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Self-Assessment Tool for Microfinance Legal and Regulatory Reform

Assessment of Financial Regulation and Access for the Poor in Georgia

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Accelerated Microenterprise Advancement Project (AMAP) is a 4-year contracting facility that USAID/Washington and Missions can use to acquire technical services to design, implement, or evaluate microenterprise development, which is an important tool for economic growth and poverty alleviation.

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The **IRIS Center at the University of Maryland** works with Chemonics on the AMAP Knowledge Generation research project. It is currently leading the research topic which focuses on developing a practical country self-assessment tool for countries to prompt thinking about key governance issues in microfinance, determine their environment for microfinance growth, and identify areas for improvement or enhancement of rules and related institutions.

Chemonics International Inc. is a global consulting firm promoting economic growth and higher living standards in developing countries based in Washington, D.C.

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Executive Summary[1]

The Self-Assessment Tool for Microfinance Legal and Regulatory Reform project will develop a tool for use by banking regulators, financial institutions and other microfinance providers, policy-makers, USAID Missions, and other stakeholders to assess a country's legal and regulatory environment – as it affects the provision of financial services to the poor. The tool will be designed to guide analysis leading to policy priorities and strategies for reform. Rather than proposing checklists of needs, the tool will present typical scenarios representative of the numerous ways in which microfinance occurs, coupled with the various institutional issues that developing and transition countries face when expanding the poor's access to finance.

This case study discusses Georgia's financial services market, the country's regulatory and supervisory environment, options for transformation among Georgia's non-licensed microfinance organizations, and governance factors that affect microfinance. This information is presented in the form of a "case narrative," which will be used in constructing the self-assessment tool.

Georgia was chosen as a case study for this project to highlight how transition economies approach the regulation of financial services and where obstacles for the low-income population to access such services might surface. The main research questions specific to this case study that the team set out to address are:

- What particular problems does the recent establishment of a market environment pose for financial institutions?
- How can new institutions of market governance – such as central banks and other regulators, ministries of finance, banking and other self-governance associations – best accommodate the needs of microfinance while promoting fair and even treatment of all financial institutions?
- Finally, what can we learn about the way to regulate and supervise microfinance activities in countries with characteristics like Georgia?

Georgia has a small financial sector where several strong institutions and numerous weaker intermediaries are governed by a capable supervisor. Universal banks are the main provider of financial services, with a range of deposit, credit and transmission services. Banks are increasingly involved in the provision of microfinance, which they view not only as sources of profit but also as mechanisms for strategic placement in the market, drawing customers in to use a variety of other services. A small number of banks have also recently started to diversify into insurance and leasing products.

There is also a nascent credit union movement and a variety of NGO-type MFI operators offering credit-only services. All MFIs interviewed as part of the study commented on increasing competition from banks in the microcredit market, coupled with an awareness that they may not

[1] Information in this document based on fieldwork conducted in September 2004, and we thank the numerous people we spoke with during that time, including representatives of USAID/Georgia. The authors gratefully acknowledge comments provided by Anicca Jensen (USAID), Anita Campion (Chemonics), and Thierry van Bastelaer (IRIS) on this report. Legislative amendments to the Georgian Civil Code passed on February 25, 2005 not considered here. All remaining errors are ours.

be able to compete on price with the banks. The small scale of existing MFIs and their inability to offer a full range of complementary services (although some are starting in the area of leasing and micro-insurance) suggests that while a small number of NGOs may succeed in upgrading their structures and becoming more competitive, others may only survive if they find viable market niches.

Banks and credit unions are licensed by the National Bank of Georgia (NBG), where supervision is housed, respectively, in the Departments of Bank Supervision and Non-Bank Supervision. Foundations and associations operate under the Civil Code with legal ambiguity about their organizational and tax status but are not subject to any official financial supervisory practices. All institutions are affected by weak legal enforcement of court decisions and collateral contracts, and judicial corruption, which collectively create a disincentive for enforcing collateral and weakens the credit culture.

In regard to the research questions, it was found that the recent establishment of a market environment creates a situation where the market is in flux: institutions are still trying to understand their own competitive advantages and settle into market niches. As they are doing so, a variety of institutional types are beginning to serve the low-income market with a number of products. The banking regulator is still settling into a regulatory and supervisory system that would lead to the creation of a mature financial system. In the midst of this, institutions are moving toward consumer lending for poorer households and small and micro enterprise lending. This creates an opportunity for the creation of a more inclusive financial sector from the start, rather than trying to force long-established market institutions to move in that direction.

