Microcredit in Russia: on the eve of a boom or a crisis?

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Introduction

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Russia has recently witnessed the rapid change of political and regulatory attitude towards the microcrediting. As recently as in the beginning of 2014 the public discourse on the issue was largely dominated by the themes of profiteering and social evils like personal bankruptcy and destitution. By the end of the year we have the issue positively mentioned by President Mr. Putin in his speech on the new directions of the country's economic development. The recent policy by the Central Bank on the possible levels of loan interest – which was often feared to exclude the microfinancial practices and thus block their development - explicitly recognized the key segments of the market and in a sense even gives to them priority over the competitive practices of "mainstream" banks. These developments are really positive, leading potentially to the more effective use of microcredit for the sake of sustainable internal economic development through stimulation of enterprise. Yet one thing which is still to be found in Russia is the proper balance of the involvement of both specialized players (MFOs) and "mainstream" (or "fully regulated") banks. The latter have more of financial and technological resources to accelerate the development of the segment, though they are more constrained by the considerations of long-term stability and thus are more rigid in their business processes. On the other hand MFOs can engage in more flexible risk management practices (which by no way imply higher tolerance to risk and assumption of massive non-returns), but they are restricted in capital and liquidity and currently occupy a relatively small niche on the overall Russian credit market.

The purpose of this paper is to build up on the vast body of the international research of the issue to outline the possible policy scenarios and business strategies for the Russian market.[1]

1 The Russian market of microfinance is currently grossly underresearched. A major academic database lists just one article on the issue of "Microcredit in Russia", published in 2004. There is a book on the issue (Gail Buyske: Banking on Small Business: Microfinance in Contemporary Russia, Cornell University Press, 2007) yet the material is now also almost 10 years old. A Google search gives a somewhat broader array of publications, but all of them come from late 1990s or early 2000s – paradoxically exactly from the period when the institutionalized microfinance market in the country was close to being non-existent. Thus the important developments which followed the financial crisis of 2008 and adoption of new regulatory framework (including the "Federal Law on microfinancial organizations" of 2010 and amendments to it in 2013) remain largely uncovered in the international and local academic or business publications.

I. Wide regional variations pose a question: what is actually a microcredit?

There seems to be a ready intuitive answer to the question "What is a microcredit?" – and a source like Wikipedia gives it: "Microcredit is the extension of very small loans (microloans) to impoverished borrowers who typically lack collateral, steady employment and a verifiable credit history". Yet the in-depth study of the issue leads to questioning almost every word of this definition.

There is huge variation in the average sum of loans, qualified as "micro" across the globe.

To start with: the idea of "very small" hardly stands the test of actual global practices. Let's take an example of Costa Rica where the statistically recognized microloan averages at over USD 6000, constituting a half of annual per capita GDP in the country. There is hardly a reason to consider such a loan to be "very small". Another example is the legal definition of the microcredit by the EU, which states the upper limit of 25 000 euro - about the average semi-annual income in the richest country of the Union, Luxemburg. The Russian legal definition of the limit of a microloan is 1000 000 roubles (ca. 20 000 euro), generally on the same level.

Actually there is huge variation in the average sum of loans, qualified as "micro" across the globe. On the macroregional level this is graphically illustrated by the statistics from "Microfinance barometer" (2012).[2]

While over half of the world borrowers were situated in South Asia, the region accounted only for 12% of the value of the global microloan portfolio. The portfolio was mostly concentrated in East Asia and the Pacific, and in Latin America and Caribbeans (34% and 33% of the global portfolio respectively) while they had only 19% and 16% of the global borrowers.

Thus the average size of the loan in Latin America was 9 times higher than in South Asia, the difference being completely non-proportionate to the difference in the relative wealth as measured by GDP per capita. Even more striking is the fact that a loan in Sub-Saharan Africa is six times higher than in South Asia though the former region is generally poorer.

Zooming into a region also gives a picture of considerable variation on a country by country basis. Let us review the example of Latin America and Caribbean. The average loan size related to GDP per capita in Latin America varies by ca. 26 times (the highest being 53% and the lowest – just 2%) and no correlation pattern between the loan size and number of loans relative to population emerges.

Based on this quick statistical exercise we can map the global microloans on two axes – penetration and loan size – in the following way (Table 1).

Those groupings also relate to different institutional and legal models. Thus while South Asian markets mostly rely on specialized microlending banks, EU and Eastern Europe tends to strictly separate the banking and MFO activities[3], and at the same time has the high share of involvement of non-for-profit organizations

Table 1. Penetration and loan size of microcredit by regions of the world

	Low loan size	High loan size
High Penetration	South Asia	Latin America
Low Penetration	Sub-Saharan Africa	EU, Central and Eastern Europe, Eastern Asia

2 Microfinance Barometer 2012.
http://www.convergences2015.org/Content/biblio/2012%20Microfinance%20Barometer%20-%20Convergences%202015_web.pdf

(charity funds, church, cooperatives) into microlending. Latin American countries generally have a mixture of specialized bank programs and MFOs operating in the for-profit mode, but with some important involvement of international NGOs. This "architecture" appears to be important in determining the strengths and possibilities of microcredit system within a specific country. In our view, Russia is still in the experimentation stage in this architectural search and finding the relevant international benchmarks can be helpful in working out the political approaches and business strategies.

"Credit architecture"

Though the variation in loan size and penetration of microcredit across the globe is wide, the issuance and approval practices are remarkably consistent. In all the markets when we speak of microcredits we actually tend to mean loans issued – or at least underwritten - by specialized institutions other than mainstream banks[4] to the borrowers which are likely to be rejected by those mainstream banks under their normal lending procedures. Actually in most of the markets the microcredits are positioned exactly as being different – less formal, more accessible – from the bank credit. On the other hand, it is important that by microcredits we mean something, which is institutionalized and legally framed as opposed to practices of private lending from friends and family, employer or illegal "loan sharks". Microcredits are also different from the practices of retail credit on various types of purchases provided by shops on their own or in cooperation with banks, such practices being wide-spread in the certain markets and affecting the models of personal and micro-enterprise finance management there. There is also intuitive consensus that loans at pawn shops (i. e. private loans against collateral consisting of personal belonging) are not part of microcredit industry[5], though some microfinance institutions do practice collateral for business loans[6].

It could be useful to re-brand the phenomenon as "de-formalized lending" (or credit), shifting the intuitive understanding of the term form the issue of size (where a lot of variation exists) to the issues of lending practices – where we can see remarkable consistency of models across the world. "De-formalized" also stresses that a) certain degree of formalization still exists, as opposed to strictly informal practices and b) the reviewed practices of lending were deliberately constructed[7] to be different from the "formal" bank lending.[8]

De-formalized lending is an important part of a larger universe of the lending prac-

3 E. g. in Germany only banks can actually issue loans, while the MFOs act as marketing and underwriting agents

4 Though regulated banks in some markets are important sources of microcredits, they are always specialized in this niche (or have specialized business-units with separate operations like, for example, CrediAmigo program within Banco do Nordeste in Brazil), i. e. they are not involved in broader range of regular banking activities, like issuing credit cards, holding checking accounts or providing mortgages or "corporate banking"

5 A few cases of "pawn-type" products within a classic "microfinancial" offering (like "Olla de Oro" – "A pot of gold" – from Financiera Universal in Peru) don't play an important role in the overall structure of the portfolio and can be neglected for the sake of global study

6 See the cases of Crediconfia and Financiera Universal in the present paper

7 In many cases the publicity or investor relations rhetoric of "microfinance institutions" stresses that they are committed to "financial inclusion" as opposed to aloofness of "banks" to the social issues. We should note, however, that this aloofness is not fully attributable to the free will of the banks, as they usually operate under a stricter regulation than "microfinance institutions", and with regulators putting special accent on the "stability" of operations, measured by lower level of "risks" calculated via regulator-approved unified methods compliant with international agreements like "Basel principles", especially after the financial crisis of 2008. Ironically the crisis itself is widely blamed on the attempt of the banks to play a role in "financial inclusion" via provision of "sub-prime mortgages", i. e. mortgages to customers with credit scores lower than generally accepted (though the specialized research of the issue tended to conclude that "wrong" were not the practices of lending, but of securitization of the loans – see: Donald MacKenzie: The Credit Crisis as a Problem in the Sociology of Knowledge). Thus the risk-averse tendencies of the global banking regulation, strengthened in the post-crisis Bazel-2 and Bazel-3 agreements play important role in creating demand for de-formalized loans

8 It may be that the slow start of the sector in Russia in 1990s was linked to the low development of credit in the overall banking system. In the absence of the practices of the "formal" credit is was difficult to construct an effective market positioning for de-formalized practices

Table 2. Microloans statistics by regions of the world

Region	Number of borrowers, million	% of world total	Value of microloan portfolio, Eur. Billion	% of world total
South Asia	58.8	56%	6.8	12%
East Asia & the Pacific	20	19%	18.5	34%
Latin America & the Caribbeans	16.5	16%	17.7	33%
Africa	5.1	5%	3.6	7%
Central & Eastern Europe	2.8	3%	6.7	12%
Middle East and North Africa	2.2	2%	0.9	2%
Total	105	100%	54	100%

Table 3. Microloan penetration and average loan size in Latin America[9]

	Microloan clients per 1000 of population	Average loan size, US dollars	Average loan size / GDP per capita, %
Bolivia	76.67	1 435	26
Peru	61.90	1 724	16
Equador	61.77	1 762	17
Nicaragua	60.02	662	15
El Salvador	48.13	48.13	13
Colombia	29.94	1 006	9
Dominicana	26.42	780	8
Guatemala	24.51	1 007	19
Paraguay	22.94	1 915	28
Costa Rica	19.76	6 462	50
Mexico	19.34	328	2
Honduras	19.33	758	16
Region Average	13.60	1 178	9
Chile	8.44	425	5
Jamaica	7.13	4 450	27
Panama	6.00	687	53
Haiti	4.91	748	6
Brazil	3.89	1 323	16
Guyana	2.81	1 299	8
Venezuela	1.25	2 648	19
Argentina	0.68	718	4

9 Calculated based on Microfinanzas en América Latina y el Caribe: El sector en cifras, population and GDP data from CIA World Fact Book

tices, which develops along two principal axes: the degree of formalization and the degree of monetization.

