entity all rights and obligations in relation to the former entity's creditors and debtors.

Foundations. The law does not directly address the foundation's right to transform. However, given that:

- A foundation, being a noncommercial organization, enjoys the rights associated with its stated goals and carries related obligations;
- The assets of a foundation must be used for purposes stated in its charter;
- A foundation is established for social, charitable, cultural, or other purposes which serve the public good; and
- The main purpose of a commercial organization is making profit;

... we can conclude that a foundation cannot terminate its operation and hand over its assets, under an Act of Transfer, to a commercial organization to be used for generating profit, because this conflicts with the foundation's goals of establishment. Consequently, a foundation cannot transform into a commercial company.

Cooperatives. As with foundations, the law does not say anything about the possibility of a credit cooperative transforming into a commercial company.¹¹⁷ Since credit

cooperatives are noncommercial organizations established for the purpose of meeting the need of their members to borrow, lend, and accumulate money, the same conclusion can be drawn for them as for foundations, that is, that credit cooperatives cannot be transformed into a commercial organization.

State and Municipal SME Support Funds. State and Municipal SME Support Funds are not allowed to transform into a commercial organization for the same reasons that apply to other foundations.

Autonomous Noncommercial Organizations. The federal law *On noncommercial organizations* clearly states the rules of transformation for autonomous noncommercial organizations: they may transform into a voluntary or religious organization, or into a foundation. An autonomous noncommercial organization is not allowed to transform into a commercial organization.

Noncommercial Partnerships. In 2002, legislators made an exception for noncommercial partnerships. In addition to the right to transform into a voluntary organization, foundation, or autonomous noncommercial organization, they were allowed to transform into a business society. There are restrictions, however, and a noncommercial partnership has to meet certain legal criteria to be able to transform.¹¹⁸ A noncommercial partnership offering microfinance services does not have this option.

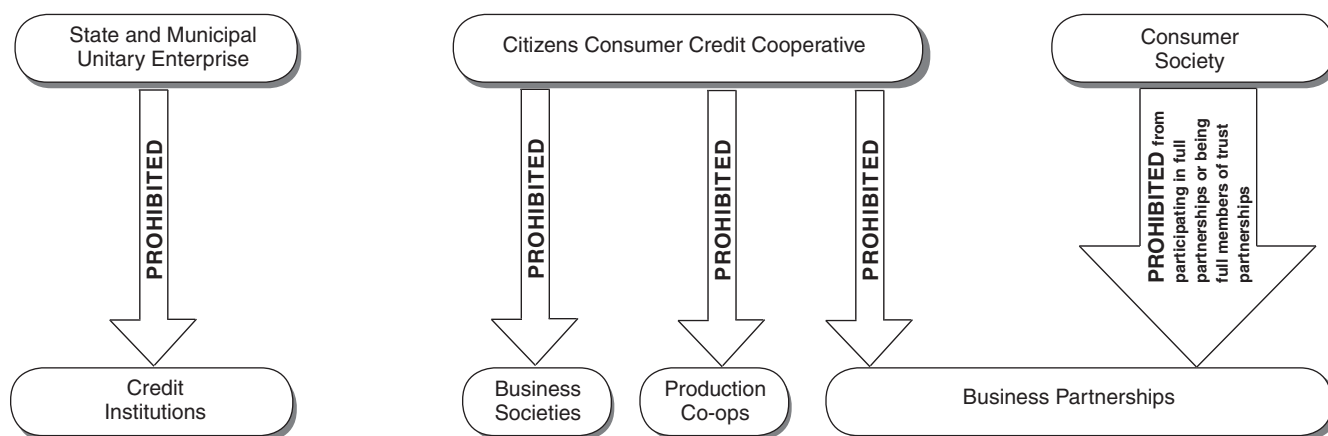
Participation in the Establishment Of Other Organizations

Figure 4 shows the legal restrictions on participating in the establishment of other entities.

The law prohibits citizen consumer credit cooperatives to contribute their assets to the equity of business partnerships and companies, production cooperatives, or otherwise contribute their property to that of other legal entities, while allowing citizen consumer credit coopera-

¹¹⁷ The only exception applies to cooperatives established as consumer societies under the federal law *On consumer cooperation (consumer societies, and their unions) in the Russian Federation*. Article 29 of this law provides for the possibility of transforming into a consumer society (without mentioning the target institutional form) by a unanimous decision of members or shareholders.