Given the small size of many of the microfinance providers in Georgia, the large number of commercial banks in Georgia, and the increasing business in microfinance being conducted by the largest commercial banks, consolidation of various financial institutions and NGO microfinance providers is likely. Taking a long-term view, the financial sector in the future will likely feature a few commercial banks, an NBFI sector that includes specialized banks and microfinance institutions with limited deposit-taking licenses, and credit unions. Promoting fair and even treatment of all these institutions would require broad licenses that allow financial institutions to determine products and services that best serve their target markets and business pursuits, coupled with strong supervisory capabilities to adequately assess the risk involved in these undertakings. While some MFIs argue that a specific law on microfinance should be passed to clarify the legal position of NGO-based MFIs, it does not appear that a new law would be necessary to resolve the ambiguous legal situation, nor is a law the most appropriate and best-suited strategy to address the current legal problems. In addition, legal ambiguities, tax burdens, and judiciary reform are important to consider as the onerous task of overcoming these inefficiencies will ease financial intermediation.

The most outstanding characteristics affecting the provision of microfinance services in Georgia is the as-yet unsettled nature of the financial and legal system. This situation tends to result in a tendency to regulate because, as in all post-Soviet legal systems, what is not explicitly permitted by law seems to be prohibited. While this may be true, detailed regulation of specific market products, such as microfinance would seem to stifle a fledgling industry. Instead, broad institutional categories that allow for a freedom of choice in market niches appear to be the best answer. Allowing such broad categories will promote innovation while simultaneously providing a sense of stability to the system.

Self Assessment Tools and the Georgia Case Study

1.1 Self Assessment Tools and the Georgia Case Study

The USAID-funded AMAP-Financial Services Knowledge Generation task order is currently developing a tool for countries attempting to assess their regulatory environment for microfinance and to design its reform. The tool is directed at governments and regulating authorities, as well as other stakeholders, including financial institutions, civil society organizations and donors. The tool will be generic, applicable in most countries worldwide. The project builds on previous experience in financial sector law and regulation.

The weak policy, legal and regulatory environment in many developing and transition countries poses a serious challenge to the sustainable growth of the microfinance sector. The lack of supportive policies, laws and regulations hinder MFIs' ability to offer – and clients to access – dependable savings, insurance and transfer services. There is a growing expectation among donors and practitioners that a transparent microfinance policy environment, supported by a flexible set of laws and regulations, will discourage fraud, improve the quality of investments in microfinance, ensure operational transparency and forge critical links to the broader financial market.

This research project aims to provide a generic tool that local stakeholders can use to assess the legal and regulatory framework for financial services to small businesses, microenterprises and poor households. This tool will help to determine problem areas, prioritize issues and develop a reform agenda for addressing them. USAID missions may further use the tool to identify policy reform issues and to determine the investments that are most appropriate in a given country. It will also offer insights and experiences from a range of countries in financial regulation and in building inclusive financial sectors. Desk study combined with field research will provide needed inputs. In brief, the tool is intended to help stakeholders generate the institutional "roadmap" for regulatory treatment of microfinance services, and in so doing to focus the policy agenda.

This report documents the findings from the second country case study in Georgia. Georgia was chosen specifically to understand how such transition economies approach the regulation of financial services and where obstacles for the low-income population to reach such services might surface. The research questions that the team set out to address were:

- What particular problems does the recent establishment of a market environment pose for financial institutions?

- How can new institutions of market governance – such as central banks and other regulators, ministries of finance, banking and other self-governance associations – best accommodate the needs of microfinance while promoting fair and even treatment of all financial institutions?
- Finally, what can we learn about the way to regulate and supervise microfinance activities in countries with characteristics like Georgia?

This country-specific report illustrates the relationship between the simultaneous development of a professional financial services industry and a market for microfinance and further discusses the specific need for reforms in Georgia.

Market for Microfinance Services in Georgia

2.1 Market for Microfinance Services in Georgia

Georgia, a small country of 4.7 million people situated in the Caucuses region, was part of the Soviet Union until 1991. At independence, Georgia operated with a centrally planned economy and over the last 14 years privatization has occurred in most sectors, including banking. Currently, the entire financial system is privately owned; several of the larger banks were formed through privatization and consolidation of Soviet-era banks, while others were founded by private investors after independence. Credit unions and credit-only NGOs also operate there; all three types of institutions serve the low-income and small enterprises with credit, payment services and some deposit-taking; leasing and micro-insurance products are being developed. There is still a need for capacity building within the financial institutions and the organizations that supervise them. Furthermore, legal and regulatory reforms are still on-going.

Overview of Financial Services Providers[2]

Georgia, with a GDP per capita of around US$1,000, seems overbanked, with 23 universal banks, 50 credit unions, several NGOs involved in microcredit and a large number of foreign exchange bureaus. Each institutional type is discussed below, along with a brief description of their regulatory treatment and the types of financial services provided to the poor.

Banks

There are 23 banks currently licensed by the NBG, with total deposits of 888.3 million Georgian lari (GEL) (US$493.5 million) and outstanding loans of GEL 862.1 million (US$ 478.9 million).[3] All banks are privately-owned, although two of the largest banks – Bank of Georgia and United Georgian Bank – were formed from mergers of formerly state-owned banks. License applications include details on origins of funds, financial data of the company, and background information on directors, managers and owners (including criminal records, if any). Currently, existing loan portfolios (such as those an MFI might own) can not be contributed as an asset for meeting minimum capital requirements, greatly hindering the transformation of microfinance NGOs into regulated financial institutions.