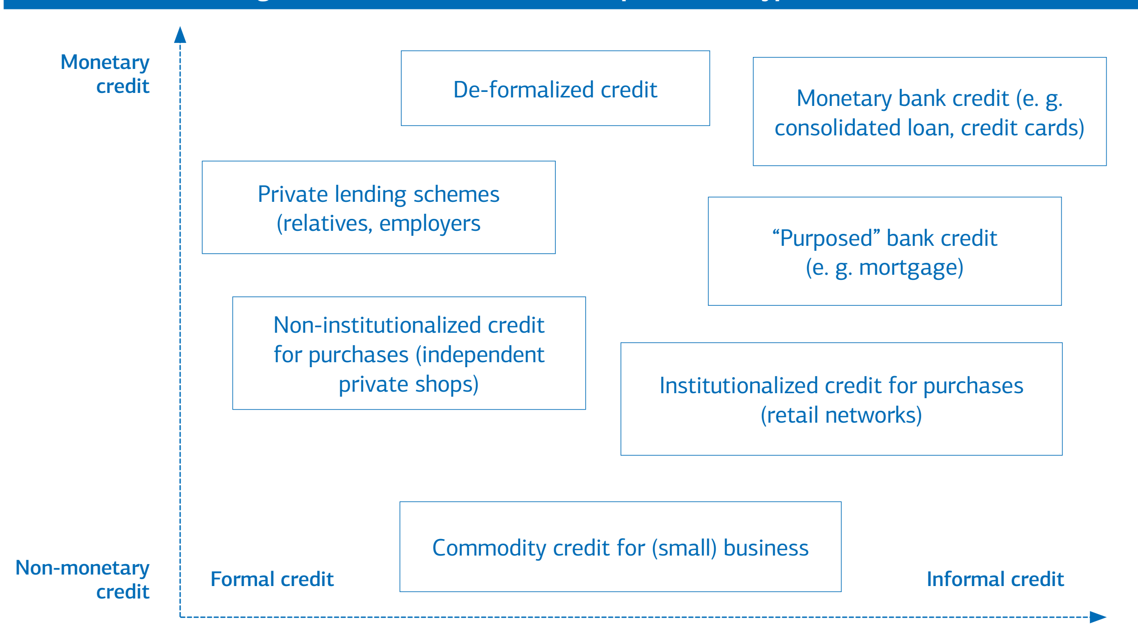
The non-monetary credit is substantially different in procedures; however its existence plays an important role in shaping the overall "credit architecture" of a country, especially when the retail credit is perceived by the customers as "interest free". The practices of commodity credit can also be important factor in shaping the small business routines determining the need for immediate cash for both operational capital and fixed capital.

The key question of "credit architecture" for a country is whether the different forms and institutions just redistribute between themselves some given market volume (determined for example by the level of economic development), or are they capable of influencing this volume through developing and stimulating the overall demand for credit? In other words: if we sum up all the forms of credit available to consumers or enterprises in a given country, starting from the formal monetary credit (banks) and going to all informal and even non-monetary credits (family, retail, etc.), then will this "total credit"

- have a stable level of penetration across countries – or be linearly growing with an easily observable parameter like level of income, or
- have substantial irregularity in the level of penetration across the countries?

In case the (a) is true the level of difference of penetration of the de-formalized finance is a result of mere re-distribution of "total credit" between various types of suppliers and it can be explained by difference in the practices of financial institutions, legal frameworks and other factors working on the supply-side. However if (b) is true than the supply-side factors are not enough for the explanation, there must be substantial differences in consumer demand. The proper answer is far from being just academic, it is of drastic importance for the policy-making. In case of (a) policy makers can take an "institution-agnostic" attitude, with no special need to focus on the issues of microcredit per se (assuming that the necessary amount of loans would be

Figure 1. The universe of credit options in a typical market



An important finding is the overall positive correlation between credit penetration and Human Development Index.

delivered anyway, just through another channel). However if we can suspect that microcredit plays its own special role in the economy, which cannot be delivered by other institutions – this will mean that special attention should be paid to the stimulation and development of the segment.

The issue of "total credit market capacity" gets some statistical exploration in the research by Foundation Planet Finance called "MIMOSA: Microfinance Index of Market Outreach and Saturation"[10], below are a few findings of the project.

The analysis finds some positive correlation between the penetration of formal and informal credit. Actually the world represents a smooth continuum on both axes, there are countries which rely on financial institutions, there are countries which prefer to borrow from friends and family and there are countries which do both. Generally there is no indication that formal and informal borrowing are in strict competition, rather they tend to reinforce each other.

An important finding is the overall positive correlation between credit penetration and Human Development Index. This contradicts a popular notion that people get engaged into borrowing because of their low financial literacy (to the extent that HDI can be used as an effective proxy for financial literacy). Indeed it seems that higher human development opens up more of possible scenarios of financial management, some of them include heavy usage of loans and some do not. The degree of variation in credit usage increases with the growth of HDI. It is noteworthy that the lower "border" of the range of credit usage remains virtually the same – there are high HDI countries with low credit usage, yet the "upper border" tends to grow quickly with the increase of HDI. For the bulk of the research sample there is a clear linear trend of growth of the upper limit of the range of the penetration of credit from the financial institutions within a given level of HDI – from ca. 10% for low HDI countries like Mozambique to ca. 25% for high HDI countries like Kuwait or Montenegro. An interpretation of this looks quite straightforward: the low HDI countries are the poorest in resources thus the supply-side limitations in them play important role and do not permit the development of credit to the theoretically possible level. With the growth of HDI – which generally correlates with growth in wealth – the supply-side limitations become less and less important.

Obviously some issues of market environment should play a role, first of all the legal framework. For the effective functioning of any form of credit the legal practices are essential, as they determine the possibilities of collection of debts by the credit suppliers and the degree of protection a customer can get in case if "something goes wrong". The MIMOSA research explores the issue of correlation of credit penetration with the development of market environment (as measure by the "Market quality score" by Microscope)[11]. Once again while there is certain positive correlation, a degree of variation within the given level of market development remains substantial. The picture may be interpreted in the following way: there is some level of the quality of the market which is "good enough". Below this level a market with high penetration can still exist, but through a system of informal conventions, supported by high level of trust through communal, family, tribal or religious links. Going beyond the "good enough level" does not influence strongly the penetration (number of clients), though the better market

10 http://www.planetrating.com/userfiles/file/MIMOSA%201_0_final%20110313.pdf

11 Research project by The Economist intelligence unit: http://www.ifc.org/wps/wcm/connect/467a47804ce326f793afd7f81ee631cc/EIU_MICROFINANCE_2012_PRINT.pdf?MOD=AJPERES

quality must be important for the overall market volume (number and size of the deals).

For the "architectural" question that we have posed, these statistical explorations generally mean that the hypothesis (b) gets the strong support: there are substantial irregularities in the penetration of credit across the countries, it is likely that these irregularities cannot be explained by the issues of supply-side (e. g. the level of economic development), thus there must be important differences of demand for credit[12]. For the policy making this means that the specifics of "credit architecture" of a country does play an important role, thus the issues of microcredit require specific attention.

12 Research by De Mel, McKenzie and Woodruff and McKenzie and Woodruff suggest that these differences in demand also don't come from rational self-limitation of customers who don't find enough economic value in credit due to its high cost. The stated research has demonstrated that though the cost of borrowing in the countries like Sri Lanka or Mexico is indeed high by the Western standards, the returns from the additional capital can amount to 63% or even 900% a year substantially outweighing the cost. In an economy like this the rational decision for a microenterprise owner is to borrow – yet many of them don't do this. See: SURESH DE MEL, DAVID MCKENZIE, CHRISTOPHER WOODRUFF RETURNS TO CAPITAL IN MICROENTERPRISES: EVIDENCE FROM A FIELD EXPERIMENT – In: The Quarterly Journal of Economics, vol. 123, issue 4, November 2008, pp. 1329 – 1372 and David McKenzie and Christopher Woodruff: Experimental Evidence on Returns to Capital and Access to Finance in Mexico – In: THE WORLD BANK ECONOMIC REVIEW, VOL. 22, NO. 3, pp. 457 –482

II.
The specific role of microcredit: financing quick social mobility

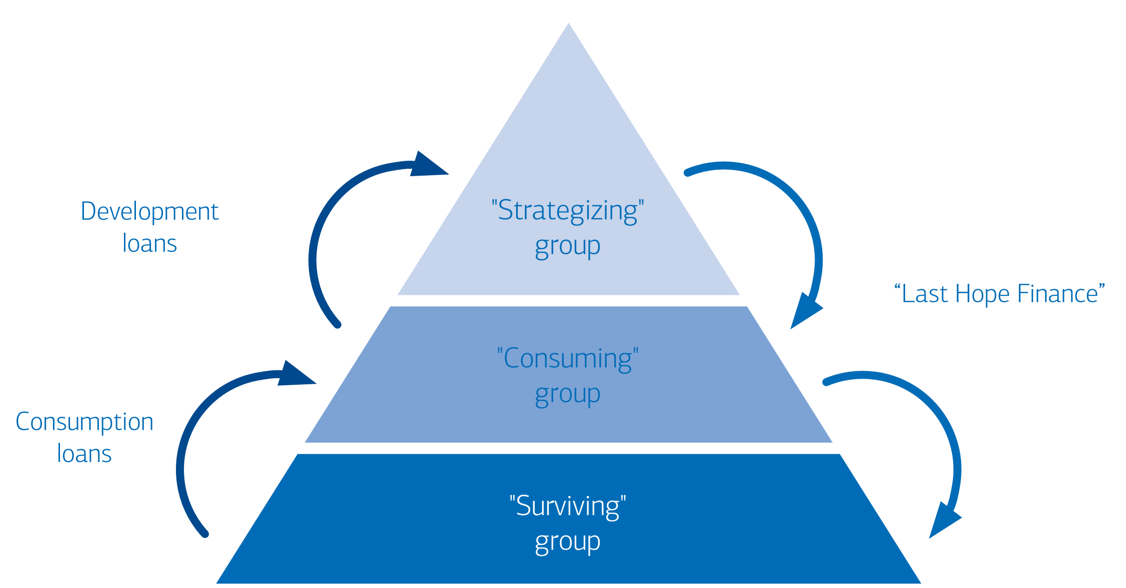
Part of the mythology around the microcredits in the world is the notion that it is targeting the "poorest" strata of the population. The statistical facts tell a different story. For example, the penetration of microcredit in different states of India[13] is not at all concentrated in the poorest parts of the country; rather the penetration tends to be the highest in the regions which are around medium level of regional product per capita. The geographical distribution of formal consumer loans from a large regulated bank tends to show the same pattern[14].

