

Pamira Sainazarova, lawyer  
Kalikova & Associates Law Firm  
[psainazarova@k-a.kg](mailto:psainazarova@k-a.kg)

## MICROFINANCE IN KYRGYZSTAN: LEGAL BARRIERS TO DEVELOPMENT

Microfinance emerged in Bangladesh, one of the poorest countries in the world. Bangladeshi economist Muhammad Yunus introduced the concept of microcredit, the main idea of which has been to grant small loans to clients for development of their small or family-owned business at low interest rates and with no or little collateral. In 1983, Muhammad Yunus founded Grameen Bank to provide microcredits to Bangladeshi citizens. Muhammad Yunus and Grameen Bank were awarded the Nobel Peace Prize for 2006 for their efforts to "create economic and social development from below"<sup>1</sup>.

Microfinance is often defined as financial services for beginning entrepreneurs and small businesses. It serves to ensure low income people better access to finance and thus to give them an opportunity to start their own business<sup>2</sup>. Microfinance has the following goals: to enhance easily accessible, cost effective and sustainable financial services for alleviation of poverty, to increase employment, to promote entrepreneurship and social mobilization.

This article offers an overview of some legal and regulatory issues relating to microfinance in Kyrgyzstan, including the current challenges of the microfinance sector. Over the years of its existence, Kyrgyzstan's microfinance sector has achieved major milestones in its development. Kyrgyzstan was the first country in Central Asia to adopt the laws governing the microfinance sector such as the Law on Microfinance Organizations of July 23, 2002 and the Law on Credit Unions of October 28, 1999. In general, the legal and regulatory framework for microfinance is in place but it fails to meet the current requirements. Thus, the need for its revision and improvement is obvious.

### MICROFINANCE INSTITUTIONS

First microfinance institutions (MFI) in Kyrgyzstan appeared with the support of international donors. Thus, for example, FINCA Microfinance Company was one of the first to start operations in 1995. Today, Kyrgyzstan's microfinance sector has a great diversity of participants engaged in microfinance. According to the National Bank of the Kyrgyz Republic, as of October 31, 2013, the microfinance sector consists of 4 microfinance companies (MFC), 212 microcredit companies (MCC), 65 microcredit agencies (MCA), and 155 credit unions (CU), of which 12 CUs may take deposits from their participants<sup>3</sup>.

The table below lists some of the distinguishing characteristics among different types of microfinance institutions operating in Kyrgyzstan:

1 [http://www.nobelprize.org/nobel\\_prizes/peace/laureates/2006/grameen.html](http://www.nobelprize.org/nobel_prizes/peace/laureates/2006/grameen.html);

2 [ru.wikipedia.org/wiki/Микрофинансирование](http://ru.wikipedia.org/wiki/Микрофинансирование);

3 <http://www.nbkr.kg/index1.jsp?item=1467&lang=RUS>.

Type	Business legal structure	Founders	Minimum size of charter capital	Other distinguishing characteristics
MFC	Open joint stock company  Closed joint stock company	Specific requirements for MFC founders are described in more detail below.	<p><i>For current MFCs:</i></p> <ul style="list-style-type: none"> <li>- KGS 10 ml. – for non-deposit-taking MFCs;</li> <li>- KGS 50 ml. – for deposit-taking MFCs;</li> </ul> <p><i>For new MFC:</i></p> <ul style="list-style-type: none"> <li>- KGS 50 ml. – for non-deposit taking MFCs;</li> <li>- KGS 100 ml. – for deposit-taking MFCs.</li> </ul>	Are allowed to take time deposits from individuals and legal entities (if properly licensed)
MCC	Any business legal structure permitted for commercial organizations	Legal entities and individuals permitted by Kyrgyz law, irrespective of place of incorporation of legal entities or place of residence or citizenship of individuals.	<p><i>For current MCCs:</i></p> <ul style="list-style-type: none"> <li>- KGS 50,000 for non-branch MCCs;</li> <li>- KGS 100,000 for MCCs with branches.</li> </ul> <p><i>For new MCCs:</i></p> <ul style="list-style-type: none"> <li>- not less than KGS 5 million</li> </ul>	
MCA	Any business legal structure permitted for non-commercial organization (except political parties, trade unions, religious organizations)	place of residence or citizenship of individuals.	Kyrgyz law does not specify a minimum size of the charter capital for a MCA since it is a non-commercial organization.	MCAs may not distribute profit among their participants and may only use it for the attainment of their statutory goals