Reporting requirements include quarterly financial statements with the balance sheet, detailed analysis of deposits and loan structure, liquidity and foreign exchange position. Trial balance sheets are due every 10 days in order to calculate compulsory reserve requirements. Annual

[2] More information on commercial banks, credit unions, and text of relevant legal texts can be found on the NBG website at http://www.nbg.gov.ge/NBG_New/home_nf1.htm. More information on foundations and associations, as well as general microfinance information, can be found at the Georgia Microfinance Stabilization and Enhancement Project website, http://www.microfinance.ge.

[3] Exchange rate as of 13 January 2005 was 1 USD: 1.8 GEL, according to the National Bank of Georgia website.

audit reports must also be submitted. Banks are restricted to an unsecured loan portfolio of 25% of the overall portfolio. The NBG recently raised minimum capital requirements to GEL 12 million (US$6.7 million), which all banks will have to meet by 2008. This will cause a number of existing banks to close and forecasts show that in the next five years only five or six of the top banks will remain, the rest having merged or closed.[4]

Banks are keenly feeling the competition. Lending interest rates, which five years ago stood at 60% p.a., now fall between 12% and 15%; deposit interest rates are currently around 10% p.a. (down from 14-15% several years ago). Banks are also starting to move into new markets, especially consumer lending and the small enterprise sector. Two of the four largest banks have started giving "express loans" of up to US$200 (21% of GDP per capita[5]) without collateral; others lend smaller amounts using movables, such as jewelry, as collateral; a third bank is the IPC-founded ProCredit Bank, where 90% of clients are in the "micro-loan" category. All clients of this "microloan" business are also given a current account, although the volume of savings garnered through this relationship is not significant as of yet.[6] In addition, the money transfer business is a new area of interest for banks and leasing products are starting to be offered by some banks. Western Union has been successful at setting up operations inside banks and other retail shops; only banks have access to the national payment system, however.

As banks move into consumer lending and microfinance, they understand that competition between them occurs mainly around interest rates and the speed of service delivery. Bank representatives often mentioned to the research team the need to build more efficient systems, friendly and accessible bank branches, and simplified loan application procedures to build this segment of their business more rapidly. As the minimum capital requirements take hold and the majority of smaller banks are closed or merge with larger banks, it seems likely that this microfinance business will remain a part of the commercial banking portfolio. Those institutions already involved are, for the most part, the strongest and largest institutions in the country and the NBG expects these institutions to remain in business in the long-run.

Credit Unions

Fifty credit unions are currently licensed in Georgia with total assets not exceeding GEL 1.5 million (US$833,000). They are licensed and supervised by the NBG's Non-Bank Supervision Department. Credit unions must have a minimum of fifty members; average size is approximately 70-80 members, mostly situated in rural areas and small towns. To establish a credit union, an application to the NBG must be submitted with the credit union charter, minutes of the general meeting, court registration, and the number of members, documents of the amount of equity and a licensing fee of GEL 10 (US$5.58). For credit union members – mostly rural residents with low levels of education – meeting these requirements currently requires help from the Credit Union Development Center (discussed below).

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[4] "Financial Sector Assessment: Georgia" (2002),.IMF-World Bank, Washington, D.C.

[5] According to the 2004 World Development Indicators, Georgia's 2003 GDP per capita was $942 (in constant 1995 US$). All loan sizes are expressed as a percentage of GDP per capita to give a sense of how "micro" the loans can be.

[6] ProCredit Bank also takes deposits, and while deposits have grown in the past 12-18 months, they still constitute less than half the loan portfolio.

Credit unions operate in traditional fashion with savings and credit operations for members only; savings mobilization has been slow but the World Bank/IFAD-sponsored Credit Union Development Center is working on training and promotional material that seems likely to increase awareness and popularity of the credit union model (see below). Loans range from GEL 50-200 (US$28-111, or 3-12% of GDP per capita), well within the range of what is considered microfinance, although one larger credit union is offering loan sizes up to GEL 2000 (US$1111, 118% of GDP per capita).

Credit unions submit quarterly financial statements and off-site inspections are carried out once a year, with generally adequate supervision. Minimum capital requirements are determined by multiplying the number of members by GEL 50 (US$28). Because the credit unions are generally small, current reporting and other requirements may be restrictive or burdensome. The bank supervisor is generally taking a long-term view that the level of supervision will be appropriate to a more mature credit union sector in a few years' time.