¹¹⁸ According to federal law *On securities market*, No. 39-FZ, April 22, 1996, a stock exchange which is a noncommercial partnership may be transformed into a joint stock company.

FIGURE 4. RESTRICTIONS IMPOSED ON PARTICIPATING IN THE ESTABLISHMENT OF OTHER ORGANIZATIONS

tives to establish bodies of self-regulation, such as associations and unions.¹¹⁹ It is hardly possible, though, to exercise this right without violating the prohibition established by the same law: while membership dues are supposed to serve as the main source of income for member-based associations and unions, citizen consumer credit cooperatives are not allowed to pay them.

Consumer societies are prohibited only from participating in full partnerships and as full members of trust partnerships.¹²⁰

Other MFIs established as noncommercial organizations may establish commercial organizations independently or jointly with other organizations or individuals. Property contributions to a commercial entity or society may include money, securities, other property or property rights, or other rights where monetary value may be established.¹²¹ If a noncommercial organization decides to establish or coestablish a commercial company, such as business partnership or society, it may contribute to the equity of the new company the unrecoverable funds it received for its statutory (noncommercial) activities, upon paying profit tax on these funds and provided that the donor authorizes such use of the grant. Revenues generated by a noncommercial organization's commercial oper-

ation may also be used to build the equity of a new company.

For a unitary enterprise, participation in a commercial or noncommercial organization requires the consent of the unitary enterprise owner. A unitary enterprise may not establish or participate in credit institutions.¹²³

Issues that Require Improved Normative Regulation

Unjustified restrictions imposed on participation in the establishment and activities of other organizations must be removed.

Participation in the Establishment Of Credit Institutions

Credit institutions are established as economic unions. MFIs established in forms allowed to participate in business societies or credit institutions may establish (coestablish) banks or other credit institutions.

The Central Bank of the Russian Federation makes the decision to register a credit institution. Whether a new credit institution is being established, or a certain type of

¹¹⁹ Ibid., Article 28.

¹²⁰ Article 21 federal law *On consumer cooperation (consumer societies, and their unions) in the Russian Federation*, No. 9, July 11, 1997.

¹²¹ Paragraph 6, Article 66 RF CC.

¹²² The charter capital [authorized capital] of a limited liability company must be at least one hundred minimum wages, as established by federal law as of the date the company files its application for incorporation (federal law *On limited liability companies*, No. 14-FZ, February 8, 1998). The equity of an open joint stock company must be at least one thousand minimum wages, and that of a closed stock company must be at least one hundred minimum wages, as established by federal law as of the date the company files its application for incorporation (federal law *On joint stock companies*, No. 208-FZ, December 26, 1995). As of April 17, 2003, the minimum wage was 100 rubles, and the RF CB-established ruble-US dollar exchange rate was 31.1905 rubles for 1 USD.

¹²³ Article 6, federal law *On State and Municipal Unitary Enterprises*, No.161-FZ, November 14, 2002.

credit institution is being reorganized or transformed into another type, they must submit the application and the papers to the RF CB.

Following the RF CB decision to incorporate a credit institution, the registering authority makes a related record in the Unified State Register of Legal Entities.

A license to perform banking operations is issued to a credit institution after the incorporation. A credit institution may perform banking operations as soon as it receives a license. The license indicates banking operations allowed to the credit institution, and their currency. The banking license has no time limit.

Within three days of receipt of confirmation from the registering authority that the credit institution has been recorded in the State Register, the RF CB notifies the

founders that they must contribute 100 percent of the bank's stated equity within a month. Failure to pay the equity or failure to pay the full amount in time can trigger a liquidation procedure.

The minimum equity requirement for a nonbank credit organization engaging in deposit and credit operations is one-tenth of the minimum equity requirement established for a bank, totaling 500,000 euros.¹²⁴ The RF CB establishes its ruble equivalent on a quarterly basis, by the 5th of the first month of the quarter, based on the current euro to ruble exchange rate.

