CONCEPT NOTE

Greater Access to Retail Finance:
Measures to Promote Microfinance in the Russian Federation

2008 - 2012

Developed by:

The National Partnership of Microfinance Market Stakeholders (NAMMS)

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Summary of This Concept Note

The purpose of this Concept Note is to define key areas of building an all-inclusive financial system to improve access to retail finance in the Russian Federation. This Concept Note provides an assessment of current access to retail finance in Russia; identifies client target groups in need of greater access to finance; identifies financial intermediaries to be involved in expanding access to retail finance; provides a summary of recommendations for better policy options and a summary of regulatory measures to be pursued by the government to enable the emergence of needed institutions and technologies in the finance market. In particular, the Concept Note highlights the links between financial inclusion and living standards, thriving entrepreneurship and SME, and other social and economic objectives.

This Concept Note is not intended to cover any areas other than expansion of retail finance and financial literacy. However, its findings and recommendations may be considered in designing broader strategies to promote the country's financial market, banking sector and SME, and form an integral part of such strategies.

As of 2008, around half of Russia's economically active population lacked adequate access to financial services.[1] Expanding access to finance to current levels in Eastern Europe by 2012, and subsequently to the levels in Western Europe by 2020, is consistent with the Russian President's message and will be a priority for the country's social and economic development. However, building an inclusive financial system requires consistent and appropriate government policies.

At the moment, most of the country's financial sector is concentrated in the capital. It requires the right policy, infrastructural and administrative conditions to enable financial institutions to expand over the entire country and to build a uniform and consistent financial environment. This Concept Note points out two main types of financial exclusion existing in the current system: territorial exclusion (due to inadequate financial infrastructure) and technological exclusion (due to mismatch between the available service delivery technologies and the needs of specific target groups).

The key distinctive feature of this Concept Note making it stand apart from other financial sector strategies is its client-centeredness. Today, financially excluded groups are low-income people, particularly rural dwellers; start-ups and microentrepreneurs. Therefore, associations of entrepreneurs and local businesses have an important role to play in the implementation of this strategy. Not limited to communicating the expectations and needs of users of financial services, they are actively involved in the process of building community-based financial institutions, such as credit cooperatives and other forms of microfinance providers.

Financial inclusion should be based on an institutionally diversified model of retail finance, reflecting the panoply of providers and technologies. A fundamental feature of the diversified model is its coordinated, two-way evolution, with banks downscaling from big cities to smaller communities and non-banks upscaling from smaller to bigger communities all at once. It is important to make sure that the regulation and supervision are matched to the actual risks involved and treat transactions of a certain risk level in the same way, regardless of the type of provider. This will avoid excessive use prudential

[1] See: Banking services for SME: credits are indispensable. Press Release №40. National Agency for Financial Research (NAFI), 2008.

supervision for non-prudential objectives and the existence of parallel financial subsystems with similar functions encouraging regulatory arbitrage.

The Concept Note highlights a few key areas for an inclusive financial system:

- expand and diversify banks' branch networks, reduce the costs of expansion;
- facilitate mircolending by banks (lending to low-income households, start-ups and microfinance institutions);
- promote non-bank microfinance institutions;
- encourage new technology making it possible to provide financial services outside bank offices – the so-called branchless banking;
- enable large non-bank microfinance providers to transform into regulated credit institutions (banks) to ensure continued growth of their functional capacity and transaction volumes; and
- improve financial literacy of the general public and SME operators.

This Concept can be implemented only if the government undertakes a number of strategic initiatives to promote enabling environment for the development of retail finance infrastructure, microfinance and branchless banking. The following are policy priorities:

- promote a favorable environment for the private capital and bank credits to flow to microfinance;
- build a multi-tiered system of credit cooperatives and support its sustainability; ensure protection of rights and legitimate interests of members and customers of credit cooperatives;
- promote the establishment of support infrastructure for microfinance and provide institutional assistance; and
- implement adequate and comprehensive regulatory policies for branchless banking.

“Design a system of measures to improve access to banking services for the population of medium-sized and smaller cities and rural communities, including by expanding the presence of banks and non-bank finance and credit institutions.”

The Russian President’s message to the Presidium of the State Council on 14 November 2006

“In order to advance the objectives of Russia’s social and economic development, it is imperative to ensure access to diverse forms of finance for entrepreneurial activities.”

The Russian President’s message to the Presidium of the State Council on 27 March 2008

1. Goal Setting

The **Goal** of this Concept Note is to define key areas of building an inclusive financial system to improve access to retail finance in the Russian Federation.[2]

Its **Objectives** are to:

- assess the current access to retail finance in the domestic market from the point of view of territorial and technological accessibility;
- identify target customer groups in need of greater access to finance;
- identify financial intermediaries to be involved in expanding access to retail finance; and
- develop recommendations for better policies and regulations to ensure integration of needed institutions and technologies in the finance market, *with a focus on microfinance technologies.*

Object of this Concept: retail finance, including microfinance operations (services and products).

Progressive Implementation of this Concept includes **(1)** building a manifold finance infrastructure covering the country's territory and creating a favorable institutional environment for the development of retail finance; and **(2)** encouraging wide use of technologies to improve financial access and coverage.

We should note that in today’s world access to finance is more than a right, but also a fundamental need of every individual and every business operator. Inequalities in terms of access to finance aggravate existing social inequalities and related social, economic and political risks.

[2] Access to financial services means territorial and technological accessibility of five basic types of financial services, i.e. credits, savings, payments and remittances, insurance and leasing.

Microfinance Objectives and Significance

Microfinance is the provision of retail financial services in small amounts (by the UN classification, up to 300% of the country's per capita GDP) to customers with low incomes or without access to conventional finance. Today it is understood to include credits, savings, insurance, leasing, transfers and payments (which reflects the concept of basic finance: LISTeC - leasing, insurance, savings, transfers and crediting), even though initially microfinance only included microcredits per se. Microfinance technologies seek to provide the entire range of financial services to low-income people, small and microbusinesses in a financially sustainable manner. In contrast to microfinance, conventional lending technologies are not suited to serving this type of customers on a large scale. The success of microcredit programs achieved in recent years has gradually alleviated the shortage of financial services worldwide. According to the Microfinance Information Exchange, in 2004-2006 total microfinance assets worldwide doubled to over $500 billion, and their customer base increased by 50%, exceeding 80 mln people in more than 100 countries. This success has been possible largely due to changed attitudes of authorities responsible for financial (banking) regulation and supervision, who increasingly take into account the specifics of microfinance in terms of reserves and supervision requirements, and promote microfinance institutions. Further development of microfinance institutions and technologies is an important factor of building an inclusive financial system based on an institutionally diversified model of retail finance.

Source: The Microbanking Bulletin №16, Spring 2008.

In Russia, microfinance technologies are increasingly accepted. As of early 2008, the country had more than 2,300 microfinance providers of various types with an aggregate loan portfolio of around 25 bln rubles. Among them, credit cooperatives[3] dominate, serving at least 600,000 clients in total.

[3] The Russian Civil Code defines a cooperative as an association of natural persons and legal entities united voluntarily in the form of a membership-based non-profit organization to meet their common material and other needs through a jointly-owned pool of the members' shares. Specialized credit cooperatives are regulated by a number of specific laws in Russia.

International Recognition of Financial Inclusion

Recently, many countries have achieved great success in making finance available to the public with the help of microfinance. The microfinance sector has gained public recognition and produced substantial practical results. Signs of such recognition included the UN Year of Microcredit 2005 and the Nobel Peace Prize awarded to 'social banker' from Bangladesh Muhammad Yunus - founder of Grameen Bank, which serves as a classic example of effective microfinance. Many national leaders of microfinance have gained international acclaim, including Banco Solidario (Bolivia), Compartamos (Mexico), and the Enterprise Development Group (US). Awarding the Nobel Peace Prize to Muhammad Yunus, the Nobel Committee noted that "Lasting peace can not be achieved unless large population groups find ways in which to break out of poverty. Microcredit is one such means."

Expected Effects. Implementation of this Concept should lead to a number of positive effects for the Russian economy and society.

Primary Effects:

- greater access to retail finance across territories and client groups;
- expansion of new microfinance technologies to support SME, encourage and facilitate start-ups;
- encourage household deposits, create more options for savings and investment;
- combat social exclusion of low-income people without social connections to improve their situation;
- discourage informal lending (usury);
- transition from cost-intensive methods of fighting poverty (subsidies and charity) to programs facilitating income-generation and access to finance to encourage self-employments and improve living standards of disadvantaged populations; and
- improve financial education and financial literacy.

Secondary Effects:

- increase the share of SME in Russia's GDP and reduce unemployment;
- increase revenues of population groups with lowest incomes;
- encourage diversified retail finance with the right balance between universality and specialization and a positive impact on sustainability of the entire financial system;
- enable consumers of microfinance services to choose from a broader range of providers, thus decreasing their dependence on a single provider and stimulating better performance of financial intermediaries; and
- improve overall social indicators, such as education, health and employment of women and youth.

It is important to note that a significant indirect effect of greater access to retail finance and expansion of microfinance will be the creation of social capital by encouraging horizontal and vertical networking in local communities. Credit cooperatives have an important role to play in such developments. This effect will be achieved through the establishment of new standards of conduct and improved social trust. The resulting social networks will:

- improve the capacity of local communities to address a range of other problems, such as poor local infrastructure, deteriorating ecology and lack of quality health care; and
- encourage the Russian people to rely on themselves to improve their situation, rather than expect the government to help them.

By making such a broad impact on the lives of people, microfinance may well become a powerful instrument of advancing social and economic objectives and building a vibrant civil society.

Current Access to Finance in Russia

As of 2008, around half of Russia's economically active population lack access to financial services. A survey of Russian businesses undertaken by the National Agency for Financial Research to estimate their access to finance revealed that the main barriers to starting a business include problems with taking a bank loan, lack of collateral, and difficulty with accessing finance both in the short term and in the long term. More than half of the surveyed entrepreneurs (55%) responded that accessing capital for business development was either too cumbersome or virtually impossible.

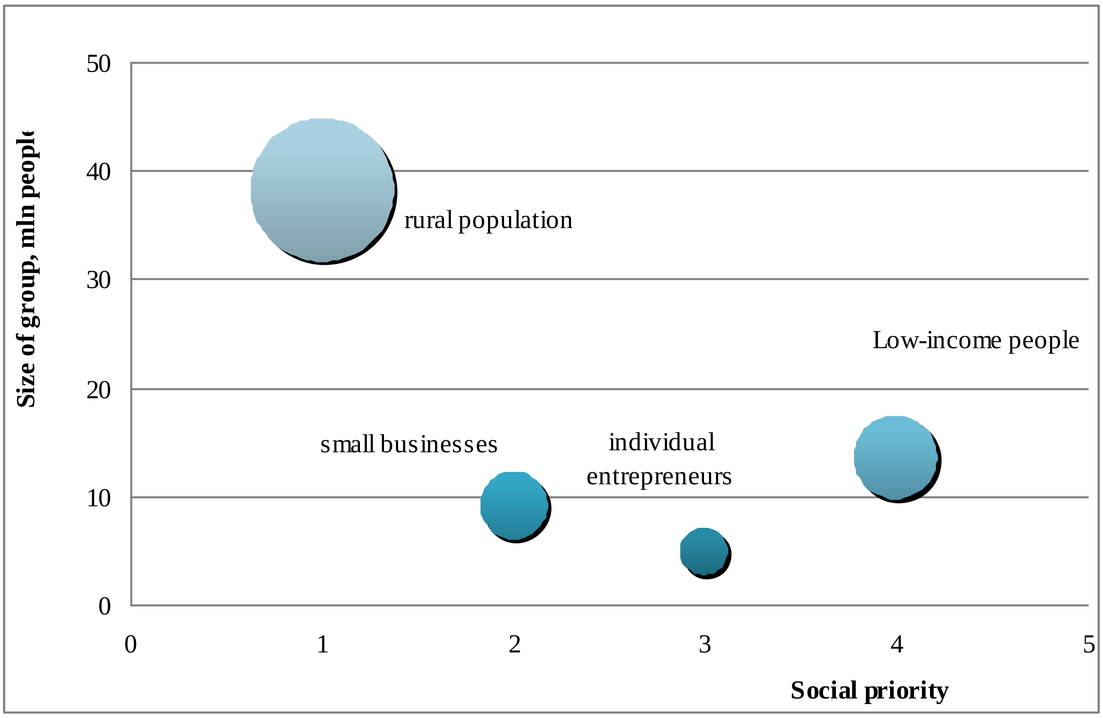
The Russian Public Opinion Center conducted a survey "Financial Services for the Population" in 2007 and found that the Russian public had a low general awareness of financial services and products available and related rules and procedures. As a result, people in Russia are not actively seeking financial services: the survey revealed that half of the population (5%) are not planning to use any financial services in the next year or two.