Foundations/Associations

Among institutions not regulated by the NBG and offering credit-only services are 11 institutions registered as 'foundations' or 'associations.' These foundations and associations are typical of NGO-created microcredit organizations around the world. Organizations such as FINCA, World Vision and Oxfam, are represented in Georgia.[7] These organizations are legally only able to offer credit, and some are well known due to their avant-garde role in lending to low-income clients. Most began by offering group loans, but many have started to offer individual loans. Total loan volume as of March 2004 stood at GEL 21.3 million (US$ 11.8 million).[8] On average, these MFIs are lending GEL 200-600 (US$111-333, or 12-35% of GDP per capita) loans at a 4% interest rate per month on a declining balance. Most MFI representatives described to the research team new initiatives to move into agricultural lending and geographically push toward more remote, rural areas. A few MFIs are working with larger insurance providers to purchase group policies, which are then packaged as micro-insurance to the clients. Most MFI officials said future goals included: diversifying products to meet changing demand and increased competition; moving into leasing, agricultural loans, and expanding into other locations; as well as building more efficient service delivery mechanisms.

Market Fluctuation and Competitive Pressures

Credit has so far been the product most in demand from low-income clients and competition between different institutions in Georgia is therefore oriented toward different credit products. During banking crises immediately following independence and again in the later 1990s, banks and other institutions collapsed and deposits were lost. Many Georgians still do not fully trust the financial system for the security of their savings. This trend is starting to change and increasing

[7] For convenience, any organization described as an "MFI" in this document will refer to these foundations and associations.

[8] "Georgia Microfinance Demand Survey" (2004). Georgia Microfinance Stabilization & Enhancement, U.S. Agency for International Development: Tbilisi, Georgia.

deposit shares are noted at many banks. Furthermore, demand for domestic and international transfer services is growing and access to these services is offered only by licensed banks. Therefore, while competition today largely hinges on the price and efficiency of credit delivery, it will soon evolve into the ability to also access a wider array of financial services, such as deposit-taking and payment services.

Banks have been keenly aware of these shifts in the market, and tend to view their growing microfinance businesses not only as sources of profit, but also as mechanisms for strategic placement in the market, drawing customers in to use a variety of other services. Banks open a current account for every borrower and several banks have introduced ATM cards – sometimes, as a luxury option for wealthy clients, sometimes as a low-cost method of access for the poor.

All MFIs interviewed commented on increasing competition from banks in the microcredit market, coupled with an awareness that they may not be able to compete on price with the banks. Most advocated their competitive advantage in offering group loans with absolutely no collateral requirements, strong reputations with certain groups of clients, quicker and simpler loan applications, and an ability to move into geographic regions generally not favored by the banks. One MFI commented that their role has been to show the way for banks, and their mission should be to continue finding un-banked niches to lead the banks toward doing business there. There seemed to be a misconception about the banking industry's current movements into the microcredit sector and what structure the loans were taking (i.e., they believed all banks expected collateral whereas most banks had uncollateralized options). Almost unanimously, these organizations also felt that the banks' ability to offer current accounts, ATM cards, or other services was not a competitive advantage because demand for such services does not exist among their clients.

This shows a dichotomy in the future market positioning of the two types of institutions; it is notable, moreover, that neither noticed a credible competitive threat from credit unions, now or in the future. Many MFIs, while showing market orientation in their drive to become more competitive, had misleading market intelligence which made them unaware of the full extent of commercial banks' activities in this regard (for example, whether or not uncollateralized loans were available). The small scale of existing MFIs and their inability to offer a full range of complementary services (although some are starting in leasing and micro-insurance) leads one to conclude that while a small number of NGOs may succeed in upgrading their structures and become more competitive – perhaps accompanied by transformation to a limited liability company or bank – others may only survive if they find appropriate market niches.

An argument has recently been made by outside researchers that the market has a vast pool of unmet demand; such estimates of unmet demand for financial services varies from US$30 million to US$263 million.[9] Although the research team is inclined to believe that the size of this

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[9] Personal correspondence from Michael Kortenbusch, director of the Small Enterprise Lending Program, 23 September 2004, and "Georgia Microfinance Demand Survey" (2004). Georgia Microfinance Stabilization & Enhancement, U.S. Agency for International Development: Tbilisi, Georgia. The demand survey and analysis used to reach the US$263 million figure did not effectively discount the demand stated by survey respondents and so seems to be an inflated figure.

unmet demand is more likely closer to the former figure than the latter, the existence of such unmet demand makes officers of each type of institution hopeful they will be able to tap into it and grow a stronger institution. Various donor projects have worked on strengthening the institutions, as described below.

Developments to Serve Unmet Demand for Financial Services

Three different donor-financed projects seek to strengthen financial services for the poor, working with the three main types of financial service providers. The European Bank for Reconstruction and Development (EBRD) works with selected banks on 'down-scaling' towards low-income clients, the World Bank financed a project based at the Ministry of Agriculture supporting the credit union development, and USAID finances capacity building for microcredit NGOs.