CU	Cooperative	10 or more Kyrgyz-resident individuals: 1) having similar occupations or professions or the same employer; or 2) residing in one or more nearest settlements or one district <sup>4</sup> .	- not less than KGS 30,000 for credit unions not licensed to take deposits; - not less than KGS 500,000 for credit unions licensed to take deposits from credit union participants.	CUs help their participants (members) by pooling personal savings of CU participants and using them for mutual lending
----	-------------	---	--	--

To coordinate their efforts, protect and represent the common interests, and to carry out joint projects, microfinance institutions establish their associations. Thus, the Association of Microfinance Institutions (AMFI) was founded in 2005 with the mission to create and maintain the enabling environment and enhance the capacity of microfinance institutions<sup>5</sup>. The Credit Union and Cooperative Association was founded in Kyrgyzstan in 2007<sup>6</sup>.

#### REQUIREMENTS FOR ESTABLISHING MFIS

Legal requirements for establishing MFIs in Kyrgyzstan are quite liberal, which has its pluses and minuses. Promoting fair market competition to ensure greater accessibility and quality of microfinance products is definitely a plus. But quantity does not always lead to quality: many MFIs prove unprofitable in reality. In this regard, many experts have suggested increasing charter capital requirements for new microfinance institutions. Higher entry requirements can serve to foster competitive companies and to assess their credit-worthiness. But increasing initial charter capital requirements can hardly serve to fully solve the problem of unprofitability of MFIs. It appears that greater efficiency can be achieved by making the legal regime more conducive for investing in microfinance, including in the way described below.

Due to the fact that in comparison to other microfinance institutions MFCs may offer a wider range of financial services, the law imposes stricter requirements on them, particularly with respect to their founders and shareholders. Thus, under Article 13 of the Kyrgyz Microfinance Companies Law, the founders and shareholders of a MFC may be Kyrgyz resident and non-resident individuals and legal entities, provided that the aggregate shareholding of a legal entity and another legal entity controlling, controlled by, or under common control with it, represents

<sup>4</sup> Under Article 11.4 of the Credit Unions Law, credit union participants may be Kyrgyz-resident individuals and legal entities organized as peasant (husbandry) farms or cooperatives. A credit union participant may not be another credit union;

<sup>5</sup> <http://amfi.kg/>;

<sup>6</sup> <http://credit-unions.kg>.

not more than 20% of the voting shares of this MFC<sup>7</sup>.

It can be assumed that such shareholding limit of 20% for MFCs was introduced by lawmakers to reduce the risk of their portfolio and to ensure high standards of corporate governance. But it appears that the legal regime should serve the long-term needs of the market assuming that donor financing is gradually decreasing. Hence, efforts to increase maximum permissible shareholding and to liberalize foreign equity requirements for MFCs could serve to facilitate investment in microfinance.

#### REQUIREMENTS FOR REORGANIZING MFIS

As noted in the table above, both commercial and non-commercial companies may engage in microfinance. This makes reorganization of MFIs difficult. For example, a MCA may not be reorganized from non-commercial organization into commercial one (MCC or MFC). Therefore, it has to establish a new legal entity to take over its assets. Such take-over of the loan portfolio is a quite time-consuming and costly process. It should be noted that the legal regime fails to regulate MFIs' conversion from non-commercial into commercial or their reorganization through merger, acquisition, division, separation, or conversion. Such regulatory gaps result in microfinance institutions being forced to find solutions to their problems on their own in order to maintain balance between their efforts to protect their interests and to observe the legal regime. Evidently, the legal mechanism enabling MFIs to transform should be in place to ensure their ongoing evolutionary growth.

As far as the MFIs transformation is concerned, some regulatory changes were made to allow MFCs and MCCs to transform into a bank<sup>8</sup>. Thus, MFCs and MCCs planning to transform into a bank must meet the following requirements:

- 1) be organized as a joint stock company;
- 2) have a minimum charter capital of at least KGS 600 million;
- 3) be in operation as a microfinance institution for not less than five years;
- 4) be not subjected to remedial measures or other sanctions imposed by the NBKR over the last two years;
- 5) be in compliance with prudential and other NBKR requirements for existing banks;
- 6) have an independent audit opinion confirming the reliability and accuracy of financial statements of a MFC/MCC as of the date of applying for a preliminary permit for a banking license.

Undoubtedly, such regulatory changes serve the needs of the market, as there are MFIs in the market whose customer base, loan portfolio, human resources, material and technical resources allow them to step up to the next level.