Thus, research findings suggest that many financial services remain inaccessible to broad public for a number of various reasons, such as lack of knowledge about financial services and cumbersome procedures hindering access to certain services. As a result, relatively few people plan to access financial services or find them affordable.

2. Client Target Groups

Groups most likely to benefit from greater access to retail finance are particularly significant from the social and economic perspectives and include (Graph 1): small businesses, individual entrepreneurs, low-income and rural populations.

Graph 1. Target groups – beneficiaries of greater access to retail finance



Source: the Federal Statistics Service and the Federal Tax Service, 2008.

Small business and individual entrepreneurs. Small and micro business owners[4] are the most active consumers of microfinance. According to the Russian Federal Tax Service, the number of taxpayers-individual entrepreneurs (operating without a legal entity) comes to 4.75 mln. people, or 3.4 percent of the Russian population.[5] As of end 2007, the Federal Statistics Service registered 1.13 mln. SME, approximately 80 percent of them falling under the category of *microenterprises*.[6] They employ a total of 9.1 mln. people, on average eight employees per enterprise.

They are a fairly diverse segment of microfinance consumers, including microenterprises, of household and commercial farms, family businesses and small start-ups. Small business owners are a class of people who create a positive outlook in society. They approach the development of their own business as a contribution to social and economic success of the entire country. Facilitating access to retail finance for SME and individual entrepreneurs is important for a number of reasons. Firstly, small business is critical for maintaining competition in the market. Secondly, small enterprises serve as a breeding ground for medium-sized companies. Thirdly, in all countries they are drivers of

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[4] Microbusinesses are legal entities - small enterprises meeting the criteria set forth in the Federal Law on the Development of Small and Medium-sized Entrepreneurship in the Russian Federation, with an average number of employees equal or less than ten.

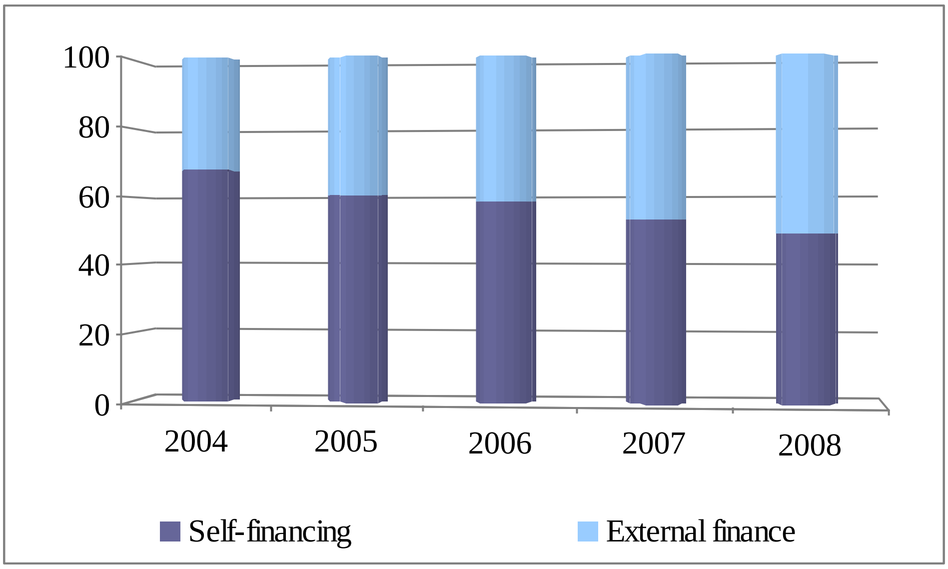
[5] The Russian Civil Code, art. 23 defines an individual private entrepreneur as a citizen who engages in entrepreneurial activities without establishing a legal entity after registering with the authorities as an individual entrepreneur.

[6] Small enterprises (businesses) or SME operators are legal entities meeting the criteria set forth in the Federal Law on the Development of Small and Medium-sized Entrepreneurship in the Russian Federation.

innovation. And finally, small business is a foundation for the emerging middle class interested in political and social stability.

Rural population. As of early 2008, rural dwellers totaled 38.2 mln. people, or 27% of the entire Russian population. The proportion of people living outside big cities has been maintained over the past decade due to low migration. Rural areas lack adequate finance infrastructure. Sberbank and Rosselkhozbank are the only banks with strong rural presence. Russian villages have been hit the hardest by low living standards and unemployment. Effective self-financing of rural entrepreneurs ranges between 49% and 53% and has been steadily falling over the past few years (Graph. 2). Consumers, as well as business start-ups require microfinance in rural areas. The high demand for finance is evidenced by the escalating rates of borrowing – the annual growth of debt financing in agriculture, hunting and forestry sectors exceeds 50%. Even though it is commonly believed that lending to rural borrowers is high risk and usually unprofitable, facts prove the opposite. The rural credit portfolio (rubles) has a delinquency rate equal or less than 1%, with ROA around 10%. Therefore, rural finance will be a priority area for expanding access in the next few years.

Graph 2. Financing structure in agriculture, hunting and forestry sectors, %.

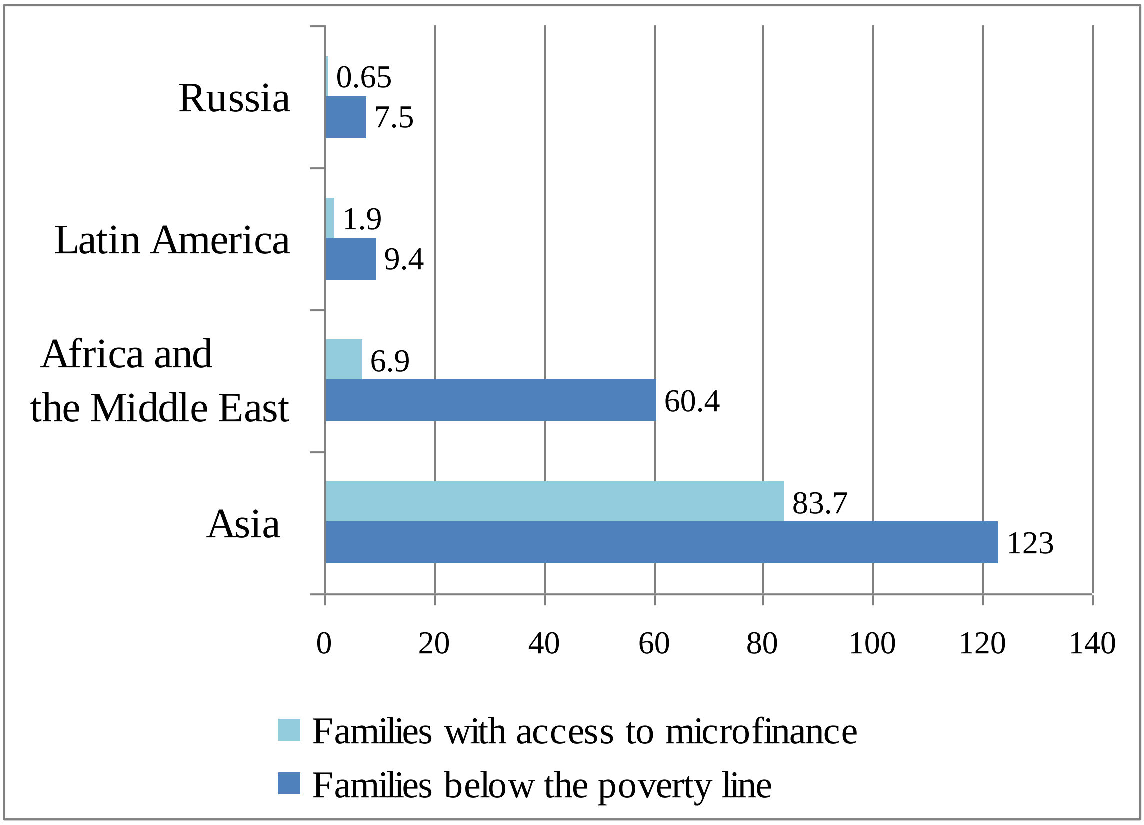


Source: the Bank of Russia

Low-income people. By official data, the number of people with incomes below subsistence minimum reached 13.4 mln, or 9.5 percent of the Russian population in 2007. Conventional banks do not perceive this group as attractive borrowers. Many factors account for their limited access to finance, such as low trust; poor credit rating; lack of business opportunities, steady employment or collateral, as well as high transaction costs of small loans. Today, less than 0.65 mln Russians have access to microfinance. As a result, microfinance coverage ratio[7] is just 9%, which is too limited even in comparison to Africa and the Middle East (Graph. 3). Starting a business or engaging in activity such as commercial or household farming does not only reduce poverty, but eventually allows low-income people to join the middle class. Clearly, without an adequate financial infrastructure and without access to finance they find it virtually impossible to run their own business, let alone make it profitable.

[7] Microfinance coverage ratio is a ratio of active borrowers of microfinance providers to the number of people living below poverty line.

Graph 3. International comparisons of access to finance for low-income people, mln households.



Sources: The State of the Microcredit Summit Campaign Report 2007, Rosstat, Microfinance in Russia: Benchmarking and Analysis in 2006, Russian Microfinance Center.

All of the above target groups generally require small amounts of finance, meeting the definition of microfinance. Specifically, aggregate demand for credit (loans) up to 300,000 rubles per borrower (active microbusinesses) is around 250 bln rubles at the moment, while aggregate supply of relevant financial services does not exceed 35 bln rubles (14% of the aggregate demand). Low-income people who consider starting their own business, but lack the seed capital, have an additional proven demand for microfinance of at least 500 bln rubles.

In view of the above, building an inclusive financial system - widely accessible to the public and business, stimulating private entrepreneurship and better living standards - is a priority for Russia's social and economic development.