Three banks – Bank of Georgia, United Georgian Bank and TbilUniversal Bank – are currently working with an EBRD-funded project to enhance their capacity in providing financial services to micro and small enterprises. The program is helping the banks to introduce new loan products, train staff, and improve the corresponding front and back office support functions, while also offering current accounts and other banking services. The outstanding loan portfolio under this project as of August 2004 was US$7.7 million (up from US$1.5 million in January 2003), with average outstanding loan size decreasing from US$3,149 in January 2003 to US$1,781 in August 2004.[10] Low-interest funding was originally provided by EBRD, but these resources are now exhausted and all banks continue expanding portfolios from their own capital. This is partly due to the successful growth of IPC-founded ProCredit Bank, which serves as a demonstration model to the other banks.

The World Bank and IFAD have been collaborating on the development of credit unions in Georgia since 1997. The project established a Credit Union Development Center that initially created 150 fairly weak credit unions by offering subsidized credit. In the last year, emphasis has been placed on training 50 of the stronger institutions with a focus on savings mobilization, despite the fact that not all 50 have been licensed by the NBG yet. Because of changes in the regulatory structure (specifically, an increase in minimal capital requirements), membership dropped in 2000 and these 50 remaining credit unions only comprise some 5000 members. With tangible management improvements in place at a number of credit unions, however, a process of consolidation through merging smaller credit unions will begin. This is envisioned to eventually create a system of 10-15 larger, strong institutions. The World Council of Credit Unions has been involved in training the credit unions in management processes and working with the NBG on strengthening supervisory practices.

The USAID funded Georgia Microfinance Stabilization and Enhancement (GMSE) program, which is managed by Chemonics International, is working with the MFIs on institutional strengthening, granting funds for on-lending and other technical assistance, and encouraging

[10] Correspondence from Michael Kortenbusch, director of the Small Enterprise Lending Program, 23 September 2004.

policy reform. This policy agenda is formulated by a Policy Coordinating Body and a Legal Action Committee comprised of the main foundation and association type MFIs in the country. While providing important technical assistance in the areas of corporate governance and financial accounting, GMSE has also encouraged the Ministry of Justice to reform the Civil Code (straightening out the legal ambiguities for foundations), tax law, banking law, and the National Banks Act. These proposed amendments would put foundations and associations on firmer legal ground, while purposefully opening up an NBFI window that is regulated by the NBG.[11] Some of these items are further elaborated below.

Obstacles to Reaching Poor Clients

While banks may be down-scaling into the microfinance market where foundations and credit unions already operate, there are a number of legal and regulatory issues that continually inhibit banks from expanding their services in the area of microfinance.

Bank regulation and supervision
While the licensing and supervision process for all regulated institutions is generally sound, there are a few details that address banks' ability to increase the volume of microfinance services being offered. In particular, microfinance and other financial sector stakeholders should discuss the usefulness of the following rules:

- The upper limit for unsecured credit in a bank's portfolio is currently 25%, although there are no rules on allowable collateral. Particular in microcredit, good portfolios may well have higher ratios of unsecured loans or loans secured by highly unusual collateral. Banking supervision should not discriminate, but rather assess credit risk according to established procedures. These procedures and skills are already in place at the NBG and so capacity to accurately assess this type of risk should not be an obstacle to increasing this limit.

- Ownership in banks is limited to 25% of voting stock by any investor. This limit is, at face value, a way of enforcing good governance. Since donors and international NGOs tend to hold the majority of shares in MFI-transformation situations, however, the 25% ownership limit might pose a barrier. Application of stringent fit and proper tests of owners and enforcement of sound governance guidelines should be adequate to enforce the same goal, and would allow for higher investment and stronger control of banks by single investors. This could affect any type of foundation looking to eventually transform into a bank.

Legal ambiguities
NGOs offering microfinance under a "foundation" license have unstable legal status and uncertainties concerning the tax treatment of their activities. Under the Foundations Law, any type of "entrepreneurial activity" should not be the prime activity of a foundation. Most organizations stress the poverty alleviation effects of their lending operations to hide the

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[11] Giorgi Otaridze and Martin W. McCormack (2003). "Proposed Legislative Amendments to Clarify and Enhance the Powers and Activities of Microfinance Institutions by removing Legislative Flaws which Prevent or Hinder their Viability and Growth as Significant Contributors to Georgia's Financial Sector." Tbilisi, Georgia: USAID.

entrepreneurial nature of the activities. This legal ambiguity creates operational risk for MFIs, however, because the Ministry of Justice could decide to define poverty lending as an "entrepreneurial activity" at any time, thereby forcing these MFIs to close.[12]

The tax situation of these MFIs is another cause of concern. Because they must register as foundations, the normal bank expenses that are tax-exempt, especially loan-loss provisioning, are subject to heavy taxation for these MFIs. Depending on the interpretation of microlending as entrepreneurial or not, income tax may be applicable; however, NGOs are not currently paying this tax. Value-added tax (VAT) must be paid on grants supplied by international donors. Other tax ambiguities have been reported and NGOs in the country – not just those offering microcredit – are working together to seek clarity on these issues.

