The Growth Of Commercial Microfinance Opportunities in Eastern Europe and the new Independent States

Introduction

The fall of communism was the seminal event in Eastern Europe's postwar history. Breakup of centralized control of every aspect of life, it was hoped, would unleash pent-up internal forces and western capitalism's inherent drive to exploit developing regions, propelling the former Soviet satellites into moderate prosperity.
Well, things haven't gone exactly as planned.

According to a recent study by the European Bank for Reconstruction and Development, the experience that has subsequently followed the fall of the Berlin Wall "has demonstrated that the transition is complex and long and that the upheavals and stresses can be harsh."[1]

More to the point, as a recent Economist survey observed, "it's difficult to criss-cross the forgotten villages of Eastern Europe and imagine the 21st century has arrived. Rather, the millennium seems to have marked a return to the 19th century. Out of necessity, villages have reverted to survivalism. People have replaced tractors in the fields, with the hoe having become the symbol of post-communism."[2]

Microfinance Activity in Eastern Europe and the New Independent States

Source: Microfinance Centre for CEE and the NIS.

BALKANS

EASTERN/CENTRAL EUROPE

CAUCASUS

CENTRAL ASIA

RUSSIA/UKRAINE/BELARUS

Subregion	Number of MFIs	Total Gross Outstanding Loan Portfolio (US$)
Balkans	44	111.1 Million
ECE	4,987	414.8 Million
Caucasus	27	38.7 Million
Central Asia	319	76.5 Million
Russia/Ukraine/Belarus	204	158.41 Million
Total	**5,581**	**799.5 Million**

However, that doesn't mean there haven't been significant strides. Indeed, free and fair elections in most former Eastern Bloc countries have led to democratic changes of government. Production has now almost completely reverted to the private sector, and goods and services are exchanged in a market-based system that would have been unthinkable just 15 years ago.

One of the key reasons underpinning this optimism is the entrepreneurial spirit that has sprouted up across the region. And among the most potent agents fueling this movement has been the boom in microfinance—the lending of very small loans to poor and uncollateralized individuals and microenterprises. Most such loans go under the radar of traditional financial institutions that extend much larger credit to more established, higher-grade risks.

Microfinance is still a fledgling industry in the former Eastern Bloc countries due to its late start and its relatively small numbers of poor compared with other regions such as southern Asia, Africa and Latin America. Still, the growth of microfinance in the region since 2000 has exceeded that of the rest of the world, fueled in part by an increase of interest among commercial microfinance institutions that have discovered the rate of return on microfinance can be higher in the former Eastern Bloc.

[1] Executive Summary, *Transition Report 1999*, European Bank for Reconstruction and Development, p.1.
[2] *The Land That Time Forgot*, The Economist, 21 September 2000.

Evolution of an Industry

In the regions of central and Eastern Europe and across the Caucasus, Balkans, Russia, Ukraine and Belarus, the concept of microfinance didn't really come into existence until the early 1990s. The closest comparable service were savings and loan cooperatives–credit unions–which date back a century.

According to Maria Nowak, founding chair of the Microfinance Centre for Central and Eastern Europe and the New Independent States, located in Warsaw, until the collapse of communism, "the majority of governments considered the prospect of encouraging self-employment or microenterprise by offering small loans to low-income people absolute nonsense."[3]

However, the loss of state-owned enterprises and jobs made many workers realize that starting up their own businesses and taking care of themselves is the only way out from under the collapse of state subsidized subsistence. "And it was the demand for credit," observed Nowak, "demonstrated by a few pilot micro-credit projects that convinced governments across the region of the potential of microfinance. And microfinance has subsequently grown with the financial and technical support of international aid."

Microfinance institutions didn't exist in most of central and Eastern Europe prior to 1990, and yet, in just over a decade, they have grown to serve 1.7 million active borrowers, according to Elizabeth Littlefield of the Consultative Group to Assist the Poor [CGAP].