3. Barriers to Financial Access

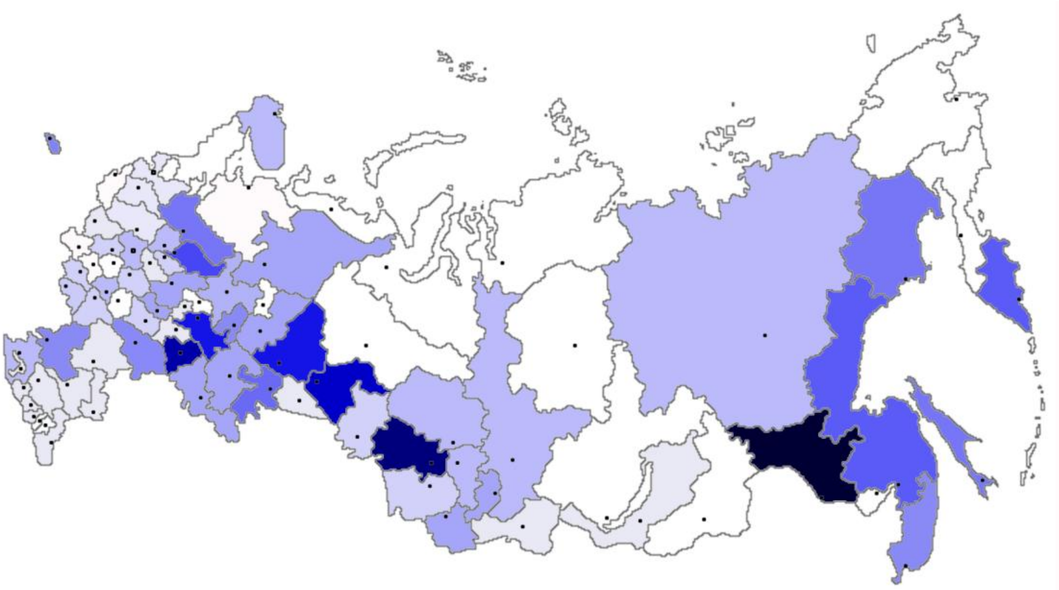
The goal of building an inclusive financial system and making retail finance available to most Russians is hindered by a number of barriers - infrastructural as well as technological.

The infrastructural barriers include **territorial disproportions in the development of financial sector.**

The development of retail finance is extremely uneven across the country. Besides Moscow, communities with the highest rates of retail finance coverage include St.

Petersburg, Novosibirsk, Samara, Tyumen and Amur Oblasts. Most other regions, however, lack adequate access to finance (Graph 5). Average rates of retail finance coverage in Russian regions are just 4% of that in Moscow. The situation is particularly acute in the Caucasus (Ingushetia, Chechnya), in sparsely populated Northern regions (Archangelsk Oblast, Karelia, Chukotka Autonomous District) and in poorer regions of European Russia (Tambov, Pskov, Bryansk Oblasts)[8].

Graph 5. Regional development of retail finance as of June 2008



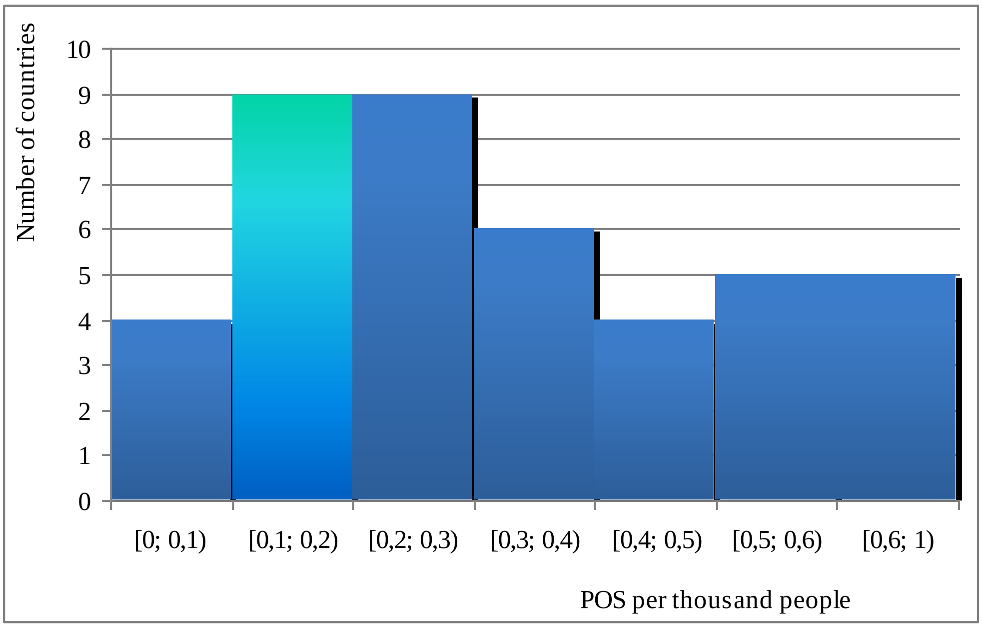
Note: See Appendix for raw data. Intensity of color indicates the degree of retail finance availability. White indicates minimal coverage of the region by retail financial services.

Regional disproportions are caused by the following factors:

1. **Underdeveloped banking infrastructure.** The development of financial infrastructure is complicated by external challenges. The high cost of setting up and running a branch network makes it unfeasible for banks to open branches in smaller communities, limiting banks' expansion from big cities to provinces. As a result, Russia falls behind many other countries in terms of banking networks development. Taking into account all branches and additional offices, their per capita ratio in Russia is half of that in any other G8 country, with just 0.169 bank branches and offices per 1,000 people here, while the global average is 0.346 (Graph 6). By average estimates across forty countries in Europe, America and Asia, each bank has around 47 retail outlets, whereas in Russia an average bank has just three branches and 19 additional offices.

[8] See Annexes for raw data.

Graph 6. Bank branch network development: distribution of countries by their ratio of bank retail outlets per 1,000 population.



Note: See Appendix for raw data. Columns indicate groups of countries with similar rates of financial service coverage. Lighter color indicates the group of countries which includes Russia.

2. **Uneven distribution of banks' infrastructure within regions.** Most of the regional financial infrastructure is concentrated in larger communities, mainly in big cities. Rural areas, smaller cities and communities with less that 50,000 population (the latter total about 130,000 communities) are clearly underserved. With the national average of 27 bank retail outlets per 100,000 population, the rate of 100 retail outlets per 100,000 population in Moscow is twice as high as in Germany or France, however communities with less than 500,000 residents have just 7 bank outlets per 100,000 people, which is almost eight times less than in the above EU countries.

Technological barriers to the development of an inclusive financial system have to do with policies concerning risk assessment, reserve allocation and profitability of bank credits. Current credit policies and standards de facto deny access to credit to small entrepreneurs, particularly start-ups, and to low-income people who consider starting their own business, since banks dismiss them as unacceptable categories of borrowers.

Banks' credit policies are significantly influenced by official regulations - in particular, loan loss reserve allocation requirements established by the Central Bank.

Thus, the main barriers to financial access are related to territory (underdeveloped finance infrastructure) and technology (financial service delivery does not match the needs of the target groups). Overcoming the said barriers requires capacity-building measures to assist the development of financial networks and also measures to promote technologies which will improve access to finance for the public and businesses.

To reiterate, it is necessary to promote a diversified infrastructure of retail finance and to create a favorable institutional environment for its development, and thus to build a foundation for subsequent expansion of new service delivery technologies to meet the needs of the public and small business.

4. Principles of Institutional Structure

This Concept is based on the principle of self-sufficiency[9] of microfinance and retail financial operations in general. Financial self-sufficiency of providers is likely to contribute to greater access to finance and a uniform financial coverage. Microfinance operations must be fully self-sufficient and financed from various unsubsidized/commercial sources. Without self-sufficiency (or profitability for commercial providers), chances of reaching out to a large number of customers with consistent, high quality and diverse financial services are slim, since the availability of subsidized resources in the form of government grants of charitable donations to be invested in this sector is far below demand. Self-sufficiency contributes to financial viability and expansion of microfinance providers.

On the other hand, microfinance is a clear example of “social entrepreneurship” i. e. business which pursues social objectives as its main purpose.

A combination of financial viability and social contribution makes microfinance interesting to a diversity of social and business actors - even those without any links among them - and gives hope for more support of the sector's development.

Therefore, the government and donors should focus more on subsidizing the costs involved in growth and development of microfinance institutions, rather than contributing to their capital - except cases where free market principles would not allow providing sufficient funding for an important group of clients (e.g. startups without their own funds to invest and maximum credit risks).

The challenge of making retail finance more accessible in Russia is shared among a number of market players. Even though they exist in a variety of institutional forms, they can be broken down into four main groups: credit institutions (banks and non-bank credit institutions); cooperative institutions (mainly credit cooperatives); nonprofit and commercial microfinance institutions (Graph 4).

[9] Or the principle of profitability for commercial organizations.

Graph 4. Institutional microfinance providers

This Concept relies on two institutional principles of building an inclusive financial system. Firstly, it should be based on an institutionally diversified model of retail finance. In other words, it recognizes the importance of all existing institutional types and technologies of delivering retail finance and microfinance. In a fast developing market with limited funding availability and lack of access to retail finance, the challenge is to maintain status quo among players and to create equal opportunities for their development taking into account the special focus of some providers. No group of financial intermediaries should have priority in accessing support.

Secondly, an institutionally diversified model should develop in two directions simultaneously, with banks downscaling from big cities to smaller communities and non-banks upscaling from smaller to bigger communities. It will allow them to meet the demand for finance and serve most consumers and at the same time it will create opportunities for "vertical" engagement between the bank-based and non-bank-based subsystems. Both subsystems should eventually converge at the point of cost-effectiveness, and this situation will correspond to primary saturation of the finance infrastructure and signify progress to a mature market stage.

Reasonable policies pursued in the past few years allowed Russia to develop a microfinance market with a reasonable balance of diverse providers: credit cooperatives are in a unique position to capture public savings for onlending to consumer and business; specialized non-profit microfinance institutions (mostly SME support funds) target their assistance at startups unserved by banks; the fast growing new class of providers - private commercial microfinance institutions – make a substantial contribution by bringing in commercial resources and investments. Banks are notably more willing to engage with non-bank microfinance providers than before. This diversity is a clear advantage for the Russian market, contributing to its sustainability and efficiency, and also to customer convenience. As non-bank microfinance develops, it will be reasonable to consider allowing them to engage in a broader range of operations (currently, MFIs are only allowed to lend, and certain MFI types may also take some basic deposits). This move should be combined with introducing appropriate specialized financial regulation and supervision matching the risks arising from such operations (see section on Financial Regulation and Supervision).

In recent years, branchless banking (BB) - the delivery of financial services outside conventional bank branches - has been effectively used to address the problem of financial exclusion. Branchless banking is based on the rapid expansion of mobile phones and the internet, enabling various financial self-service strategies and a wide use of e-money in retail transactions. As is the case with other countries where vast territories lack adequate financial infrastructure, BB in Russia may serve as a catalyst by dramatically boosting progress to financial inclusion, since the physical financial infrastructure is complemented by its virtual counterpart delivered through information and communication technologies[10] (see section on the Prospects of Branchless Banking).

5. Policy Framework

At the federal level, microfinance is governed by the Civil Code defining the status of consumer cooperatives, nonprofit and commercial institutions, and providing for basic types of contracts, such as loan and credit contracts and agency contracts. Microfinance relies on the capacity of legal entities, such as their right to lend money and to enter into agency arrangements. In addition, a number of federal laws define the status, purpose of activity and some other conditions for certain types of microfinance market participants. Key legislation includes the Federal Laws on Banks and Banking; on Credit Consumer Cooperatives of Citizens; on Agricultural Cooperatives; on Non-Profit Organizations; on Limited Liability Companies; and on Joint Stock Companies (see Legal Harmonization of This Concept.) However, the existing policy framework is incomplete and insufficient for sustainable, long-term industry development.