Some MFIs have argued for a specific law on microfinance to clarify the legal position of NGO-based MFIs. In their view, such a law would establish the legality of non-profit microlending, establish tiers for different activities, and subject some MFIs to financial supervision. The three envisioned tiers would allow for NGOs on the bottom tier and a joint-stock for-profit company on the top tier, with limited deposit-taking allowed (similar to the Kyrgyz law). This envisioned law would only allow a 10% distribution of profit to shareholders. Such a law may not be necessary, however, to resolve the ambiguous legal situation, nor is it the most appropriate and best-suited strategy to address the legal problems. There are, in fact, substantial risks to this approach including its inconsistency with existing financial law and the NBG's strategy for financial sector development. In addition, there are high costs and uncertainties involved in moving a law through the parliamentary process.[13] Furthermore, most foundations heads explicitly stated that they did not intend to seek a license to take deposits; only one foundation had a long-term goal to begin accepting deposits.

Other regulatory barriers

The main obstacles to innovation, increasing outreach and improving service quality for low-income clients come from the areas of tax and civil law, tax administration, court enforcement, and credit information.

Weak enforcement of court decisions, especially in the liquidation of secured pledges on defaulted loans, is one significant area for all institutions.[14] A two year timeline is reported for enforcing a defaulted loan agreement, with little success at actual execution of the transfer of security. There is currently no official system of sharing credit information among financial institutions, resulting in borrowers accessing multiple loans. Loan applicants' credit histories are checked manually by loan officers (there are reports that loan officers call their colleagues at other banks and foundations for information on unknown credit applicants, but this practice is

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[12] Otaridze and McCormack (2003); Kate Lauer and Timothy R. Lyman (2001), "Survey of the Legal and Regulatory Environment for Microfinance Institutions in the Republic of Georgia" (mimeo).

[13] It is recognized that this approach was discussed among GMSE's Policy Coordinating Body after the Ministry of Justice had reviewed a series of proposed legislative changes to the Civil Code that would have reduced the legal uncertainty facing the microcredit NGOs registered as foundations and associations. The Ministry rejected these proposed changes, suggesting instead that a specialized law on microfinance should be considered.

[14] "Financial Sector Assessment: Georgia" (2002)

legally doubtful due to privacy laws). Moveable property is not registered in any central location, nor is there a clear secured transactions law that prioritizes claims on pledges. All of these issues increase risks, either discouraging lending or increasing prices for the client.

Some of these obstacles are beginning to be addressed. A new tax code was slated to be discussed in parliament during the fall of 2004, which may simplify the tax code and reduce the overall level of taxation. A credit information registry is currently being established by a private individual, and a public system is also being discussed; both systems intend to capture both positive and negative information and engage the full range of regulated and non-regulated institutions. These initiatives could lighten any regulatory burdens on financial intermediation, mitigating some risk in operations, and pave the way for such institutions to continue their outreach of services.

3.1 Supervisory Approach

The National Bank of Georgia (NBG), the country's central bank, is the main financial licensing and supervision agency. Through its department of Banking Supervision, it licenses and supervises all commercial banks, while the Department of Non-bank Supervision is responsible for credit unions and foreign exchange bureaus. This split in supervisory departments occurred in 2002 and was designed in anticipation of a larger non-bank financial sector as both credit unions and other specialized financial institutions grew.

Bank supervision procedures analyze each bank's risk management procedures using CAMEL ratings; most staffing and other resources are spent on the 10 banks that hold 90% of all banking assets. Procedures are generally adequate and the NBG is working on incorporating the Basel Core Principles into its reporting and supervision framework while trying to align capital requirements with US standards. Quarterly financial statements are used to conduct peer group analysis among the banks to benchmark performance and flag any unusual circumstances. All reports are submitted electronically to the NBG on a secured system that produces the peer group analyses and other reports required for supervision.

On-site inspection practices are risk-based, concentrating on loan portfolio quality, asset qualification, collateral quality and loan application decisions. Supervisors look closely at how loan loss provisioning changes in line with the repayment schedule, quantity and quality of collateral, and the credit history of the applicant. If the unsecured portion of a bank's portfolio seems high, further inquiry will be made about the loan decision process.

Perceptions and Regulatory Arbitrage

Among the major banks, there seems to be a good working relationship with the NBG, an appreciation of the analysis they provide in the course of off-site supervision, and a respect for its authority. The Credit Union Development Center reports frustration among credit unions at the stringent, onerous requirements placed on them by the NBG, but these practices generally correspond to international best practices (e.g., WOCCU's PEARLS system). Because these credit unions do not currently have the capacity to fulfill all regulatory and supervisory requirements, some regulatory arbitrage may be occurring.

NBG supervises approximately 50 different credit unions with both on-site and off-site inspections. Financial statements are provided on a quarterly basis, which include the balance sheet, income statement, asset classification, and capital structure. NBG staff review these documents, and conduct on-site reviews to verify these documents once per year.