If so authorized by the RF CB Board of Directors, participants (shareholders) may contribute in-kind assets or building or premises to the equity of a new or existing credit institution.¹²⁵

PROPOSED GUIDELINES FOR PROMOTING LEGAL ENVIRONMENT REFORMS

As problems arise, there arises the need to adopt new legal norms or to change the current regulation of certain aspects of microfinance activities. Problems and approaches to their solution are not the same at different stages of development of microfinance in general and of individual microfinance institutions. For the dynamic development of microfinance and MFIs, it is important that all MFIs work together on improving the legal environment for microfinance activities.

The following stages may be identified and associated with specific types of problems and their solutions, as identified in Russia (see Figure 5):

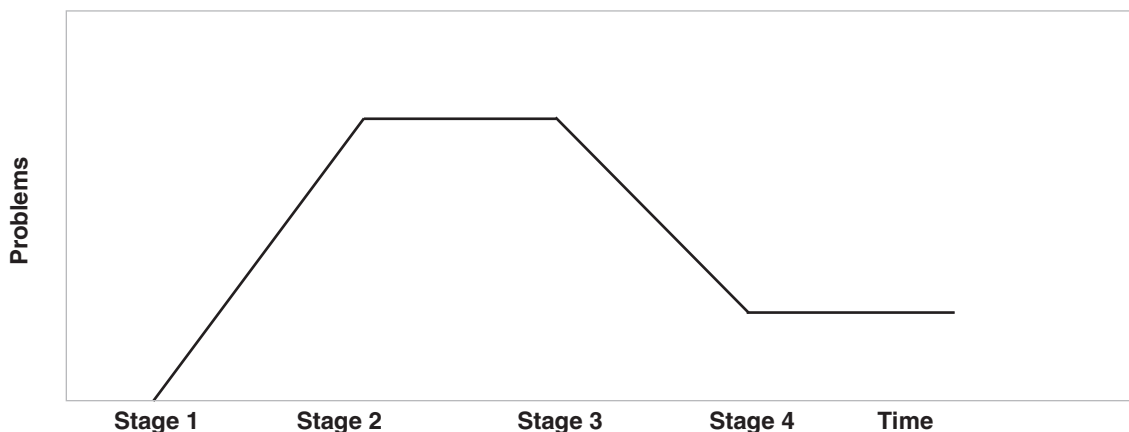
Stage 1—Microfinance emerges as an activity that is virtually unregulated by law. It carries out its operation based on the general legal premise that “anything is permitted which is not expressly forbidden.” As microfinance evolves, more and more activities take place that are neither permitted nor forbidden nor regulated in any way by effective laws. Problems multiply, but no legal solutions are offered.

Stage 2—Microfinance continues to evolve; new MFIs emerge in large numbers; their operations are numerous and diverse. Now there is a clear need for legal norms

to establish clear and unambiguous provisions regulating microfinance activities. Most practitioners are aware of the problems, but the microfinance sector has not developed a consistent approach to their solution. Different, sometimes mutually exclusive solutions for the same problem are suggested to organizations at different stages of their development and established in different institutional and legal forms.

Stage 3—Microfinance becomes commonplace. There are conflicts of interest among different groups, dictating the need to coordinate approaches and reach a compromise. Members of the microfinance community come to understand that the development of each individual organization is linked to the development of the entire community, that legal provisions must meet the needs of all or most members of the community, and that a fair balance must be achieved among official, public, and individual interests. As a replacement for their freedom to do “anything that is not expressly forbidden,” MFIs reach a new level of freedom allowing their full and balanced development in a legal environment. MFIs collectively work out solutions that suit most members of the microfinance community, are supported by society, and are endorsed by the government.

FIGURE 5. STAGES OF LEGAL PROBLEMS AND SOLUTIONS



Stage 4—The accumulated legal problems of microfinance activity have been addressed, one by one. Quite few new questions arise; most of them are answered promptly. The pressure of problems at any given time is manageable and this allows for a steady, sustainable development of microfinance.¹²⁶

Microfinance practitioners in Russian regions have a different assessment of the current situation. Participants at the Legal Experts group meeting in Khabarovsk in June 2003 believe that Russian microfinance institutions are currently in the middle of Stage 1, while participants at the Moscow meeting in May 2003 are of the opinion that Russian MFIs have already reached the middle of Stage 2.