Greater access to retail finance requires a series of steps to create a favorable environment for microfinance, for the development of branchless banking and retail finance infrastructure. The following is considered priority legislation.

Credit cooperatives. The country has entered a credit cooperative boom; credit cooperatives grow in numbers, volumes of deposits, etc. Policy measures are required to improve sustainability of the system of credit cooperatives at all levels and ensure adequate protection of their members and customers. Some of the steps needed to achieve these goals are as follows:

- finally adopt and enact the framework federal law on Credit Cooperatives (adopted in the first reading in 2002) containing basic provisions on regulation and self-regulation of credit cooperatives, principles of establishing a multi-tiered system of credit cooperatives, property liability insurance vis-à-vis members of cooperatives, etc.;

- adopt a new version of the Federal Law on Credit Consumer Cooperatives of Citizens introduced in the State Duma in 2007 (to replace a former draft of 2001) to clarify the mechanism of cooperative establishment and regulation, including financial performance targets; and

- amend the Federal Law on Agricultural Cooperatives for consistency with the framework legislation on cooperatives.

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[10] Lyman T., Pickens M., Porteous D. Regulating Transformational Branchless Banking: Mobile Phones and Other Technology to Increase Access to Finance. CGAP Focus Note №43, January 2008.

Legal Harmonization of this Concept

This Concept relies on formerly adopted documents relevant to microfinance operations and financial access. In implementing the Concept, a few key documents should be considered, including:

International documents signed by Russia: G8 Action Plan: Applying the Power of Entrepreneurship to the Eradication of Poverty of 11 June 2004

Federal Laws:

- The Civil Code of the Russian Federation
- on Banks and Banking
- on the Development of Small and Medium-sized Entrepreneurship in the Russian Federation
- on Housing-Saving Cooperatives
- on Credit Consumer Cooperatives of Citizens
- on Non-Profit Organizations
- on Consumer Cooperatives (Consumer Societies and Their Unions) in the Russian Federation
- on Agricultural Cooperatives

Acts of the President and the Government

- Medium Term Program for Russia’s Social and Economic Development (2006-2008)
- Decree of the Russian Government of 17 May, 2008, №178 on the Governmental Commission for SME Development.
- Messages and instructions adopted following the meeting of the State Council Presidium “On overcoming administrative barriers to SME development and on taxation policy measures designed to stimulate SME growth" of 27 March 2008,

Regulations adopted by executive authorities:

- Strategy for the Russian Banking Sector Development before 2008, adopted by the Russian Government and the Central Bank in 2005
- Concept of the Development of Agricultural Credit Cooperatives, the Ministry of Agriculture, 2006
- Concept of the Development of a System of Rural Credit Cooperatives, the Ministry of Agriculture, 2006
- CBR Regulation of 21 September 2001, No №153-P on Specifics of Prudential Regulation of Non-Bank Credit Institutions Engaging in Deposit and Credit Operations
- Order of the Ministry of Economic Development and Trade of 20 April 2006, №103, on the Establishment of a Council for SME Credits and Microfinance under the Aegis of the RF Ministry of Economic Development and Trade.
- Order of the Ministry of Economic Development and Trade of 5 March 2007, №75, on the Implementation, in 2007, of Measures to Ensure State Support of SME.

Adopt flexible policies to enable institutional transformation of market participants. An effective institutional model of retail finance should provide a path for market participants to "transform" into a different charter type: non-bank financial institutions reaching transaction volumes and performance standards similar to those of regulated banks should be allowed to transform[11] into banks[12] or NDCO without limitations. Similarly, struggling banks unable to meet the performance requirements established by the Bank of Russia should be able to downshift by changing their legal status.

In particular, provisions to be amended include article 14 ("Documents to be submitted by a credit institution applying for registration and/or for a license to perform certain banking operations") and 16 ("Grounds for denial of registration or a license to perform certain banking operations to a credit institution") of the Federal Law on Banks and Banking, and a number of CBR regulations and instructions. Such amendments would relax certain eligibility requirements for senior managers of [regulated] non-bank deposit-credit institutions - namely, candidates with a history of managerial positions in MFIs (not just in regulated banks) will be eligible. Therefore, CEOs of successful MFIs will be able to continue their careers as CEOs of non-bank credit institutions.

Active [unregulated] microfinance institutions should be allowed to transform into [regulated] deposit-credit institutions to facilitate the development of their business and reduce the costs of such transformation. Such amendments will enable large microfinance institutions to transform into regulated credit institutions. No additional risks are involved, since the operational capacities of deposit-credit institutions are similar to those of non-bank microfinance institutions.

Facilitate the development of retail finance networks and branchless banking. Overcoming the problem of underdeveloped banking infrastructure requires more consistent legal regulation of bank agents. Agency arrangements can dramatically increase the availability of financial services with limited investment in infrastructure. The provision to be amended is article 13. 1 (Performance of certain banking operations by a commercial institution, which is not a [regulated] credit institution) of the Federal Law on Banks and Banking, to broaden options for agency arrangements and to expand the range of eligible agents by adding non-profit organizations, i.e. many microfinance institutions.

Another required step would be to adopt a law to define and regulate e-money, related transactions and payment systems. Such a law may be based on the draft Law on the National Payment System prepared by the Ministry of Finance and the Bank of Russia, or a separate Law on Electronic Money, and a number of CBR regulations and instructions concerning prepaid financial instruments. The same measures will also contribute to the development of BB - both mobile phone-based and internet-based.

To enable the development of retail financial services, AML/CFT recommendations made by the Financial Action Task Force on Money Laundering (FATF) should be

[11] The term 'transformation' is not used here in its narrow legal meaning, but from a broader business perspective. Thus, transformation may mean, among other things, establishing a new credit institution and transferring all outstanding financial transactions to this new entity.

[12] It will not bring about a substantial change in the country's credit system. As of 2008, non-bank credit institutions are not numerous or prominent, and account for no more than 0.5% of the banking sector's total assets.

adapted to accommodate microfinance. While recognizing the importance and necessity of anti-money laundering and combating the financing of terrorism, it must be noted that restrictions should not discourage the development of retail finance infrastructure and service delivery networks. Specifically, the Federal AML/CFT Law should be amended to enable delegation of customer identification and account opening to agents on behalf of the bank. In addition, customer identification requirements should be lifted for transactions below a certain amount, which will remove existing barriers to expansion of retail financial services (e.g. domestic transactions equivalent to 1,000 euro and below may be exempt from KYC requirements).

Balanced policies. It is important to maintain balance in adopting laws and policies affecting microfinance institutions. It should be noted that microfinance is delivered by a wide range of market operators existing in diverse institutional forms and subject to different policies and standards. Introducing separate policies for microfinance - e.g. by adopting a special Law on Microfinance Activities (Institutions) - creates a risk of overregulation which may discourage further expansion of the market and limit the range of its participants; therefore, introducing separate microfinance regulations should be approached with caution and preceded by a careful analysis of their potential implications.

6. Financial Regulation and Supervision

State regulation and supervision play an essential role in creating a favorable environment for financial inclusion and microfinance. The challenge is to maintain balance between protecting depositors and creditors of deposit-taking institutions, on the one hand, and expanding access to finance, on the other. As revealed by international experience, successful microfinance programs occur where authorities adopt a balanced approach to regulation and supervision.

1. First and foremost, Article 27 of the Federal Law on Credit Consumer Cooperatives of Citizens (State Regulation of Credit Consumer Cooperatives and their Unions) requires that a government regulator should be appointed to supervise credit consumer cooperatives of citizens. It is important to bear in mind that the government regulator appointed to supervise credit consumer cooperatives and their unions will probably supervise other types of credit cooperatives as well, and eventually other non-bank microfinance institutions as relevant legislation is adopted. It appears that the Ministry of Finance will be appointed as regulator, given that its Financial Policy Department keeps a registry of credit consumer cooperatives of citizens and has many years of experience in dealing with microfinance, including preparation of relevant policy proposals.

The Council for SME Credits and Microfinance established under the aegis of the Ministry of Economic Development and Trade is responsible for coordination of all interdepartmental policy-making relevant to support of microfinance and lending to SME. In line with the Presidential messages and the objectives set before the Prime Minister, it is necessary to step up the efforts to improve the system of government incentives to microfinance and to implement relevant measures in the framework of programs intended to assist the development of SME, to fight poverty, and to preserve employment.

The ideology of government regulation and supervision in this sphere relies on the Guiding Principles on Regulation and Supervision of Microfinance designed by CGAP and adopted by the World Bank's donor countries, including Russia. An important premise of the Guiding Principles is to avoid using burdensome prudential supervision for the wrong purposes. Due to low financial risks in the microfinance sector, non-prudential supervision should be at the core of government regulation, including general provisions of relevance to microfinance institutions, such as protecting consumers; preventing fraud and financial crimes; tax and accounting issues; statistical reporting, etc.

Key Principles of Microfinance Regulation and Supervision
(based on the Microfinance Consensus Guidelines, CGAP, 2003)

- Prudential supervision of microfinance should be introduced gradually as the industry develops. At its early stages, microfinance should be subject to non-prudential regulation.
- Generally accepted standards and regulations common in traditional banking are not suitable to non-bank microfinance and need to be adjusted. Prudential standards and requirements should accommodate the specifics of microfinance.
- Prudential regulation should be focused on the type of transaction being conducted and its risk profile, rather than the type of institution conducting it.
- Prudential standards should not be applied to institutions which do not take deposits from the public.
- Institutions with a limited membership serving small local communities - such as credit cooperatives - need not be prudentially supervised even if they capture deposits.
- Microcredit should not be subject to stringent reserve requirements, since most microcredits are not collateralized, and the credit analysis is often based on unofficial (management) reporting. Otherwise, microfinance will not be feasible for the lender due to high reserve requirements.
- Consequently, if a full-service bank decides to offer microfinance products, it should be able to have this operation exempt from strict prudential regulations.

Adapted from: Christen R., Lyman T., Rosenberg R. Guiding Principles on Regulation and Supervision of Microfinance. – Wash.: CGAP/The World Bank Group, 2003.

