ESSAYS ON REGULATION AND SUPERVISION

Kazakhstan's Microfinance Law

Opportunities and Future Challenges

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ABOUT THE SERIES

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Kazakhstan Country Context

Country Background

Kazakhstan is situated directly south of Russia, bordering China, Kyrgyzstan, Turkmenistan, and Uzbekistan. The country covers 2.7 million square kilometers and has approximately 15 million citizens, making it the least densely populated country of Central Asia. Kazakhstan is blessed with rich mineral resources[1], including significant amounts of oil and gas along the Caspian Sea.

1. Kazakhstan's mineral reserves include iron, coal, lead, aluminum, copper, zinc, nickel, silver, and gold.

After the break-up of the Soviet Union in 1991, Kazakhstan was the last Soviet Republic to claim independence. Nursultan Nazabaev has been the named president since this time. Kazakhstan has been able to weather the economic storms faced by all the former Soviet Republics in the 1990s, mainly due to its healthy oil and gas reserves which have attracted significant foreign investments. As of 2004, Kazakhstan's GDP per capita was $5,630.[2]

2. World Development Indicators (2003), stated in PPP $.

The Microfinance Sector and Existing Regulatory Environment

Millions of workers lost their jobs as the Russian Centralized economy collapsed. Many factory workers, as well as government staff, were left to make their own way in the new market economy. Many of these individuals turned to small trading in bazaars and as street vendors as a means of self employment. As a result, almost overnight Kazakhstan developed a huge informal sector that had limited skills, resources, and access to capital.

With limited funds to start and run their enterprises, many of these nascent businesses turned to informal money lenders for working capital. By the mid-1990s, as the foreign donor community and international NGOs became more active in Kazakhstan, the idea of creating microfinance institutions to serve this population took hold.

Passage of a Non Bank Financial Institution License

In 1996, USAID and several international NGOs began lobbying the Kazakhstan Government for a legal form of micro financing. In 1997, the Government approved and passed a National Bank of the Republic of Kazakhstan (NBRK) regulation allowing local legal entities to apply for non-bank financial institution (NBFI) licenses. This NBFI regulation allowed the NGO lending community to apply for and secure a NBRK license for 'lending only' purposes.[3] This was an important step as it allowed the unregulated NGO sector to become part of the regulated formal financial sector, requiring greater transparency, mandating

3. In 1997, most microlending was being done through international NGO's representative offices or donor umbrella schemes.

provisioning requirements, raising reporting standards, and formalizing overall operational systems.

The passage of this regulation was a huge achievement and opened the possibility for the non-profit sector to legally provide micro loans. Unfortunately, only a handful of organizations chose to register in this legal form – preferring to operate under the umbrella of international donor institutions and/or NGOs. As a result, the NBFI regulation secured the formalization of several important institutions but did not bring the country-wide results that the Government had hoped.[4]

Some of the reasons the NGOs resisted applying for an NBFI license was the fact that there were perceived increased costs due to: (1) new types of reporting to the NBRK; (2) mandatory physical security requirements that would have to be met; and (3) increased scrutiny from local tax authorities about the payment of salary and profit taxes. In addition, some NGOs were operating their MFI programs on a cash-only basis, never depositing excess funds into a bank account, i.e., never using a bank account for their lending activities. This allowed the programs to avoid the scrutiny of tax authorities regarding profits and salary taxes. As an NBFI, this practice would have to stop due to increased visibility and oversight by various tax authorities. In the early months after the regulation was passed there were significant waiting periods to receive a license as the Central Bank developed its internal procedures for NBFIs; these issues have since been addressed.

In the late 1990s there was a perception by the international NGOs and local NGOs that becoming an NBFI would entail risks and costs. As many groups were operating under the umbrella of the international organization's representative office status and had extremely limited reporting requirements, becoming a localized entity was considered by many to be a potential risk.[5] Many international NGOs were unsure about how they might transition their MFI (operating under a representative office status) to a local entity and had concerns about the strategic implications of these actions. In the late 1990s, Kazakhstan's economic and political stability were also much less clear. As was noted by a NBRK Advisor during that time:

"These [informal] entities were not moving to the formal financial sector in an attempt to avoid high levels of documentation requirements in the formal sector, an elongated and not overly transparent process for banking activity licensing, a regulatory regime that did not adequately distinguish microlending organizations from commercial banks, and finally to avoid taxes."[6]

Organizations that chose to register as an NBFI considered the positive aspects of being an NBFI to outweigh the possible negative side effects of regulation. One of these organizations was the Kazakhstan Loan Fund (KLF). The most important issue at that time for KLF was to be considered part of the formal financial system. Prudential regulation gave investors

4. As part of the lobbying efforts, donors had suggested that legalizing microfinance would bring a significant number of new resources under the supervision of the Central Bank.

