Inclusive Finance Policy for Ukraine in the Context of Global Microfinance Crisis

By

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Abstract

The thesis aims to formulate policy recommendations for building an inclusive finance system in Ukraine based on the experience of other transition countries and put within the context of global microfinance crisis. The system is expected to contribute to the solution of the problem of underfinancing of small and medium enterprises, alleviation of poverty and strengthening of middle class, and macroeconomic growth and development. The institutional and regulatory framework of inclusive finance system was developed based on the analysis of economic data, my own experience of working at microfinance institution in Horn Africa, interviews with industry practitioners taken at Global Microfinance Forum 2012 and informal interviews with Ukrainian entrepreneurs. I found that the “mission drift” in microfinance industry contributed to dangerous threats, like clients over indebtedness and methodological flows, which must be controlled by the policymaker. I also found that the current policies in Ukraine of governmental-led support of small and medium enterprises are inefficient and should be replaced by the creation of microfinance industry with operational self-sufficiency. The solution given in the thesis proposes to divide the industry into social and commercial microfinance and concentrate the policy on channeling the micro savings, held “under mattresses”, into the financial system.

Table of Contents

List of Abbreviations

GDP – Gross Domestic Product

GNS – Gross National Savings

SCSU - State Committee of Statistics (of Ukraine)

ADB - Asian Development Bank

NGO – nongovernmental organization

CPPs – Client Protection Principles

CGAP – the Consultative Group to Assist the Poor

MIX - Microfinance Information Exchange

SMEs – Small and Medium Enterprises

PAR – Portfolio at risk

MFC – Microfinance Center (network of 105 microfinance institutions from Europe and Central Asia.)

LAC – Latin America Countries

CUs – Credit Unions

OSS – Operational self-sufficiency

CIS – Commonwealth of Independent States

USD – American dollars

NBCO - Non-Bank Credit Organizations

LEA – Local Enterprise Agencies

EMN – European Microfinance Network

MDGs – Millennium Development Goals

SCURPE - State Committee of Ukraine for Regulatory Policy and Entrepreneurship

GNI – Gross National Income

Section 1: Introduction

One of the biggest threats to the growth and development of Small and Medium Enterprises (SMEs) is the limited access to finance sources from traditional banks, which is due to the absence of credit history, insufficient collateral and low interest of banks in providing small loans. The commercial bank's administrative costs on provision and monitoring of such loans are higher than the generated profit. Therefore, SMEs are in need of alternative sources of financing from the institutions that provide services to the pre-bankable clients. The model of providing financial services to the clients, not covered by traditional commercial institutions, received a name of "inclusive financial model" and when it is used for low or middle-income clients it is more specifically defined as "microfinance".

The inclusive finance policies led by governments around the world have already significantly contributed to the increase of sustainability of financial system – a system that attracts or "includes" broad layers of population in the generation of national income. Regardless of the rich international experience and prevalence in other transition countries, the concept is not implemented in Ukraine, where the development of SMEs is of great importance since the economy is in transition.

The Achilles heel of the development projects in Ukraine and one of the reasons for the relatively slow transition process is the prevalence of the model mainly based on governmental funding. This system, existing since independence in 1991, has two main disadvantages. Firstly, governmental authorities cultivated among people the feeling of entitlement to address financial support, which did not stimulate the development of private initiative. Secondly, the red tape and level of corruption made it impossible to use the money in the most effective and efficient way. As a result, entrepreneurs divided into two groups: one, which build close relations with regulatory authorities and one, which didn't. The first group evolved into the big companies in 2000s while the second disappeared or scaled down. The rethinking of development nexus in Ukraine suggests that the system should be reshaped into one, where private entities do not lobby governmental support, but rely on their own operational self-sufficiency. This target brings to another condition, which is about finding another source of funding.

Revealingly, there is a source of funding, which is different from state budget or external financial assistance. One notable aspect of Ukraine national economy is the presence of a large amount of savings outside the financial system, which people keep "under the mattress". Heavy reliance on state provision of services during the communistic times and harsh economic conditions of 1990s, including constant high inflation, widespread financial pyramids and painful devaluations of national currency have led to the distrust in financial institutions. On the other hand, the "mattress" is not the best way to save money that can be channeled into the financial system to stimulate macroeconomic growth and serve the development goal.

The two problems – underdevelopment of SMEs and presence of free liquidity inside the financial system – seem to be interrelated in a way that the second can contribute to the solution of the first. But the fact that this has not happened before suggests that the transmission mechanism should be developed.

With regard to the necessity of transmission mechanism development, the current paper focuses on the two aforementioned problems and proposes a resolution in a form of building a system of inclusive finance based on the internal sources of people's savings, which aims to restore the people's trust in financial intermediaries. The main goal of the paper is to formulate the architecture of the microfinance industry in Ukraine along with a regulatory framework, based on recent global trends and challenges as well as experience of other countries. This goal is a part of a bigger one, described in the Millennium Development

Goals (MDGs) of the UN, which is to enhance the welfare of the state by promoting the economic development and reduction of poverty. The final policy recommendations of the current paper are addressed to the government of Ukraine and National Bank of Ukraine, which possess policy tools of regulation and supervision of banking and quasi-banking system.

This paper uses methods including the analysis of economic data, qualitative analysis of global experience in building inclusive finance policy and interviewing practitioners of the microfinance industry. The research is built on observational techniques, based on field experience working at Kenyan microfinance organization. Since the data is often subject to non-disclosure policy, a vast part of the study was done through informal channels, like unstructured interviews and private mailings. The big contribution has been made by the network, established during the Global Microfinance Forum 2012, where the ideas and views of industry insiders were collected and analyzed.

Underlying the main objective of my research question, it is necessary to rely on two assumptions:

1) The ultimate goal of the government is the outward shift of production possibilities frontier rather than the redistribution of existing income;
2) The implementation of the microfinance strategy requires sustainability and operational self-sufficiency (OSS) of industry players in the first place, rather than the fast growth.

The current study represents a continuation of a research on finance, where the main goal is the development impact. The evolution of microfinance studies started with the analysis of the reasons of success and failure of the model along with the research on the methods of sustaining MFIs' capacity of lending to the poor (for instance Nair 2001, Brau and Woller 2004). The research then turned to the assessment of the impact and the role of the governmental intervention (for instance Coleman 2006, Cull, Demirgüç-Kunt and Morduch 2008). The study on microfinance for Ukraine is represented by Bobrov (Bobrov 2006), Lapishko (Lapishko M.L. and N.V. Kryven 2009) and others. There is, however, a lack of literature on inclusive finance policy in Ukraine, where the most of researchers like Krupka (Krupka 2002) or Partin (Partin 2002) focused mostly on the best policies of state support of SMEs. This paper will fill the gap by considering a policy, where the new microfinance industry will rely on own institutional and regulatory mechanism.

Modern practitioners are looking for the new opportunities in providing financial services with strong social mission, which they call "responsible finance" assessing the influence of the "mission drift" on the whole concept. The main debate focuses around the relevance of regulatory support of double bottom-line approach or the business model, which assess both social and commercial consequences of the actions undertaken. This paper engages in the debate by proposing a model of microfinance for a new transition market, discussing the best way of governmental intervention.

Just as a kitchen knife can be both a tool of cooking and a tool of murder, microfinance can be both an instrument of SMEs development and an instrument of destroying already poor households. In skillful hands, microfinance can lead to the poverty alleviation and contribute to the formation of a class of new entrepreneurs. On the other hand, wide liberalization in the industry may lead to the methodological flows in micro financial institutions (MFIs) and desperate over indebtedness of the clients.

I start my research in Section 2 with the problem of phantom financial source and the introduction of the microfinance concept. My first argument is that the question of financing the small-scale investments on macroeconomic level has been ignored for many years while this question is crucial for industry and the one the strategy formulation should start with. However, examples of many countries showed that the starting push of the industry development should be done with the help of internal sources. With the aim to find such source, I recall the model of inflows and outflows of the open economy and come to a conclusion that economic growth and financial sustainability of a national economy apart from foreign inflows directly depends on the level of savings. My second argument is the necessity to focus not only on the micro lending, but also on the micro savings. Recent research showed a shift in the paradigm of savings in Ukraine into the one with strong understanding of its necessity. And I propose to use microfinance as a channel to include "mattress money" into the financial system. But the design of the policy should be particularly careful and based on fundamental principles and applications. That is why I provide basic principles required for the policy formulation as well as an introduction into a modern discussion of a "mission drift" in microfinance and commercialization of industry.

Since there's a solid experience of microfinance practice around the globe – the next goal, put in Section 3, is to extract the most relevant experience and learn the most crucial mistakes in order to foresee them at the stage of policy formulation. I proceed with finding how microfinance contributes and correlates with macroeconomic growth. Interdependence between two gives us an understanding of how to fit the industry into financial architecture of a country – is it a separate industry with a straight-forward social mission or it is an industry, which exists in close cooperation with other banking and non-banking institutions? The argumentation leads us through contradictory results: although microfinance portfolio in the previous studies showed high resilience to macroeconomic shocks, the whole line of economies around the world experienced microfinance crisis in 2007-2009. I argue that the relations between microfinance and macroeconomic growth strengthened in the last year and were supplemented by two additional channels: the macroeconomic growth through the development of SMEs and through banking sector development. I come to a conclusion that microfinance model should be built within the context of macroeconomic conditions, which still can't be the basis of policy formulation. With respect to the aforementioned statement, I investigate the main problems microfinance recently faced and propose policy decisions with regard to them. The government should tackle the problem of uncontrolled growth of MFIs by limiting the possibilities of main actors to deviate from double bottom-line approach, which shows in starting playing as commercial banks. The policymaker should tackle the problem of over indebtedness and multiple borrowings by introduction of rating system with the clear and transparent identification of strengths and weaknesses of each active MFI. Finally, the policymaker should avoid an inappropriate intervention and remember the "cobra effect" – the difference between desired and obtained policy outcomes.

The Section 4 of the Thesis aims at learning the experience of inclusive finance policy of countries in transition. The case of Romania proposed the step-by-step sequence of legislative development initiatives, which should include the research of working group, governmental listening and dialogue with all stakeholders. The experience of Hungary shows an importance of local enterprise associations, while the case of Poland proposes an example of institutional building. The practical threats and opportunities of inclusive policy implementation are discussed in the case of Russia, where the main conclusion of the division of industry into social and commercial microfinance is made.

While discussed in Section 3 policy recommendations may be applied by policymakers in different countries, Section 5 formulates specific ones for the case of Ukraine. The Section is divided into the crucial for policymaking parts, discussing the current state of microfinance, rationale for policy along with goals and outcomes. Whereas the potential supply of microfinance in the form of "mattress money" is discussed in Section 2, the potential demand of microfinance in terms of a number of clients discussed in Section 5. With the target client group of people occupied in SMEs, households of rural areas and recent graduates an industry may account for as much as two million of potential clients with annual growth of 2-5%. The policy propositions, discussed in Section 5 are about the creation of separate institutional architecture with the separation mechanism dividing industry players into those, playing in social microfinance, and those, playing in commercial microfinance. This is the basic innovation of the Thesis and the followed prudential and non-prudential regulations are aimed at supporting the new system.

Section 2: Microfinance as a Tool of Financial Sector Development

This section of the paper introduces the source of solving the problem of underfinancing of small and medium enterprises (SMEs). The building of inclusive financial system requires additional funds, notably for the emerged micro financial institutions (MFIs) to be able to operate on the market. The first thing to do is to define the scale of hidden "mattress" reserves microfinance industry can rely on. The second task of the section is to introduce the concept and changing nature of micro financing as a tool of channeling micro savings into the financial system. Finally, the section introduces a set of principles, which should constitute the basis of both governmental inclusive finance policy and MFI's corporate strategy.

The development stage of an economy apart from the other factors is generally measured by its annual economic output per capita (Todaro and Smith 2003). It is clear that for the development of a nation the GDP should increase faster than the nation's population. The essential elements required for achieving high rates of sustainable economic growth and development include investments in domestic infrastructure, capable human capital and stimulation of entrepreneurship (CIDA 2011). According to Fohs the promotion of developing and emerging countries has initially focused on the expansion of the microloan sector in order to strengthen small-scale private investments and give the poor population direct access to income generating facilities. But the financing of such measures on a macroeconomic level has been neglected for many years (Fohs 2012).

As a result, the success and fast growth of the aforementioned small-scaled investments required the growing inflow of finance sources. If the policymaker relies exceptionally on the internal sources of financing, than according to National Income and Product Accounts the long-run equilibrium in closed economy provides a theoretical principle (Mankiw 2008):

$$\text{Savings (S)} = \text{Investments (I)}$$

But in this model the assumptions are the balanced national budget and balanced foreign trade, which is not true in real life. It is important to remember that on practice savings equal to investments only in closed economy and in an open economy at any given point of time there is an imbalance.

To understand the importance of national savings in developing a sound financial system it is necessary to recall the model of flows of income in an open economy. According to Bokros, the domestic use of income (DU) equals to GDP and imports of all goods and service (IM) less the exports (EX):

$$DU = GDP + IM - EX = Consumption\ (C) + Investments\ (I)$$

As a result, the disposable income equals to GDP plus importation of income (Y_{M}) minus the exportation of income (Y_x):

$$DY = GDP + Y_M - Y_X = Consumption\ (C) + Savings\ (S)$$

In order to present the investment-saving balance, it is necessary to recall that current account deficit (CA_{def}) contains trade account ($IM - EX$) and transfer account $Y_M - Y_X$:

$$CA_{def} = (IM - EX) - (Y_M - Y_x) = Investments\ (I) - Savings\ (S)$$

Now it is possible to establish the investment-saving balance:

$$I - S = (IM - EX) - (Y_M - Y_X) = \Delta FDI + \Delta FPI + \Delta L - \Delta R$$

Where FDI equals to the flow of foreign direct investments, FPI – to the flow of foreign private investments, ΔL – to the flow of lending, ΔR – to the flow of reserves. Finally, the key equation to show the flow of income in an open economy is following:

$$(I - S)_G = (S - I)_H + (S - I)_E + \Delta FDI + \Delta FPI + \Delta L - \Delta R \text{ (Bokros 2011)}$$

The equation shows the flow of income between three domestic sectors: government, households and enterprises, and one external. Since $(I - S)_G$ represents the government position, the main question arising from the equation is whether $(S - I)_H + (S - I)_E$ and

$\Delta FDI + \Delta FPI$ will help the national economy to grow. But, as I will show in the Section 3, while discussing the experience of other countries, external capital inflows are very reluctant to enter unstable and emerging markets. The building of the inclusive finance policy should account for the inflow of investments from abroad only when the industry already performs for a certain period of time. And it is very unlikely that FDI will appear in the initial stage of industry development, even with strong institutional and regulatory framework. An important assumption of the current paper is that inclusive finance policy should implement operational self-sufficiency (OSS) of the industry in the first place, refusing the direct governmental assistance. Therefore, the national economy with high demand for investments at the initial stage of inclusive finance policy formation requires high level of savings in order to be able to organize and develop microfinance industry.