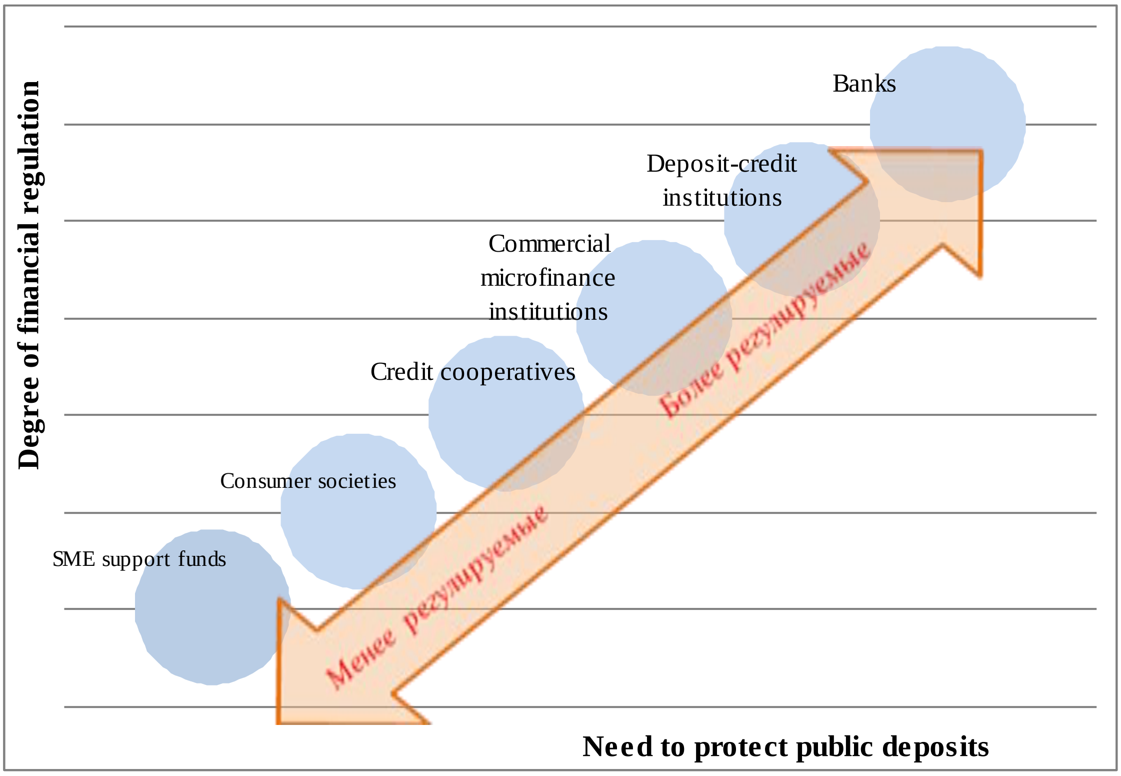
Thus, financial regulation and supervision of microfinance providers should be based on two core principles. On the one hand, regulators should strive for equal legal and regulatory treatment of financial transactions with the same risk profile, regardless of the type of provider, to avoid creating parallel, separate segments of the financial market and encouraging 'regulatory arbitrage'.[13] On the other hand, regulation and supervision of microfinance providers should be matched to the risks faced by their creditors and depositors, and the entire financial system. Specifically, credit cooperatives, even though they appear to engage in conventional lending, are exposed to lesser risks than conventional banks. Cooperatives serve a limited circle of members who collectively manage the cooperative and jointly bear subsidiary liability for its obligations. Cooperatives are not allowed to take deposits from non-members. All members of a cooperative have equal rights, regardless of their share. Even less are the risks faced by non-deposit-taking microfinance institutions lending from their own funds and/or financed by qualified investors and licensed financial intermediaries.

As a result of a light-touch approach to supervision, effective microfinance institutions across the world demonstrate high levels of outreach combined with low delinquency rates in serving unbanked clients. In Russia, delinquency rates in effective credit cooperatives and other microfinance providers is lower than in banks and does not exceed 3%.

[13] This approach is supported by the international practice. For example, the Desjardins association of credit unions in Canada complies with the Basel Committee recommendations for banks and other credit institutions.

Thus, microfinance requires a customized approach, rather than 'one size fits all' solutions (Graph 7). As long as a microfinance institution does not take money from unqualified investors – i.e. natural persons - its regulation and supervision should rely mainly on general civil law provisions. In designing specialized laws and regulations, care should be taken to avoid over-regulation, which is likely to create unaffordable costs and hinder the expansion of retail financial services to remote territories.

Graph 7. Matching the level of regulation to the risks involved in microfinance operations



In designing rules for financial regulation and supervision of the banking sector, regulators should take into account certain specifics of microfinance operations. Firstly, low-income people and small businesses usually lack adequate collateral, but its absence should not be a barrier to microlending. Secondly, it is far more difficult to trace the revenues of certain low-income groups or their purchases of small assets, as opposed to incomes of salaried middle-class borrowers. Thus, microborrowers are less transparent, and by standard methods of borrower assessment should be classed as low quality borrowers. In order to facilitate access to finance for these target groups, a simplified procedure must be established for microloans.[14] In particular, special loan loss reserve requirements should be established for bank credits to start-ups and low-income public, and also to microfinance institutions, with a stronger emphasis on timely repayment rather than on initial assessment of creditworthiness. As revealed by international experience, special reserve allocation requirements combined with establishing a reasonable proportion of such credits in the bank's portfolio do not lead to increased credit risk, but effectively encourage banks to microlend. As of today, more than twenty

[14] Microcredit is a lending technology which serves as an effective alternative to conventional collateralized credit; it is designed to accommodate short-term loans to low-income or unbanked customers.

countries have introduced special procedures for reserve allocation sensitive to specific characteristics of microfinance customers and operations.

2. The microfinance market today has poor transparency due to lack of official statistics on most microlenders, in particular credit cooperatives. Currently they disclose voluntarily to industry associations. The relevant authorities are advised to introduce a comprehensive monitoring and disclosure system for the microfinance market, similar to existing system for other financial institutions (such as insurance companies and private pension funds.) Such monitoring and disclosure should be made part of non-prudential supervision and should include special forms of statistical and financial statements. Data collection will make it possible to determine the scale of microfinance market, the structure of assets and liabilities of its participants, which, in turn, will enable an accurate assessment of their risks to inform adequate policies of regulation and supervision.

7. Institutional Capacity Building

Expanding access to retail finance requires capacity-building efforts and relevant guidance on behalf of all stakeholders, including government, non-governmental organizations and the market participants. Priority areas include:

- **Human capital development.** A skilled workforce is the key factor of success for a finance institution. Regional authorities are advised to encourage the establishment of local (or branches of federal) Resource Centers for microfinance and credit cooperatives, and to become involved in federal-level training and retraining programs offered by microfinance associations and their members both independently and in collaboration with colleges and universities.

- **Developing national microfinance standards.** There is a need for shared standards to enable microfinance performance assessment regardless of the institution’s charter type. Today, such standards are developed by associations of microfinance institutions and adopted voluntarily. By adopting and applying certain standards endorsed and recommended by the Russian Ministry of Finance, such as accounting standards, operational standards, performance standards or financial reporting standards, providers should be able to improve their microfinance performance.

- **Introduction of rating assessment and benchmarking.** The Russian microfinance market today is virtually excluded from credit rating assessments. Such ratings, however, would enable the market participants to assess their financial risks more accurately and to attract more finance from banks. To achieve this, credit ratings should be endorsed by relevant regulatory acts, the rating methodology should be adapted to microfinance, and all major actors of the microfinance market should be rated. Similarly, benchmarking should be introduced systematically, since it enables comparisons across different types of market players. At the moment, voluntary rating and benchmarking programs are carried out by the Russian Microfinance Center. In the future, it is advisable that they participation should be required and supervised by a self-regulating organization. In the medium term, rating and benchmarking should involve at least half of the microfinance market operators.

- **Managing credit risks.** For effective credit risk management, non-bank credit institutions, cooperatives, consumer societies, as well as microfinance institutions should be encouraged to participate in credit bureaus. By keeping records of microfinance borrowers, credit risks can be effectively managed, which, ultimately, will expand access to finance.

- **Credit guarantees.** It is essential to allocate funds from the local and federal budgets to implement MFI support programs including credit guarantee programs to enable MFIs to borrow from banks, as provided for in the Medium Term Program for Russia's Social and Economic Development.
- **Financial literacy.** Financial literacy enables families to manage their income and expenses better; it prevents social crisis and encourages financial planning. Moreover, financial literacy makes it possible for low-income people to become effective users of financial services. In implementing financial literacy programs recently initiated by the Russian Government and the Ministry of Finance, it is important to adapt them to specific requirements of the audiences such as low-income groups and small businesses.

- **International cooperation and exchange.** It is important to facilitate information exchange to create a single information space for microfinance in Russia and across the borders. Benchmarking programs will facilitate performance assessment of domestic MFIs and make international comparisons. By engaging with international institutions, Russian practitioners will enrich their methods and increase their impact. Strategic partners of the Russian microfinance industry include prominent international institutions, such as the Consultative Group to Assist the Poor (CGAP), the Small Enterprise Education and Promotion Network (SEEP), the International Bank for Reconstruction and Development (IBRD), Agencies for International Development (AID), the European Bank for Reconstruction and Development (EBRD), the United Nations Development Program (UNDP), the European Microfinance Network (EMN), the Microfinance Information Exchange (MIX), and others.

The above list of institutional capacity building activities is not exhaustive, but these areas are key for comprehensive development of retail finance infrastructure and microfinance market in Russia.

8. Sources of Funding

The demand for microfinance is enormous and requires mobilization of funds from all potentially available sources.

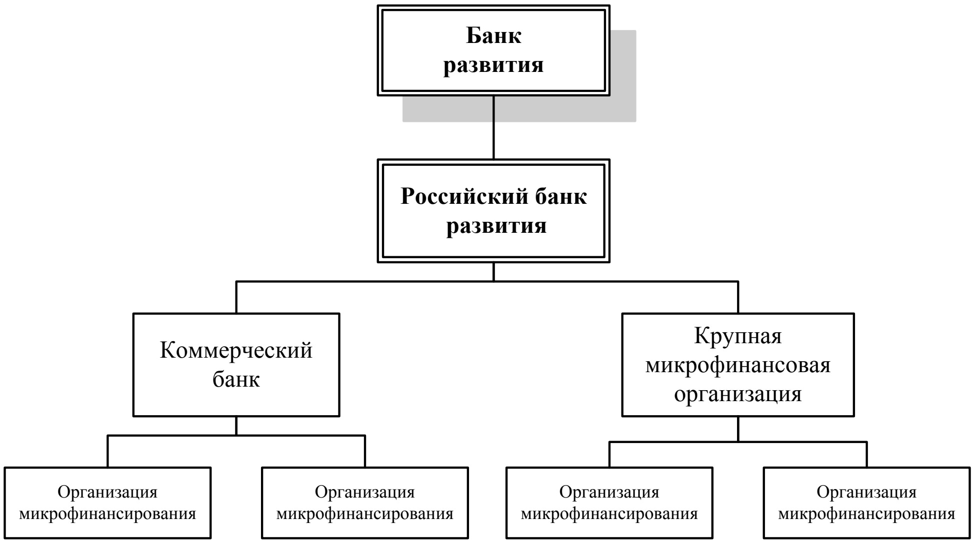
Subsidized funds which used to be an important resource for service provision are not sufficient to finance scale-up of services. The following are considered key sources of funds for microfinance:

- equity capital of commercial microfinance institutions;
- bank loans;
- savings mobilized by credit cooperatives;
- corporate finance mobilized by deposit-credit institutions;
- grants (dedicated, non-recoverable contributions by SME support funds);
- allocations from the state budget; and
- charitable resources.

As before, credit cooperatives' share capital and members' savings continue to be the main sources of microfinance. However, external funding plays an increasingly important role. Commercial banks lend to microfinance institutions for subsequent on-lending to target groups.

Therefore, an important potential source of funding for microfinance is the Development Bank (State Corporation ‘Bank for Development and Foreign Economic Affairs’, or Vnesheconombank), required by the Federal Law to engage in financial support of SME. At the moment, their financial support is channeled through the Russian Development Bank and disbursed in two phases: the Russian Development Bank makes finance available to regional market players to onlend to SME operators, while the Russian Development Bank supervises the use of allocated funds. Microfinance providers should be included as recipients of the Bank's funds for subsequent onlending. To expand access to bank loans, the Russian Development Bank should adopt a special model of lending to MFIs (Graph 8). As revealed by other countries' experience, a Development Bank as the leading financial institution plays an essential role in facilitating microfinance expansion and development.