Because the NBG only began supervising credit unions in 2002, there has been a steady emphasis on staff training in this area, fully cognizant of the different needs in non-bank supervision as compared to bank supervision. It seems that the NBG department has been able to continue applying professional levels of expertise in supervision and enforcement and when necessary, insolvent credit unions have been closed.

The National Bank of Georgia’s long-term view of financial sector development, furthermore, seems to include some changes in the non-bank financial institutional sector. The Non-Bank Supervision Department is building its own capacity by supervising credit unions, and would benefit from technical assistance in this regard. The Bank Supervision Department envisions a streamlined commercial bank sector in the near future, and would be interested in how some of the existing, very small banks that currently exist might be accommodated in a different regulatory window from non-bank financial institutions.

4.1 Institutional Transformation

There are no guidelines on upgrading an existing institution to a bank. In particular, there should be clear rules on the valuation of existing credit portfolios and how they can count toward meeting minimum capital requirements. This is of particular importance for NGOs with substantial existing loan portfolios interested in becoming banks.

In terms of transformation in the banking sector as a whole, the Banking Supervision Department of the NBG is already concerned with the large number of banks in the financial system; consistently rising minimal capital requirements will start to squeeze out many of the smaller banks with more specialized operations. As this occurs, it is expected that the NBFI sector will emerge as a viable option for more specialized institutions. This will require few legal changes as currently limited liability companies can be registered and offer some types of financial services (other than deposit-taking); the NBG will need to further develop its supervisory practices to accommodate these types of institutions. Existing MFIs have not chosen this route because it implies a heavier tax burden than under the foundation or association option, and so the tax implications would also need to be addressed. Given current capabilities at the NBG, however, shifting toward a more varied NBFI sector in a few years' time should not pose a major obstacle as the risk-based supervisory practices currently in use by both the bank and non-bank supervisory departments are highly adaptable to new types of business.

Key Findings

5.1 Key Findings

In this section, the research team attempts to answer the research questions that were identified as particularly relevant for transition economies.

What particular problems does the recent establishment of a market environment pose for financial institutions? As Georgia settles into a new economic and political environment, financial institutions are in a state of flux as they integrate market principles, determine market demand, and build products to fill certain market niches. The banking regulator is still settling into a regulatory and supervisory system that would lead to the creation of a mature financial system. In the midst of this, formal financial institutions, namely commercial banks, are moving toward consumer lending for poorer households and to small and micro enterprise lending. This creates an opportunity for the creation of a more inclusive financial sector from early on, rather than trying to force long-established market institutions to move in that direction. In terms of regulation and supervision, this means that already regulated market institutions can move into lower-income segments without facing the legal obstacles that NGOs currently face, especially with regards to their uncertain legal status and higher tax burdens. It also implies that alternative forms of financial institutions may not yet be recognized by the regulatory regime and thus face increased difficulty in transforming to formal financial institutions. Thus, the transition to a market environment has posed both opportunities and challenges to financial institutions. Formal financial institutions, such as commercial banks, have begun adopting market-based principles that lead them to reaching a wider array of clients to create a more inclusive financial sector. NGOs wishing to transform into formal financial institutions, however, still face obstacles to doing so, as was discussed above, which limit their ability to contribute significantly to the growth of this newly oriented financial sector.

How can new institutions of market governance – such as central banks and other regulators, ministries of finance, banking and other self-governance associations – best accommodate the needs of microfinance while promoting fair and even treatment of all financial institutions? The head of Banking Supervision at the NBG best addressed this question with his long-term vision for financial sector development in Georgia. His vision includes the strengthening of a few commercial banks, an NBFI sector with specialized banks and microfinance institutions with limited deposit-taking licenses, and credit unions. Promoting fair and even treatment of all these institutions would require broad licenses that allow financial institutions to determine products and services that best serve their target markets and business pursuits, coupled with strong supervisory capabilities to adequately assess the risk involved in these undertakings.

Finally, what can we learn about the way to regulate and supervise microfinance activities in countries with characteristics like Georgia? The most outstanding characteristics affecting the provision of microfinance services in Georgia is the as-yet unsettled nature of the financial and legal system. As described throughout this document, institutional types are still determining where their competitive advantages will take them; regulators are constructing an architecture for the financial system; donors are funding industry strengthening projects; legal enforcement is still moving away from Soviet-era bureaucracy and corruption. As all of this is happening, there is a tendency to regulate all financial institutions and activities because, as in all post-Soviet legal systems, what is not explicitly permitted by law seems to be prohibited. While this may be true, detailed regulation of specific market products, such as microfinance, would seem to stifle a fledgling industry. Instead, broad categories that allow for a freedom of choice in market niches are the best answer. These would allow for an intermediary NBFI window whereby existing MFIs could scale up, other commercial banks could scale down into specialized areas, and other innovative models of financing could also take flight. Georgia is a step ahead in the forward-thinking nature of the bank regulator, who recognizes the important role of strategic risk management. Allowing such broad categories will promote innovation, while simultaneously providing a sense of stability to the system.