There are numerous practical examples of national economies, which hold both economic growth and financial sustainability due to net positive $(S-I)_H + (S-I)_E$ position. For instance, the Japanese government, due to high savings, is able to lead the policy of demand stimulation and has the big deficit position, being among the world leaders in terms of public debt (CIA 2010). China and Germany are the other examples of economies, the financial sustainability of which is predetermined by the high level of savings. Thus, this source should be used by the government of Ukraine.

The question arising among the first before the actual policymaking is about the scale of savings Ukrainians keep out of the financial system. As a matter of fact, people in post-Soviet countries during the early stage of transition saved little comparing to developed industrial countries. The main reason was the existence of pent-up demand in Soviet times, which created the so-called "economics of shortage", where money didn't perform its main functions (Kornai 1980). At the early stage of transition, people still claimed the policy of wide welfare state and didn't have a habit to save.

The research made in 2011 by IMAS International[1] underlines the changes which took place in the last decade in the culture of savings of Ukrainians. According to the research, 70% of Ukrainians understand the necessity of savings and one third plan to increase savings annually. An important feature is that 47% of Ukrainians save their money in cash. To compare, only 3% of Austrians and 28% of Czechs use the same method of savings. Moreover, 70% of Ukrainians save money mainly for rainy days, without investment purposes[2]. Here it is important to notice that savings kept in national currency as deposits in banks often don't help to escape from inflation. Due to the economic slowdown nowadays Ukrainians save only 508 hryvnas[3] per month, which may be called as "micro savings". But the scale of "mattress money" or "money under the pillow" is very difficult to measure. According to the official data of Ukrainian government, Ukrainians keep approximately 14,4 billion dollars under the pillow (SCSU 2012). Unofficial data gives a number of 40 to 60 billion dollars (Commentaries 2012). The idea, therefore, is to overcome the distrust in classical banking system and stimulate the transfer of the aforementioned savings into the financial sector and increase the inclusion of the population of Ukraine in the generation of domestic income. The general mission of inclusive finance policy in other words can be explained by the G20 commitment to microfinance:

> The G20 commitment recognizes the over two billion adults around the world who do not have access to formal or semi-formal financial services. Most people are already aware of how greater access to basic financial services through microfinance can transform lives and improve welfare. Awareness is growing that access to wider set of financial tools, such as saving products, payment services (both domestic and through international remittances) and insurance provides poor people with much greater capacity to increase or stabilize their income, build assets, and become more resilient to economic shocks. (G20 2010)

[1] The IMAS International was founded in 1972 and it is one of the leading Austrian research companies. It specializes on consulting and operates mainly in Austria and CEE countries. The research was made under the supervision of ErsteGroup.
[2] Here it means that 70% of people do not perceive their savings as investments. Even if this money is not "under the mattress" – the banking deposits since 2010 hardly allow people to escape the inflation.
[3] Official exchange : 508 hryvnas = 62,89 USD (from http://www.xe.com/ucc/)

Therefore, micro savings which Ukrainians keep "under the mattresses" can be used both to increase private wealth and to support the financial system of the national economy. And the system of inclusive finances provides a mechanism for this policy. It is important to understand that microfinance is just one of many private and public-sector tools to support development in poor countries and countries in transition and that the aforementioned mission should be modified and adjusted to every country or region.

Originally microcrediting was used exceptionally by the non-profit sector, while commercial sector required more conventional forms of collateral before granting loans to microfinance institutions. But in contemporary world microfinance is getting more and more important and achieves higher credibility in the traditional world of finance. The traditional banking industry has started to realize that the potential borrowers of microloans more correctly fit into a category called pre-bankable (Fohs 2012). It turned out that clients from this category require a variety of financial products. As a result, the mainstream finance industry has started to see the profit opportunities in microfinance. It is necessary to understand the concept before proceeding.

Microfinance is defined as the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households and their micro enterprises (ADB 2000). Beginning from the 1980's world famous pioneers, such as Grameen Bank in Bangladesh or ACCIÓN in Latin America, have proved that the poor can be solvent. The amount of separate transaction is not big ("micro") and usually it is lower than average GDP per capita, although the precise definition depends on a country context. According to ADB, microfinance services are provided by three types of sources:

- Formal institutions, such as rural banks or cooperatives;
- Semiformal institutions, such as NGOs; and
- Informal sources such as money lenders and shopkeepers (ADB 2000)

Regardless of the initial function of serving the poor, the current debate on the nature of microfinance leads to a conclusion: microfinance is becoming more commercial. Industry experts refer to the phenomenon of "mission drift" (for instance Bragar[4], Arasli[5]). There are several reasons for this. First, traditional NGOs in growing number started to transform into licensed banks and non-bank financial intermediaries in order to access public funds or small savings deposits (Drake and Rhyne 2002). The examples include ACLEDA Bank in Cambodia, Xac Bank in Mongolia, Spandana and SKS in India. Second, banks and financial companies have noticed the potential of micro crediting to enhance their product mix. This opportunity lures the entry of profit-seekers into the microfinance segment by offering new products, establishing separate branches or providing external financing for MFIs (Maksudova 2010). The examples include ICICI Bank, ABN-AMRO, Citibank, HSBC in India and China and ANZ Bank in Fiji. This is called "mission drift" since the initial mission was different. As Muhammad Yunus, the founder of microfinance model, noticed:

> We created microcredit to fight the loan sharks; we didn't create microcredit to encourage new loan sharks. (…). Microcredit should be seen as an opportunity to help people get out of poverty in a business way, but not as an opportunity to make money out of poor people (Iqbal 2010).

This mission drift has important implications for the policymaking since it reveals the motivation of institutions operating in the industry. The model of microfinancing to work properly should be built with regard to this motivation.

In spite of mission drift, microfinance is still considered to be an industry of "responsible finance". This term was recently created by industry practitioners specifically to underline the difference between microfinance and traditional finance. By using this term they stress that microfinance companies are not loan sharks, that the basic mission is development and poverty alleviation. As a supporting argument, a number of initiatives were taken in order

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[4] Bob Bragar is as expert advisor on managing legal risks in microfinance industry at Legal Risk Strategies for Impact Investors (The Netherlands)

[5] Burcu Guvenek Arasli is founder and CEO of Finance for All (Turkey), having an experience of 20 years of working in microfinance industry.

to assist the two key dimensions – client protection and social performance. With the aim to keep clients as the driving force of the industry, the Smart Campaign[6] has formulated seven Client Protection Principles (CPPs), namely:

- Appropriate product design and delivery;
- Prevention of over-indebtedness;
- Transparency;
- Responsible pricing;
- Fair and respectful treatment of clients;
- Privacy of client data;
- Mechanisms for complaint resolution. (Smart Campaign 2011)

These key principles are reinforced by the Consultative Group to Assist the Poor (CGAP) Key Principles of Microfinance, endorsed by the Group of Eight[7] (CGAP 2004). Among these principles special attention should be paid to the CGAP Principles 4,5,7,8 and 9 as they should be sustained during the formation of inclusive finance system in Ukraine:

> Microfinance can pay for itself and must do so if it is to reach very large numbers of poor people: financially sustainable providers can improve services and increase access to financial services. (CGAP Principle 4)
>
> Microfinance is about building permanent financial intermediaries, attracting savings, making loans, providing other financial services, and building financial sustainability as institutions and financial markets improve. (CGAP Principle 5)
>
> Interest rate ceiling hurt people by making it harder for them to get credit. (CGAP Principle 7)
>
> The role of the government is to enable financial services, not to provide them directly. In this respect, government should set policies to stimulate financial services for the poor while protecting customers. Macroeconomic stability, avoidance of interest rate caps, subsidized government lending, reduction of corruption and improving the environment for microbusinesses are the objectives (CGAP Principle 8)
>
> Donor funds should complement private capital, not compete with it (CGAP Principle 9)

Bearing in mind the mission of savings and the mechanism which is going to be implemented in the policy framework, it is necessary to state the target. To put the question

[6] A movement of hundreds of MFIs around the globe.
[7] The G-7 plus Russia.

differently – what is the development impact of the microfinance tool? Although the question is clear and decisive – it is very difficult to show the impact in quantitative measure. Basically, this is one of the main reasons of investor's skepticism about microfinance – it's unclear how to build an investment strategy if you can't measure the impact. But the supporters of microfinance policy stress that there are things of utmost importance for poor people, the impact of which is extremely high even though is difficult to put in figures. Nevertheless, my argument here is that the target of the policy – quantitative or qualitative should be put and it is done in Section 4 of the Thesis. One lesson learnt is that the target is different for each nation or a group of nations and it should be adjusted to the internal economic conditions, which is why the analysis of international experience is made is Section 3.

In this Section I have stressed the importance of national savings in sustaining a sound financial system with the main argument of the necessity of focusing not only on microcredits, but also on microsavings. At the initial stage of microfinance policy we may see a lack of FDI while savings, which Ukrainians keep outside the banking system, should be channeled into it through microfinance scheme. I've provided an understanding of the classical microfinance concept and introduced the contemporary discussion of mission drift. One possible suggestion is that mission drift to a big extent has contributed to the crisis of microfinance, which we observe nowadays. Mission drift may be a good thing or a bad, but it is a fact, which we should account for while policymaking instead of eliminating it. That is why I have recalled the basic principles of micro financing, which regardless the scale of commercialization, should be sustained. But since the industry has gone the different from the predicted direction, it is necessary to find out what implications this change made on the contribution to macroeconomic growth and underline the most crucial mistakes from the global microfinance.

Section 3: Recent Trends and Contemporary Challenges of Microfinance Industry

In the previous section the concept of microfinance was introduced and the current changing nature of this industry was discussed. I have stressed the importance of channeling microsavings into the financial system and recalled the main principles to be held while constructing the inclusive finance policy. The goal of the current section is to provide a direction of policymaking – should the microfinance industry be an independent system or it should fall within the national macroeconomic one? This question arises mainly because the clients of traditional banking and microfinance are different by their nature. I answer this question by providing the analysis of the relations between microeconomics and macroeconomics.

The second task of the section is to track and analyze recent trends and challenges of the microfinance policy. According to the debates held during the Global Microfinance Forum 2012 in Istanbul, the industry is in crisis, which can be noticed in different parts of the world. The logical way of developing the policymaking process is, therefore, to learn from the mistakes in order to foresee them at the initial stage of policymaking. The second target of this section is to propose policies for avoiding mistakes made by other governments in different parts of the world.

3.1. Relations of Macroeconomics and Microeconomics

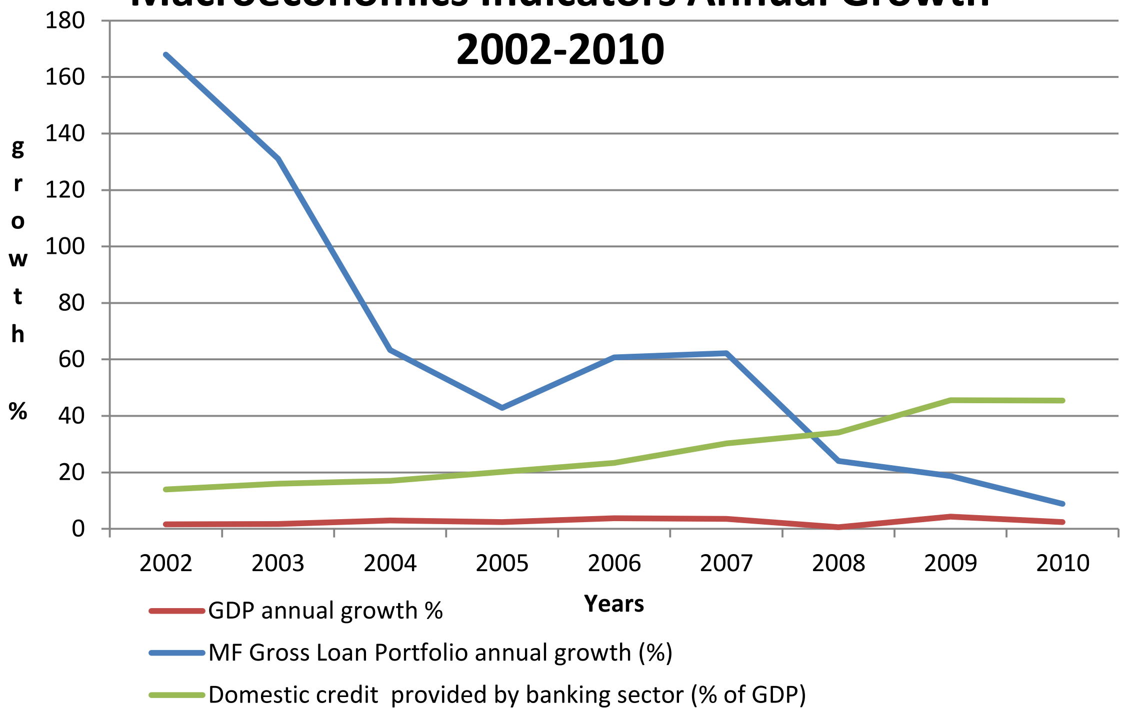
The development of the microfinance industry in the last decades has proved that it cannot be observed independently from macroeconomic factors. According to a recent study by Ahlin (2010), performance of Micro Financial Institutions (MFIs) is highly dependent on the general macroeconomic conditions. For instance, more developed financial system reduces transaction costs, lowers interest rates through broad competition, and softens the consequences of defaults (Ahlin 2010). On the other hand, Ahlin stresses that developed institutional environment does not predetermine successful microfinancing. The basic notion that can be extracted from Ahlin's study, is that national economic background cannot be ignored, but microfinance industry does not completely correlate to macroeconomic performance.

Here it is essential to present a study made by Gonzales in 2007. Gonzales used econometric analysis to assess the resilience of microfinance to macroeconomic shocks. He took a sample of 811 MFIs in 88 countries reporting data to the Microfinance Information Exchange (MIX) mainly in the period 1999-2005 and demonstrated that after controlling for MIX and country characteristics, there is no evidence to suggest a strong relationship between changes in GNI per capita and indicators of microfinancial institutions' (MFI) portfolio risk. He concluded that microfinance portfolios have high resilience to economic shocks.

In this regard it is useful to investigate the channel between microfinance and macroeconomic growth and reestablish a model, created by Maksudova. First, it is important to show the dynamics of relations between microfinance and macroeconomics figures (Figure 3.1).