Graph 8. A multi-tiered refinancing system in the microfinance market.



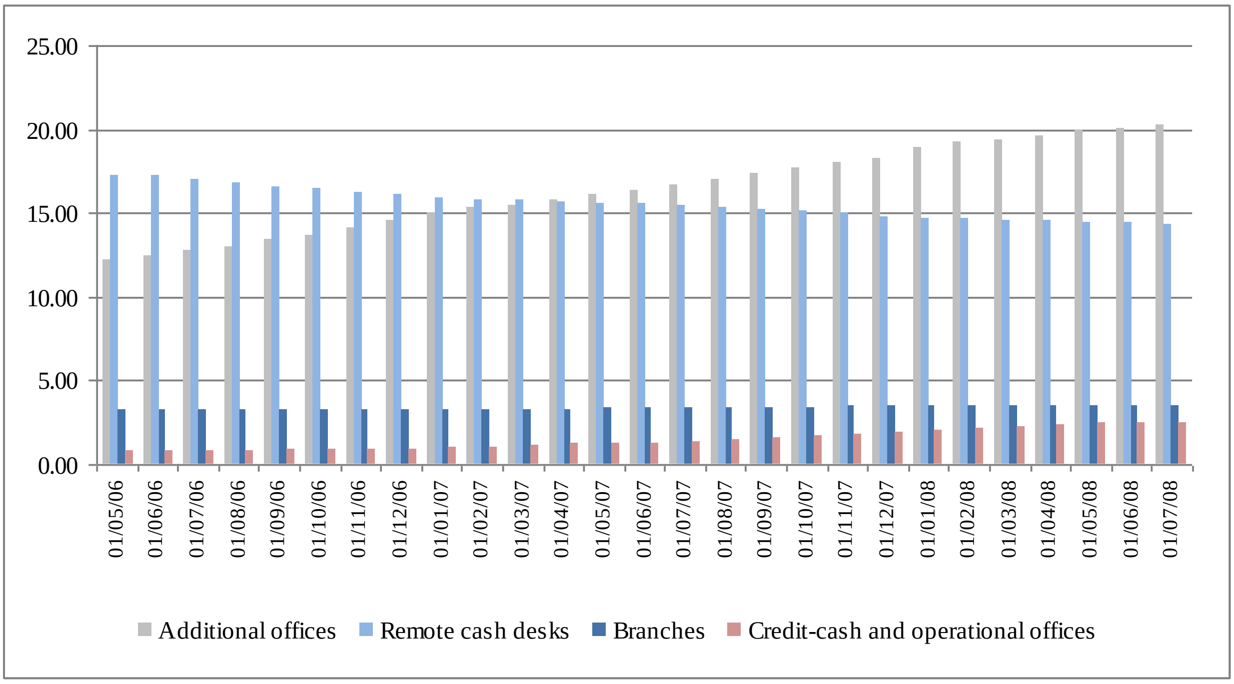
9. Banking and Non-bank Infrastructure Development

The government is expected to stimulate the creation of an infrastructure to reduce transaction costs involved in small retail financial operations. There are a number of ways to facilitate the development of service delivery channels: expand the service delivery networks of conventional banks, use technology where conventional service delivery is impossible for objective reasons, and promote non-bank microfinance, including the establishment of a multi-tiered system of credit cooperatives, among others.

It should be noted that the Bank of Russia has taken some significant steps to create a favorable policy environment for the regional banking infrastructure. The expansion of retail banking services in the domestic market occurs mainly through additional offices, as opposed to ‘remote cash desks’ (Graph 9). More specifically, the number of banks’ additional offices increased by up to 70% between 2006 and 2008, whereas the number of remote cash desks dropped by 20% over the same period. Credit-and-cash offices and operational offices are expanding even faster: their number doubled to reach 2,500 units, even though they are still fewer by an order of magnitude than additional offices. Other types of banks’ subdivisions demonstrate sustainable growth. However, mobile teller units expected to substantially facilitate retail cash transactions have been growing rather slowly. As of July 2008, 56 of the 58 registered mobile teller units belonged to Sberbank.

To facilitate further expansion of financial service delivery outlets, it is recommended that mobile teller units are allowed to perform more functions and operate similarly to additional offices (in particular, by performing KYC and initial customer assessment).

Graph 9. Dynamics of retail banking services in the Russian domestic market, 2006 – 2008, thousand units



Source: the Bank of Russia

An important source of expansion for non-banks is the emergence of a multi-tiered system of credit cooperatives. At the moment, the development of credit cooperatives in Russia occurs at two levels. At the local level, individual cooperatives are set up and operate independently from one another (these include regional cooperatives or branches of larger oblast-level or supra-oblast-level cooperatives.) They mobilize their members' savings under loan agreements to resource their 'funds of mutual financial assistance' and onlend to other members in need of finance. Very often, a credit cooperative is the single financial institution in a rural community. In villages lacking other providers – even post offices - only credit cooperatives can transfer payments, such as rent/utilities and other bills, as instructed by their members.

At another level, national and regional networks of credit cooperatives have been formed by active first-tier (grassroots) coops operating in Saratov, Rostov, Tomsk, Yaroslavl, Volgograd, and Leningrad Oblasts, in Stavropol and Altai Krais, in Yakutia and other Russian regions, and some coops' networks now cover more than one region of (supra-regional.)[15] Their functions are to mobilize finance from external sources for first-tier coops, and to establish guarantee and insurance funds. In addition to these financial objectives, second-tier coops are expected to ensure sustainable development of rural coops in Russian regions, in particular:

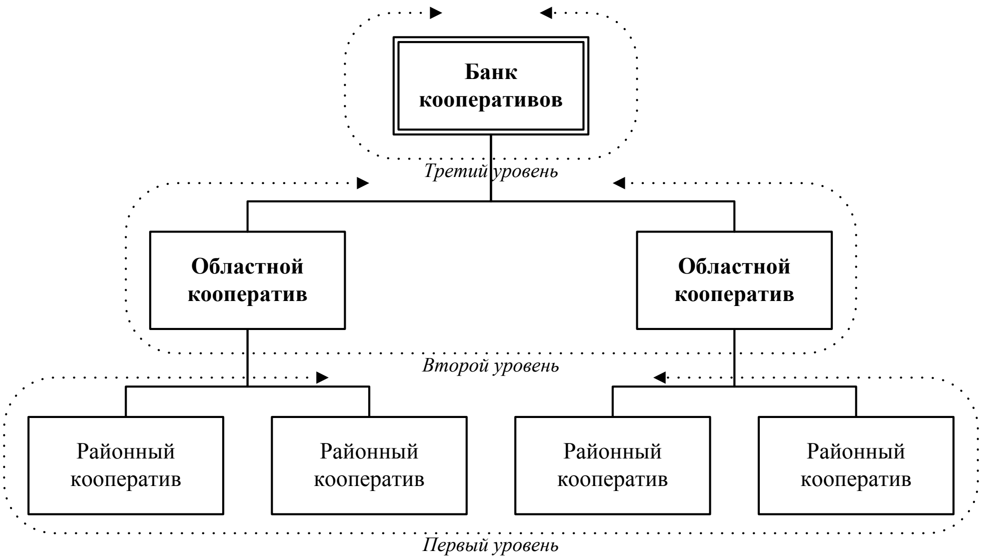
- design and adopt uniform performance standards and rules of conduct for first-tier coops;

[15] Such a system may be two-tiered or three-tiered; in the latter case, second-tier coops unite to form a third-tier (federal level) coop. We do not describe third-tier cooperatives here, since their basic parameters are similar to those of second-tier coops.

- facilitate training and professional development of coops' staff;
- audit first–tier cooperatives;
- represent and advocate on behalf of credit cooperatives vis-à-vis government, etc.

Since first-tier credit cooperatives are numerous, second-tier coops may serve as agents for the government regulator and assume certain functions of monitoring and supervision of the grassroots coops (*"delegated supervision"*). Adopting a model of delegated supervision could achieve a substantial reduction of costs for the government regulator, without sacrificing the quality of supervision, given that all financial cooperatives bear subsidiary liability for their members' obligations.

Graph 10. An emerging three-tiered system of credit cooperatives in Russia



A third (apex) tier of credit cooperatives must be formed to facilitate further development of the country's microfinance infrastructure "from the bottom up" (Graph 10). It involves effective networking of regional cooperatives and their entry into the nationwide financial market. The apex tier may consist of credit institutions founded by second-tier cooperatives (who then become members of the third-tier structures.) In this connection, it is advisable to lift any restrictions on credit cooperatives' participation in credit institutions. Credit cooperatives in other countries are allowed to establish banks and banking groups, insurance companies and other specialized institutions. According to the European Association of Cooperative Banks, Europe has about 4,500 cooperative banks serving 140 mil clients and accounting for 20% of the entire banking market of the EU (see Appendix for details.)[16] According to IMF, cooperative banks have a positive impact on the financial sector as a whole.

[16] Annual Report of the European Association of Co-operative Banks, 2007.

Cooperative Banks and Financial Stability

Cooperative banks are an important, and growing, part of many financial systems. In a number of countries, they are among the largest financial institutions when considered as a group, and their share has been increasing. By the IMF estimates, the market share of cooperative banks in terms of total banking sector assets increased from about 9 percent in mid-1990s to about 14 percent in 2004. Cooperative banks are particularly numerous and large in Europe. The five largest cooperative banks in the European Union rank among the EU's top 25 banking groups in terms of consolidated equity. Reflecting the cooperative banks' focus on retail banking, their market share in retail business is even more substantial: for example, 5 EU member countries have more than 40 percent market share of cooperative banks.

The IMF experts' analysis reveals the importance of cooperative banks for the financial system. In contrast to some assumptions in theoretical literature, cooperative banks have been shown to provide higher financial stability than commercial banks. This finding is due to much lower volatility of the cooperative banks' returns, which offsets their relatively lower profitability and capitalization and makes them more resilient to bank crises than commercial banks.

Source: Hesse H. and Cihàk M. Cooperative Banks and Financial Stability. IMF Working Paper №2, 2007.

In Russia, banks owned by cooperatives may be allowed to perform only selected banking transactions or they may offer their customers a full range of banking services, because once a cooperative bank is registered as a formal credit institution it will be subject to standard supervision by the Bank of Russia. A well-balanced system linking grassroots credit cooperatives to third-tier federal-level institutions will be instrumental in meeting the ever-growing need of SME and rural dwellers for financial services.

It is also advisable to encourage further development of non-deposit microfinance institutions, commercial as well as nonprofit. Such institutions are more likely to finance start-ups, and the experience of some countries in Western Europe, in particular France, reveals that such lending can be very effective in many ways. Indeed, a twenty-year history of France's largest microfinance institution, Association pour le droit à l'initiative économique (ADIE), demonstrates a rate of return of around 97% on group solidarity or guarantee-secured loans to start-ups; full repayment at loan maturity occurs in 94% of cases; start-ups' success rate is 65%, and 80% of entrepreneurs give up their unemployment compensations following a start-up loan.

Thus, microfinance achieves a positive effect both for the state budget by reducing public costs of unemployment compensations and increasing the taxable income, and for the country's economy and social well-being by boosting competition and encouraging economic activity of the public.

It should also be emphasized that the development of microfinance in France and other EU countries had been hindered for a long time by statutory interest rate caps and restrictions on financial intermediation. These policies blocked MFI growth and held them back from reaching sustainability. Once the restrictive policies were repealed in early 2000th in response to advocacy efforts of the European Microfinance Network (EMN), opportunities opened up for MFIs to grow dynamically, to access external capital to finance their operations, and to achieve sustainability. The new policies also made MFIs and microcredit more attractive to banks.