5. In the late 1990s, Representative Offices had very limited reporting requirements to the Ministry of Justice and not until 2005 did these entities come under greater scrutiny to abide by Kazakh laws and the tax code.

6. Stirewalt, Bryan. "Microlending Organizations in Kazakhstan: Regulation and Supervision Issues".

confidence that an institution met certain norms and requirements. As such, becoming an NBFI opened many doors for KLF to seek commercial funding; KLF obtained its first commercial loan in 2001 from the Dexia Fund, managed by Blue Orchard.

Less tangible benefits of being an NBFI include the various standards that this legal form must meet and the respective transparency and stature these bring. Several examples include: (1) NBFI Chief Accountants and General Directors must pass an exam conducted by the Central Bank; (2) NBFIs must be able to produce standardized balance sheet, income statements, and portfolio reports; (3) physical security requirements are similar to those of a commercial bank[7]; and (4) provisions must meet Central Bank requirements and are considered a pre-tax expense (although this was not allowable until the tax code was changed in 2002).

7. This includes having a vault room for cash, electronic security system, bars on all windows and 24-hour security guards.

In 2004, the NBRK created a new regulatory body for commercial banks, NBFIs, insurance companies, mortgage firms, leasing organizations, and credit partnerships. This regulatory body is called the Financial Supervisory Agency and is responsible for all prudential regulation in Kazakhstan. In 2005, the Supervisory Agency is considering withdrawing its supervision of NBFIs and credit partnerships. This is being lobbied against by the NBFIs and the MFI Association of Kazakhstan.

Passage of a Microlending Organization Law

By 2001, USAID re-initiated its work with the NBRK to promote the growth of NBFIs and the informal microfinance institutions. Various options were presented to the NBRK regarding the legalization of microlending activities in Kazakhstan. The Bank's USAID Advisor during this time drafted a multi-tiered MFI Law for the Central Bank's consideration. This would have allowed limited supervision of 'lending only' institutions and prudential regulation of the top level, deposit taking entities.

The Central Bank remained concerned, however, about regulating a sector that would be operating in very remote regions of the country, would be difficult to audit, and whose financial results the Bank would ultimately be held responsible. As such, the Central Bank rejected the multi-tiered draft law concept and internally drafted a new law on Microlending Organizations. This law was written in a manner that would remove Central Bank responsibility from overseeing microfinance activities.

In 2003, the Government passed the "Law on Microlending Organizations" which allowed commercial and non-commercial organizations to register with the Ministry of Justice as Micro Lending Organizations (MLO).[8] Unfortunately, the MFI sector was given limited opportunity to vet this new law before it was passed. There were informal discussions held with selected international NGOs and donors but for the most part, there was limited support for the MLO as it was passed.

8. For-profit institutions must register as an economic partnership; non-profits as a public fund.

Under the MLO Law, organizations are monitored by the Government Statistics Agency and supervised by the Ministry of State Revenue through local tax authorities. MLOs are not supervised by the Central Bank and are not considered part of the formal financial system; MLOs are therefore exempt from all prudential norms set by NBRK. The basic requirements to become an MLO are:

- to stipulate micro lending as a key activity in the Charter document
- to secure a minimum charter capital of approximately $5,300[9]
- to make individual loans of not more than $5,300
- to make no individual loan of more than 25% of the MLO's total capital

9. This is not required for non-profits.

There are no restrictions on MLO staffing or hiring except for a required internal audit function. MLOs are not required to make provisions for loan losses or to follow a bank chart of accounts. Accounting and reporting functions are to be carried out in compliance with the rules of the Law on Microlending Organizations and the laws of the Republic of Kazakhstan on accounting standards and financial reports.

One of the few reporting requirements for MLOs is an annual external audit. MLOs are also subject to fair practice standards and must inform borrowers of their rights and responsibilities; copies of approved loan procedures must be posted in a publicly accessible location within the MLO. In terms of transparency, MLOs must publish their annual balance sheet and income statements.

The Law on Microlending Organizations has several weak areas of concern that are being addressed through the lobbying efforts of the newly created MFI Association of Kazakhstan, AMFOK. Of greatest important is the issue of provisions. MLOs do not have the same privilege as NBFIs to consider provisions as a pre-tax expense. The law also limits individual credits to $7,500 and AMFOK is requesting this to be raised to $30,000. Due to this and several other minor points, AMFOK is lobbying the Government to make changes in the MLO Law and tax code to address these issues.

After the passage of the Law on Microlending Organizations in 2003, over 125 organizations legally registered as MLOs. Most are small, privately formed institutions providing services in one city or area. Many of these new MLOs were formed to serve a group of known individuals and have limited civic-minded motivations. Most of the larger MFIs operating in Kazakhstan remain working as NBFIs and plan on continuing in this legal form or transforming into a commercial bank.