I will use data from Europe and Central Asia countries, as this group is the most relevant for Ukraine due to its geographical, cultural and economic closeness. The macroeconomic indicators such as GDP annual growth and annual growth of domestic credit provided by banking sector are confronted to microfinance loan portfolio growth for the period of 2002-2010. The data extracted from MIX Market and WB World Development Indicators. The relation shows that microfinance gross loan portfolio growth rates are higher than annual growth rates of region's GDP and domestic credit provided by banking sector for the years of 2002-2007. The banking sector demonstrated relative stability over the years before the credit boom of 2007-2008, while microfinance sector is booming over the same

Figure 3.1 Microeconomics and Macroeconomics Indicators Annual Growth 2002-2010

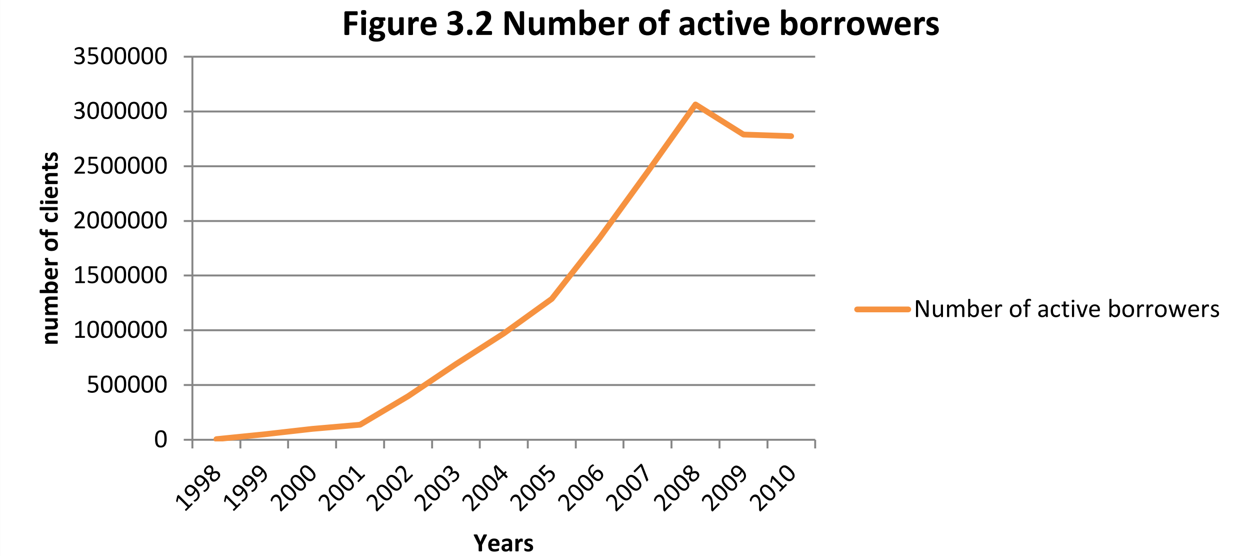


Source: Data extracted from MIX Market and World Development Indicators

period regardless the rates of GDP growth and expansion of banking credit. It is necessary to note here that there is no clear evidence what contributed the most to the rapid growth of microfinance sector as well as to the further slowdown. Rather we are interested here in the fact, that figures were independent with regard to each other.

As a matter of fact, it is very difficult to measure the direct influence of microfinance on macroeconomic growth, but here it is worthwhile to mention an important contribution to development goals – more and more people are getting access to credit sources. Figure 3.2 shows the constant growth of borrowers from MFIs. The growth of borrowers, in its turn, means more development and growth projects.

The initial so-called "classical microfinancing" is focused on group loans, with women as a target client group and prevailing share of consumer purposes loans. For instance, in Eastern and Horn Africa the loans given to the clients are secured by the group responsibility



Source: Data extracted from MIX Market

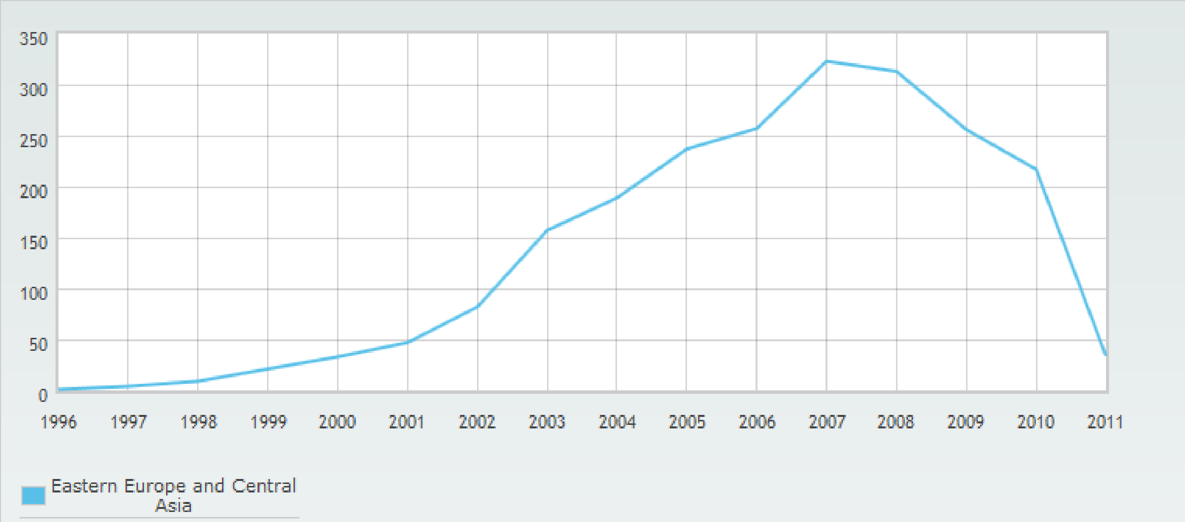
with the obligatory presence of a guarantor. For instance in Kenya there are so-called "biashara" loans, which are the loans for the group projects – a group saves money together and spent them for a certain good – cloths, mattresses, pillows etc. Apart from such projects, people mostly ask money for buying crops and expect a good harvest next season. Recent trends in many regions, including transition economies, shifted the attention towards the SMEs projects – MFIs start to ask questions how a microloan can contribute to the further growth – in Europe and Central Asia it means the technological development of enterprises. Microfinancing became an issue of SMEs development, which is another channel of contribution to macroeconomic growth. In this respect, it is essential to pay attention to the growing share of start-ups stemming from MFI's loans and growing number of firms providing loans to start-ups[8] (Figure 3.3(a) and Figure 3.3(b)).

Finally, one of the most important changes happened in the channel of relationship between microfinance and banking sector. As mentioned in section 2, microfinance used to be considered a separate industry with the only mission to help the poorest layers of society.

[8] MIX Market provides the percentage data only for 2010 and 2011

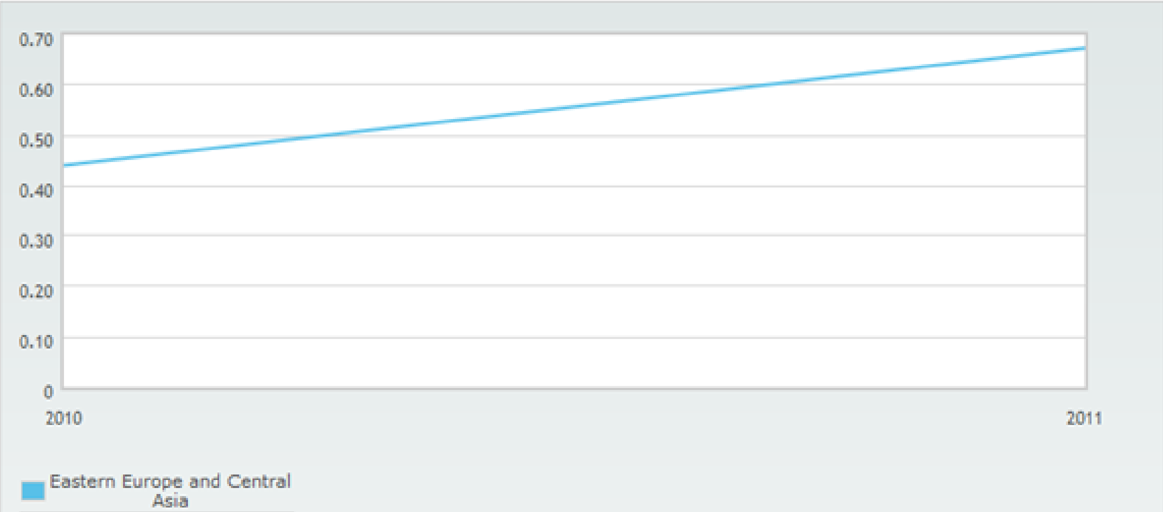
However, the mentioned already "mission drift" has led to the commercialization of the industry – more and more commercial banks engage in microfinancing (Figure 3.4)

Figure 3.3 (a) Number of MFIs providing loans for start-ups, 1996-2011



Source: MIX Market, Microfinance International Exchange

Figure 3.3 (b) Percent of Financed Microenterprises that are Start-ups (weighted average), 2010-2011



Source: MIX Market

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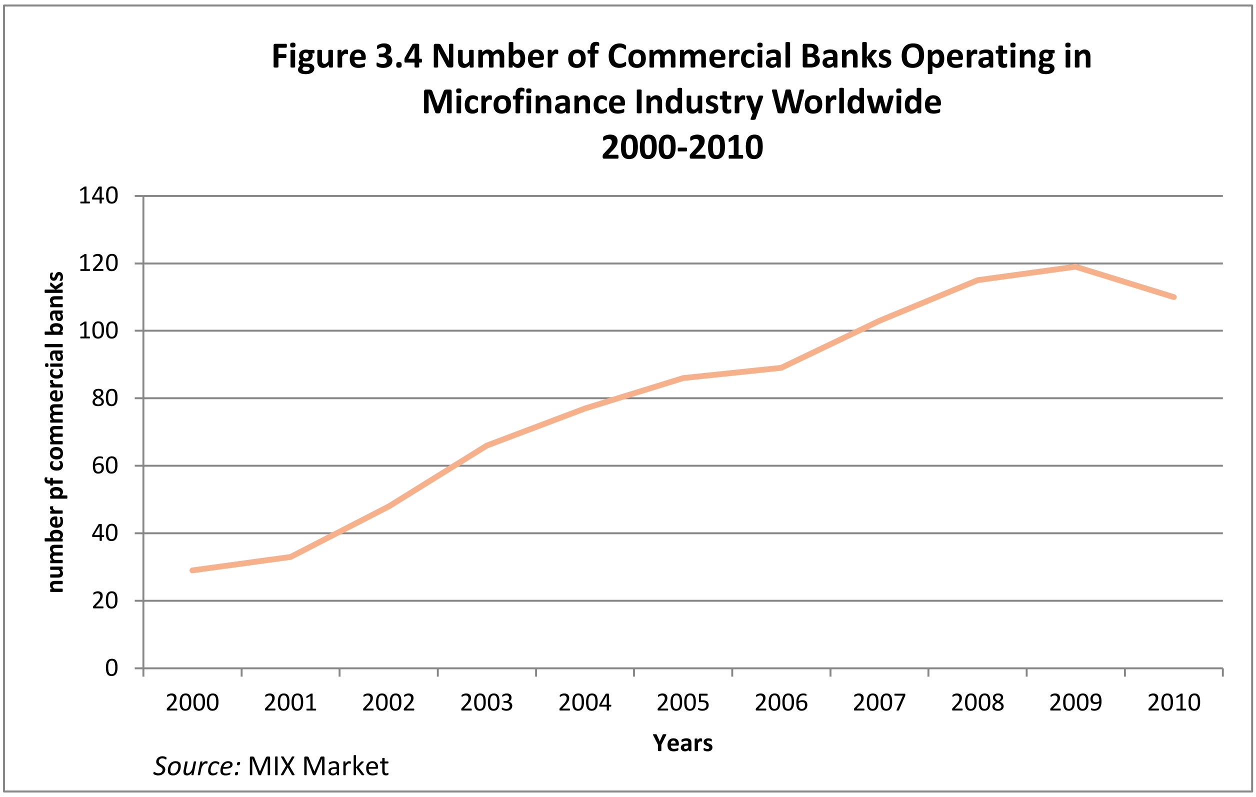
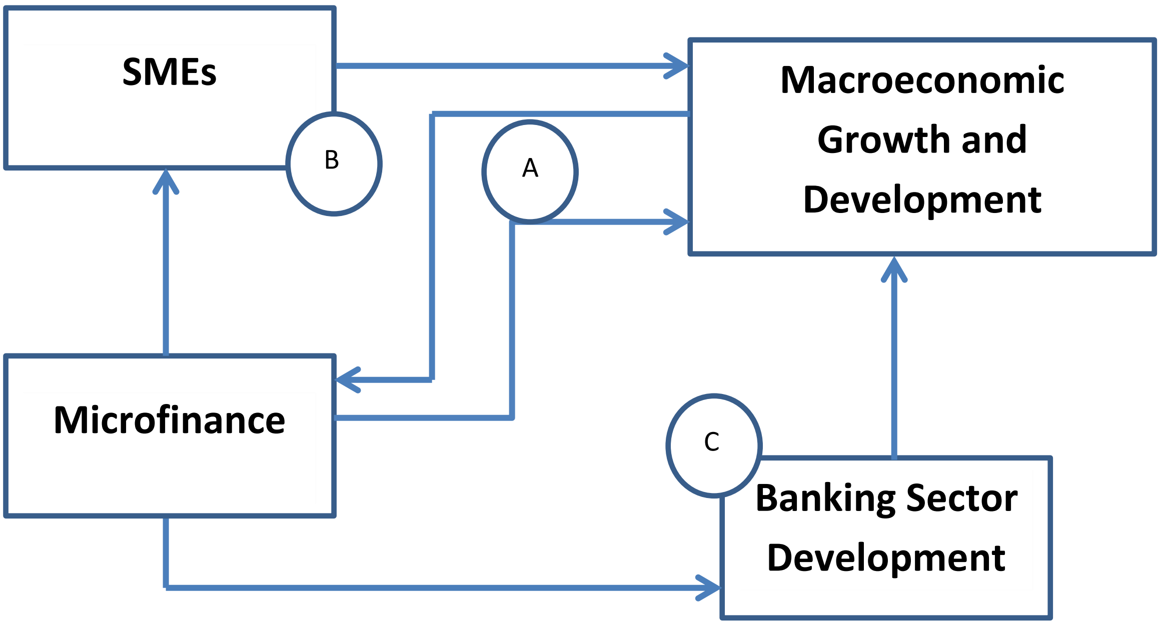


The aforementioned changes happened in recent years in relations between microfinance and macroeconomic growth could be summarized in the model showed in Figure 3.5, which represents the rethinking of the model, presented by Maksudova (Maksudova 2010). A new element was added – the SMEs, several relations were dropped as irrelevant to the mission of current paper and contribution channel through banking sector was added.

The A-channel shows a previous existing relation between microfinance and macroeconomic growth and development: people get access to consumer loans and this allows changing the poverty nature. The new channels became clear recently – microfinance contributes to macroeconomic growth through the development of SMEs, providing access to credits to start-ups, encouraging private initiative. Channel C reveals a contribution of microfinance to macroeconomic growth through banking sector development – commercial banks strengthen the competition in industry and increase investments.

Figure 3.5 The Channels Through Which Microfinance Contributes To Macroeconomic Growth and Development



Source: Extensively developed from the framework introduced by Maksudova (Maksudova 2010)

The highlighted relations have a big impact on policymaking. Basically, the importance of the inclusive finance policy should be justified by the aforementioned relations, with the core idea that the microfinance model should be built in the context of macroeconomic conditions, which still cannot explain the majority of the performance of MFIs (for instance Ahlin and Lin 2006). The relations also reveal the need to analyze the changes happened recently in microfinance industry, which is to be discussed below.