A similar picture emerges from the analysis of the Latin American data. Peru, Ecuador and Salvador, three of top 5 markets by penetration, measured by number of micro-loans per 1000 of population, are definitely not the poorest in the region, much close to being somewhat below average (with the GDP per capita of USD 11100, USD 10600 and USD 7500 respectively compared to the regional average of ca. USD 12 600). The 3rd poorest country of the region, Honduras shows quite the mediocre level of penetration of the microcredit and the country which has by far the lowest per capita GDP, Haiti, has one of the lowest microloan penetrations. It should be also noted that the level of GDP per capita in the poorer Latin American countries like Bolivia (USD 5500), Nicaragua (USD 4500) or Honduras (USD 4800) is still higher than India (USD 4000).

The data strongly suggests that de-formalized lending is not really penetrating the very poorest social strata or regions, concentration in the "moderately poor" areas. The phenomenon can be explained via a model of the society at large consisting of three social strata:

- *"Surviving" stratum:* people in this stratum regularly experience problems with supply of physiological necessities: food and water, cloths, energy, habitation, etc. Usually the stratum comprises the people without steady paid employment, including large

Figure 2. The social model of de-formalized lending



13 Kavita Anand: Variation in Indian Microcredit: The Role of Human Capital and Client Accessibility

14 Raymond Fisman, Daniel Paravisini, Vikrant Vig: Cultural Proximity and Loan Outcomes

part of traditional agricultural workers in the developing countries, seasonal workers, small street vendors, and all others underemployed or fully unemployed, especially when not being part of well-developed social security programs. These people live in the conditions of irregularity of in-flows of finance and goods in kind which often fall beyond the level required to meet the basic expenses of everyday life. Even in the developed countries some part[15] of population may fall in this stratum (provided the relatively high cost of living), in the developing world the figure can reach 80% of population of the poorest countries.

- *"Consuming" stratum:* usually includes all types of people with steady paid occupation as well as the owners of micro- and small-business which generate the in-flow of finance stable enough to cover the basic living expenses and regularly generating a surplus which can be used for "enhanced consumption" (e. g. buying "premium" goods, having recreation), but is not enough for the sake of substantial advancement of business or personal development (like getting formal professional education). A popular living strategy after reaching certain level of well-being will be not expanding this level further (marginal returns may be too small), but conserving this level with decreasing the efforts to obtain it - plainly working less extensively - thus improving the quality of life through extended recreation. This group comprises ca. 80-85% of people in developed countries and 15-30% in the developing world

The data strongly suggests that de-formalized lending is not really penetrating the very poorest social strata or regions, concentrating in the "moderately poor" areas.

- *"Strategizing" stratum:* the income is so high that it brings the consumption to the level of "saturation"[16], thus the people in this stratum focus on building the strategies of long-term development of the self and the family (building business, receiving education, high-quality migration[17], etc.). This group has financial inflows that at times generate very big surplus over the basic living needs, this surplus can be converted into valuable long-term assets (savings and investment) that allow periods of strategic setback in income: restructuring business or abstaining from paid employment for the sake of education or seeking for higher-paying job. Such strategic actions are designed to bring the well-being of the person and his/her dependents to a new level. Even in the most developed countries such strategies can be afforded by no more than 5-10% of population, in the developing world the figure should be in the range of several percent, though it may be unexpectedly high due to the much lower cost of basic living.

The model has implications both for the supply and demand side of the credit. We can reasonably assume that the volume of demand is grow-

15 As the stratification involves the understanding of the qualitative side of life, including the self-perception and personal life strategies, it is very hard to give strict estimates based on observable characteristics like income or educational level. The stated ranges are given primarily for illustrative purposes, though they seem reasonably accurate within the context of the further analysis. For example the current notion of "poverty line" in the developed countries is not sufficient in describing the "surviving" group there, as in most cases the relative approach (usually 50% below country average) is used in statistics, and the upper part of the poverty group can afford some "enhanced consumption" though at a very modest level. We roughly estimate that in the developed countries about half of the "poverty" group is actually facing the issues of physiological survival

16 I. e. no important gains in the perceived quality of life can be achieved via increase of quality of consumed products or in frequency of the consumption

17 Migration to a wealthier society without loss or with growth of the social status, a new trend, noted recently in the migration from the developed countries of Eastern Asia – like Korea or Taiwan – to the USA

ing from "surviving" to "strategizing" groups and this growth is likely to be significantly non-linear. On the supply side the key issue is the sustainability of the business which largely relates to the actual returns of loans and interest on them. Theoretically the chances of a poor person and a richer person to return the loan of, say, 10% of respective monthly incomes should be equal. The practice, however, is much more complex. We still lack a "unified theory of loan returns"[18] which would work in 100% of the cases and even the mainstream banks with very strict lending procedures and relatively high loan rejection rates can have material part of their loan portfolio at risk.[19] The banking practitioners generally accept that sustainability of income grows with the growth of income and thus the chances of the higher-paid person to return a loan are higher even for the case of the same proportion of the income. This perception is the key factor shaping the global supply of the credit.

In the case of the "survival" stratum the unsustainability of income is really a permanent fact of life. In case of borrowed finance this unsustainability is increased by the fact that money is the only "product" which has invariably "reverse" economy of cost to consumer, i. e. the more affluent a consumer is the cheaper he/she can "buy" the money, whilst for any other product there is a developed infrastructure of "economy offerings", where products with somewhat reduced functionality can be purchased for considerable lower price than the "regular" or "premium" versions.[20] The possible impact of expensive loans on the "surviving" consumers is illustrated by the findings of the research on capital returns in Ghana. While for the growers of non-traditional crops the return was reaching the level of 250- 300% a year – well beyond the credit interest, thus fully justifying borrowing - for the traditional crops the return was in the range of 30-50% a year, which can be lower than the interest rate. In the latter case credit will lead to negative consequences for borrower's well-being.[21]

For the consuming and strategizing strata the evaluation of the sustainability of income is a complex matter. It is possible – and actually common – that a discrepancy exists between self-attribution of a person to one of the strata and attribution of the same person by an observer. What banks do through their credit-approval procedures is in fact the instrumentalization of such observations/assessments of clients' social status through formal sets of criteria usually through the specialized software applications. These instruments deal with objectively observable characteristics like sex, age, income, place of residence, nature of occupation, education, etc. The "objectivity" of these instruments usually doesn't permit the analysis of motivations, aspirations, and self-development strategies

18 One of the obstacles to creation of such a theory is the difficulties of empiric verification. To verify the possible hypotheses one would need to compare the results of theory-driven lending procedure to a set of cases where loan approval would be given at random. This poses a serious practical problem, though recently some very interesting and innovative experiments were performed by a number of researchers in countries like India, Philippines and Mexico, see references in: Abhijit B. Banarjee and Esther Duflo: Giving Credit Where It Is Due – in: Journal of Economic Perspectives, vol. 24, No. 3, Summer 2010, p. p. 61-80

19 The practice of development of the banking "scoring" systems for the moment takes little from the contemporary advances of behavioral sciences, treating the probability of return as a function of "hard" economic characteristics like income (sometimes demography is used as proxy for them), with low attention to the psychological treatment of the issue. Just a few banks internationally allow their lending officers – usually in the case of business loans - to give a "soft" assessment of a lender (obtained via an interview) and even overrun the decision of a scoring system – see the analysis of the procedure in: Sumit Agaral, Robert Hauswald: Distance and Private Information in Lending, Oxford University Press, 2010

20 Though it is beyond the research scope of the text, I feel I cannot abstain from expressing a position on the issue of finances for the most destitute groups. My personal view is that development of the "survival" group with the help of commercial credit (especially the short-term one) is not a viable social strategy, as the need to return the loan will too often lead to unacceptable suffering. Monetary or non-monetary transfers to this group should not be conserving its status and create some infinite dependence, but they probably should be subject to the return only under certain conditions. The global legal framework will not permit a commercial financial institution to be flexible - and thus humane – enough to perform such activity on any large scale, it should be strictly reserved to non-commercial organizations

21 Christopher Udry, Santosh Anagol: The Return to Capital in Ghana, Economic Growth Center, Yale University, 2006

thus they may come to a sharp conflict with the person's self-attribution. Thus there is vast array of cases in every credit market, when a person perceives him/her- self as belonging to a different stratum (usually a higher one) than suggested by the bank's instruments.

De-formalized lending's social role is primarily in financing the upward social movements, especially during the crucial moments of transition from one group to another

De-formalized lending's social role is primarily in financing the upward social movements, especially during the crucial moments of transition from one group to another. These are the cases which are usually rejected by the banks' rigorous systems of credit approval.[22] Our model suggests that there exist two classes of de-formalized loans – transition from "surviving" to "consuming" group and from "consuming" to "strategizing", "consumption loans" and "development loans" respectively. This distinction doesn't fully match the common notion of "enterprise" and "personal" credit. A lot of micro-enterprises in the world are not developed in a "strategic" way, through conscious and consistent efforts to make them more profitable or sustainable. Rather they are a vehicle for providing certain immediate income to the owner and his/her family, and the loans made to start or maintain such enterprises are consumption loans within our model. On the other hand there are sometimes practices of financing development of enterprises through a loan officially declared as intended for personal consumption.[23] Also the loans that are taken for the purposes of personal development – like education – are officially classified as being for "consumption".

Another social niche for de-formalized lending is the "financing of the last hope". People tend to resist social destitution, especially when it is caused by "external" circumstances (like illness, business failure, job loss, etc.). In this case the consequence of types of credit tends to be reverse: as banks do have some inertia in their systems, a person can usually rely on the cheaper bank financing for some time after the unfavorable event. E. g. in case of unemployment a bank usually doesn't have means to know about it and respond with an action like recalling a credit card or reducing its credit limit. It is only after these cheaper sources are exhausted (default on the bank loan with no possibility of restructuring) that a person turns to more expensive de-formalized lending. Unfortunately, the chances of repaying a loan under such circumstances are relatively low and most of the cases of loan defaults come from this type of deals.[24]

The institutions operating in the field of de-formalized lending tend to have their own views and opinions on the risks and returns associated with each of the described types of loans. These opinions are largely shaping the lending product portfolios which are offered to the customers, promoting certain "rightful" occasions for lending. For example in North-East of Brazil the very popular CrediAmigo program from the Banco do Nordeste[25] doesn't permit to take any personal consumption credit. Various con-

22 Once a person is firmly established in the new group he/she can get access to the resources of formal bank credit which always come at more beneficiary terms

23 This was relatively common practice in Russia at certain periods of time, where the banking procedures developed in a way which made personal loan more available than a business loan for a sole proprietor or self-employed person

24 Once again I feel a comment on ethics is needed. As in the case of developing of "surviving" groups the risks of loans as "last hope financing" in case of downward social movements are generally unacceptable. Chances of default are very high and such a default will further accelerate the social descent. The institution of "personal bankruptcy" combined with social aid programs seem a more effective instrument, but they are rarely available in the developing markets. However commercial credit is a poor remedy for complex social issues.