"The commercial versions have proved that providing financial services to the poor can be as economically viable as it is in other regions," Littlefield said in a recent report.[4]

What has propelled microfinance are supportive government and non-governmental organization [NGO] policies, interest rates that cover costs, demand-driven products, and a steady focus on enhancing efficiency across the entire loan process.

As a result, the region is experiencing 30 percent annualized growth in clients served. But according to many industry observers, microfinancing has barely tapped the latent demand, currently meeting only five percent of the potential market. This means that despite some impressive inroads, microfinance is still in its nascent stages, requiring substantially greater capital and organizational support for it to significantly affect impoverished regions of Eastern Europe and Central Asia where globalization has failed to reach and where urgently needed near-term solutions must be local in nature.

On the whole, microfinance is also impartial as to which countries it flows into first, unlike other sectors of the financial industry which tend to favor those countries in line for admission to the European Union. Microfinance bypasses the formal sector, and thus will benefit little from the reduced trade barriers and transfer of wealth that comes with EU entrance. However, commercial microfinance in particular may see a slightly higher uptick into countries such as Poland, Czechoslovakia and Hungary because as those countries march toward EU admission they are likely to see the kind on increased efficiencies that commercial microfinance lenders like to see.

Microfinance Institutions Take Hold

"The state of microfinance development," according to Sarah Forster, program director at the New Economics Foundation in London, "varies quite dramatically across central and Eastern Europe and the new independent states, with the highest level of activity in the western region dominated by credit unions, in the Balkans by NGO MFIs and microfinance banks, and in the Caucasus by NGO MFIs and downscaling commercial banks. The lowest level of activity was in Central Asia, Russia, Ukraine, and Belarus."[5]

As of the end of 2002, there were nearly 6,800 microfinance institutions operating across central and Eastern Europe and the newly independent states, lending more than $1.4 billion.

There are four basic types of MFIs operating in the region. More than 6,500 credit unions make up and execute half the total outstanding loans, worth more than $700 million, reaching nearly 1.9 million borrowers. Member-owned and operated, CUs are the oldest grass-roots financial institutions in the region, financed largely through customer deposits that in turn get lent out to other members. They have 2.24 million active depositors with $455 million in assets, representing more than two thirds of all deposited assets and 95 percent of all active depositors in the region.

NGO MFIs make up a distant second, involving 169 institutions lending over $200 million to nearly 300,000 borrowers. Not licensed to accept deposits, they are comprised of public and private non-profit associations and foundations that specialize in lending to self-employed individuals and microenterprises.

The 20 microfinance banks in the region are lending $351 million to nearly 100,000 customers. Last to develop locally and seeking commercial and social goals, these institutions are fully regulated for-profit commercial banks. They offer a broad range of services and products for profit-minded micro and small enterprises, including savings accounts, money transfers and foreign exchange. Microfinance banks hold an estimated $218 million in deposits.

---

[3] See: STATISTICAL SUMMARY: Central and Eastern Europe and New Independent States, 30 September 2001

[4] Foreword, *The State of Microfinance in Central and Eastern Europe and the New Independent States*, CGAP Regional Reviews, 2003, p. ix

[5] Sarah Forster et al, *The State of Microfinance in Central and Eastern Europe and the New Independent States*, CGAP Regional Reviews, 2003, p. 43.

Microfinance Institutions by Type

MFI Type	Number	Total Gross Outstanding Loan Portfolio (US$)	% of Total Gross Outstanding Loan Portfolio	Total Active Borrowers
Credit Union	5,447	408.4 Million	51%	1,452,523
NGO MFIs	100	107.9 Million	13%	197,069
Commercial Banks	24	125.1 Million	16%	23,308
Microfinance Banks	10	158.2 Million	20%	41,660
All MFIs	5,581	799.6 Million	100%	1,714,560

And finally, there are 43 downscaling commercial banks extending $153 million of credit to 35,000 microenterprises. These institutions are part of restructured retail banking arms of mainstream banks, and like microfinance banks they are seeking to serve micro and small enterprises.