3.2. Recent Trends and Challenges After 2004-2008

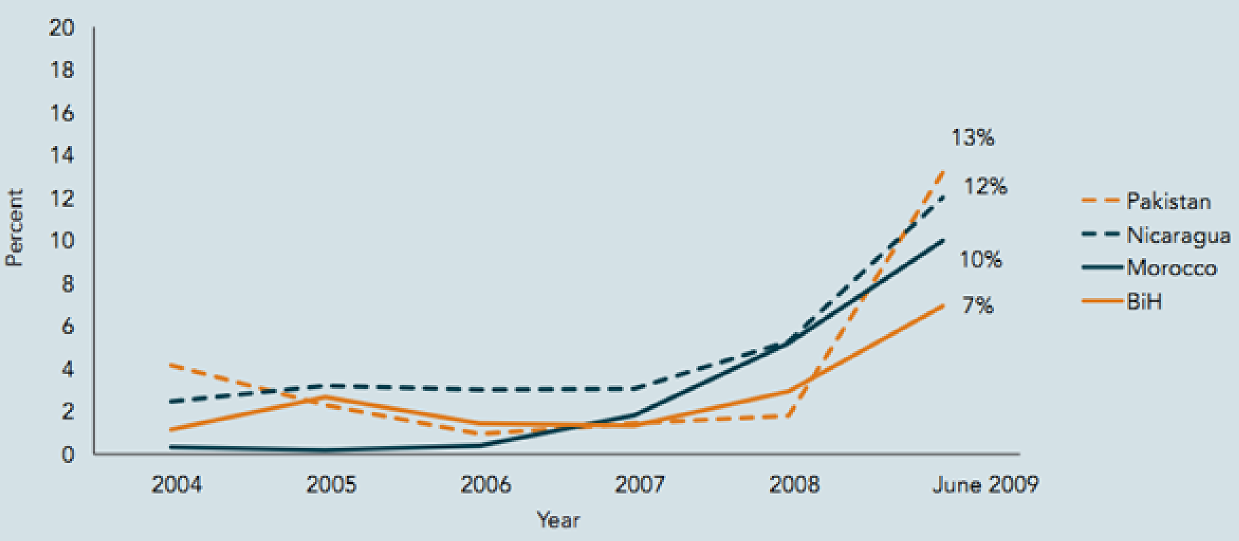
While constructing the microfinance model in Ukraine it is important to understand that industry develops in the context of the global economy. Therefore, the new challenges facing global microfinance after 2004-2008 should be taken into consideration in order to avert possible downturns when industry matures. With regard to this aim, it is crucial to determine the key recent trends and challenges as well as to formulate a policy of overcoming them.

3.2.1. Problem of uncontrolled growth

In fact, the microfinance industry has demonstrated unprecedented growth in emerging countries in 2004-2008. According to MIX, the average annual growth of assets for this period amounted to 39%. The sum of all loans extended to MFI clients estimated at 60 bn US dollars. The number of clients grew from 7,6 million in 1997 to 137,5 million in 2010 (Maes and Reed 2012).

Quick and uncontrolled growth led to the lack of sustainability and erosion of MFIs' lending discipline. In order to gain more clients MFIs started to take more risks, which led to the crisis of non-repayments (Chen 2010). According to Chen, the severest crisis was observed in Pakistan, Nicaragua, Morocco and Bosnia and Herzegovina, where the portfolio-at-risk (PAR) over 30 days exceeded or was close to 10% (Figure 3.6, Chen 2010). An erosion of discipline was driven mainly because of the methodological flaws, which means that MFIs failed to maintain the chosen methodology of asset management, client assessment,

Figure 3.6 Portfolio-at-Risk over 30 Days



Source: Chen 2010

loan provisions and engagement of staff. In this respect Rozas provides an example of FuegoNord Nigerian MFI, established by foreigner without banking or microfinance experience (Rozas 2011). Following the common trend, this entity grew very fast in the overheated market with no regulation. But very soon the market revealed the weaknesses and punished the company – FuegoNord had to go through several cycles of restructuring and portfolio shrinking, mainly because of overburdened internal systems and weak governance. Additionally, the company has lost its focus and started to invest in real estate on global markets. Similar stories happened to Artemis in Ghana, Phaethon in Morocco, Hestia in Pakistan and others (Rozas 2011).

Policy Implications.

The above trend shows that as soon as MFIs deviate from the initial double bottom-line approach and start playing as commercial banks, the correlation between macroeconomic trends and entity's performance increases. Therefore, it is crucial for a policymaker to control the maintaining of the MFI's initial methodology and mission. Since it is difficult and unnecessary to control every aspect of all MFIs performance in the economy, the best tool to be used is to restrict completely or to certain extend for MFIs to operate as investment banks, which means the limitation of investments in real estate and stock market. The basic notion is to keep the liquidity of the MFI and keep the confidence of the clients. This can be done by establishing special leverage and liquidity policies. A policymaker should keep in mind that these policies should be soft enough for MFIs to grow during the good macroeconomic times and tough enough to survive during the bad ones.

3.2.2. The Problem of Over Indebtedness and Multiple Borrowings

As a result of aggressive growth strategies of lenders more and more microfinance clients around the world experience the problem of over indebtedness, which represents a threat both to the notion of the double bottom-line and to financial and operational sustainability of MFIs. A microfinance customer is over indebted if he/she is continuously struggling to meet repayment deadlines and repeatedly has to make unduly high sacrifices to meet the obligations (Guvenek 2012). However clear the definition of over indebtedness is, the measurement of it is challenging. The debate is about whether to take individual cash flows into account or those of all households in the economy. A survey made by EDA Rural Systems and CGAP in four Indian cities shows two cities which experienced mass defaults in 2009 and two, which didn't (Appendix 1). The research reveals that every fourth had a default primarily because of excessive debt and every third had to sell private assets to repay the loan.

The obligation to repay, as a result, has led to another disease – multiple borrowing. An example can be extracted from the research on the borrowing patters since 2008 made by MFC in Bosnian and Herzegovina, Kosovo and Kyrgyzstan (Figure 3.7). It shows clearly that the growing ratio of borrowers with multiple borrowings is associated with the growing PAR over 30 days.

Because of the Smart Campaign Client Protection Principles (CPPs), already mentioned in Section 2, it is quite difficult to obtain data on private borrowings, but in private talks representatives of Nicaragua, Morocco and Pakistan MFIs mention the ration of 40% of active borrowers who had multiple borrowings in times of repayment defaults in these countries (Chen 2010).

Figure 3.7 Borrowing Patterns since 2008

	Multiple Borrowing				Repayment
	% of borrowers with multiple loans	Average number of loans	Cross-borrowing from banks and MFIs (among multiple borrowers)	Average loan term (months)	% borrowers overdue>30 days
Bosnia and Herzegovina	58%	2,30	66%	37	15,8%
Kosovo	25%	1,37	53%	26	8,4%
Kyrgyzstan	31%	1,46	32%	14	1,3%

Source: Microfinance Center (network of 105 microfinance institutions from Europe and Central Asia.)

Policy Implications

The fight against over indebtedness implies the implementation of early-warning index, which represents a set of indicators signaling a level of risk of over-indebtedness in a given market. One possible solution is to start with the indexes formulated by the studies made by the University of Zurich Center for Microfinance (Appendix 2). The availability of data required for measuring the represented variables often is limited or lies within the category of private information. Therefore, MFIs should calculate own loan profiles with a possible support of national department of statistics or credit bureaus. In this situation specific microfinance facility (the institutional framework is discussed in Section 5) establishes a common formula for calculating an over indebtedness (using indices represented in Appendix 2) and a common grade with a certain threshold, beyond which an MFI can't go. Every MFI submits a report stating the grade of over indebtedness for a certain period of time. If the grade is above or close to the threshold, the credit bureau engages with special Commission, the final report of which enables the credit bureau to write-off the debts in automatic regime. This provides MFIs with initiative to underestimate official grade of over indebtedness to avoid forced write-offs. Therefore, a credit bureau will assess the grade according to the available data – macro level indicators and industry level indicators. Additionally, with regard to the experience of the European Commission, credit bureaus will organize household surveys for certain period. Grades will be compared and analyzed, and in the case of different grades – reassessment of the firm level indices should be made.

3.2.3. Inappropriate State Intervention

According to the Citi's Microfinance Banana Skins survey 2009, political interference is among the biggest threats to microfinance industry. The main argument is that microfinance needs to be regulated by the policymaker, but inappropriate regulation will severely harm both the industry and clients. The two most widespread inappropriate state interventions are the introduction of low interest caps and providing direct subsidized loans to clients.

Microfinance has long been criticized for charging higher interest rates compared to banks. The social pressure in many cases (like the “No Payment Movement in Nicaragua”) led the governments to set the interest rate cap – for instance in Bangladesh the annual interest rate that MFIs can charge has been capped at 27% (Economist 2010), in India – at 26% (Chakraborty 2011). The outcome of such policy is the decrease of MFI’s financial and operational sustainability as well as decreased financial inclusion. For example, the IDB research on Latin America countries (LAC) (Campion, Kiran and Wenner 2010), which analyzed the data for 35 MFIs from seven LAC countries (Bolivia, the Dominican Republic, Ecuador, Haiti, Mexico, Nicaragua, and Peru) for the years 2005 through 2008, shows that in case of capped interest rates – the poor clients in rural areas are the first to be eliminated from the MFIs lending scheme because of the high cost of serving them. Implementing a cap is a market distortion, which only limits the performance of MFIs.

Another widespread way of regulating the microfinance industry is providing direct loan subsidizes to clients avoiding microfinance schemes. This step leads to the creation of the culture of non-repayments as it happened in Colombia in 1970s and 1980s. Providing government loans transforms microfinancing into microcrediting – the concept comes to simple address assistance instead of building a successful financial development model. Even Muhammad Yunus, the founder of the microfinance concept, refused to provide loans with zero interest rate. Besides, such governmental policy is unreliable and, as a rule, not long-lasting – the end of the election campaign may cease the provision of necessary means.

Policy Implications

In order to avoid mistakes and undesirable consequences, the policymaker should remember the "cobra effect" in microfinancing or the difference between the expected and actual outcome of the policy.

One widespread solution for building inclusive finance system among authorities is the creation of state MFIs or MFIs with a high share of governmental funds. With this a policymaker expects to provide a target group of clients with the direct financial assistance. Secondly, he/she expects to benefit from the absence of intermediaries. Besides, authorities take responsibility for the interest rate and can regulate it without market pressure. The actual outcome of such policy, however, is different leading to the creation of the culture of non-repayments and decreased financial inclusion, as it was shown in the examples above. Additionally, such intervention distorts the market and decreases the private investments since private MFIs cannot compete with low interest rates, introduced by the government. The policymaking implication is, thereafter, is to let the market to create operational self-sufficient MFIs. The examples, shown above provide an argument that "crowding-out" effect of the government can be very significant with negative influence on the industry. The second policy recommendation is to focus on the control of the environment instead of a company-based control. The policymaker still needs to introduce a strong prudential regulation (discussed in Section 5), but he/she should not be a "secret police" of the industry, but rather a facilitator of the environment.

Another widespread governmental tool used for regulating the microfinance industry is the introduction of interest rates ceilings. In most cases governments try to achieve three main goals using such a tool: an increase of financial inclusion, softening of market overheating and increase of the social constituent. But this policy actually leads to a decrease of financial inclusion, as discussed above, and again – to market distortions and decrease of credit provision. As a result few MFIs will remain in industry and decreased competition will negatively influence the clients. Instead of this, government should create an understandable and transparent information resource, where clients can clearly see the list of all microfinance programs in the market with terms and conditions. In this way the government relinquishes the responsibility for the investors' money (just like in case with ordinary commercial banks, where only a part of savings is guaranteed to be returned by the government is case of bank's insolvency), but acquires the responsibility of grading the institutions. Another policy to be introduced instead of interest rate ceilings is the restriction of the change of interest rate during the loan period. Usually this period in microfinance does not exceed one year and it represents a term, during which MFIs can sustain the interest rate of the time of issuing. In other case, that would be an unreliable MFI.

Finally, governments in many regions of the world (including Ukraine) prefer to address direct financial assistance through governmental body rather than to create microfinance system. The governmental expectations of such policy are that the increased efficiency and increased speed of financial sources provision. In addition, governments are happy to have a total control over the funds and projects. However, it turns out that resources are mostly wasted because recipients do not take as much responsibility for granted funds as they take for their own. To add to that, direct assistance is a subject to constant corruption and in most cases funds do not find the most efficient user, but the one, who was "the first in line" for receiving grants. Regarding this policy, the policymaker should abandon the concept of direct governmental assistance in microfinance as such. One lesson must be learnt – the building of operational self-sufficient entity impossible if the funding acquired is free. By refusing the concept of free funding, the government will be able to avoid the MFIs' moral hazard.

This section has presented several important policy implications, which are applicable for most policymakers around the globe dealing with inclusive finance system building, including Ukraine government. Several researchers suggested that microfinance and macroeconomics condition goes anticyclically, but this claim became very strong after the crisis of 2007-2008 and consequent global microfinance crisis. The lack of data and relevant research, however, prevents us from clear definition of which factors and to what extent contributed most to the crisis of microfinance – worsening of global macroeconomic conditions or the microfinance "mission drift". But one thing is clear - the new channels of the microfinance contribution to the macroeconomic growth have appeared, namely SMEs-channel and Banking sector-channel. Since these channels work in both directions, i.e. microfinance contribute to macroeconomic conditions thorough them as well as macroeconomic conditions contribute to microfinance development through these channels, the microfinance industry is to be built with prudential and non-prudential regulation protecting the industry from both microfinance and macroeconomic problems.

This section has also shown that the architects of inclusive finance policies around the globe failed to foresee dangerous mistakes, the most visible of each are: uncontrolled growth of microfinance and followed erosion of lending discipline, over indebtedness of clients and multiple borrowings and inappropriate governmental interventions. The recent trends and challenges in microfinance have proved that very often policymakers should remember "what not to do": do not allow actors to deviate from double-bottom line approach and become loan sharks; do not allow them to burden people with debts, help to assess people's solvency; do not intervene with straight-forward thinking because actual outcomes may deviate from the expected ones. As far as the recommendations given in this section may apply to almost every government (including Ukraine) dealing or planning to deal with inclusive finance policy, the specific recommendations for Ukraine should be made. But prior coming to the formulation of specific policy for Ukraine, it is essential to learn the experience of other countries close in terms of economic development (transition countries) and cultural peculiarities.