25 See the case below in the paper

sequences may follow from the point of view of borrowers strategies – from internalizing the idea of non-appropriateness of credit for personal consumption enhancement to finding ways to mask the personal consumption needs with business development purposes for the sake of bank approval of the loan. It appears that every country (or even a region within a large country) has a legacy of specific attitudes towards the issues of lending which shape the actual consumer behavior.

III.
Supply-side: the current development of microcredit market in Russia[26]

The microcredit in Russia is provided both by specialized institutions (microfinancial organizations and credit cooperatives) and the mainstream banks, through what is called "fast non-collated consumer credit", these two market segments are reported separately. The statistics for the officially designated "microcredit" market comes from self-regulatory bodies and de-formalized lending by banks gets included into overall banking statistics. This separation of data creates some misconceptions about the size, penetration and growth rate of microcredits in Russia.

On the surface the microcredit market grew rapidly in the past decade: the volume as of January 1st 2014 was 11 times bigger than on January 1st 2004 in nominal roubles (the rouble-to-dollar rate was quite stable throughout the period, thus the growth in nominal dollars was of the same order). However, this impressive growth figure is by far outpaced by the dynamics of the portfolio of consumer credit of the mainstream banks, which grew during the same period by about 33 times. Thus microcredit has been largely losing its market share.

In volume terms the consumer credit of the regulated banks (almost 10 trillion roubles, about USD 260 bln) is 145 times bigger than the volume of microcredits (68 billion roubles, some USD 1,4 billion), and one should also count for the official loans from the banks to "small and medium enterprises" which amounted to 7,7 trillion roubles (USD 164 bln).[27] Thus the MFOs capture relatively small share of the total potential market; it is important to evaluate which part of the formal bank loan portfolio relates to the practices of de-formalized lending.

The volume of bank credits falling under the de-formalized procedures can be estimated at 300 – 450 billion roubles[28], still much higher than the total volume of "microcredit" portfolio, but more comparable in size. We didn't include the regulated banks' loans to small and medium enterprise into calculation as none of them go under de-formalized procedures within the existing regulatory requirements. So we arrive to approximately the following distribution of the overall de-formalized portfolio: 15-20% goes through "microcredit" channels and the rest – through the regulated banks. We should note that some part of the loans claimed as "for consumption" actually goes for the purposes that can be equally considered the development of micro-enterprise/self-employment (think of the maintenance of a mini-van car which is used for business and private purposes[29]).

There is no official statistics on the volume of the pawn-shop lending in Russia, yet some private research estimate it at over USD 1 bln, over half of the official microcredit market.[30]

As was said, within the microcredit market there are essentially two legal forms, "credit cooperatives" (unions) and "microfinance organizations" that hold almost equal shares of the total portfolio: 47% and 53% respectively. Though there are important legal differences between the two forms of incorporation, most of them act as for-profit organizations, the choice of the form is dictated by ad hoc considerations of the founders and is not representative for the differences of goals or approaches to lending. There are a few subsidiaries of international microfinance organizations on the market, however NGOs generally don't play an important role, the not-for profit segment being definitely underdeveloped compared, for example[31], to the EU. As

26 The analysis that follows relies mostly on the statistical data from the joint reports of Russian Microfinancial Center and NAUMIR (National Association of Microfinance Market Stakeholders), http://www.rmcenter.ru/about/news/detail.php?ID=4225

27 Here and after unless stated otherwise all the Russian bank system statistics comes from the official site of the Central Bank, www.cbr.ru

28 Method of estimation involves deducting from the consumer loan portfolio of the regulated banks the share of Sberbank, which is definitely highly formalized in the procedures, ca. 1/3 of the portfolio; then deducting the share of housing loans (including mortgages), outstanding debt on credit cards, loans for car purchases, and purported loans for retail purchases. According to various sources those constitute 28%, 10%, 9% and 8% of the total consumer loan portfolio respectively, i. e. ca. 55% combined. Out of the remaining portfolio about 10-15% were likely issued under procedures that can be considered de-formalized

29 In this sense a part of auto-credit portfolio also goes for business development, but screening out this part is impossible based on the existing statistics

30 Step by Step Marketing Agency: Kabinetnoye issledovaniye rynka lombardov [Pawn-shop market desk research]

Figure 3. Dynamics of loan portfolio of "microcredit" organizations

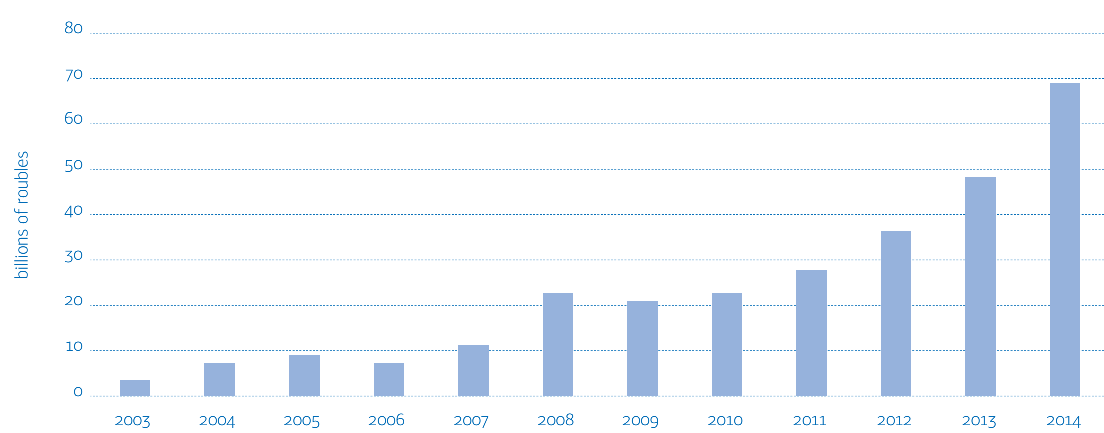
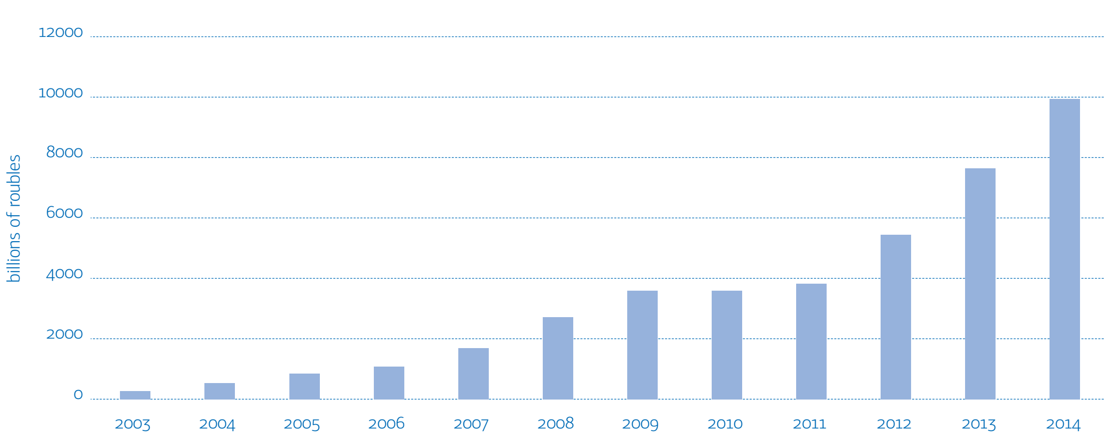


Figure 4. Dynamics of consumer loans portfolio of regulated banks



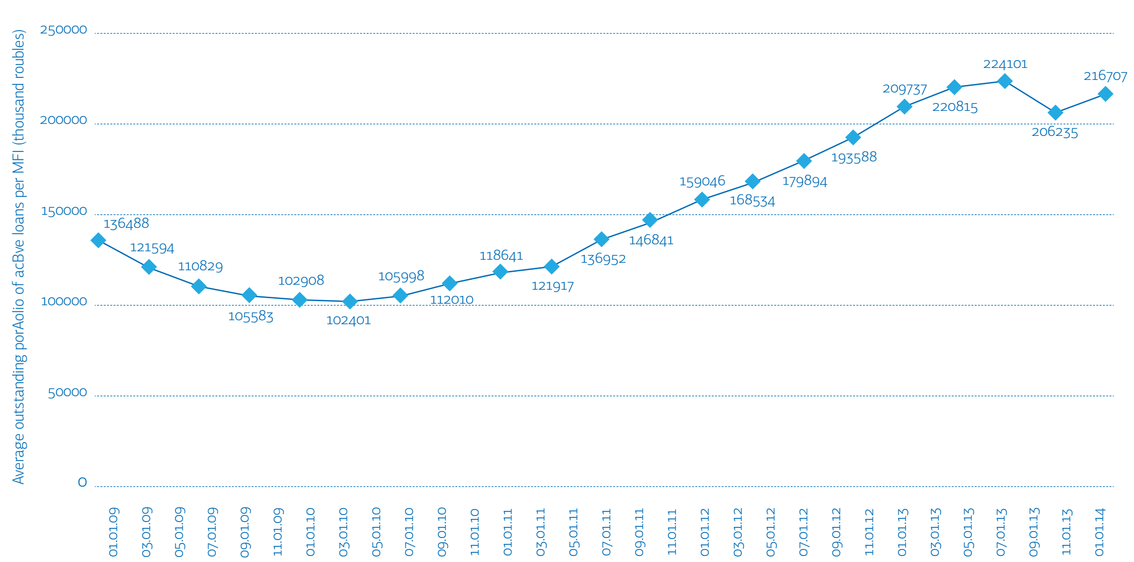
31 Since mid-1990s some international microfinance organizations like Opportunity International (launched in Russia in 1994) or FINCA (1999) tried to penetrate the market, but with a modest success. Partly the operations were limited by the ambiguous legal framework. More importantly it looks like the companies expected largely different demographic and psychographic profile of entrepreneurs in Russia, building up on the experiences of the "classical microcredit" markets like Bangladesh or Kenya. The organizations sought to adopt "as is" the products targeted on relatively archaic rural or recently urbanized population bound by social institutions like "large family", "tribe", "village" or "neighborhood". Instead they found a market which – though being definitely poor and inexperienced in market enterprise – was second or third generation urban, with high educational standards (high school being compulsory and the rate of tertiary education among the highest in the world), socially atomized and more competitive than cooperative. Probably it was the cultural inflexibility – driven by the focus on social rather than commercial achievements - that prevented international MFOs from building a noticeable market presence when the legal issues were solved and the market experienced quick growth in late 2000s – a pattern strikingly different from the mainstream foreign banks in Russia at that time.

for the lending schemes all the local institutions lend on the individual basis – not to "solidarity groups" which are so popular internationally. The market consensus is that the Russian society is very atomized and competitive and the idea of collective borrowing goes largely against the predominant cultural values.