Prioritized Areas for Reform

6.1 Prioritized Areas for Reform

Although the purpose of the field work was not to recommend reform options, the team identified some possible actions that would lead to a more effective financial sector, able to provide more and better services to the poor.

Minor adjustments should be made for existing institutions and the creation of an inclusive financial sector. Many NGOs named their ambiguous legal status as an important obstacle. It seems that the legal status could be solved adequately by clarification from the Ministry of Justice regarding the interpretation of the meaning of 'entrepreneurial activity.' If NGOs, donors and the government were to be in agreement, such a solution would be easier to implement, while legal reform (affecting the civil and corporate law, as well as foundation law) could be pursued in the longer term.

Furthermore, the NBG needs to remain resolute in its intentions to build a generic non-bank financial institution (NBFI) sector open broadly to all types of institutions with limited bank licenses. This will allow MFIs a way to formalize their operations, allow smaller banks to downscale into more specialized NBFIs, while not pigeonholing the provision of microfinance services to one institutional license. In so doing, the NBG needs to maintain an open dialogue with the MFI sector such that the needs of microfinance providers are taken into account. This is especially true in examining options for transformation – for example, whether the NBG will accept existing loan portfolios as acceptable contributions toward minimum capital requirements will remain a critical element.

Strengthening other legal procedures will remain crucial to the ability of institutions to efficiently provide financial intermediation. Judiciary reform is an important step for improving the effectiveness of the financial sector, but worldwide experience in this area shows convincingly that it is a complicated and long process with numerous implications. Important steps would include enhancing the independence and impartiality of courts and modernizing the civil code (which is based on German law). Advances made under the USAID-funded Georgia Rule of Law project will aid in this endeavor.

Current initiatives to create credit information registries and moveable property registries need to be encouraged. It will be prudent to streamline initiatives in both the public and private sector to ensure that only one credit bureau is established, especially given market volume. In addition, rule of law issues, such as ambiguous tax administration and weak court enforcement, should continue to be addressed in the country.

Each of these considerations is in some way related to the characteristics of the Georgian economy, its market and regulatory environment, and its governance. These translate into a useful scenario for the development of the self-assessment tool, as follows.

Development of the Self Assessment Tool

7.1 Prioritized Areas for Reform

The information collected during the desk research and field trip was designed to feed directly into the thought process for development of the self-assessment tool. The Georgia case study was chosen specifically for its ability to provide unique insights into how microfinance markets are evolving in transition economies, and what regulatory choices may be unique to that situation. Lessons learned from the case studies will feed into the several sample 'case narratives' that will constitute the analytical core of the tool. The case narratives will be used to guide discussion about the user's specific country situation, to identify important areas for reform, and to offer possible interventions. Below is a possible format for the case narrative supported by the Georgia information.

Country Environment	**Strategic Considerations**	**Possible Responses**
Low variety of market participants	While the financial sector is not advanced and the microfinance industry is not significant, a somewhat diverse range of institutions offer microfinance services, with potentially significant growth expected in the future.	Allow market forces to prevail; eventually institutions will settle into market niches and find their competitive advantages. Because a wide range of institutions are providing these services, a specific microfinance license may stifle potential growth. Allow broadly defined licenses that encourage product development and innovation.
Medium regulatory environment	Some legal ambiguities exist for a certain class of institutions.	Ensure a level playing-field; do this through proportionate interventions.
High supervision capacity	Supervisory practices adequately assess risk among different types of institutions.	Allow weaker institutions to fail in achieving supervisory requirements; consolidations and mergers among institutions will create stronger industry. If broadly defined licenses exist, weaker institutions may devolve into the NBFI sector.
Low transformation options	Institutions have no options for formalization.	Foster a non-bank financial intermediary sector as it becomes appropriate in the market. Identify and remove obstacles to transformation, such as the inability to accept existing portfolio as capital.
Low governance environment	Institutions do not have sufficient credit information; collateral enforcement is too difficult as to be prohibitive.	Continue judicial reform projects and push for establishment of a single credit information bureau.

Appendix

Interviews held during fieldwork in Tbilisi, Georgia, September 2004:

Regulatory authorities
- National Bank of Georgia: Head of Bank Supervision, Head of Non-Bank Supervision
- Ministry of Economic Development

Financial institutions
- Bank of Georgia
- United Georgian Bank
- TbilUniversal Bank
- ProCredit Bank
- Oxfam
- Constanta Foundation
- FINCA
- World Vision Georgia

Relevant Donors and Donor projects
- USAID
- GMSE (USAID microfinance industry strengthening project)
- GEGI (USAID project working on financial regulation and corollary laws such as credit information)
- Georgia Rule of Law (USAID project working on judicial reform and legal strengthening)
- Small Enterprise Learning Program (EBRD project to strengthen commercial bank capacity in serving micro and small enterprises)
- World Bank/IFAD/Ministry of Agriculture-sponsored Credit Union Development Center

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