All experts agree that the main principles for promoting reforms in the legal environment should be the following:

- Jointly designed and adopted decisions which suit most of the microfinance community;
- Jointly promoted legislative proposals which are well considered and well developed (a substandard law is ineffective and often counterproductive);
- Legislative initiatives must support microfinance actively rather than allow it passively; and
- Laws must meet the actual public need by improving the regulation of relations that already exist.

Urgent and Long-Term Reforms

The microfinance community faces both short-term and long-term challenges in relation to legal reform.

Short-term reforms are needed to legalize MFIs that are established and operate in a legal vacuum; it is also necessary to repeal or amend legal provisions that hinder or block the development of microfinance.

Long-term reforms aim to ensure sustainability, market viability, and the self-sufficiency of MFIs; they should promote investment in microfinance, ensure transparency, and address other issues, in particular gaps and inconsistencies in the effective legislation. The implementation period for long-term reforms will take up to seven years.

Therefore, issues that require improved normative regulation, as defined in this paper, may be categorized accord-

ing to the time period needed for implementing relevant reforms:

- Short-term legal reforms must address the following issues:
 - Establishing federal legal provisions of state support of microfinance activities performed by organizations created under various institutional and legal forms;
 - Adopting a law allowing the establishment of credit cooperatives with corporate participation;
 - Improving the law *On state SME support in the Russian Federation*;
 - Improving provisions regulating the use of a simplified system of taxation;
 - Reflecting MFIs' legitimate interests in the bill *On mutual insurance*; and
 - Reflecting MFIs' legitimate interests in the bill *On credit bureaus*.
- Long-term legal reforms must address the following issues:
 - Removing the uncertainty caused by a lack of legal definitions of microfinance terms and concepts;
 - Assistance in organizing state control over credit cooperatives at the level of subjects of the Russian Federation, which would protect the rights of MFIs and their borrowers, therefore promoting the development of small business and MFIs;
 - Systematization of legislation regulating credit cooperatives;
 - Prudential regulation of credit cooperatives;
 - Systematization of legislation regulating noncommercial organizations;
 - Regulation of the establishment of guarantee funds;
 - Removal of unjustified discriminatory restrictions and administrative barriers to socially beneficial activities of noncommercial organizations;
 - Improvement of tax legislation;
 - Creation of conditions for effective realization of formally provided tax benefits; and
 - Removal of unjustified restrictions imposed on participating in the establishment and activities of other organizations.

To enable the development of microfinance, a necessary instrument of small business support, both urgent and long-term reforms must be implemented in accordance with the above principles.

¹²⁶ Members of the Policy Advisory Group meeting on May 21, 2001 defined the following timelines for the stages:

Stage 1: 1994-2001;

Stage 2: 2001-2005; and

Stage 3: 2005-implementation of long-term reforms.

MAIN CHARACTERISTICS OF A PERFECT LEGAL ENVIRONMENT FOR MICROFINANCE ACTIVITIES

The experience of microfinance institutions in various countries makes it possible to describe the main characteristics of a legal environment that could enable microfinance to develop to the fullest extent, that is, a perfect legal environment. In different periods and in different countries, the actual legal environment may correspond to a perfect environment more or less, and the more it corresponds, the greater the chances for the sustainable development of microfinance and MFIs.

The description of a perfect legal environment offered below is the collective product of a number of professionals.¹²⁷

Development of Institutions that Deliver Microfinance Services

The development of diverse institutional and legal forms of MFIs should help them become more committed and better able to provide access to financial services for all customers, including those who cannot access credit at the moment.

There is no single, perfect type of organization. At any stage of development of microfinance services it must be possible for the following types of organizations to run microfinance operations:

1. Noncommercial organizations focusing mainly on microfinance;
2. Credit cooperatives or similar membership-based organizations focusing on microfinance as their main type of service;
3. Commercial organizations that use their own funds to provide microfinance services as their main operation;
4. Specialized credit institutions licensed to perform certain banking activities, that deliver microfinance services and take deposits from individuals and/or organizations; and
5. Banks that are given the same opportunity as other institutions to run microfinance operations.