As for the portfolio split of microcredit, about 50% of it are the business loans to enterprises and sole proprietors, 15% are short-term payday loans, and the balancing 35% are the longer term consumer loans. The smaller share of payday loans in "instant" portfolio is partly explained by the very nature of the business, their share would be much bigger if evaluated on the annualized basis, as they allow multiple borrowing by one customer within a year. For the reasons of public image[32] the microcredit market players try to downplay the importance of the payday loans in their business so a detailed analysis of the issue is not possible on the available statistics.

The microcredit market is currently very fragmented with over 3800 registered organizations. The failure rate is quite high: up to the moment over 500 firms were officially delisted as MFOs, it is safe to assume that almost all of the cases can be attributed to business failure. Many small entrepreneurs in the regions get attracted to the business by the current general media discourse which stresses the high margins and

Figure 5.Dynamics of average portfolio of an MFI in Russia



E. g. as of 2012 FINCA Russia claimed ca. 14 000 clients (source: Russian Microfinancial Center, rmcenter.ru), Forus Bank Russia (subsidiary of Opportunity International) had a bit over 31 000 clients as of June 2014 (http://forusbank.ru/about/). It is not fully clear from the reports if those are active or total clients. In the former case the numbers would compare favorably with the average statistics of an MFO in Russia (a bit over 2000 clients), but will anyway be far behind the 200 000 something clients of the leading Russian microfinancial organization, Domashniye Dengi (Home money, operating under the business model of Provident Financial from the UK) - http://investor.domadengi.ru. Cf. this position with the importance of international banks like Citi, Raiffeisen or Societe General in the mainstream consumer lending in Russia.

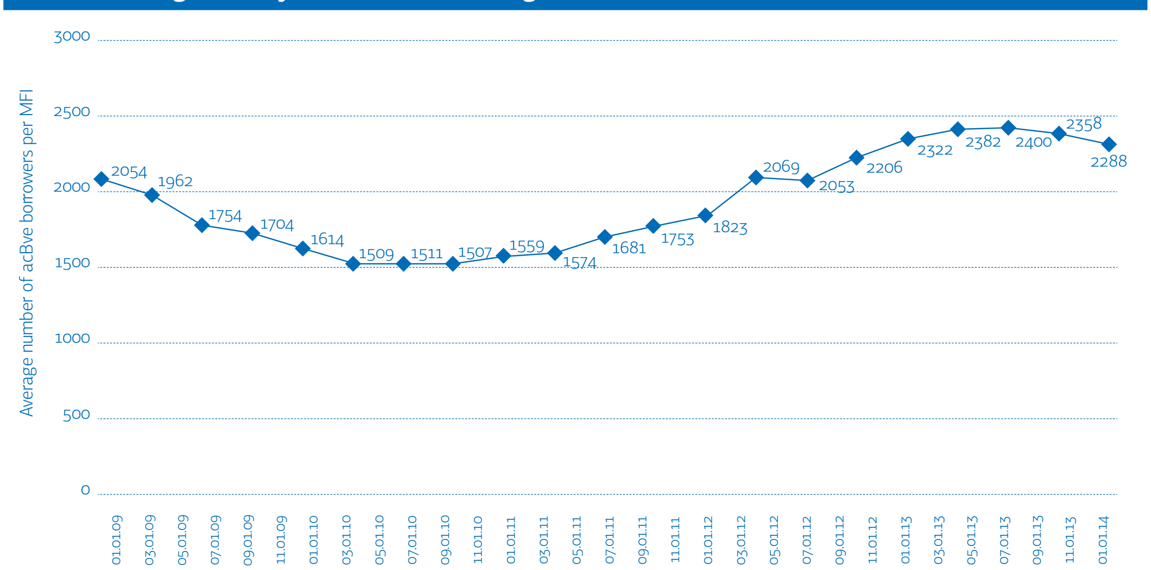
32 There is a lot of negative publicity in Russia around the payday loans, which are represented as a form of financial exploitation, media stressing the huge annualized interest rates (which indeed can go over 1000% in case of fixed interest fees on short period of the borrowing, quite on the level of comparable businesses internationally)

ease of legal procedures, while omitting the importance of solid risk management and securing effective funding. An average outstanding portfolio of an MFO stays at slightly over 200 mio roubles (about USD 7 mio), the figure showed considerable growth since 2009, but recently started to decline.

An average number of active clients stays at about 2000, which implies the average loan size (payday loans included) of 100 000 roubles (ca. USD 3000) and the total number of borrowers from "microfinance" organizations of about 8,7 mio persons. However this figure cannot be used for estimation of penetration rate, in many cases the same client is shared by several MFOs. World Bank estimates the net number of microfinance clients in Russia at 1,8 million, which looks more realistic.

As the law restricts the possibilities of attracting deposits for the MFOs[33], finding the sources of funding stands as the crucial business issue. According to statistics average volume of "savings" (i. e. deposits) per MFO is 99 mio roubles, i. e. covers a bit under half of loan portfolio. The balance comes from "investment" and "loans" which may include funding from founders, private investment arrangements and borrowing from the banks. The latter, however, is currently relatively small. A poll of 200 credit cooperatives has shown that under 9% of them used crediting at banks during the past 5 years (6,6% in the form of credits and additional 2% as overdraft on the current account) – yet almost 40% would like to use bank crediting, 38% of cooperatives stating that they regularly need additional cash for operations.[34]

Figure 6. Dynamics of the average number of active borrowers of an MFI



32 There is a lot of negative publicity in Russia around the payday loans, which are represented as a form of financial exploitation, media stressing the huge annualized interest rates (which indeed can go over 1000% in case of fixed interest fees on short period of the borrowing, quite on the level of comparable businesses internationally)

33 These cannot be smaller than 1,5 million roubles (ca. USD 30 thousand) and they are not subject to the state guarantee unlike the bank deposits. The size limitation does not affect the member contributions to credit cooperatives

34 Presentation on the demand for financing by the credit cooperatives by Voprosy Kreditnoy Kooperacii [Issues of Credit Cooperation] - http://www.slideshare.net/alisakononenko/ss-34560887

Figure 7. Average interest rates on funding and loans for MFIs

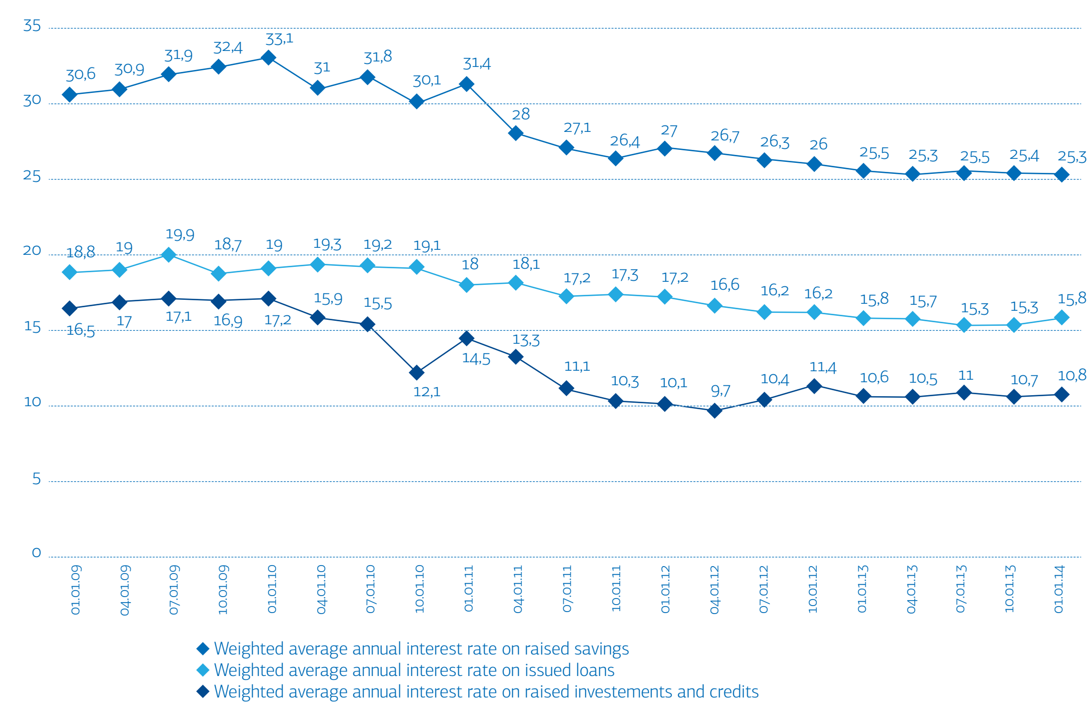
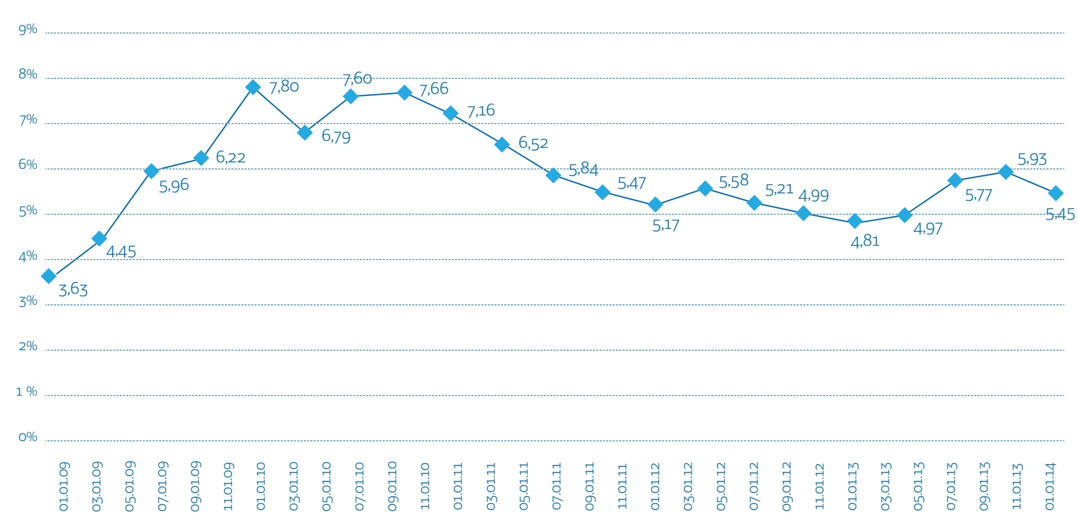


Figure 8. Dynamics of the average rate of portfolio at risk over 30 days



Thus in Russia – like in many other places in the world – the sustainability of commercial MFOs is a challenge, despite the high interest rates. The net margin between the cost of funding and the income from lending is 10-15% as shown in the chart:

Thus in Russia – like in many other places in the world – the sustainability of commercial MFOs is a challenge, despite the high interest rates.