Success Stories

Several encouraging examples of how MFIs are succeeding include the St. Anthony's Parish Credit Union. Started in 1996 as Poland's first parish credit union, St. Anthony's wasn't originally conceived as a source of microfinancing. Instead, it thought of itself as a small savings and loan institution looking to serve no more than 200 members. However, by offering lending rates that were cheaper than other financial institutions, it triggered latent demand for capital and quickly grew to serve more than 2,600 clients.

In Romania, Racastie-based VAAD – a local acronym standing for Future for Teenagers in Difficulty – processes wood into lumber with a staff of young people who were brought up in state-run children's homes. Commercial banks repeatedly turned it down for business loans because it seemed a high risk. VAAD then approached CHF Romania—an NGO MFI—for a loan. "We found CHF to be a flexible and open organization right at the time we had almost lost hope," explains Tiberiu Stan, the group's general director. With loans in October 1999 and November 2000, the group expanded from 8 full-time employees generating sales of $4,000 a month to 69 workers with a monthly turnover of $22,000.

In 1996 in Sarajevo, Hajdur Vehid, a local craftsman, decided to start up a repair shop for industrial sewing machines. With money of his own and a $1,500 loan from LOK–a local microcredit organization–he rented a space in the old part of town. He started with a few discarded sewing machines that he repaired and put up for sale. Three years later, his clients grew to include some of the largest clothing producers and exporters in the country.

"Microcredit is the best thing for a small-business entrepreneur," posits Vehid. "It provides just enough money when additional capital is necessary. The capital can be successfully turned over, enabling an enterprise to grow and repay the loan. I have successfully borrowed and repaid four loans and am slowly expanding my business."[6]

Risk and Return

Geneva-based Blue Orchard Finance, a $50 million commercial microfinance fund which specializes in loaning money to local MFIs, forecasts the industry could easily absorb another $10 billion over the next decade as microfinancing is shown to be a bonafide asset class for private investors.

Cedric Lombard, Blue Orchard partner and founder, cautions that the growth needs to be managed properly, especially in a region as volatile as Eastern Europe. "If you just throw money at an industry it is going to grow, but will it grow systematically or will it create corruption and destroy assets? There is a capacity for absorption, but it has to be done in a manner that respects their own capacity to grow."

Capital sources, like Blue Orchard, normally charge from 2 to 5 points above LIBOR to the local MFIs, who in turn add their own risk premium in lending to end borrowers. Blue Orchard reports a loan loss rate of less than 5 percent, less than that involved when lending to sub-prime borrowers.

Sarah Forster of the New Economics Foundation corroborates similar numbers on the local level. "The region's MFIs," she reports, "have achieved good financial results, with impressively low delinquency levels. Only 3.4 percent of all loans are more than 30 days past due. Operating efficiency is generally good as well."[7]

Profitability varies widely across the region, with Polish credit unions among the top performers, according to Forster. In general, microfinance banks have the highest level of financial performance. Forster has observed that "six of the region's oldest microfinance banks have achieved an average return on equity of 4.47 percent after 3-4 years of operation."

Some NGO-MFIs are profitable, while others do not charge enough interest to cover their own costs. Scale is often the culprit in such matters. Given the small amounts being loaned and fixed costs for executing each loan, small lenders will find it difficult to become profitable until they grow to an adequate size.

At this time, assessment of risk and return is at best uncertain, compromised by limited access to accurate information. For example, a recent report put out by the Warsaw-based Microfinance Centre found that only 511 credit unions responded to its performance

[6] Ibid., p.13.

[7] Sarah Forster et al, *The State of Microfinance in Central and Eastern Europe and the New Independent States*, CGAP Regional Reviews, 2003, p. 60.

survey. They reported on average that only six percent of loans were under- or non-performing.