In fact, Russia is in a better starting position due to absence of restrictive polices such as described above, and measures should be taken to preserve the enabling regulation to promote a dynamic growth of microfinance.

Larger non-deposit MFIs should be allowed to transform easily into regulated credit institutions to access more finance if a lack of funding sources limits their growth.

10. Branchless Banking Services for Remote Customers

In implementing the Concept, a particular focus should be on the regulation of technology-driven branchless banking. At the moment, many developing economies (such as India, South Africa, Brazil, the Philippines, and Columbia, among others) see an expansion of branchless banking. Commercial institutions use POS terminals and mobile phones to reach clients in rural communities and subcontract local entrepreneurs to perform transactions on their behalf with consumers of financial services. Mobile phone-based banking is expanding since many people use mobile phones, while a significant part of the public do not have bank accounts. Remote service delivery through retail agents allows banks to cut their costs and to reduce overcrowding in their branch offices, as well as expand to new markets. The cost of opening a POS terminal with a retail agent is estimated at less than 0.5% than the cost of setting up a bank office.

Models of Branchless Banking

Currently, two models of branchless banking exist worldwide. One of them is bank-led and makes use of retail agents and non-banks. Both models make use of information and communication technology, such as mobile phones, prepaid and debit card, and card reading devices to transmit transaction data from retail agents to customers or to the bank. Some forms of branchless banking, such as internet banking and ATM, should be regarded as extensions of conventional banking.

Branchless banking has the potential to increase access to financial services and expand coverage within a short time. For example, in Brazil, where just 15% of the population had access to financial services in early 2000th, the Central Bank allowed banks to use agents for retail transactions since 2003. Banks use retailers, post offices, lottery kiosks and other agents, so that by 2008 the share of the population covered by banking services increased to nearly 70%. Today each municipality in Brazil has agents providing branchless banking services on behalf of a regulated bank.

The Philippines adopted a different model of branchless banking. In 2004, mobile operator Globe Telecom established GCash, a mobile-based service which enables customers to use their mobile phone as a sort of 'e-wallet' without needing a plastic card. One of the strongest drivers of interest in GCash services is the large flow of international remittances from Filipinos who work and live abroad and regularly remit money to their families at home. Just about one fourth of the 93 mln Filipinos are directly served by banks, but more than 40% of the country's population use mobile phones. GCash services present an interesting example of a symbiotic relationship between banks and mobile operators. GCash earns money on each transaction through SMS traffic, and banks earn commission on currency exchange, etc. GCash makes loan repayments and disbursements, salary and bill payments possible, as well as domestic and international remittances. Moreover, GCash is subject to special supervision by the National Bank of the Philippines.

A branchless banking model emerging in Russia has two components (Table 1):

- use of bank agents, including large network-based agents, such as the federal postal service (the Russian Post), microfinance institutions, mobile phone operators, internet providers, etc. This model usually entails that the customer has an account with the bank or as a minimum, the bank assumes subsidiary liability for the transactions;
- mobile payments and web-based payments, as well as retail micropayments, where the customer does not open a bank account and does not deal with the bank. Such transactions usually involve de-facto e-money.

Access to branchless remittance services is particularly important for regions where families subsist on money remittances from their relatives working in cities with a booming economy or, in some border areas, in another country. Technology has potential to cut transaction costs dramatically by creating opportunities for growth and for serving more customers.

Table 1. Microfinance transaction and provider matrix

Service provider	Account management	Remittance without account opening	Savings	Credit	Loan	Plastic card	E-money account	Mobile phone	Internet
Bank	╬	╬	╬	╬		╬			╬
Deposit-credit institution			╬*	╬					
Cooperative			╬	╬					
Post		╬							╬
Communication service provider/operator (phone, internet, etc.)							╬	╬	╬
Microfinance institution					╬				
Other retail agents					╬		╬		

** Deposit-credit institutions are allowed to take deposits from legal entities, but not from natural persons.*

Certain specific risks are associated with the development of branchless banking, mainly posed by the bank agents. The regulatory challenge is not to eliminate risks by imposing restrictions on the use of bank agents, but rather to find a reasonable risk/benefit approach balancing the risks involved against the obvious advantages offered by branchless banking. It is recommended to introduce bank liability for agent actions. In addition, AML/CTF rules should be accommodated to branchless banking. If the Russian Post and other bank agents are to deliver financial services to remote clients, they must be allowed to perform KYC for the purposes of lending, payment, remittances, and other transactions. For this purpose, is advisable to review CBR Regulation No 262–P on Identification of Customers and Beneficiaries by Credit Institutions with the Purpose of Counteraction to Legalization (Laundering) of Proceeds from Crime and Financing of Terrorism.

11. Financial Literacy

Financial literacy of the public is an important focus in building an inclusive financial system. Lack of basic financial knowledge and skills limits people’s ability to make the right decisions for their financial well-being. Low financial literacy of the public is associated with the following negative consequences and threats at the microlevel:

- move victims of financial fraud;
- overindebtedness;
- shortage and ineffective allocation of personal savings.

At the macroeconomic level, low financial literacy may result in:

- distortions and poor development of financial markets;
- low trust in financial institutions and in their regulation by the state;
- additional burden on public budgets at all levels; and
- slowed down economic growth.

The relevance of financial literacy in Russia is expected to increase over the next decade due to a growing range of sophisticated financial products available in the market and an increased role of individual pension savings. Moreover, improved financial literacy may contribute to poverty reduction. People with financial knowledge will understand taxation policies, which may in turn result in better tax collection and boost SME development.

Financial literacy is a priority for well-developed markets, as well as emerging economies. In the first half of 2000th, financial literacy, alongside financial education and financial service consumer protection, were recognized by the EU Commission and by OECD as priority objectives for the development of societies. In Europe, more than 180 financial literacy programs are underway. The most successful national programs of this type have been designed and implemented in the US, UK, Germany and Austria, and in emerging economies such as Bulgaria, Slovenia and Romania.

A government-endorsed financial literacy program should be adopted in Russia at the federal level and extended to the regional level with appropriate modifications. Its main target audience may include children and young people under 35 who are receptive of innovations and new information, and they, in turn, may subsequently share their financial knowledge with the older generation. As revealed by the European experience, financial literacy courses are most effective when delivered as part of school or university curricula (the best known example is Financial Driver's License in Austria.) A separate focus should be on people with low incomes or adults with education below college level. Financial literacy courses for them may be provided by non-profit organizations (professional associations or NGOs) or consumer protection societies. Courses for this target group should focus on daily management of personal finance and on financial planning (examples include Stay Positive in the Netherlands and MoneyHelp in the UK.) Special courses should be designed for the most vulnerable or inexperienced social groups, such as financial management for young households.

Projections concerning future development of financial products and e-money suggest that even today the main part of financial education should have an online focus. It will allow adapting web-based financial service models to Russian circumstances in a flexible manner, with minimum costs. Some international programs use web-based courses as the single channel to deliver financial literacy courses (e.g. Dolceta, an online program in EU countries) or in combination with other educational tools (FSA's Consumer Communications in the UK). At the same time, it is advisable to use all possible communication channels - such as print, TV, radio, and workshops - to reach the maximum number of people.

A government-sponsored financial literacy program cannot be implemented by governmental institutions alone, but should be based on public-private partnerships. The state may rely on major market players with long-term development strategies, and also on regional authorities willing to assist the development of their local financial markets. Training providers should include institutions with a direct stake in financial literacy (banks, investment companies, and others), educational establishments (schools, colleges and universities), professional intermediaries (consulting companies, research agencies), and non-governmental groups (associations and unions).

It would be reasonable for each association to take responsibility for designing a financial literacy program for its respective market segment. It is worth noting that the Russian Microfinance Center begun, on its own initiative, to offer training courses and workshops addressing the problem of poor financial literacy.

Coordination of efforts to improve financial literacy may be delegated to a public body, such as the Steering Committee for Financial Literacy set up with participation of the

Russian Ministry of Finance. The role of government in a federal program of financial literacy should focus on the following:

- organize public debates on the issue;
- monitor federal and regional financial literacy programs to make sure they are not used to advertise specific products or companies or to attract customers;
- ensure collection and processing of information submitted by the public, including complaints;
- improve legislation to combat unscrupulous market operators; and
- enforce tougher transparency requirements for financial institutions and for the market as a whole, including public disclosure and standard contracts.

12. Expected Results

This Concept combined with the Concept of Long-Term Social and Economic Development of the Russian Federation before 2020 and strategies for the financial system development will ensure:

- establishment of an effective and competitive microfinance system in all Russian regions, accessible to the entire Russian population and doubling the availability of standard financial services (credit and deposit) from 1.6 to 3.8 thousand euro per capita by 2012 (which corresponds to the level currently observed in Central and Eastern Europe) and to 33 thousand euro by 2020 (which corresponds to that of Western Europe);
- sustainable development of the microfinance market and its infrastructure facilitated by a comprehensive policy framework ensuring effective regulation and supervision:
    - credit cooperatives evolve and grow in size to reach at least twenty million customers (each cooperative should be able to service thousands of customers, and together they should involve 25% of Russia's economically active population[17]);
    - a nationwide network of specialized microfinance institutions, non-bank credit-deposit institutions and their subsidiaries cover all regions of the country and have available to them adequate resources to meet financial needs of microbusinesses, including startups and potential entrepreneurs (total assets at least $40 billion);
- country-wide expansion of branchless banking and retail finance networks: at least half of mobile operators' regular clients and internet users in Russia should use mobile and web-based banking to make remittances and payments;
- microlending programs, small business credits and cooperation with non-bank MFIs are established as integral part of credit policies in major Russian federal banks;
- government-sponsored programs in support of microfinance expand to all Russian regions and at least to one half of district-level municipalities.

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[17] Economically active population are those potentially capable of producing material values and providing services. By the UN SNA methodology, economically active population includes: entrepreneurs (self-employed), employees, and persons currently unemployed, but seeking employment. By Rosstat's data for 2007, economically active population totaled 75.3 million, or 53% of the Russian population.

Successful implementation of this Concept, alongside measures stipulated in the Concept for Long-Term Social and Economic Development and in the Federal Law on the Development of Small and Medium-sized Entrepreneurship in the Russian Federation, should result in the following:

- the costs of dealing with administrative barriers will drop to 3% of small business revenues, which will further promote small entrepreneurship and increase their production volumes;
- the number of small businesses will double by 2012 to reach 2,100 thousand, and the number of individual entrepreneurs will increase by 2.5 times to reach 11 million.

In accordance with the Russian President’s message resulting from his meeting with the State Council Presidium and entitled “On overcoming administrative barriers to SME development and on taxation policy measures designed to stimulate SME growth" of 27 March 2008, successful implementation of this Concept should result in the attainment of the following target indicators:

- the share of small business in the country’s GDP increases to reach 30%;
- the share of people engaged in small business increases to reach 30%; and
- poverty level drops at least by half.