Generally we can observe that while the interest rates on de-formalized loans in Russia are quite on the level of the international figures (even the notorious payday loans are provided at the same rate as in the UK or the USA), the cost of funding is considerably higher, the banks and institutionalized investors seem to be reluctant to participate in the market.[35] Together with price competition brought by the market fragmentation this makes running a successful MFO in Russia a tough task. Most of the smaller companies find their competitive strategies in relaxation of the risk policy, which leads generally to the growth of the arrears.

The official statistics of loans at risks doesn't look disturbing compared to the other markets, yet there are evidences that this comes from massaging the reported figures and the real values are much higher.[36] Some regional MFOs are known to be operating with the arrears amounting to 20-30% of the portfolio. They usually try to conceal this in reporting to avoid sanctions from the regulator and withdrawal of investors' funds.

Summing up: until recently in Russia the microcredits were losing the market share, which is the dynamics unusual in the world. Deformalized lending from the banks was some 5 times larger in volume than loans from MFOs and credit cooperatives.[37] Taking into account that most of this volume is personal consumption loans, we have to conclude that the overall share of loans to enterprises (small and micro-) on the market is small (at maximum 12-15%, allowing for some of the "consumption" loans be actually used for business development). The Russian MFOs are operating generally on the international level of loan interest (1-2% a day for payday loans and up to 60-70% annual for longer term loans), yet the cost of funding for them is higher than in many other markets. Provided the large number of MFOs and their average small size this high cost challenges the commercial sustainability of their business.

35 Even the public offering of bonds by Domashniye Dengi was placed at 19% annual interest which is almost 2 times higher than the borrowing rate of a first-class Russian retail bank like VTB 24 (9,9%) - http://www.rusbonds.ru/nwsinf.asp?id=3533957, http://www.rusbonds.ru/cmncorp.asp

36 An important reason for suspicion is that the reported MFOs statistics looks very favorable against the Central Bank figures for the consumer loans in the regulated banks, which valuate the portfolio at risk at 13-14%. It is quite unlikely that the de-formalized loans in MFOs have substantially better performance. Source: Centrobank zafiksiroval rekordny nevozvrat rossiayanami kreditov [Central Bank marks the record arrears on the loans by Russians] – Izvestia, 13.05.2014 http://izvestia.ru/news/570672 . One should note that while the quality of reporting of regulated banks is generally high – under the threat of loss of the license which is very difficult to regain in Russia – they also do some massaging of the arrears figures to provide a less disturbing picture both to the regulator and investors\stakeholders

37 It is interesting to note, that while in many countries the "Microfinance organizations" were quite successful in their public efforts to denounce the "mainstream banks" as being socially aloof, in Russia it is the banks that currently hold the public sympathies in the dispute, stressing the lower interest rates and more humane procedures in loan collection, effectively by-passing the issues of "financial inclusion" in the discussion

37 Интересно отметить, что в то время как во многих странах микрофинансовые организации достаточно успешно доказывали социальное равнодушие универсальных банков, в России именно такие банки пользуются общей симпатией населения благодаря своим низким процентным ставкам и более цивилизованным способам взыскания кредитов. При этом проблема охвата финансовыми услугами эффективно замалчивается.

IV.
Demand side: the Russian market and the possible “benchmarks”

The Russian market for microcredits is still in relatively early stage of development and the way it grows, institutionalizes and legalizes can be changed considerably both by overall economic conditions and by policy making. To better understand the possible development scenarios we can use the comparison with other markets, some of them having longer history of development. To exclude the effects of overall economic development we focus on the countries within the bracket of GDP per capita (PPP) of +30% and -30% to the current level of Russia (USD 18100), i. e. in the range between USD 12000 and USD 24000. The resulting sample of 18 countries including Russia looks like follows[38]:

Half of the sample consists of European countries (5 are from the "new EU", 2 are "old EU" and 2 - Russia itself and Belarus - are non-EU), 5 are in Latin America and 4 in Asia

Substantial amount of statistics on banking, formal and informal credit is available for the listed countries from the World Bank Global Findex (Global Financial Inclusion Database).[39] The data permits to make some important comparisons.

Table 4. Comparative sample countries: GDP per capita and population

Country	GDP per capita, USD PPP	Population
Slovakia	24 700.00	5 443 000
Greece	23 600.00	10 775 000
Portugal	22 900.00	10 813 000
Poland	21 100.00	38 346 000
Hungary	19 800.00	9 919 000
Chile	19 100.00	17 363 000
Argentina	18 600.00	43 024 000
Russia	18 100.00	142 470 000
Malaysia	17 500.00	30 073 000
Belarus	16 100.00	9 608 000
Mexico	15 600.00	120 286 000
Turkey	15 300.00	81 619 000
Bulgaria	14 400.00	6 924 000
Kazakhstan	14 100.00	17 948 000
Venezuela	13 600.00	28 868 000
Romania	13 200.00	21 729 000
Iran	12 800.00	80 840 000
Brazil	12 100.00	202 656 000

38 The GDP per capita range actually produces a very diverse group of 46 countries with almost half (21) situated in South America and Caribbean, 14 in Europe, 8 in Asia and Pacific and 3 in Africa. The substantial part of the sample consist of the countries quite small in population and overall economy size, like the island states of the Caribbean, but also the Baltic states in Europe, and some Pacific islands. We assume that the smaller countries have substantially different financial infrastructural and institutional challenges, thus they should be omitted from the sample. We have drawn the lower limit of population for the countries in the sample at 5 million, but we have additionally dropped Lebanon (5,5 mio of population) for the reason of exceptionally dense population (its territory is just 10 000 sq. km, almost 5 times smaller than the territory of Slovakia which has the same population), such compactness also implies substantially different infrastructural situation.

39 http://databank.worldbank.org/data/views/variableselection/selectvariables.aspx?source=Global-Findex-(Global-Financial-Inclusion-Database)

Figure 9. Penetration of the formal banking (bank and any form of credit within the sample)

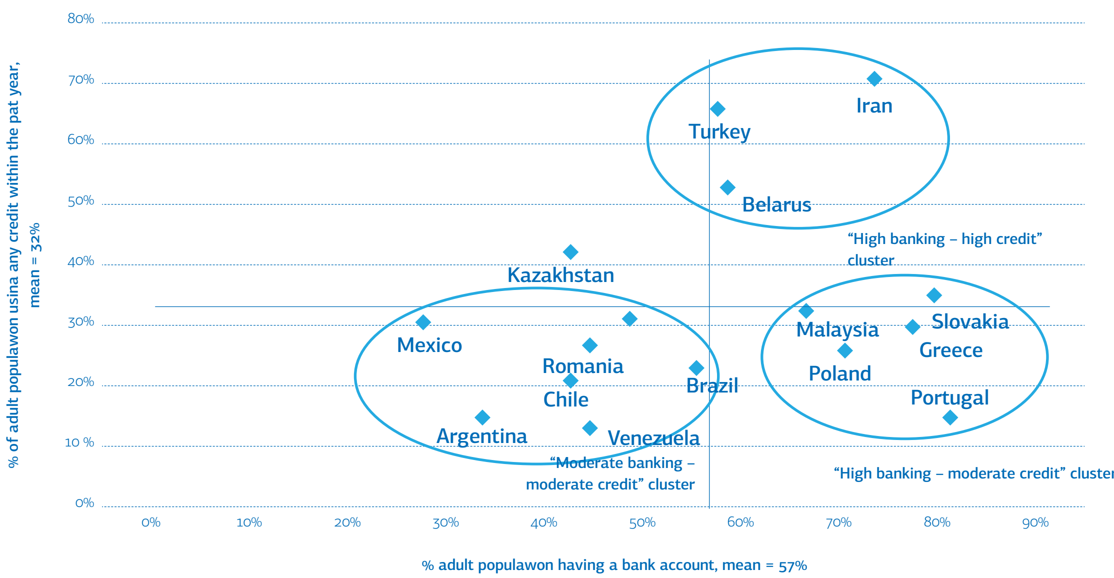
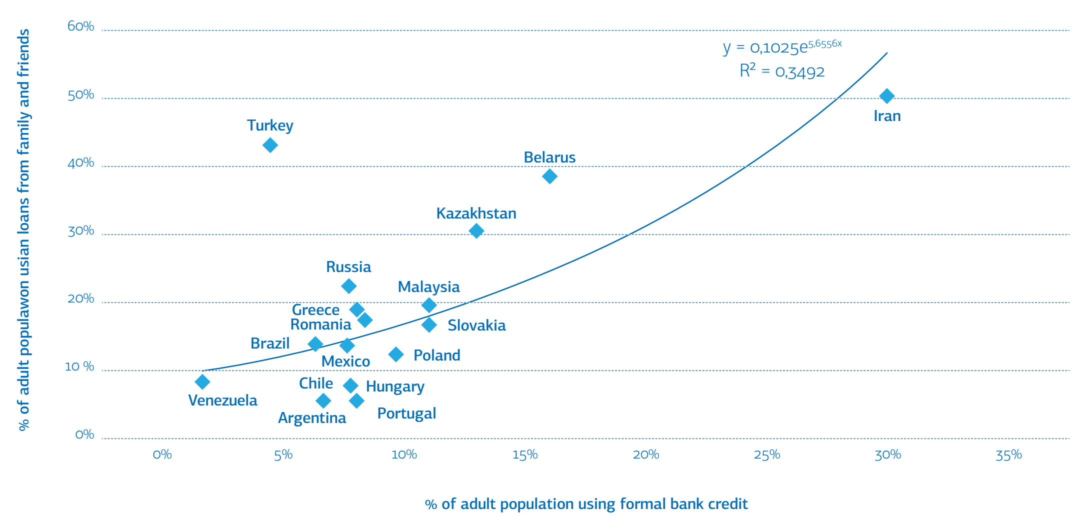


Fig 10. Usage of formal bank credit and informal lending from family or friends



Generally all the countries in the sample have medium to high development of banking and credit. While the penetration of the banking services (as measured by having a bank account) is a rather smooth continuum, the use of credit tends to be split – there is a high-credit group of Iran, Turkey and Belarus. Russia is somewhat below average on the usage of banking (38%) and is almost exactly in the middle on the credit usage (31% vs. the sample mean of 32%).