Access to Adequate Sources of Assets

Many MFIs operating in Russia as noncommercial organizations have their microfinance programs supported by foreign and international donors. However, grant funds become less available over time and may disappear altogether at some point in the future. For this reason, organizations of all institutional forms, for as long as they offer microfinance services, must have access to diverse sources of funding which, together, ensure their long-term sustainability. Laws should allow MFIs to access suitable funding and, given the social benefits associated with microfinance, should create an environment which makes investment in MFIs attractive. MFIs should be able to access the following types of funding for their operations:

1. Funding from foreign and international noncommercial organizations;
2. Funding from foreign and international commercial sources (such as international investment funds);
3. Credit from local commercial banks (should be accessible in effect, not just formally);
4. Funds borrowed from individuals and organizations; and
5. Central and local government funding on a call-for-proposal basis accessible to all MFIs.

Prudential and Non-prudential Regulation

All types of institutions that deliver microfinance services should be subject both to prudential and non-prudential regulation corresponding to the specific risks faced by MFIs of a particular type:

1. Prudential norms for MFIs that do not accept deposits from individuals should take the form of recommendations, rather than mandatory provisions (it is in the organization's own interests to ensure stability of its operation);
2. Prudential regulation for credit cooperatives and similar organizations that are membership-based and managed by their members must be suited to the

¹²⁷ See the Introduction to this paper.

specific nature of the organization, whose assets come entirely, or mostly, from members' contributions; and

3. Full-scale prudential regulation should be applied to organizations that take deposits from private individuals.

Taxation Regime

The taxation regime that laws and other acts establish for MFIs should be clear, unambiguous, and fair.

Noncommercial organizations that deliver microfinance services as the main focus of their activities should be entitled to the same tax advantages as other noncommercial organizations working for the public good.

Any exceptions to the general provisions for taxation purposes and any specific methods of taxable base calculation should take into account the economic situation in the country and the potential public good of the operation. The taxation of financial transactions should be based on the type of transaction, rather than the type of organization, and similar transactions should be treated under the same taxation regime, whether performed by commercial banks or noncommercial organizations.

Double taxation should not exist in a perfect legal environment.¹²⁸

Activities Involved in Lending and Enforcing Obligations

Provisions regulating the legalization of loans and debt instruments must be clear and allow MFIs to accept various types of loan security, especially those that are more accessible to MFI clients, such as group guarantees, or the pledge of business assets and personal property.

The mechanism of enforcing obligations must be simple and effective, including the legal proceedings and the collection of debt through the sale of collateral.

Transformation of Organizations that Deliver Microfinance Services

Participation in the Establishment of Other Organizations

Transformation of an MFI, that is, a change of its institutional and legal format, or its participation in the establishment of another organization may be necessary to access new sources of funding for microfinance purposes, allowing them to expand the range of financial services delivered. In particular:

1. Noncommercial MFIs should have available to them practical mechanisms of transformation or participation in the establishment of a commercial organization through contributing the loan portfolio as part of the authorized capital of a commercial organization;
2. Practical mechanisms should be elaborated allowing the transformation of a commercial organization that delivers microfinance services without taking deposits from individuals, into a licensed financial organization; and
3. From the legal perspective, all MFIs should be allowed to be cofounders of associations and unions.

Integration of Microfinance in a Wider Finance Sector

On the one hand, microfinance should be perceived as an integral part of a broader finance sector, while on the other hand, there should be a clear, generally accepted or legally established definition of microfinance activity and MFI.

In some cases, legislation regulating other activities of financial institutions may include provisions that regulate microfinance—if necessary, by amending such legislation. When a concept is new, separate normative acts regulating microfinance should be adopted, in addition to effective legislation. Special care should be taken to avoid the appearance of new and “unwelcome” actors that use softer regulations applied to MFIs for purposes inconsistent with the public interest.

¹²⁸ Members of many Russian credit cooperatives funded exclusively by their members' contributions and distributing their profits among members believe that the current provisions impose double taxation on them: first the interest is taxed under the corporate profit tax [tax on the property of organizations], and then under individual income tax.