Of the 588 NGO MFIs responding, only 4.05 percent were identified as at risk.

The 20 downscaling commercial and 10 microfinance banks reported a remarkably low percent of troubled loans: 0.37 percent and 0.69 percent, respectively.

Given the limited number of MFIs reporting and the likelihood that only those that are doing reasonably well would respond to such a survey, more research is necessary to more accurately discern delinquency rates and the actual percent of loans that need to be written off. More capital would likely flow into the region once lenders are more confident about risk.

Need to Expand Capital Access

MFI capital has been supplied through a variety of sources, ranging from outright grants to commercial loans and socially-motivated equity.

Between 1996 and 2001, the region's largest funding source was the European Bank for Reconstruction and Development. Its small business division supplied local MFIs with $310 million, or 38 percent of all capital that was flowing into the region. The World Bank raised $150 million and US AID another $115 million.

Germany's Commerzbank invested $20 million and the Citigroup Foundation raised $395,000. Deutsche Bank Microcredit Development Fund accounted for another $250,000, while BlueOrchard Finance invested $200,000.

However, microfinance operations are still significantly undercapitalized.

CGAP's director Elizabeth Littlefield observes that "with 95 percent of the region's microfinance demand still unserved, it will take committed, generous, and collective action to meet the area's low-income commercial financial needs. But such a commitment will enable these people to build assets, educate their children, seize opportunities, and chart their own paths from poverty to prosperity."

However, the potential of microfinance is seriously restrained by its lack of access to capital. When MFIs borrow, they would benefit from debt that is of longer maturities and quoted in local currency terms, which would eliminate the impact of depreciating exchange rates that frequently pushes up the cost of the loans.

According to the Microfinance Centre, many "MFIs have debt-to-equity ratios of 1:1 or less, suggesting a large capacity to leverage their existing capital base and increase the flow of commercial funds." At the same time, the Centre found that "most donors and commercial funders of all types expect to increase their funding of microfinance in the region over the next three years."

The main problem: while MFIs are seeking to diversify their capital base, with special focus on increasing commercial-debt financing and socially-motivated equity and debt investments, international funders do not see enough viable MFIs in the region.

Commercial lending would offer the quickest and least obstructed access to increasing capital. However, four key barriers interfere with the commercial flow of capital.

First, many MFIs lack operational and accounting transparency—keys to encouraging large, sophisticated institutions to seriously consider lending.

Second, lender perception of risks–political, macroeconomic, contract, collateral, supervision, management, competition, and currency–are often magnified again because local institutions frequently fail to adequately address them. And foreign sources of capital may not be inclined to expend the money and effort to discern the security of lending themselves.

Third, existing laws and regulations make it difficult for MFIs to borrow or transform into another legal form that can borrow more easily.

And lastly, certain donor practices work against enhancing the creditworthiness of MFIs, making it harder for them to secure commercial financing.

The region, therefore, doesn't suffer from a financing gap between the demand and supply of funds, but from these barriers that impede the flow of capital into MFIs from readily available funds from outside the region that are looking for a secure way in. As these barriers erode, the growth of microfinance funds flowing into the former Eastern Bloc is likely to accelerate.

About the MicroCapital Institute

The MicroCapital Institute is a non-profit organization supported entirely through private donations. Our mission is to educate financial professionals on the emerging asset class of microfinance. We offer a full line of research materials and presentations for investors and financial managers, including:

- Seminars
- Conferences
- Newsletters
- A Web site
- Industry Analyses
- White Papers and Special Reports
- Case Studies
- Individually Tailored Presentations

With offices in Boston, San Francisco and London, MicroCapital Institute comprises a team of research and finance professionals headed by Nancy Yonge. Dr. Yonge has more than 25 years experience in international investment and finance.

The MicroCapital Institute
1610 Sutter Street, #204
San Francisco, CA 94109
Tel/Fax: 877.669.5904
Email: **info@microcapital.org**