Within the sample there is a positive correlation between the level of GDP per capita and the penetration of bank accounts (r = 0,55), yet the level of GDP per capita is negatively correlated with the usage of credit (r = -0,32). This may come from the fact that in better developed personal banking environment people will tend to use effectively products like credit card overdrafts which they usually don't reports as "credit" in answering the polls.

The relationship between the formal and informal credit within the countries of the sample generally confirms the trend described earlier (through the findings of the MIMOSA project): the usage of all forms of credit is positively intercorrelated. Below are the correlations between the formal banking credit taken within the past year and some forms of informal borrowing

When it comes to the institutionalized deformalized lending the sample demonstrates two clearly distinct models. The European countries tend to have relatively small "microcredit" market which involves just several percent of population and is largely driven by the non-for profit organizations[40]. For the European countries within our sample the share of users of "microcredits" reaches maximum a fraction of percent, tens of thousands of people in absolute figures. Arguably this comes from a highly developed and generally quite inclusive banking system which provides effective loan products to most of the consumers and entrepreneurs apart from some very special group. This logically leads to the dominance of non-for profit organizations on the microcredit market (NGOs alone occupy 22% of the market, to this should be added communal, religious, governmental and other non-for-profit organizations), with reliance on interest-free funding from charity.

A very different model is demonstrated by the Latin American countries, most of them have highly developed microcredit markets with hundreds of thousands and millions of borrowers and substantial size of average loan. Within our sample Mexico is clearly among the most penetrated markets, Argentina and Venezuela have quite modest penetration by the standards of the region, but are much above the typical European levels and Brazil and Chile fall in between (see Table 2).

Russia clearly differs from the "European" model in number of "micro-borrowers" and the institutional composition of the market. Indeed even by the Latin American standards the penetration of "microcredits" is rather high:

If we add to this penetration level of "official" microcredits an estimate of the number of customers of the de-formalized bank loans, the figure is likely to triple. This will put Russia closer to the countries which are substantially poorer than those in the analyzed sample, like Colombia (29,4 per thousand) or El Salvador (47,6 per thousand).

Table 5. Correlation between informal borrowing and formal bank credit

Form of borrowing	Correlation with the formal bank credit
Informal private loans	r = 0.82
Loans from friends and relatives	r = 0.57
Loans from a retail shop	r = 0.89

40 European Microfinance network

Some explanation may be found in the structure of wealth distribution across Russian regions:

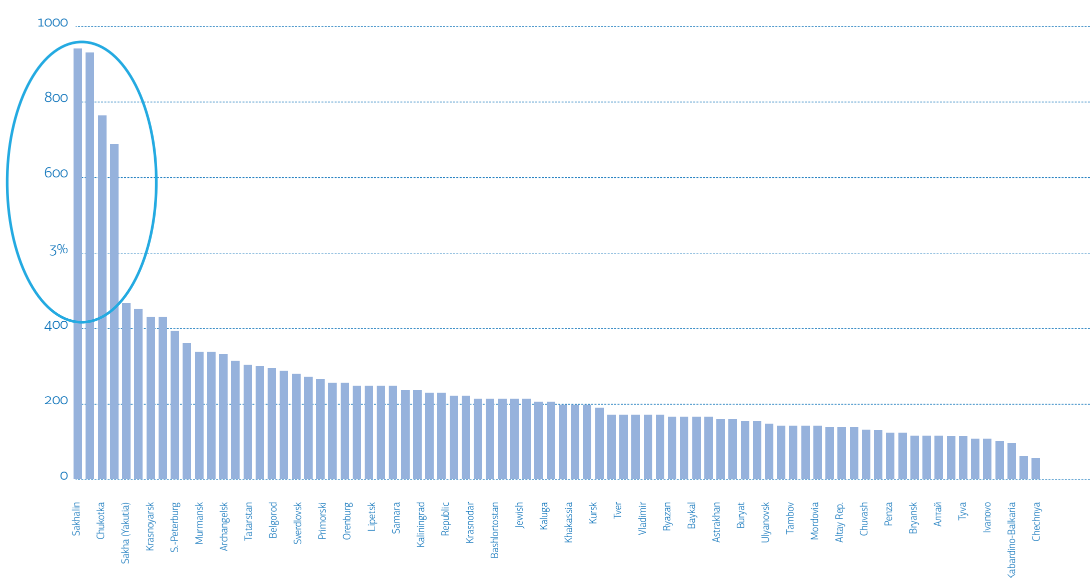
This distribution has a very peculiar form - four regions clearly stand out as the drivers of the average Russian level of GDP per capita, followed by a sharp gap - the 5th region in the ranking is 2 times lower than the 4th. If we take the relatively "superrich" regions out of the picture Russia will turn from an "upper medium" into a "lower medium" country by international standards with GDP per capita falling to around USD 10000 (PPP), fully comparable to Columbia (USD 11 100).

Another important issue on the demand side is the relatively low share of enterprise credits in the overall microcredit portfolio. This is highly correlated with the overall underdevelopment of the private enterprise, especially compared to the reference countries. As indicated by the Global Entrepreneurship Monitor[43] Russia is substantially below global levels of penetration

Table 6. Number of borrowers from the "microcredit" organizations per 1000 population[41]

Mexico	19,04
Russia	12,24
Chile	11,45
Brazil	5,05

Figure 11. Distribution of Gross Regional Product per capita by Russian regions[42]



Four outstanding regions are Sakhalin, Moscow, Chukotka and Tyumen (in ths. roubles)

41 Calculated on the basis of Microfinanzas en América Latina y el Caribe: El sector en cifras

42 Rosstat (State Statistical Committee)

43 http://www.gemconsortium.org/docs/3106/gem-2013-global-report

of ownership of an enterprise. This figure stands at 5,8% compared to 9,3% in Poland, 9,5% in Slovakia, 10,1% in Romania, 12,3% in Iran, 15,9% in Argentina, 17,3% in Brazil or 24,3% in Chile. The Russian rate of launch of new enterprises (3%) and the intention to start an enterprise (2,6%) are also considerably lower than the levels of the reference sample countries, so the gap is growing with time.

Russia has specific mindset defining entrepreneurship motivation. As indicated by the same research, an above average share of the Russian entrepreneurs are driven by necessity, not an opportunity – 35,4% and 42% respectively, for comparative sample the same pattern emerges for the countries that also passed the painful transition from the socialism like Romania (31,6%/31,6%), Slovakia (40,2%/40,2%) and Poland (47,4%/32,7%), while being distinctly different market economies with long history like Greece (23,5%/35,8%), Mexico (6,7%/26,3%), Argentina (29,8%/47,4%), Brazil (28,6%/57,4%) or Chile (20,1%/57,7%). Russia is also marked with rather low public regard of entrepreneurship as career strategy and the social standing of reasonably successful small entrepreneur is not very high compared to, for example, middle-management employment. The Russian public opinion is still often suspicious of entrepreneurship as a life strategy, associating it with all sorts of risks, involvement into illegal or semi-legal practices and general psychological and social insecurity. Russia's score on "Entrepreneurship as a good career choice" is 65,7 compared to the average for Latin America of 73,6 or for Middle East of 72,4 with individual countries of the world scoring as high as 84 (Brazil), 85 (Vietnam), 79,5 (The Netherlands) or 82,3 (Bosnia and Herzegovina). Russia is also below many peer countries or whole regions in "high status associated with successful entrepreneurship".

The nature of the relationship between penetration of enterprises and the intention to launch new ones, and the volume of enterprise microcredit may pose a "chicken and egg" problem. Obviously financing is the crucial issue in launching a business, so it is likely that the lack of offer on the supply side does play important role in checking the growth of entrepreneurship in the country. Unfortunately, while some of the Russian mainstream banks have de-formalized the lending procedures for personal consumption, none of the important market players have arrived to the similar liberalization (involving, the informal hands-on assessment procedures of the venture instead of relying on processing of official accounting reports) targeting the small and micro-business. The current resources of MFOs, with restricted supply of funds, are insufficient at the moment to boost the small business financing in the country.

Summing up: Russia demonstrates the high demand for de-formalized credit, on the level of the world's most penetrated markets. On this background the fact that MFOs are losing their market share looks like a paradox. However there is an explanation. The Russian market has an unusually high share of loans for personal consumption, and until recently banks were eager to cater to the segment. This was usually performed not through the more informal methods of credit approval, but through mere increase in tolerance to risk, leading to growing arrears. Operating on the level of interest comparable to MFOs, but with much cheaper funding the banks were just covering the losses with higher profit margins. These practices can hardly be called sustainable or healthy and it is likely that we will soon witness a major crisis created by them.

V.
What is in the future?

We are likely to be seeing very turbulent year on the overall credit market in the country. The general economic turmoil may bring important social shifts, drastically decreasing the incomes of the "consuming class", which currently holds the bulk of the credit portfolio. A massive default may follow, to avoid it the customers will seek for the "finance of last hope". Both banks and MFOs would do better if they avoid the temptation to profiteer from such financing, which is almost sure to bring financial loss, and at the same time vastly complicate the social problems.

The self-reliant growth becomes the motto of the day, and this growth will definitely require financing through targeted credit.

On the other hand, just to bring crediting to the full halt will obviously be destructive for the economy. The self-reliant growth becomes the motto of the day, and this growth will definitely require financing through targeted credit. Thus all the market players need to learn very quickly to differentiate between the good and bad demand for loans in the situation, when the formal scoring models will start producing gross errors (as their statistics was based on the different socio- economic behavior).

For the regulator the challenging task is to create the policies and procedures which will recognize and support such flexibility and selectivity. Incidentally the regulatory intentions of the recent past seemed to be quite the opposite. Yet it seems that rigidity of actions will not be working, being another way to effectively bring the issuance of the loans to a halt, it will be just fixing the losses of the current loan portfolios without giving a chance to the market players to recuperate those losses. To mitigate the social risks we urgently need lawmaking to create the framework of "manageable default" (aka the "personal bankruptcy", though the term has too strong negative connotations in Russian), protecting the social standing and human dignity of the borrowers on the one hand and creating effective risk management instruments for the suppliers of the loans on the other hand.[44]

Further reassessment of the role of de-formalized loans in the economy is needed, with the focus on exploration of its constructive potential. Even in the case of consumer loans – the "microcredits" tend to cater to the existing supply more than creating it. The need for financial inclusion will be high and growing in the context of the persisting regional inequalities. It is quite possible that the medium-income regions will suffer less from the economic turmoil – as they have less to loose. In this case they may form the base of the new economic growth, such movement should be recognized early and supported through financing.