Annexes

Table A. Regional development of retail finance index as of June 2008

Region	Financial services per capita, thousand rubles	Index	Region	Financial services per capita, thousand rubles	Index
Moscow	617.3	1.000	Omsk Oblast	4.2	0.007
Transbaikal Krai	177.4	0.287	Kursk Oblast	4.1	0.007
Amur Oblast	55.3	0.090	Voronezh Oblast	3.8	0.006
Novosibirsk Oblast	43.8	0.071	Ryazan Oblast	3.5	0.006
Samara Oblast	42.3	0.069	Altai Krai	3.4	0.006
Tyumen Oblast	41.5	0.067	Ivanovo Oblast	3.2	0.005
St. Petersburg	37.3	0.060	Irkutsk Oblast	3.0	0.005
Sverdlovsk Oblast	31.4	0.051	Penza Oblast	3.0	0.005
Republic of Tatarstan	26.8	0.043	Belgorod Oblast	2.9	0.005
Kostroma Oblast	22.1	0.036	Tver Oblast	2.6	0.004
Khabarovsk Krai	16.3	0.026	Republic of Adygeya	2.6	0.004
Kamchatka Krai	15.1	0.024	Republic of Buryatiya	2.4	0.004
Chelyabinsk Oblast	14.4	0.023	Smolensk Oblast	2.2	0.004
Kaliningrad Oblast.	11.0	0.018	Republic of Chuvashia	2.0	0.003
Magadan Oblast	10.5	0.017	Republic of Kabardino-Balkaria	2.0	0.003
Sakhalin Oblast	10.4	0.017	Republic of North Ossetia-Alania	2.0	0.003
Vologda Oblast	10.0	0.016	Tula Oblast	2.0	0.003
Republic of Udmurtia	9.4	0.015	Novgorod Oblast	1.9	0.003
Saratov Oblast	9.4	0.015	Republic of Dagestan	1.8	0.003
Rostov Oblast	9.1	0.015	Vladimir Oblast	1.6	0.003
Primorsky Krai	8.7	0.014	Stavropol Krai	1.6	0.003
Nizhny Novgorod Oblast	7.9	0.013	Volgograd Oblast	1.5	0.002
Krasnodar Krai	7.6	0.012	Leningrad Oblast	1.5	0.002
Republic of Alati	7.4	0.012	Astrakhan Oblast	1.4	0.002
Republic of Komi	6.7	0.011	Ulyanovsk Oblast	1.3	0.002
Republic of Khakassia	6.7	0.011	Kurgan Oblast	1.2	0.002
Orenburg Oblast	6.6	0.011	Republic of Karachayevo-Cherkessia	1.0	0.002
Republic of Mordovia	6.5	0.010	Republic of Kalmykia	0.9	0.001
Republic of Bashkortostan	6.4	0.010	Republic of Tyva	0.9	0.001
Perm Krai	6.3	0.010	Oryol Oblast	0.8	0.001
Moscow Oblast	5.8	0.009	Republic of Marii El	0.7	0.001

Region	Financial services per capita, thousand rubles	Index	Region	Financial services per capita, thousand rubles	Index
Tomsk Oblast	5.7	0.009	Tambov Oblast	0.6	0.001
Lipetsk Oblast	5.6	0.009	Pskov Oblast	0.5	0.001
Yaroslavl Oblast.	5.4	0.009	Republic of Karelia	0.4	0.001
Krasnoyarsk Krai	5.4	0.009	Republic of Ingushetia	0.3	0.000
Republic of Sakha (Yakutia)	5.4	0.009	Archangelsk Oblast	0.3	0.000
Murmansk Oblast	4.9	0.008	Bryansk Oblast	0.2	0.000
Kemerovo Oblast	4.9	0.008	Republic of Chechnya	0.0	0.000
Kirov Oblast	4.9	0.008	Jewish Autonomous Oblast	0.0	0.000
Kaluga Oblast	4.2	0.007	Chukotka Autonomous District	0.0	0.000

The index is a ratio of total credits and deposits of natural persons to the regional population. The ratio in Moscow (city) is one.

Source: the calculation is based on the data available from the Bank of Russia and the Federal Statistics Service.

Table B. Banking network development: an international comparison

Country	Number of banks	Number of branches	Population, thousand	Branches per bank	Branches per thousand people
Spain	352	43691	40491	124.1	1.079
Cyprus	40	715	792	17.9	0.903
Italy	778	45413	58145	58.4	0.781
Bulgaria	32	5569	7262	174.0	0.767
France	411	39886	60876	97.0	0.655
Belgium	104	5882	10403	56.6	0.565
Iceland	25	164	304	6.6	0.539
Austria	871	4279	8205	4.9	0.522
Portugal	48	5533	10676	115.3	0.518
Germany	2049	42438	82369	20.7	0.515
Luxemburg	156	234	486	1.5	0.481
Switzerland	331	3495	7581	10.6	0.461
Japan	247	56361	127288	228.2	0.443
Canada	70	14324	33212	204.6	0.431
Slovenia	22	741	2007	33.7	0.369
US	7175	111040	303824	15.5	0.365
Denmark	181	2000	5484	11.0	0.365
Greece	62	3637	10722	58.7	0.339
Poland	647	12447	38500	19.2	0.323
Finland	338	1646	5244	4.9	0.314
Malta	18	114	403	6.3	0.283
Norway	147	1234	4644	8.4	0.266
Croatia	33	1118	4491	33.9	0.249
Hong Kong	203	1515	7018	7.5	0.216
Sweden	126	1947	9045	15.5	0.215
Serbia	37	2158	10159	58.3	0.212

Ireland	73	879	4156	12.0	0.212
The Netherlands	140	3478	16645	24.8	0.209
Romania	39	4470	22246	114.6	0.201
Czechia	37	1989	10220	53.8	0.195
Lithuania	11	689	3565	62.6	0.193
Estonia	13	247	1307	19.0	0.189
Montenegro	11	124	678	11.3	0.183
UK	335	10950	60943	32.7	0.180
Russia*	**1080**	**23823**	**140702**	**22.1**	**0.169**
Hungary	37	1382	9930	37.4	0.139
Slovakia	24	715	5455	29.8	0.131
Singapore	115	484	4608	4.2	0.105
Armenia	21	298	2968	14.2	0.100
Latvia	24	224	2245	9.3	0.100
Turkey	46	6849	71892	148.9	0.095
Albania	17	294	3619	17.3	0.081

Note: the estimates for Russia include bank branches and additional offices.

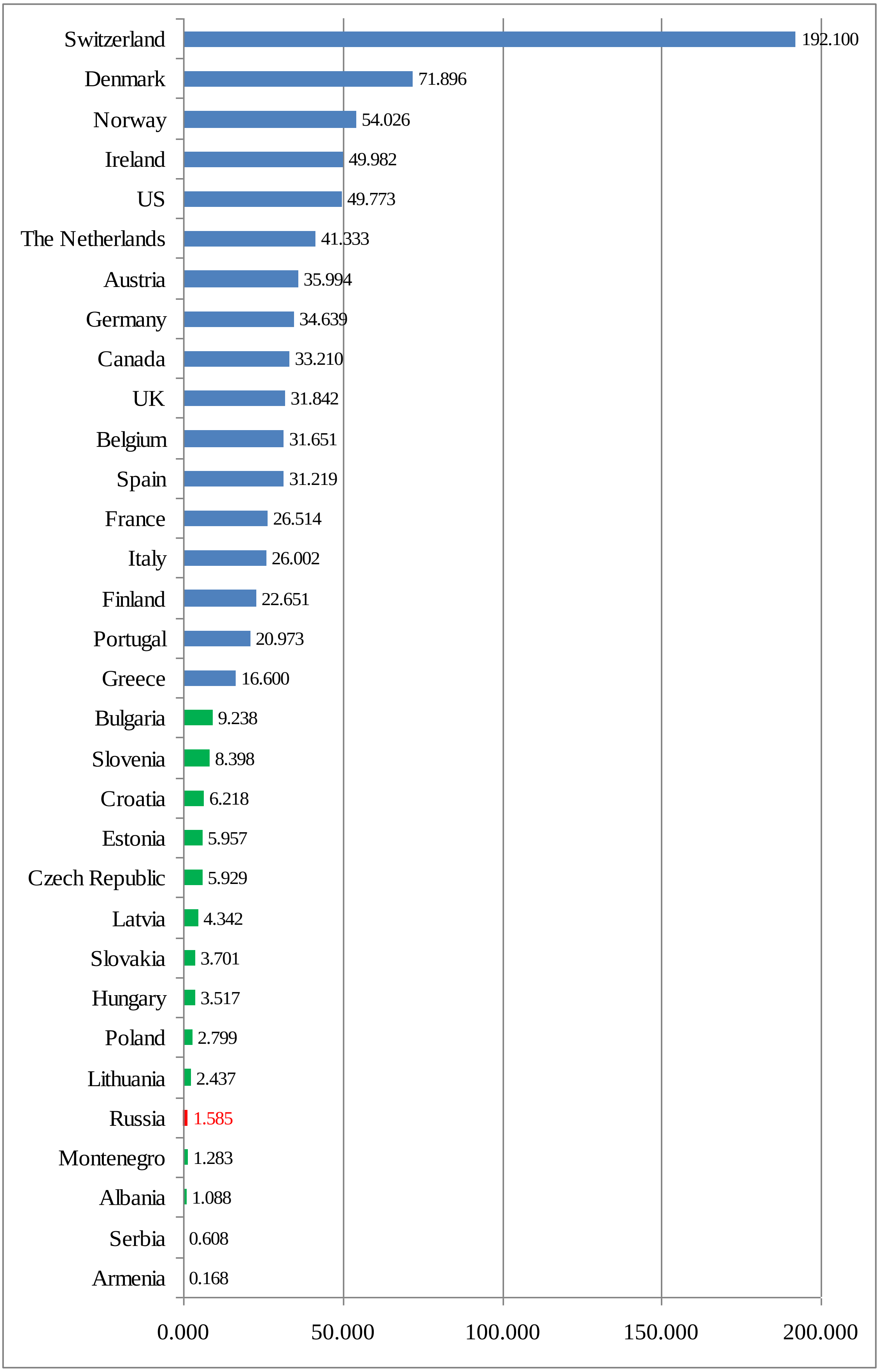
Sources: BIS Statistics on payment and settlement systems in selected countries №82, March 2008; CIA World Factbook, 2008; Statistics of European Banking Federation, 2008; and the Bank of Russia

Table C. Cooperative banks in Europe

Country	Number of banks	Number of clients, thousand	Share in the deposit market, %	Share in the credit market, %
Germany	1255	30000	15.8	11.8
Austria	666	5100	34.9	31.1
Poland	584	10500	12.3	8.3
Italy	527	13100	30.3	26.7
Switzerland	405	3000	18.6	12.1
Cyprus	293	600	22.8	21.7
Finland	232	4000	32.7	31.1
The Netherlands	188	9000	39.0	25.6
Hungary	143	1000	9.9	3.6
Romania	124	1103	1.0	0.7
Portugal	105	1200	5.0	3.0
Spain	83	9878	5.0	5.2
France	79	52500	43.6	45.9
Lithuania	59	68	1.2	0.8
Denmark	25	122	0.5	0.5
Greece	16	175	0.8	1.0
Luxemburg	13	120	10.0	10.0
Sweden	10	69	n.a.	n.a.
Belgium	8	n.a.	n.a.	n.a.
Bulgaria	1	741	2.7	2.4
Ireland	1	15	n.a.	n.a.
Slovenia	1	172	2.2	1.4
UK	n.a.	n.a.	1.0	0.7

Source: Annual Report of European Association of Co-operative Banks, 2007. - p. 36.

Graph. Availability of retail finance: a cross-country comparison (ratio of total bank deposits and credits of natural persons to the population, thousand euro)



Source: MFPA Center for Economic Research, calculation based on data available from national Central Banks and Statistical Agencies.