#### SECURITY INTEREST PERFECTION REQUIREMENTS

---

<sup>7</sup> This limit does not apply to legal entities engaged in banking or finance and to foreign non-commercial organizations, if they meet the requirements of the National Bank of the Kyrgyz Republic (NBKR);

<sup>8</sup> Section 9 of the Bank Licensing Regulation as amended by the NBKR Executive Committee's Resolution dated July 27, 2011.

As it is known, one of the characteristics of credit (including microcredit) is collateral. With the enactment of the Pledge Law in March 2005, much has been done to simplify the process of creation, perfection and enforcement of security interests. Nevertheless, currently many issues remain unresolved.

At present, taking security is a time-consuming and costly process consisting of the following stages:

1. Collecting necessary evidence of security interests including certificate of no claim over immovable property of the borrower issued by the Land Office;
2. Certifying security interests with the public or private notary. In the latter case, the borrower's costs and timing will increase;
3. Creating a lien by registering security interests with the appropriate public notary;
4. Registering a security interest agreement with the Land Office.

Perhaps, the proposal to abolish the requirement for notarization of security interest agreements might seem cardinal, but it could be reasonable from the perspective of optimizing the process of perfecting security interests. If security interests could be perfected in the Land Office, this would reduce the above four stages to one, i.e. registering security interests with the Land Office only. This would also help simplify the release of security interests by reducing the number of registration bodies to one, i.e. the Land Office, especially since certain regulatory changes related to agreements of sale, donation or other alienation of property allows their certification in the Land Office, without going to the notary.

#### SECURITY INTERESTS IN MOVABLE COLLATERAL

Under the Pledge Law, security interests in movable collaterals (except pawns) securing the obligations amounting to more than 300 index rates must be mandatorily registered with the pledge registration office (PRO)<sup>9</sup>.

From January 1, 2006, the index rate is equal to KGS 100 per month<sup>10</sup>. This means that security interests in movable collateral securing the loans amounting to more than KGS 30,000 must be mandatorily registered with the PRO.

It should be noted that this requirement serves only the interests of the state, as it boosts revenue collection through stamp duties. As far as the interests of creditors and borrowers are concerned, this requirement only raises costs for borrowers and creates legal barriers for creditors.

Before the enactment of the Pledge Law Amendment Act dated December 17, 2008 №265, the registration of security interests in movable property with the PRO was voluntary and was carried out to give the pledgee priority over other unsecured creditors and third parties.

#### NON-JUDICIAL ENFORCEMENT OF SECURITY INTERESTS

<sup>9</sup> Article 21.1.1 of the Pledge Law of March 12, 2005 N 49;

<sup>10</sup> Parliament Resolution Approving Index Rate Amount of June 15, 2006.

Non-judicial enforcement of security interests (proposed in the abolished Mortgage Law of May 25, 1999) stirred plenty of disagreement and lack of understanding in practice. This legal mechanism was introduced as an alternative method of enforcing security interests since the judicial enforcement is usually deemed as a long and expensive process, which certainly has effect on credit conditions.

Currently, a bill proposing amendments to the Pledge Law of March 12, 2005 is pending before Parliament. The initiators of this bill propose to abolish non-judicial enforcement of security interests in the collateral being the pledgor's sole residence. Indeed, the bill has a socially-oriented character and serves to protect the pledgor's and his family members' right to housing. But it should be noted that the enactment of this bill can result in financial institutions stopping to offer or setting limits on loans secured by a borrower's sole residence. Sole residence is known to be owned mainly by the middle class and rarely by the low-income people. Accordingly, the proposed enactment can indirectly serve to widen income gap between rich and poor by reserving free access to finance for wealthy people only.

Non-judicial enforcement of security interests has been practiced by financial institutions around the world as an effective tool in dealing with delinquent borrowers. Financial institutions are only interested in loan repayment (at least those committed to fair and responsible lending practices) and pursue enforcement against delinquent borrowers only as a last resort.

#### CONCLUSION

As noted above, microfinance proves as an effective means of emerging from poverty and enhancing entrepreneurial capacity of people without access to finance. Ensuring appropriate conditions and, first of all, the proper legal regime, is essential for the microfinance sector's further growth and prosperity.

According to microcredit founder Muhammad Yunus, poverty means being deprived of all human value. Indeed, there is no freedom without economic freedom. That is why, it is important to promote microfinance as a measure of both economic welfare and level of democracy when each individual has the opportunity to fully exercise his rights and protect his interests.

Published in AKIpress Analytics section on 07/01/2014