Section 4: Global Experience in Regulating Microfinance

The formulation of inclusive finance policy requires several important steps to avoid widespread mistakes and implement best practices. As the term is new and not widely used in Ukraine, I have made an introduction into an understanding of it as well as presented the current debate and basic principles in Section 2. Section 3 led to a conclusion of changing pattern in relations between microfinance and macroeconomic growth. It also proved the presence of microfinance crisis with the main challenges presented and solutions proposed. Since Section 3 presented general solutions, applicable for most governments dealing with inclusive finance policy, including Ukraine, the current section analyzes the experience of transition economies, which has particular interest due to cultural, political and economic closeness with the main aim to use this experience at the stage of policy formulation in Ukraine. Lessons will be drawn from the experience of Poland, Hungary, Romania and Russia.

The development of microfinance industry in countries in transition occurs differently than in developing ones. Microfinance programs in such countries do not fight poverty in the first place, but are aimed at supporting entrepreneurial initiatives. As a result, the final outcome apart from poverty alleviation and the provision of minimum subsistence for living is stimulation of business activity and development of local markets in mid- and long-run. Microfinance for countries in transition is a tool contributing to the creation of entrepreneurial middle class.

The microfinance environment in transition countries is different as well – it is characterized by more stable macroeconomic conditions, more developed banking infrastructure, higher educational level of clients and professional level of loan providers. Thus, the main contribution to macroeconomic growth in countries in transition goes through channels B and C, i.e. through SMEs and banking sector. The clients are people who are willing to develop own business in order to increase family welfare. The range of services is wider than in developing world and includes consulting, insurance, deposit-taking, financial education etc. Still, as the history of microfinance has proved, there is no perfect inclusive finance policy and every government should analyze the experience of other policymakers.

4.1. The Case of Romania

The development of the microfinance industry in Romania is important for current research primarily due to the high demand for its services from micro borrowers. According to FAO Investment Centre about 89% of the private active SMEs are micro-sized enterprises [9](FAO 2005). This case presents a solid step-by-step recipe of financial inclusion policy formulation. With the aim of increasing their accessibility to financing, the Romania government has implemented the following sequence of legislative initiative development:

1. *The assignment of a working group on the development of regulatory structure for micro financing*. This group gathered the necessary for the law firm information and studied the experience of other countries. In the end it came to a policy recommendation of the creation of regulation on NGO transformation into MFIs and the minimum capital requirements of 200 000 euros.
2. *The development of microfinance legislation*. This step involved the working group's presentation in 2004 of the first draft law on the microfinance law in the Parliament.
3. *Governmental presentation of the law*, which represented the position of the Government and National Agency for SMEs and Cooperatives.
4. *Lobbying of microfinance legislation*. This step included the presentations of the law to the National Bank, bankers' associations and different civil commissions. EBRD along with active Romanian MFIs participated in the process. It is important not to undervalue this step of policymaking since lobbying becomes more and more

[9] According to Romania National Institute of Statistics, microenterprise is the one with 10 or less employees.

important. According to EMN, almost half of European MFIs carry out lobbying activities (Jayo 2010).

Although the process slowed down after the elections of 2004, it remains a good example of the sequence of steps on the adoption of legislative framework. The proof of this statement came quickly with the increased inclusion of population in the financial system declared by the government.

The regulatory framework itself in Romania was developed in 2003 through 2009 and includes three main laws (Doiciu and Bialus 2005):

- The Governmental Ordinance no.40 (2000), which provides licensing for non-bank credit organizations (NBCO) to manage public funds;
- The Credit Unions law no. 266 (2006), which regulates Credit Unions (CU) and their national apex structure: CUs National Union (UNCAR);
- The Non-Bank Financial Institutions Law no. 93/2009, which is the main law for MFIs. It established the supervision of MFIs by the National Bank; defined the minimum capital requirements; established specific features of the environment – no interest caps, no deposits, transparency in setting costs, client protection etc.

The case of Romania provides an example of plain and transparent legislative initiative development. The government of Ukraine should use this method when working on the legislative framing of the inclusive finance policy. It includes the research of special group of professionals (might be experts from abroad since there is no solid experience in Ukraine), negotiations in the Parliament, feedback from the industry actors. The legislative framework also should include several laws easy to understand, but not the huge books of laws possible to read only by professional lawyers.

4.2.The Case of Hungary

Hungarian experience of microfinance is important because of the great importance of the local entrepreneurial network. Hungarian microfinance started in 1990 with the creation of the Hungarian Foundation for Enterprise Promotion, where government became the main shareholder.[10] This case is important in terms of the creation of local microfinance networks by the aforementioned Foundation. Microfinance in Hungary has started without Parliamentary adopted regulation and clearly falls within the category of subsidized micro-crediting (Kállay 2003). The Foundation used local enterprise associations (LEAs) as intermediaries in the transactions, which became the most important microfinance actors (Kovács 2008).

According to the European Microfinance Network (EMN), LEA programs include incubator house initiatives, industrial park programmes, subcontracting and subcontracting factoring, e-business and risk capital programmes, clusters, agricultural and tourism development projects, development of microcredit programmes and involvement of commercial banking resources in credit granting to SME. The basic principle of LEA operations is decentralization, which meant that each LEA manages own fund. Kovács states that each LEA had microfinance division with appointed microfinance officer, who passed a professional preparation on international programs. A Hungarian wishing to apply for a microloan had to submit a specific application with detailed business plan. This plan was assessed afterwards by the special board and field trips were made. The main advantage of the model is the high speed and flexibility of the model (Kovács 2008).

However, the model was changed after 1999 into more centralized one with the main aim of increasing the available funds “into one hands”. In 1999 Hungarian government has created the State Committee for Microfinancing and adopted a law “On Small and Medium

[10] Source: A ZMVA megalakulása http://www.mvfportal.hu/?regio=16&lang=ENG

Enterprises and Support of Their Development", which established the maximum credit provision to SMEs at 12 000 euros and restricted the provision of microloans by commercial banks. In April 2004 Hungarian Development Bank established an interest rate ceiling of 8%, which was lower than the Central Bank's one (Kovács 2008).

Since there is a wide network of different governmental non-commercial local offices dealing with entrepreneurial development, the case of Hungary provides an example of how to transmit the presence of such offices into the network, which is necessary for inclusive finance building.

4.3.Poland as an Example of Microfinance Institutional Building

To extract ideas for successful microfinance institutional modeling, it is useful to examine an example of Poland. Most of the information in this sub-section is generalized from the sources of European Microfinance Network. The case of Poland is highly relevant for building institutional architecture of microfinance in Ukraine since it presents on of the best microfinance models on the continent.

Historically, there were three models of microfinance entities: credit unions, traditional MFIs and network of Loan Guarantee Funds. In 1991 Polish government established a clear regulation of CUs based on voluntary membership, allowing the payment of interest rates on deposits and increasing interest rates for loans. This model became very successful mainly because of the following reasons:

a) Distrust of commercial banks, which provided loans exceptionally on commercial basis;
b) Political support, which showed in promotional campaign underlying honesty and credibility of CUs;
c) Clear legal framework for CUs activity;
d) Support from the foreign investors (mainly USAID).

The CUs model of microfinancing in Poland includes seven organizations, which carry specific functions (European Microfinance Network 2005):

1) The National Association of Cooperative Savings and Credit Unions (SKOK, Spòldzielcze Kasy Oszcedosciowo-Kreditowe), which is the main prudential body, which regulates and supervises the functioning of the CUs system. The organization also engaged in the provision of commercial services and gained financial sustainability 5 years after the existence.
2) A Central Financial Facility (CFF), which acquired the functions of Central Bank for Credit Unions. CUs deposit 5% of their savings and all capital reserves within this institution. The CFF is the only CU, which is allowed to get direct borrowing from Central Bank of Poland in times of downturns. CUs as opposed to commercial banks get an interest for reserves kept within the CFF. These reserves are circulating in the financial system all the time – CFF make investments either in governmental bonds or provide loans to member CUs.
3) A Stabilization Fund with the function to lend money to CUs in times of downturns and crises. CUs-members of CFF are obliged to contribute 1.22% of their total assets to the Stabilization Fund, which upon the necessity lends this money to CUs upon preferential interest rate.
4) The TUW-SKOK Mutual Benefit Insurance Company, which provides insurance services to CUs and covers saving deposits, properties and causalities.
5) The H&S Software Company, which is responsible for the implementation of standardized software necessary for data collection and reporting.
6) The SKOK Credit Union School and Training Centres, which provide training to CUs office employees. These centers are spread across the country.
7) The Foundation for Polish Credit Unions (FPCU), which owns some SKOK assets and help to design the CUs policy (European Microfinance Network 2005).

The traditional microfinancing sector in Poland provides an example of a model with special methods, used to stimulate repayments. The concept in this model is about providing the credit resources to those entrepreneurs who have a clear vision of how to complete a business plan. Loan-officers in Poland have changed the paradigm of communication with clients into the one, where loan-officer supports the clients and establish close connections. MFIs in Poland led a campaign, explaining the clients, that the final target is the creation of entity with sustainability and OSS, which is risky business, justifying high interest rates. Polish MFIs still use classical collateral in a form of group guarantee, which levies social pressure on the client. (European Microfinance Network 2005).

Another model of microfinancing in Poland is the network of Loan Funds and Guarantee Funds. Technically these are two supplementary models of micro loans provision to SMEs, which are often combined within the same institution. The Loan Funds started to operate in 1994 with the tranche provided by the World Bank to sustain the development of entrepreneurship. A number of practitioners point out that Loan Funds are not well-organized and are not homogeneous: some operate as loan providers on a small scale, others – as training centers (extracted from European Microfinance Network). The biggest part of funding comes from the local or central government and, as a result, Loan Funds usually implement governmental policy with regard to the provision of loans to recent graduates or unemployed. But this model of microfinancing requires guarantees like pledges, mortgages or guarantees of Guarantee Funds (European Microfinance Network 2005).

The Guarantee Funds in Poland are divided into national ones (Bank Gospodarstwa Krajowego, the National Bank of Economy) and independent regional ones (European Microfinance Network 2005). The primary task of these structures is issuing individual and group (so-called "wallet guarantees") loans, which cover up to 60-70% of the sum applied for by the borrower or co-operating bank. Most guarantees are granted for investment purposes (51%), purchasing of equipment (27%), real estate (12%) and carriers (10%).

4.4. Practical Experience of Russia Microfinance Industry Development

The experience of Russia microfinance is important in several regards. Firstly, this is a country which has very close cultural peculiarities and economic development path along with common political past. As a result, Russia and Ukraine have many things in common in terms of doing business and vision of inclusive finance. Basically, the Russian and Ukrainian understandings of social mission of microfinance is different from those of Asia or Western Europe colleagues and puts profit as a cornerstone. The mission drift is very strong in this region and, therefore, learning the practice of Russia microfinance industry development will help to guide the efforts of Ukraine policymakers on the balancing of social responsibility and commercial interests. Another important consideration is that Russia has already passed the initial stage of microfinance development, whereas Ukraine is still there and policymakers may learn from the impediments of the Russia model.

Microfinance industry in Russia started to develop nearly twenty years ago with the appearance of foreign companies. Microfinance companies with originally Russian capital started to appear ten years after. Here is an important difference between Poland on the one hand and Russia and Ukraine on the other – in the 1990s there weren't any external foreign support of the inclusive finance. Instead CIS experienced macroeconomic instability, primary accumulation of savings and first privatization process, which pulled SMEs development issues far away from the focus.

The initial model of microfinancing established by foreign owners, was very close to the model of Munammad Yunus, the founder of the microfinance concept, and was based on the principles of fighting against poverty. The model was based on group loans, group guarantee scheme and targeted primarily female entrepreneurs (Sigal 2012). In private talks, practitioners of Russian microfinance point out that it was a mistake to establish a model which was used in developing world. Indeed, the poverty in Russia and poverty in India or

Pakistan are absolutely different things. Therefore, the pioneers of Russia MFIs started to transform microfinance into a service of supporting microbusinesses, developing or solving emerged financial problems. They have stopped providing any group loans and focused on individual instead, along with giving up the focus on women loan initiative[11]. This modification to the classical microfinance gave a second wind to Russia microfinance and it is relevant to Ukraine case as well. The proposition is, therefore, to focus on individual loans and broad group of clients at the very beginning of policy implementation.

The major condition for MFI industry sustainability in Russia is the presence of solid demand for loans from the side of entrepreneurs, who couldn't get access to financing even from those banks which had specific programs for SMEs development. This situation cannot be called as a disadvantage, but it rather highlights the fact of the existence of the demand for those who ready to work with pre-bankable clients. Another peculiarity, which is similar to Ukraine, is the total absence of regulatory framework for microfinance industry at the initial stage of development. Even though it can be considered as a disadvantage, the absence of regulatory framework did not prevent the appearance of MFIs. Russian microfinance practitioners have started with the Civil Code, which prescribes the right for a person to lend and borrow. Still, recently Russia government enacted several laws regulating the microfinance industry[12] and the current debate focuses around the question of toughening the regulation for MFIs. The proponents argue the urgent necessity to increase the regulation and supervision, whereas opponents claim the importance of gradual transition to more solid control. As I have already shown in Section 3, the absence of regulatory framework may lead to dangerous consequences and, therefore, it is advisable to introduce the rules of the game before the game starts.

[11] Meaning an artificial focus. In Russia MFIs' portfolio women are still the major group, but this is done due to the market conditions, not artificially due to company's strategy.
[12] For instance – Federal Law "On credit cooperation" from 18.07.2009 or Federal Law "On microfinance and Microfinance Organizations" from 04.01.2011

Now it is important to track how Russia microfinance industry performed since its birth. This information will give us a sight of potential growth in Ukraine and the path industry develops. The overall Russia microloans portfolio for ten years grew up to 1,2 billion USD[13], which is not a big amount in comparison with country's size, but the potential is very big. Currently the market is operated by 1200 private cooperatives and 1300 financial organizations[14]. Some 70% of the market is financed by private investors, while banking loans account for 15% only. An important debate focuses on the level of interest rate, which is 27% for the moment being. But this interest rate applies only for those clients who apply as entrepreneurs, while those who apply as natural person get a rate of 40-60%.

A particularly important philosophy of Russian microfinance, which applies for Ukraine as well, is the absence of concentration on interest rate in the first place. Recall the discussion of the mission drift in the section 2, where commercialization of industry and high interest rates are listed among the main contributors to the change. Russia microfinance supply side is looking for the demand, which is inelastic concerning the interest rate, which on practice means that MFIs provide loans to those entrepreneurs, who needs to get money exactly when they need it regardless the interest rate. This group of clients takes money for a short period of time, usually – several months and the sacrifice they are going to make by paying high interest is less than the sacrifice of not having money at all since banks refuse them in other case. The loan from microfinance may be crucial in terms of supporting the production. Interviews with private entrepreneurs in Ukraine shows that most of them frequently experience imbalances of cash flows and commercial banks in most cases refuse to provide short-term microloans[15]. In such case Ukraine entrepreneurs play a trick by attracting consumer loans and since commercial banks often provide small consumer credits – entrepreneurs have to issue documents for the employers, friends and even members of their

[13] Data from Russia Microfinance Center
[14] The number is approximate since the Regulator does not require legal authorization of financial organizations.
[15] These microaloans may range from 5000 to 50000 USD

families. This involves high transaction costs, which were decreased by microfinance scheme in Russia.