Theoretically banks and MFOs could come to a mutually beneficial solution when former divest from the retail market and use the funding for provision of liquidity to the latter. Currently MFOs are not treated as strong institutional borrowers, and are not associated with lower reservation rates. There seems to be deep suspicion among the bankers (who view themselves as "certified professionals") towards the managers of MFOs ("irresponsible amateurs") which puts a strong barrier to such a development. International practice tells that specialized "microfinance" organizations are often more effective than the banks in creating the sustainable schemes of lending to those being "subjectively" creditworthy (i. e. having the means and motivation to repay the loan but not fitting properly into the limits of the big formal approval procedures, especially the automated "scoring sys-

44 Currently voluntarily writing off a bad debt – even as part of the socially responsible action – is likely to bring implications for the bank's accounting and taxpaying that will put the act on the verge of legality. Banks were criticized on several occasions for demanding loan payments from people in the areas of natural disasters (like the flood of 2013 in the Far East), but the banks were just following the obligatory procedures imposed by the regulator and fiscal agencies

tems"). They can effectively operate on a smaller scale due to lower fixed costs, this enables them to penetrate small markets and lend under the "grassroots" knowledge of local residents and businesses. This capability can be utilized and developed, while the products can be made more beneficiary for the customers through the better supply of funding – as we have seen, the current cost of funds in Russia is very high. This can be done by banks which in turn will receive considerable profits at lower risks. A two-layered system like this exists effectively in "microcredit" in Germany, on some other markets the non-banking financial organizations (like Acion International) are the important source of liquidity and suppliers of credit "know how" to the MFOs operating "in the field". Developing such system in Russia will likely be beneficial for re-starting the social and economic development, especially in the regions. Importantly no major costs are involved, just redesign of some of the current practices and views.

A two-layered system of the regulated banks supplying the funds and know-how and specialized MFOs dealing with the actual provision of loans, especially in the smaller locations and to specialized social and economic groups can be effective in achieving the otherwise contradictory goals of low risk in the banking system, social financial inclusion and economic growth through the stimulation of entrepreneurial activity.

VI. Some cases of microfinancial institutions from the referent countries

Below we have collected three brief descriptions of various approaches to microcredit from three Latin American markets which are characterized with high development of the segment. The cases illustrate approaches to product portfolio and credit approval practices, and give some indication of possible financial performance of specialized MFOs and banks. While the three countries have somewhat different legal regulation, generally in all three the regulatory approach focuses on development, not restriction of the segment, giving a role both to specialized microcredit institutions and banks.

Crediamigo / Banco de Nordeste, Brazil[45]

Type: A microcredit program from a mainstream bank
Owner: Banco de Nordeste
Founded: 1997 with consultation from the World Bank and Accion International
Number of active clients (2014): 1 732 000
Current loan portfolio (2014), USD: 1,2 bln
Average loan size (2012), USD: 850
Number of branches: 396

Legal landscape for microcredit in the country: a federal law was introduced in Brazil in 2003 requiring all the financial institutions in the country to use not less than 2% of their customer deposit portfolio for funding of loans to the poorest groups of population. The regulation of microcredit was further expanded in 2005 through PNMPO, National program for promotion of lending to small entrepreneurs with additional funding for the loans provided from FAT, Fund for support of the workers, which is actually the national institution for insurance from unemployment.

CrediAmigo (literally – CreditFriend) is one of the most famous cases of massive microcrediting in Latin America. The program focuses on the country's poorest and less developed region and provides funds to small entrepreneurs with special attention to women (who represent 65% of the client base). The credit approval is made by bank managers (1600 in 2010 with the average of 3000 clients and 500 active loans per manager) through rather informal, "hands on" procedures, including interviews and on-site inspections. The program was acclaimed as the best Latin American microlending business in 2008 and 2010 by Inter-American Development Bank.

Products: the program offers five credit products, three for the "solidarity groups" (totally ca. 80% of the portfolio) and two for individual lenders (20% of the portfolio). The sum vary in the range of ca. USD 50 – USD 7500 and the interest rate is 1,2% a month for all products + 3% lump sum upon approval, except for "Community credit". The solidarity products are somewhat shorter – not longer than 12 months, while the individual loans can be up to 24 months. The "Community Credit" is a very interesting niche product aiming to stimulate the popular initiative in infrastructure development. It is granted to groups of 15-30 people living in the same community and committed to undertake small improvements like road repairs, street lighting, sewage upgrade, etc. The interest rate is rather low – 0,41% a month + 1% lump sum upon approval. The bank also offers life insurance.

Financial results (2010): on the active portfolio of ca. USD 220 mln the net profit was ca. USD 12,5 mln., providing RoA of 5,7%. The rate of defaults (in bank's terminology – overdue up to 90 days) was 0,72% of the portfolio), the rate of losses (in bank's terminology – overdue over 90 days) was 0,52% of the portfolio. These are among the lowest risk rates one can find in the reports of microcredit institutions across the globe.

The case demonstrates that when arranged on a large scale and properly funded a program of microlending can be economically effective and sustainable even despite the higher costs associated with the de-formalized credit approval procedures through large workforce of field managers. It also demonstrates that de-formal-

45 Source: CrediAmigo corporate reports , http://www.bnb.gov.br/content/aplicacao/Produtos_e_Servicos/Crediamigo/gerados/Resultados.asp

ized credit approval per se does not need to be associated with high level of loan non-returns. These findings are consistent with analysis of financial performance of other massive microcredit programs, like CrediAmigo (Mexico, no relation to Brazilian operations) or Compartamos Banco (Mexico, Guatemala, Peru). However, as we will see in the following two cases operating a smaller MFO poses much of a challenge.

CrediConfia, Mexico

Type: Microfinancial Organization ("Multi-purpose non-regulated microcredit company", SOFOM ENR under the Mexican law)
Owner: privately owned
Founded: 2006
Number of active clients (2014): 25 000
Current loan portfolio (2014), USD: 9 mln
Average loan size (2012), USD: 380
Number of branches: 25

Legal landscape for microcredit in the country: Mexican defines microcredit as solely intended for enterprise (basis for distinction: being returned through sources other than fixed salary). A special legal form exists: "Multi-purpose non-regulated microcredit company", SOFOM ENR in Spanish abbreviation.

CrediConfia is a typical midsize company, operating in Central Mexico, with heavy presence in the state of Puebla as well as Federal District and Mexico state. Like many of the microfinancial operations in the world it focuses on women as clients with one special product explicitly requiring that a new solidarity group should be 100% female and even a mature group (with 3 or more loans successfully repaid) should have female majority.

Products: the program offers three products, one individual and two for the "solidarity groups" (one for female groups and one gender-neutral). The individual loans are offered in the range of USD 700 – 14000, the solidarity products are in the range of USD 150 – 1500. The loans are offered for the period of 4,5 – 6,5 months, with typical loan length calculated in bi-weekly periods (9 – 13 of them) and repaid on a bi-weekly or weekly basis (short repayment intervals are generally common in Mexican microcrediting). The annualized interest rates including the fixed lump sums paid upon loan approval are in the range of 169% - 229%. The individual loans should come with collateral (a vehicle can serve with the ownership documents deposited at the MFO), for solidarity loans 10% of total credit hold by the group should be collated.

Financial results (2010): the net interest income was ca. USD 3 mln., while the operational expenses amounted to almost USD 5,4 mln., 61% of them being the payroll. Thus in 2009 and 2010 the company was operated at considerable loss (USD 1,1 mln and almost USD 1,8 mln respectively). The situation was salvaged by the intervention of Accion International fund in 2012, which invested almost USD 2 mln into the company and also helped it improved operational effectiveness through better technologies. The detailed financial report after the deal is not available, yet Accion corporate site states that the company was turned into being operationally profitable.

Financiera Universal, Peru

Type: Microfinancial Organization ("Rural caisse for savings and credit", CRAC under the Peruvian law)
Owner: as of 2012 owned by Grupo Morisaenz (Ecuador)
Founded: 1995 (before acquisition was operating under the brand Profianza, some branches continue to hold the brand)
Number of active clients (2014): 14 000
Current loan portfolio (2014), USD: 25 mln
Number of branches: 34

Legal landscape for microcredit in the country: the Peruvian legislation on microfinances is considered by some experts to be among the most elaborate and balanced in the world. The market is regulated by the country's Central Bank, which is targeting solely the level of risks in the system. No restrictions on terms and conditions of the loans are imposed, yet separate legislation on consumer rights in financial services prescribes standards of transparency of the deals and client information. The state had some earlier attempts of direct involvement into the microcrediting, but the designated national bank went bankrupt in 1990s, since then such activities, as well as subsidizing the interest rates, were considered ineffective

Financiera Universal is another typical midsize company, this time with operations concentrated in rural areas of a poorer country, with some part of clientele coming from small farmers.

Products: the company offers a very diverse product portfolio, which includes not only the "classic" microcredit products both for consumption and enterprise, including a separate agricultural product, but also a pawn-shop-like offer called "Olla de Oro" ("Pot of gold") – loan collated by golden jewelry. There is also a specific deposit product, targeting salaried employees – the employer actually writes the paycheck to the benefit of Financiera Universal and bring certain percentage income. Such a scheme is possible due to widespread retail credit which permits to purchase the necessities in cashless mode and pay the grocery bills once or twice a month. Loan sizes are in the range of USD 175 – 10 000 with the interest rate of 69,59% per annum and the duration in the range of 3 to 36 months, with monthly or bi-weekly payments.

Financial results (2010): like in the case of Credi-Confia the company was deeply "in red" when operating independently. In 2011, before being acquired, it had the net interest income of ca. USD 4 mln and operating expenses of ca. USD 7 mln, generating net loss of ca. USD 2 mln (after some non-operational income). The availability of funds was putting a severe check on the operations, the new owner managed to boost the loan portfolio bringing the net interest income in 2012 to ca. USD 27 mln with operating expenses growing to USD 28 mln. The company managed to turn a small net profit (under USD 100 000), though the boost of portfolio brough the rapid increase in risk rate, with losses almost doubling within a year from ca. 3% of portfolio (better than market average in Peru) to 5,5% (a bit underperforming vs. the market).

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