Kazakhstan Loan Fund

History and Legal Structure

The Kazakhstan Loan Fund (KLF) was founded in 1997 as the first non-bank financial institution (NBFI) to offer micro lending services in Kazakhstan. KLF was initially funded through a USAID grant with technical assistance from ACDI/VOCA, an American non-for-profit.

The first step to become a legally registered MFI in Kazakhstan was to register with the Ministry of Justice. As such, in 1996 ACDI/VOCA (KLF's legal founder) registered KLF with the Ministry of Justice as a non-for-profit, Public Fund. The second step in the process was for this new Public Fund, the Kazakhstan Loan Fund, to apply to the NBRK for a non-bank financial institution (NBFI) license. KLF's NBFI license was secured in November 1997 and KLF subsequently disbursed its first loan the same month.

As an NBFI, KLF is prudentially regulated and must meet many reporting and regulatory requirements as second tier banks. For example, the physical security of KLF's property must include bars on the windows, security guards, an electrical security system, and a vault room.

At the same time, KLF's status within the formal financial system also allows it certain tax privileges. The most important two include exemption from value-added tax on interest income and the calculation of profit tax after loan loss provisioning.

During KLF's 7 ½ year history, there has been much internal debate about the value of being part of the formal financial system. On the one hand, there are quarterly reporting requirements and physical security requirements that increase overall costs. On the other hand, being prudentially regulated has proven to be a great asset to KLF as it has grown beyond grant funds and secured international investments. KLF currently has an active portfolio of $7 million with $3.5 million in commercial loans from both international and local sources.

Transformation

KLF is now faced with a situation where its capital needs exceed its current ability to raise new sources of debt/equity. This is in part a reflection of its non-profit status, and thereby its unclear ownership structure as a non-profit.[10] As a non-profit, KLF also cannot distribute dividends.

10. As a non-for-profit, KLF has no clear owner but is governed solely by its Board, with limited powers given to the founder (such as liquidation rights).

There is no specialized MFI law in Kazakhstan that enables KLF to become a for-profit entity and take deposits. The only legal organizational form that can take deposits and make currency transactions (accepting of remittances, etc) is a second tier bank. To address this issue, the KLF Board of Directors has decided that the KLF will undertake a transformation process over the next five years to secure a banking license and become the first MFI Bank in Kazakhstan. The minimum charter capital for banks is $15 million and the status is accompanied by a wide range of physical security, MIS, and staff requirements.

KLF has completed a set of financial projections and a business plan that presents a synopsis of how the transformation into a bank will be completed. This will require KLF to sustain an active portfolio of at least $25 million, accompanied by plans to open at least two new branch offices (in Astana and Kyrzlada) and 13 new sub-offices around the country.

Challenges of Transformation

According to the current legal requirements in Kazakhstan, commercial banks must be registered in the form of a joint stock company. As joint stock companies have a host of reporting requirements and are legally complex to manage, KLF will first expand its equity base to meet the minimal commercial bank requirements before legal transformation begins. This will allow KLF to operate in its current legal form until it meets the minimal charter capital requirements to become a commercial bank.

It is important to note that legal requirements constrain KLF as a non-profit from liquidating its assets and capitalizing a for profit, joint stock company. As in most countries, these legal barriers exist to prohibit rent seeking behaviors. As such, KLF will register the new joint stock company as a separate legal entity and the non-profit will continue to exist as one of its owners.

KLF will initially register the joint stock company with the minimum charter capital in cash. It will then gradually liquidate each branch and transfer its assets into the joint stock's charter capital. By transferring its assets (both portfolio and fixed assets) into charter capital, KLF will maintain the value of its equity and avoid taxation on the transfer.[11] For fixed assets this can be done through one official 'assessment' of the assets before they are transferred. The portfolio will be gradually transferred over during a 3-5 month window as KLF loans come due. All new loans will then be disbursed from the joint stock company.[12]

KLF will be re-registered with the name of the *Kazakhstan Development Foundation* and retain its original founder, ACDI/VOCA. One challenge, however, was to determine the new mission of the Foundation since its original mission of providing microloans will be given to the joint stock company. The strategic vision for the Foundation will be to deliver MFI training programs as well as provide support to the communities where KLF lends. As such, the Foundation is envisioned as having the following key objectives: (1) to provide free and fee-for-service training and consultations; and (2) to provide mini-grants and in-kind donations to the communities where KLF, JSC operates.