An important peculiarity to be taken into account is the relationship between Russian banks and MFIs. Usually banks do not fund MFIs and even if they do – the minimum interest is 14%, which means that cheap microfinancing is impossible. The foreign investors are not active on the Russian market primarily because of the already mentioned mental difference – foreign investors are interested in reputation while Russian ones – in profitability at the first place[16]. Therefore, MFIs in Russia experience such opportunity as stable and growing demand along with the threat of undercapitalization.

In private talks Russian microfinance practitioners mention that foreigners mention three main reasons of not investing in country's MFIs:

1) Russia is still considered to be a country with risky economic environment;
2) The unclear and not transparent methods of accounting;
3) Russia MFIs are primarily commercial ones, and foreign investors wish to see social constituent.

The policymakers in Ukraine should understand that they will not avoid the same prejudice while implementing the inclusive finance policy. It should be stated clearly that an "honest word" even of the highest representative of Ukraine will not be enough for foreign investors. This is exactly why I proposed in section 2 and in further sections to start building the reputation of the industry without accounting for foreign capital at least within the first 5-10 years. This is exactly why the internal source of "mattress money" should be used. Only when a foreign investor sees that the industry is growing and the risk is diminished, the foreign capital inflows will start.

[16] The information is extracted from the speech made by Pavel Sigal ,President of the Centre of Microfinancing & Noncommercial Partnership "Microfinancing and Development" during the Global Microfinance Forum 2012: New Opportunities in Responsible Finance. Istanbul 12-13 April 2012

The analysis of the experience of countries in transition allows learning important lessons of building inclusive financial policy. The case of Romania provides an example of step-by-step introduction of regulatory framework with the main conclusion that all the stakeholders should take part in the process. The case of Hungary shows high importance of building the system using the local networks which, if organized correctly, become the crucial agents of the microfinance policy. The experience of Poland should be accounted for by Ukraine policymakers while constructing the institutional architecture. The main idea is that institutional framework should include only the most important elements avoiding building of huge new bureaucracy. Finally, the case of Russia proposed important practical aspects with the main idea of necessity to divide the industry into the social and commercial one. This allows investors to understand better the mission of the actors in the market. With the experience gathered from countries in transition, it is now possible to formulate specific for Ukraine case policy recommendations for building inclusive finance system.

Section 5: Formulating Ukraine Policy on Microfinance

Previous sections of the paper analyzed the information crucial for inclusive policy formulation. Section 1 presented an understanding of the concept, financial source for the policy and introduced basic principles to be sustained during policymaking. Section 2 allowed coming to a conclusion that microfinance policy should be formulated within the macroeconomic context. With regard to current trends and challenges, section 2 also proposed a set of "do not" policies and alternative governmental behavior. In section 3 the relevant experience of transition countries was given and current section 5 will use all the knowledge obtained from previous sections to propose specific solutions for formulating policy on microfinance.

The starting point is given in the sub-section on the state of microfinance in Ukraine. The necessity of governmental intervention is described in the rationale for policymaking part. The goal and outcomes of the inclusive finance policy are formulated afterwards. The sub-section on social base provides an understanding of the scale of potential microfinance industry. The policy formulation proceeds with the place of microfinance policy within the other existing governmental policy with the main aim to avoid overlapping of policies and multiplication of bureaucracies. With regard to the lessons learnt from the experience of transition countries, the sub-section on institutional architecture proposes a system of different actors united into microfinance industry. The prudential and non-prudential tools are discussed in the sub-section on regulatory framework.

5.1. The State of Microfinance in Ukraine

The system of inclusive finance in Ukraine is in its infancy and is mainly represented by the traditional financial institutions – banks, leasing centers, investment funds, NGOs and credit unions – which exercise support of SMEs. There is no specific regulation concerning microfinance and, as in the case of Hungary, the model of SMEs development is governmentally-led.

There are many governmental funds of entrepreneurial support in Ukraine, which have a newly-created (2000-2003) network of 114 branches in the regions and is partially supported by the Ukraine Fund for Entrepreneurial Support, which is another operational self-sufficient (OSS) organization. There is a widespread network of 3083 consulting organizations across Ukraine, which is supplemented by 1693 local unions of entrepreneurs. However, the functioning of the system is completely dependent on the governmental budget policy and oftent conducted in manual regime.

Another source of financing SMEs in Ukraine is Ukrainian commercial banks, which implement the programs of EBRD[17] and German-Ukraine Fund[18]. Still, the microloans provided by these banks are not sufficient to support SMEs and the requested loans from entrepreneurs are subject to collateral. In 1995 EBRD provided a credit line for a National Bank of Ukraine and Ministry of Finance with the aim to support SMEs, which is now managed by the special governmental Group on Projects Management. According to Microfinance Information Exchange (MIX), there are three entities in Ukraine which provide microfinance services – HOPE and Khosen, which rely mainly on granting scheme, and ProCredit Bank with foreign capital. These entities remain local, covering no more than 20 000 clients.

Therefore, the current stage of microfinance is characterized by such features as the absence of microfinance model as such; total dependence on state budget funds; the absence of regulatory and supervisory framework; direct governmental loan provision to SMEs through commercial banks; lack of experience of microfinancing. This is the starting point of

[17] Such banks as “PrivatBank”, “Forum”, “CreditPromBank”.
[18] Such banks as “ProCreditBank”, “CreditPromBank”.

the policymaking describing the initial condition of the industry, which the inclusive policy is going to change.

5.2. Rationale for Policy

The development of SMEs through microfinance will contribute to the creation of a middle class in Ukraine, which contributes to the overall increase in welfare. Throughout the years of independence, the Ukrainian economy experienced a solid inflow of foreign capital from international bodies, but the government failed to direct it for the development purposes. As a result, the inequality between rich and poor became huge with 35% of population below the poverty line (CIA World Factbook)[19]. Microfinance is a method of provision low and middle-income people with the tools, required for the realization of their private initiative.

The main reasons for the government to be involved in microfinance are:

- Creation of favorable business environment, i.e. regulatory and institutional frameworks is both indispensable for microfinance and impossible without governmental intervention;
- The new channels demonstrate a strong interaction between microfinance development and macroeconomic growth, which leads to poverty reduction and completion of MDGs;
- The lack of supervision of microfinance may lead to harsh negative consequences like over indebtedness and uncontrolled growth;
- The participation of the government will be a signal for foreign investors that investment climate improves and the risk of investing in Ukraine MFIs is decreased;
- The necessity to implement and support a confidence from people’s side in newly created institutions.

[19] The State Committee of Statistics of Ukraine provide a number of 21,8%

The formulation and implementation of inclusive finance policy requires active participation of the government. This is the only way to signal to both people and in future to foreign investors that the functioning of the industry is "approved" by the policymaker. Additionally, this is the way to introduce the trust in the newly created institutions.

The Microfinance Policy and Strategy has the following purposes:

- Building of inclusive financial system, which empowers low and middle-income population with tools to increase welfare;
- Increase effectiveness and efficiency of governmental support of entrepreneurship;
- Establishment of rules of the game in microfinance market with clear specification to all stakeholders of what government is intended to and what is not;
- To promote the concept of impact finance with the aim of poverty alleviation;
- Increase the resilience of SMEs to financial downturns.

While the government introduces the rules – it should also signal that there will not be any administrative pressure. The aforementioned purposes are specific for Ukraine and all the stakeholders must receive a message that regulator does not have the purpose to allow earning money in microfinance and open up new opportunities for loan sharks. The purposes declare that the government wants to support those in need, but not to overburden them. As soon as this concept (of impact finance) will be misunderstood – the regulator comes into play.

5.3. Goal and Outcomes of the Policy

The goal of Microfinance Policy is the structural reformation of the economy by means of SMEs development along with the increase of overall income levels and consuming capacity. This goal is about the shifting from the paradigm, where the national economy depends heavily on the big previously state-owned enterprises into the one, where SMEs contributes the most to the GDP growth.

The short-run outcome of this Policy will be an increase of financial inclusion, which reveals in the growing number of active borrowers, MFIs and start-ups along with the constant or decreasing rate of bankruptcies and PAR over 30 days.

The medium-run outcome of this Policy will be the development of financial services and MFIs' products, coverage across the country with inclusion of rural areas, mobilization of savings. An increase in foreign financial inflows is expected.

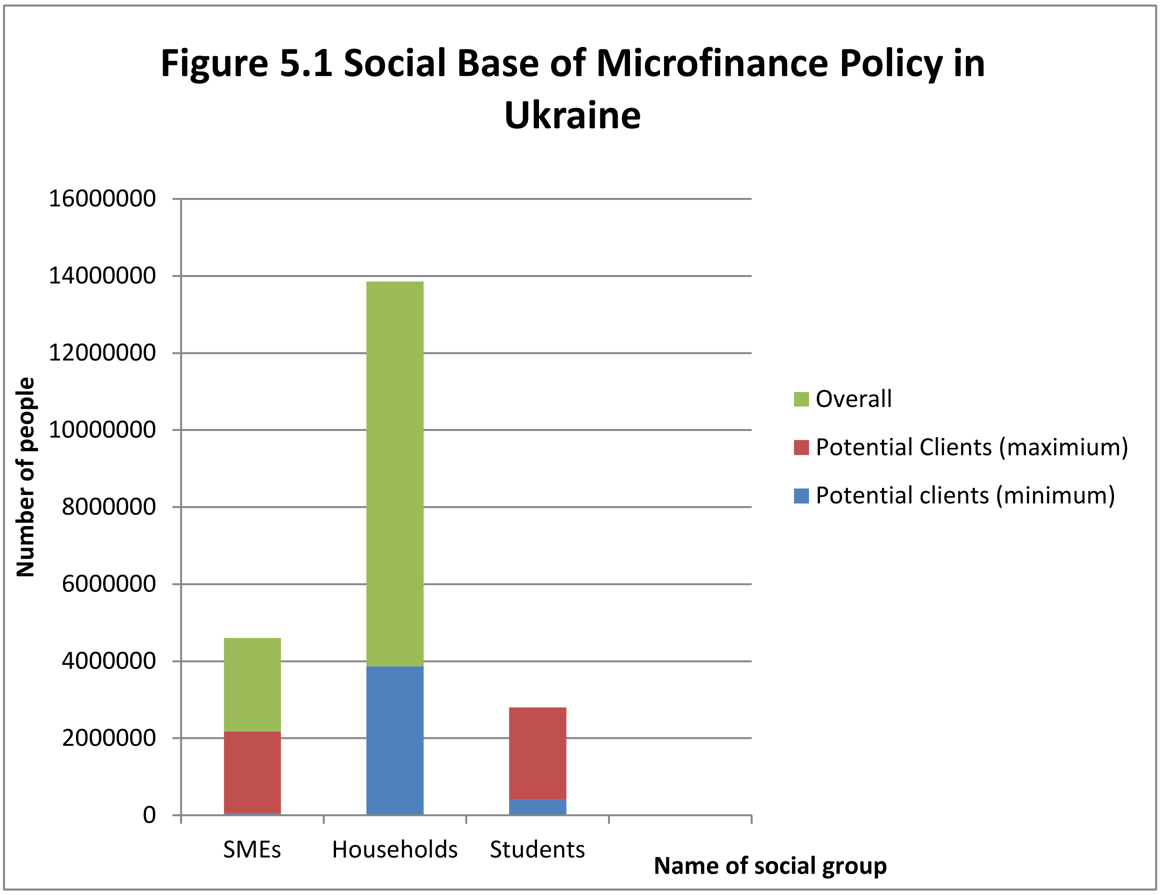
The long-run outcome of the Policy is the completion of the national economy paradigm shift and strengthening the culture of strong support of private initiative. The outcome is also about the GDP and GNP growth, reduction of number of people below the poverty line and increased resilience of the economy to shocks on external markets.

5.4. Social Base of the Microfinance Policy

An inclusive finance policy is going to include a part of the society (previously not included or included to some extend) into the financial system. To understand what part of the society is going to be covered it is necessary to analyze the social base of microfinance policy. This information is important both for policymakers, industry actors and investors. The Social Base of Microfinance Policy, therefore, will include mainly three categories of population (Figure 5.1).

5.4.1. People occupied in SMEs

This category according to the State Committee of Statistics of Ukraine (SCSU) account for 4.6 million people in 2010. We should remember that this does not mean that the industry may account for 4.6 million clients, but only for founders and co-founders of SMEs. Still, the border is very blurred as many entrepreneurs in interviews confess that the official owner is not often the real one. We need to define here that the loan, as in the case of Russia,



will be individual and several people within the entity may apply for a loan (but the ordinary workers will hardly agree). This is important since if the policy allows not individual, but group loan – entrepreneurs will have a stimulus to artificially divide the company. But since we know that SMEs are not large in terms of occupied people per one entity, and we do not know how many real owners are there in each entity – we may only make an approximation of the social base, which is:[20]

$$\textit{The worst case} = \frac{2507300}{250} + \frac{2073600}{50} \approx 51\,501 \text{ (Potential clients)}$$

$$\textit{The best case} = \frac{2507300}{51} + \frac{2073600}{1} \approx 2\,122\,763 \text{ (Potential clients)}$$

The calculations, based on the data of 2006-2009 provided by State Committee of Statistics of Ukraine (SCSU) there is a 2-5% growth rate of this number per year. This

[20] The calculations made based on data on data from SCSU: 2507300 - number of occupied in medium-sized enterprises; 2073600 – number of occupied in small-sized enterprises. According to Ukraine legislation, a small-size enterprise ranges from 1 to 50 employees, medium-size – from 51 to 250.

category is forecast to attract financial resources with the aim to finance current entrepreneurial needs – the ongoing projects, repair or replacement of damaged or outdated equipment, building storage places, production machines etc. This category is going to be the basic category since here people already have experience of doing business and proved some success (the entry requirement for this category may be 3-years of existence in the market and stable profitability).

5.4.2. People occupied in households, primarily in rural areas.

With population of 45 million people, the target group is basically households living below the poverty line. Based on the governmental data, the industry may rely on demand of approximately 10 million people. But it is reasonable to provide one loan to one household in order to avoid both dangerous overheating and over indebtedness as discussed in Section 2. Therefore, accounting for 2.59 people per one household, we come to a number of approximately 3 861 000 of potential clients. This group of clients is riskier than the previous one since they may not have any business experience. The proposition is about providing the loans only after a certain certification in training center (based on the previously mentioned consulting organizations across the country). Such training will teach the Potential clients how to build a business plan, maintain accounting standards and report to financial authorities.

5.4.3. Students and Recent Graduates.

This group is among the most dynamic since it annually provides approximately 400 000 potential clients. This group, however, lacks experience and represents high risk as well. In order to prevent the failure projects the funding is to be done through so-called business incubators – research institutes which usually exist on the basis of High Educational Institutions, and provide a platform for students for presenting and evaluating projects. This group may include students of the last two years at the university and recent graduates within five years of graduation (so – the potential number of clients is approximately 2400000).

5.5. The Place of Microfinance Policy within Other Governmental Policies

This part of policy making makes a proposition on where the microfinance policy should fit within the other governmental policies on development of SME. The assumptions, stated in the introduction section together with the basic microfinance principles, mentioned in section 2 and previously discussed examples of inappropriate governmental intervention lead us to a policy, where government should create a relevant microfinance environment, but in no way provide direct financing to MFIs. But some part of resources (for the administration of the policy, consulting and training) may be redirected from other programs, which have the same aim. It is important that governmental policies do not overlap and, thus, it is necessary to define the place of microfinance policy within the others.

The definition the existing policies should be done first. From the open sources of State Committee of Ukraine for Regulatory Policy and Entrepreneurship it is possible to extract the following active governmental policies of SMEs development:

- *National Program of Assistance for Small Business of Ukraine*. The policy lies within the responsibilities of the Ministry of Economic Development and represents the intervention on the state level. The funds are directed for educational programs; business plans contests; conferences; reporting and monitoring of entrepreneurial development of Ukraine;
- *Regional and Local Programs of Small Business Development*. This policy lies within the responsibilities of the Cabinet of Ministers (the Government) based on the recommendations of another governmental body – State Committee of Entrepreneurship (DerzhComPidpriyemnitsta). The financing is executed on

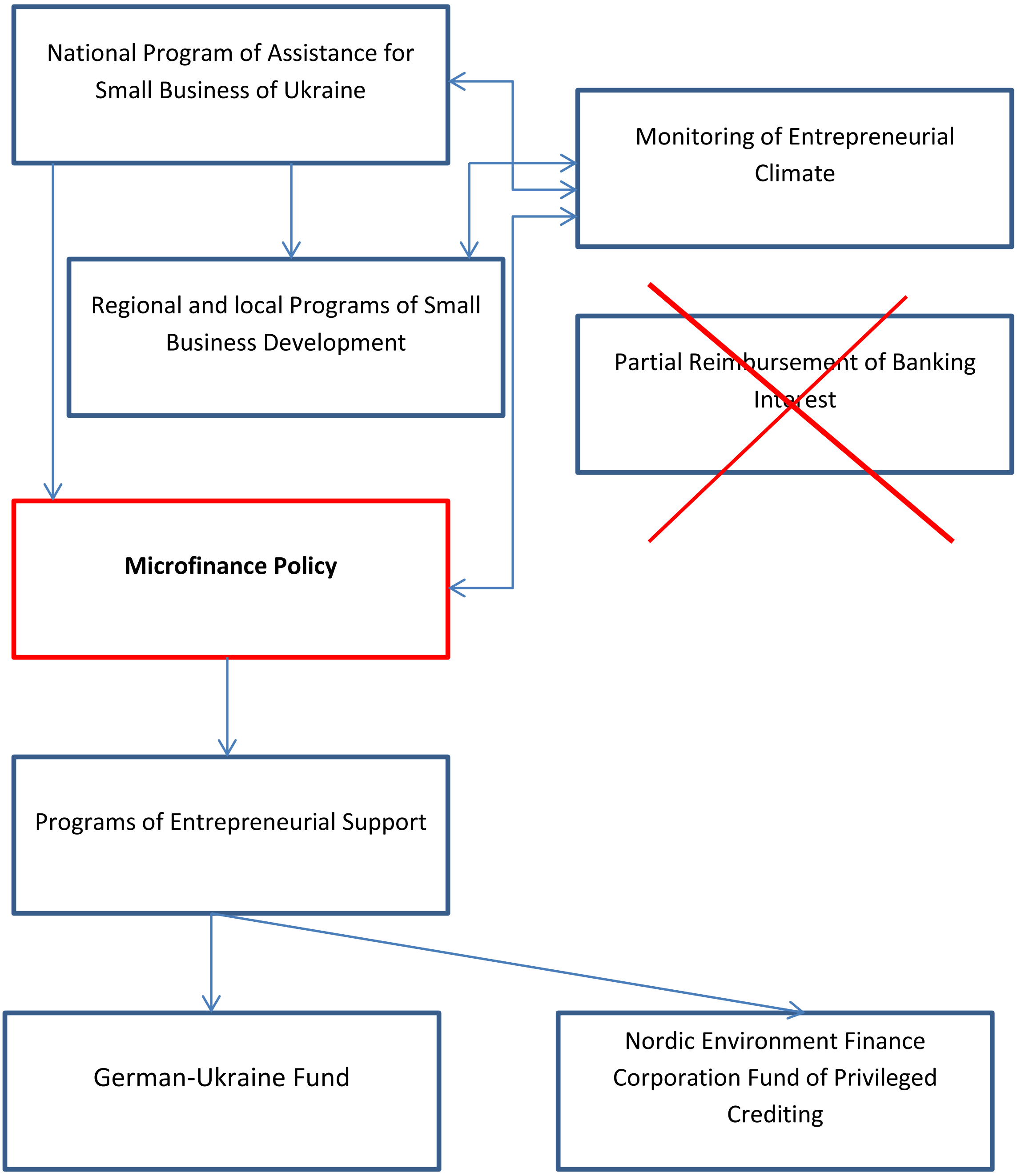
regional and local levels in 27 regions[21] and aims mainly at privileged crediting of investment projects, compensation of previously taken banking interest and informational assistance.

- *Programs of Entrepreneurial Support*. This policy includes two funds – the German-Ukraine Fund, which is self-funded, and – the Program of Privileged Crediting – financed by external Nordic Environment Finance Corporation.
- *Policy of Partial Reimbursement of Interest on Loans.* The Policy is executed by SCURPE and represents a policy of direct financial assistance to private entities;
- *Monitoring of Entrepreneurial Climate,* which represents the creation of rating of business climate in Ukraine by SCURPE.
- *Micro crediting Policy,* which represents another channel of direct governmental assistance to enterprises. The Ministry of Economic Development provides financial sources through the fund and remains the main actor.

Figure 5.2 shows how microfinance policy should fit in the other national programs. It is essential to eliminate the policy of partial reimbursement of banking interest to SMEs primarily for the following reasons. Firstly, it contradicts our basic assumptions and provides sources to companies, which do not perform good enough. Let us recall the basic principles, stated in Section 2, where the government should not provide financial services directly. Second, this policy overlaps with other policies, like National Program of Assistance for SMEs or proposed Microfinance Policy. Thirdly, the actual reimbursement is made only to the companies, which have close relations with authorities.

[21] 25 actual regions plus Kyiv and Sebastopol as special territories.

Figure 5.2 The Place of Microfinance Policy Regarding Other Policies



A useful policy implication is to change the subordination of policies in the following way. National Program of Assistance for Small Business of Ukraine will still perform on national level with the current functions. Regional and Local Programs of SMEs Development will perform only in several points of the country, not in all 27 regions simultaneously. Firstly, it will enable the economy of scale and the most efficient use of funds in several regions. This may be a program of technological innovation in agriculture in region A. Second, it may redirect funds to the most depressive regions and equalize the levels of economic development of regions.

Microfinance policy should be an independent part of National Program of Assistance for SMEs. The two existing Programs of Entrepreneurial Support – the German-Ukraine Fund and the Nordic Environment Finance Corporation Privileged Crediting Fund – should be a part of Microfinance Policy. Firstly, these two Programs execute the same mechanism, but with another philosophy. Secondly, an independence of Microfinance Policy will enable the government to create a separate institutional structure and implement specific regulations and supervision.

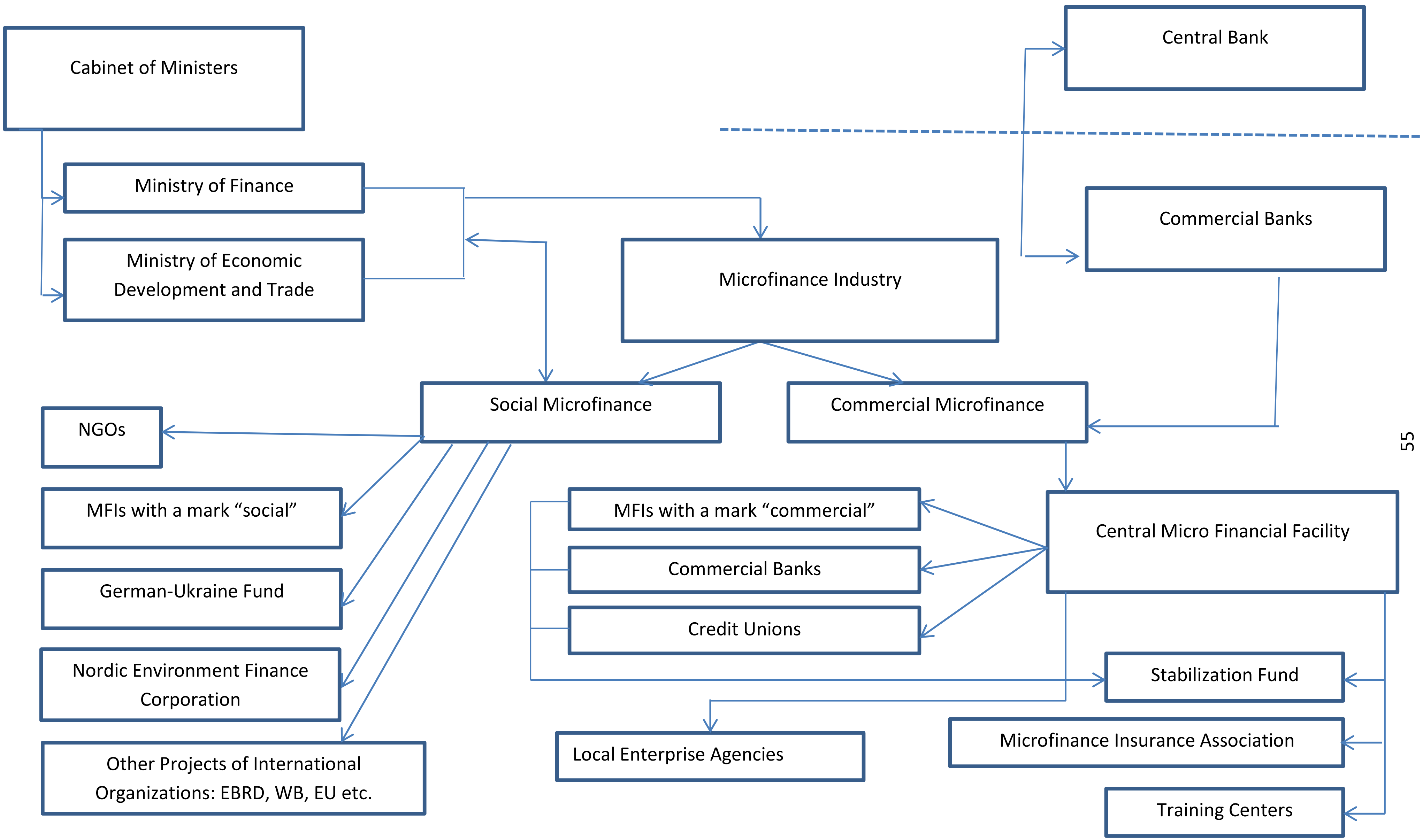
Eventually, all three policies will contribute and simultaneously be supported by the policy of Monitoring of Entrepreneurial Climate.

5.6. Institutional Architecture of Microfinance Industry

Having shown the experience of transition countries in section 4, it is advisable to divide the microfinance industry into commercial and social microfinance. The proposed institutional architecture is shown in Figure 5.3.

The social microfinance industry will be the prerogative of Cabinet of Ministers and respective Ministries – Ministry of Finance and Ministry of Economic Development and Trade. The social microfinance will put the main and exclusive aim – to provide sources to low- and middle- income citizens. Therefore, this part of industry will be served exclusively by NGOs or specific MFIs, marked "Social Microfinance" either as a part of name or in the first articles of manual.

Figure 5.3 Institutional Architecture of Inclusive Finance Industry



Conversely, commercial microfinance will be a part of the financial system of a country, where the first level belongs to the Central Bank as a regulatory and supervisory body of the second level – commercial banking. As has been shown in Section 3, it is inevitable outcome of the fast microfinance industry growth that commercial banks will engage in the industry. And it is important to understand that nobody can prevent them from doing so – commercial banks themselves establish the requirements for loans and can provide them to those, whom they decide to be solvent. Additionally, MFIs itself transform into commercial banks. Thereafter, the commercial microfinance will be served primarily by commercial banks, credit unions or MFIs with the special mark "Commercial" either as a part of name or in the first articles of manual.

It should be stated clearly that the differentiation between "Commercial" and "Social" is made specifically for investors, which bring additional funds in industry. The proposed structure implements the separation mechanism: from the very beginning investor choses between "Social Microfinance", which is another word for "donation" – or "Commercial Microfinance", which is another word for "venture business". The commercial microfinance is focused primarily on those clients, who are not afraid of high interest rate. This group of clients is more sensitive to time than to price and willing to get money as soon as possible. The differentiation is important because the rules of the game will be different for different microfinance. Logically, the social mission of "Social Microfinance" will make foreign investors as well as national government very loyal to this particular kind of microfinance. Therefore, it is absolutely inevitable to establish a border line, which says where "Social" field ends and "Commercial" field starts. This is to be discussed in the following sub-section on regulation tools.

In order to develop the institutional architecture of microfinance industry it is worthwhile to refer to the credit union (CU) model of Poland, which was described in section

4. To improve the regulation and supervision of microfinance players it is important to create a new body called Central Micro Financial Facility (taken from the Polish model), which will perform the same function for commercial microfinance as Central Bank perform for commercial banks. The body should be independent with regard to Central Bank or Cabinet of Ministers and simultaneously an influential authority. The disadvantage of such policy is the creation of another bureaucratic structure, the nature of which should be explained in clear words to the public. Another critics of experts, which may appear, is that Central Bank can perform the functions of Central Micro Financial Facility. Here it is necessary to highlight that Central Micro Financial Facility will have a different from Central Bank nature – a nature of self-regulation with the main aim to create an operational self-sufficient (OSS) commercial industry, just like the commercial banking industry, but on a smaller scale and with the development aim.

As mentioned in the previous paragraph the newly-created Central Micro Financial Facility will be an influential authority. The microfinance industry requires influential body in the same way as commercial banking requires supervision and regulation. To elaborate why this mechanism will be influential it is important to provide the structure of it. Just as in the case of Poland, the Facility will have a Stabilization Fund, which holds certain share of Commercial Microfinance Industry actors' assets. In times of non-repayments or other microfinance crisis (which may go both cyclical and anticyclical to macroeconomics shocks as it was elaborated in Section 3) Stabilization Fund play a role of "life vest". Additionally, the Facility will have a Microfinance Insurance Association, which will include both national and international insurance companies. In private interviews, representatives of microfinance insurance companies expressed their readiness to insure microfinance in transition and unstable countries. They do not require any governmental guarantee apart from the stability of national currency. Additionally, the Facility will include the training center, operating on local level and providing the education for potential clients.