Initially, the Kazakhstan Development Foundation will own all of the new joint stock company. This fact actually conflicts with the goals of the transformation; that is, to obtain a clear ownership

11. Asset transfer would involve a 20% value added tax. Contributions to charter capital are tax exempt.

12. The Joint Stock Company (JSC) will retain the name of Kazakhstan Loan Fund (KLF), JSC.

structure of the Kazakhstan Loan Fund. The situation of KDF owning KLF, JSC cannot be avoided at the outset and during the transformation period KLF will aggressively seek potential equity investors that will dilute the Foundation's ownership. However, given KLF's current growth pattern and average annual retained earnings from interest income of $1 million it will take many years for the Foundation's ownership to become wholly private.

In summary, KLF's transformation process can be considered in several stages, as described below:

- *Stage I.* KLF continues working as a non-for-profit while seeking new external sources of debt funds. Technical assistance and grant funding is identified for a new MIS and accounting system that will meet banking standards. Efficiencies are made to reduce staffing and overall operational costs. Expansion continues through new branch and sub-office openings.

- *Stage II.* Purchase and installation of an accounting/MIS up-grade to meet bank requirements. Staff training on new systems is completed. Marketing research on savings products is conducted and a range of services developed. Necessary physical security changes are made to each branch office. Attention is given to educating clients about the up-coming changes and the offering of new services. Branch and sub-office openings continue.

- *Stage III.* All new systems are on-line; Central Bank requirements are met; human resources are restructured and retrained; savings products are in-place. Equity funding is secured.

- *Stage IV.* Minimum charter capital requirement is met and KLF transforms into the first MFI bank in Kazakhstan. Savings services are launched.

Future Challenges

THE EXISTING LEGAL FRAMEWORK for MLOs and NBFIs in Kazakhstan leaves them at a clear disadvantage to the commercial banks in terms of savings mobilization, product diversification, and expansion. Specifically for MLOs, their lack of regulation puts them at a clear disadvantage to leverage their existing resources through commercial borrowing. These conditions will also make it difficult, except for the largest MFIs, to diversify their product offering and capture a larger market share.

Some NBFIs are considering transformation into a commercial banking structure that would allow deposit mobilization. Most MLOs will likely remain smaller, regional efforts that remain focused on a localized set of clientele. In the future, the key providers of microfinance services will be a few large NBFIs and the for-profit sector that includes transformed MFIs as well as commercial banks.

There are examples from the region that Kazakhstan could follow to provide its MFIs a more flexible regulatory environment. Both Kyrgyzstan and Tajikistan have MFI laws that allow for various ‘tiers’ of activities with all tiers reporting to the central bank. In both countries, MFIs have three legal choices under which to operate:

- Level I: Non-for-profit agencies or public funds can operate as lending only entities with limited oversight and regulation from the Central Bank.

- Level II: For-profit organizations (LLC or joint stock companies) can operate as lending only entities with limited oversight and regulation from the Central Bank.

- Level III: Joint stock companies are carefully regulated by the Central Bank and are allowed to capture savings.

It may be that through additional donor funding, advice, and support Kazakhstan will be able to capture some of the lessons learned from its neighbors and develop its own multi-tiered law for regulating microfinance activities. This would draw the unregulated MLOs into the formal financial system, increase their ability to attract investors, and open the door to diversifying their product range. Until that time, most MLOs will be unable to significantly borrow funds or attract equity and will be unable to mobilize savings.

In the future, the key providers of microfinance services will be NBFIs and the for-profit sector that includes transformed MFIs and commercial banks. There are also growing possibilities for credit partnerships to take on a new, more active role in supporting microfinance as the government considers revising the credit partnership law in 2005.[13]

One key challenge for MFIs will be to maintain their client base by providing a wider range of services. This will be vital to successfully compete with commercial banks that continue to expand their lending to the small business sector. MFIs will need to explore the opportunities of offering products that will allow clients to meet all of their financial needs through one institution. This will mean the development of not just savings services, but debit cards, ATM services, insurance products, and remittance transfers. In order to adapt to changing market demands, MLOs will have to address the legal barriers of broadening their services to maintain their market base.

13. Credit partnerships in Kazakhstan operate like credit unions but are not allowed to capture savings.

Concluding Remarks

KAZAKHSTAN is an economic leader in Central Asia. Many of its developments serve as an example for the other Central Asian countries to become more market-oriented.

The Kazakhstan MFI environment has unfortunately not played a leading role for Central Asia. Both Kyrgyzstan and Tajikistan have sound MFI frameworks that allow MFIs to operate in a regulated environment.

What is needed in Kazakhstan is an all encompassing law that would allow for a range of microfinance activities to operate with varying degrees of prudential supervision. This would include limited supervision of lending only institutions and greater prudential regulation for deposits mobilizing institutions. The result will be greater transparency for the microfinance community, improved access to formal commercial and public sources of capital, and as such – greater opportunities to expand outreach.

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