The architecture of microfinance industry should be fulfilled by one more very important element, taken from the Hungarian case discussed in Section 4, which is – Local Enterprise Agencies (LEA). In Section 4 the shift in Hungary from decentralized into centralized model was mentioned. It is, however, unclear whether this movement was made due to the maturing of industry in Hungary or because of the changed policy. But this mechanism is expected to add additional flexibility to the architecture. LEA is a point, where the Commercial Microfinance will start. This sort of actors will evolve on the basis of local unions of entrepreneurs with the main difference – changing channels of funding, which is to be discussed further.

5.7. Regulatory Framework

The rules of the game in the microfinance industry in Ukraine should be designed especially neatly and accurately. Policymakers must understand that the implementation of a new mechanism requires an establishment of people’s trust in it, which is the most difficult part. Therefore, the regulation and supervision of the industry should be transparent, understandable and efficient so that it protects as many stakeholders as possible in the best way. This sub-section basically relies on the experience of recent global trends and challenges in microfinance industry, discussed in section 3. While section 3 gave a clear answer for the questions: “what not to do” and “what to do instead”, this sub-section proposes on what rules to implement. With respect to the national aspect, it is necessary to start with the division of regulatory framework into prudential and non-prudential regulations.

5.7.1. Prudential Regulation in Microfinance

One possible reason for the emerged problems of over indebtedness and uncontrolled growth discussed in Section 3, is the absence of prudential regulation, which is the set of supervisory and regulatory rules aimed to minimize the institutions risk-taking and ensure the stability of financial system. Since this paper is based on the idea of mobilization of “mattress savings”, prudential regulation in deposit-taking requires significant attention. The prudential regulation and supervision of inclusive finance system of Ukraine is to be performed by the introduced in the previous sub-section Central Micro Financial Facility. An important remark has to be made here – the policymaker must use prudential tools of regulation only to solve prudential tasks. i.e. to ensure OSS of MFI and protection of depositors \ MFI clients. It should not be used to solve any other problems.

The policymakers should keep in mind that the initial task of the prudential regulation is to establish people’s trust in such a way, that they feel that their savings are protected. As an input of inclusive finance policy we have people, who afraid to invest in any banking institution and they are ready to have a negative growth of savings (equal to inflation rate). So, the task of prudential regulation is to add credibility to the microfinance industry in a way that compensates the people’s “feeling of security”, which they have while keeping the money “under mattresses”. Along those lines, the risk of investing money remains, which should be accounted for by all stakeholders. Thereafter, prudential regulation in the short-run should focus on the protection of clients. In the mid-run it should focus on the possible systemic risks.

To build a regulatory and supervisory framework in inclusive finance policy the authority should start with the explanation to the public what does microfinance mean, what is the mission, goals, advantages and disadvantages. This basic information is discussed in Section 2, but here it is important to stress on the necessity to establish a special microfinance licensing divided into two types – “Social Microfinance License” and “Commercial Microfinance License”, issued by the Central Micro Finance Facility. The license may be issued to the institution, which satisfies:

- Minimal capital requirements – with the aim to sustain OSS and support the required infrastructure of MFI;
- Reserve norms – a share of capital hold within the Central Micro Finance Facility and used in times of downturns;
- Limits of Non-collateral financing - represented by a certain threshold of a relation of provided loans without collateral to the existing assets.

It is very important to keep in mind the problem of uncontrolled growth, which, if not paid attention to, can contribute to macroeconomic slump through the same channels as microfinance can contribute to macroeconomic growth. The licensing should be steady, but controlled process.

Other prudential tools include:

- Simplified credit documentation comparing to ordinary commercial banks;
- Periodical reporting system;
- Establishment of the rating system and transparent disclosure of it through the special web-page;
- Regulation of shareholders origin;
- Insurance of deposits.

A key notion of the previously proposed institutional architecture is the division of the industry into social and commercial. As previously mentioned, this division should establish a separation mechanism or, in other words, a border line, which signifies the end of social and beginning of commercial microfinance and vice versa. Prudential regulation should solve this problem. The policy should implement such prudential regulation that actors in the market reveal themselves, i.e. “social” actors play in “social microfinance field” and “commercial” actors play in “commercial microfinance field”. The best way to ensure the efficiency of the mechanism is to make the separation at the stage of entering the industry, i.e at the stage of licensing. This can be done by providing potential MFIs with the information concerning advantages and disadvantages of each “playing field” (Table 5.4).

Table 5.4 Separation Mechanism: Social Microfinance vs. Commercial Microfinance

Social Microfinance		Commercial Microfinance
Lower	Capital Requirements	Higher
Soft	Non-collateral loans provision threshold	Very Strict
Limited	Profits	Not Limited
Binding	Vicious Relations	Indifferent

The first criterion is capital requirements. Social microfinance serve exclusively social projects – building small community flood controls or consumer goods loans – with no or unclear return. Low return means lower risk – investors, who go for social microfinance play a role of grantees rather than profit-seekers. Conversely, commercial microfinance analyzes the business plan and especially the net return. These actors look for the balance between the social mission and profit. An example – providing loans for buying a tractor is a good social mission project, but commercial microfinance may be interested in analyzing the price of harvest and potential return. They want OSS, they don’t want to rely on donors schemes. Commercial microfinance goes for higher risk and receives higher capital requirements.

Second criterion is the provision of non-collateral loans. Social microfinance should receive a small or even no restrictions on this indicator. Conversely, commercial microfinance should have very strict threshold or even being restricted to provide loans without collateral at all. This practice is widespread in Georgia, Russia, and Azerbaijan.

Third criterion is the profit limit. The policymaker should introduce a certain market-average limit of profit, justifying “social” and “commercial” projects. It is, however, difficult and irrelevant to do it in the current research since the focus is different. But it is clear that, for instance, a player, which constantly gets the net profit of 1-2% per microfinance projects, has different market behavior from the one, which gets over 10%. And the word constantly should be underlined (the policymaker should look at firm in dynamics).

The fourth criterion is what can be called “vicious relations”. Before licensing, the Central Micro Financial Facility checks the potential microfinance for the shareholders. There is a number of international banks, organizations, NGOs, which has development goals in the first place with the clear declaration of it[22]. These should be the only possible shareholders of social microfinance. In other words, a policymaker asks investor: “What do you want to have – profit and development or development with small or no profit?” and if he receives an answer “development”, he asks – “How can you prove your intentions?”. If there’s no prove – there is a risk that you will play as a commercial microfinance, where the structure of shareholders should not be binding.

In other words, the separation mechanism proposed should separate the actors at the stage of entering the industry. Potential MFIs have stimulus to be “social” since the capital requirements are lower and they can freely provide non-collateral loans. But, at the same time, they are limited to have profits and can’t get funding from all potential investors. Accordingly, potential MFIs have stimulus to be “commercial” since they are free to choose any source of financing and absolutely free in terms of profits, but, at the same time, they have high capital requirements and restrictions on non-collateral lending.

5.7.2. Non-Prudential Regulation in Microfinance

As a matter of fact, non-prudential regulation is as important for the microfinance policymaking as the prudential one. As mentioned previously, in order to channel the “mattress” savings into the financial system the trust in new institutions should be implemented. The essential part of the non-prudential regulation, therefore, is the protection of the MFIs clients.

[22] For instance – EBRD, KfW, Finance For All etc.

One of the major concerns, discussed in Section 3, is the possible over indebtedness of the clients, which could be resolved with the introduction of a grading system. Here it is essential to discuss a technical moment. With respect to the mentioned in Section 1 Consumer Protection Principles (CPPs), the grading system should be transparent and easy to understand. The proposition, therefore, is to publish the monthly grades on an easy-to-find web-page and in popular printed media. The information should include all the necessary terms and conditions – interest rates, terms, scale of loan, and other conditions. The philosophy behind this step is that Central Micro Financial Facility is not responsible for the given MFI, but helping people to determine the risk of every actor.

Another aspect of the non-prudential regulation includes the actions of the government against frauds and financial pyramids. This aspect should be regulated in the same way as it works for other financial actors. It means that the authority bodies, which supervise financial institutions, should make legislative amendments and include MFIs into the list of objects, which are to be checked.

An important mission of the non-prudential regulation is to minimize the transaction costs of MFIs in assessing the creditability of clients. The global microfinance companies in this question refer to the creation of credit bureaus – organizations, which collects information on client's relations with previous creditors. In the conditions of Ukraine financial system this innovation might be very useful if used correctly with several remarks to be mentioned. Firstly, as it was mentioned in this section, the policy should rely on certain group of clients, where students and recent graduates as well as members of households may not have any credit history. Secondly, credit bureaus should have only informative mission. In the private interviews Ukraine businessman complain that very often commercial banks mention some small additional payments for loans in Loan Agreement in small low-visible font. The client, therefore, artificially becomes a "bad client", which is reported to the national security system. As a result, no bank provides a loan to this client, apart from the one, which made him a "bad client". Therefore, credit bureau should be completely independent from MFIs, do not count on small debts of several US dollars and work in close cooperation with national security system.

There are both advantages and disadvantages of the creation of credit bureaus. One possible disadvantage is the disclosure of the confidential information on client's credit history. On practice, commercial institutions are very hostile to this mechanism and disclose information about clients only if it is required by the law. On the other side, credit bureaus by providing more statistical information stimulate MFIs to increase the supply of funds to clients. On the early stage of inclusive finance policy, it is, therefore, recommendable to introduce voluntary exchange of information between MFIs and credit bureaus, i.e. both clients and MFIs should be interested in disclosure. The stimulus for clients is that by having good discipline – they open a way to new financial sources. The stimulus for MFIs – by disclosing information about clients they get access to information about potential clients and better compete on the market.

Conclusion

The creation of a system of inclusive finance policy in Ukraine is an important tool for development of small and medium enterprises and strengthening of the middle class. It predetermines the creation of microfinance industry, which aims to channel “mattress” micro savings of Ukrainians into the financial system through micro financial institutions and contributes to the macroeconomic growth and development. However, recent “mission drift” in microfinance around the globe led to a reputational crisis of industry and raised a fear that new institutions become “loan sharks”, irresponsibly using low and middle-income population for getting profits. Recently emerged challenges in global microfinance - like client over indebtedness, uncontrolled growth and methodological flows – lead to a conclusion that microfinance need to revise the incentive system and has clear segmentation on social and commercial microfinance. The era of “low hanging fruit” – when the competition in microfinance industry was low – has finished. The appearance of inclusive financial policy in Ukraine, therefore, would occur in the context of global microfinance crisis. But the presence of a high demand for finance from target group of clients which cannot be covered by banks predetermines the necessity of such policy.

The institutional and regulatory framework of the microfinance policy should be adjusted to economic and cultural peculiarities of Ukraine. The most important task is, therefore, to implement a trust of the society in new institutions. At the initial stage of policy implementation the government should not rely on foreign investments and should focus on the promotion of a new bureaucracy. A set of prudential and non-prudential tools are aimed at strengthening an idea among society that taking money “out of the mattresses” is not very risky. The microfinance crisis helped to reveal weaknesses, which now could be taken into consideration by the government.

Due to the specific business culture the government should introduce a separation mechanism, dividing those actors with pure development and poverty alleviation goal from those, seeking the profit in development projects. The second group of institutions is looking for clients which more sensitive to time than to interest rate. A proper conclusion is that by the prudential and non-prudential regulation the government should explain to investors that microfinance is about the long-term commitment with appropriate expectations.

An inclusive finance policy should be considered as a tool of poverty alleviation and development, but not as the only tool. The policy has limitations, which are to be taken while policymaking. Firstly, it accounts for a certain share of society, notably low and middle-income population. Secondly, an operational self-sufficiency of industry players requires the assessment of microfinance project due diligence, which is difficult to organize at the initial stage of policymaking. Likewise, the mechanism of grading the actors in microfinance industry and analysis of solvency requires additional research and is to be made after the industry already launched. Additionally, the launching of the policy requires governmental funding at the beginning, even though in mid-run and long-run the industry should demonstrate operational self-sufficiency and sustainability.

In the final analysis, microfinance policy should have a social impact which differentiates the industry from others, where the profit-seeking motive is at the first place. In microfinance the balance should be found and clients should have a business idea for growth and development of small and medium enterprises. Only this case will lead to a social impact.

Policy Summary

Inclusive finance policy represents a useful tool for poverty alleviation and development of small and medium enterprises in Ukraine with the potential number of two million clients. The main task is to create an industry with operational self-sufficiency rather than the one relying on governmental financing. However, governmental support is required at the initial stage of industry development preliminary because of the necessity to introduce the trust in the new financial mechanism for attracting "mattress money" of Ukrainians (microsavings). The following policy recommendations are advisable for fast growth of microfinance in Ukraine:

1. The division of industry into social microfinance with pure development goal and commercial microfinance, where players look for the balance between development and profit;
2. The introduction of licensing of microfinance institutions (MFIs) as a separation mechanism with the aim to reveal the motivation of industry players at the stage of entering the industry;
3. In the short-run until the growth of inflow of foreign capital to focus the prudential regulation mainly on client protection. In the mid-run microfinance industry should account for systemic risk;
4. Avoid the mistakes of inappropriate policymaker intervention, like introduction of interest rate ceilings, governmental ownership or direct assistance to clients;
5. The supervision and regulation in the industry should be tough enough to enable players to survive during recession and soft enough to grow during good macroeconomics times.

Appendix 1

Repayment stress or regret response	Respondents in Non-default Towns	Respondents in Mass Default Towns
Was repayment was a burden?	3%	21%
Is your debt excessive?	10%	24%
Would you have taken so many loans on hindsight?	45%	22%
Skipped meals or important expenses or sold assets to repay	2%	34%
Weekly amount that was being repaid at the time of crisis (Rs.)	514	583
Max amount respondent believes she can repay every week (Rs.)	533	458
Gap between amount per week actually paid and max stated capacity (Rs.)	19	-125

Source: Survey made by EDA Rural Systems and CGAP, 2009

Appendix 2

System of Indicators for Construction of Early-Warning Index

	Variable	**Data Source**
Macro level Indicators		
	GDP per capita growth	WDI database
	Remittances	WDI database
	Inflation	IMF's WEO
	Political/economic Stability	WB's World Governance Indicators
	Corruption	WB's World Governance Indicators
Industry level Indicators	Market Penetration	MIX
	Number of Microfinance Service Providers	MIX
	Growth Rates of Total Loan Portfolio	MIX
	Total numbers of loans outstanding and of borrowers	MIX
	Quality and use of credit information system	Global Microscope, Doing Business, Brown et al. (2009), Survey
	Perceived commercial bank involvement	Survey
	Perceived level and trends in competition	Survey
	Perceived investment flows	Survey
	MFI liquidity	MIX
Firm level Indicators	Average loan balance per borrower	MIX
	Loan requirements and lending methodologies	Survey
	Productivity (borrowers per staff member)	MIX
	Growth and market targets	Survey
	Multiple lending	Survey
	Supervision	Survey
	Consumer lending	Survey
Household level indicators	Questionnaire	Survey

Source: Center for Microfinance – University of Zurich

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