

RUSSIAN MICROFINANCE GROUP**Curriculum, Research and Outreach in Microfinance**

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1. INTRODUCTION TO MICROFINANCE IN RUSSIA**1.1. Microfinance for the poorest**

Microfinance has been established as a tool to reduce poverty all around the world. Many informational sources consider microfinance as a mean for small business support. However, this course distinguishes microfinance for the poorest from small business support.

The reason for choosing microfinance for the poorest proceeds from a great need for financial and educational support of the poorest in Russia. During the last ten years, numerous programs have been elaborated and implemented in order to support small business in particular. Nevertheless, the poorest, as a less appealing sector for investing money in comparison to small business, still remains undeveloped. The poorest are not able to get credits from any commercial credit institutions since they do not have enough collateral, and do not have running business.

To most, microfinance means providing poor individuals with small credits, or loans to help them engage in productive activities or to grow their tiny business.

Microfinance for the poorest is the relationship between microfinance institutes (MFIs) and poor borrowers, based on distribution of credits, or loans under terms of repayment, recurrency, and time.

MFIs offer financial and educational services to the poorest. Most MFIs for the poorest are noncommercial organizations committed to assist some sector of the low-income population. Their aims have social rather than business nature.

Typical microfinance borrowers are low-income individuals that do not have access to formal institutions. Microfinance borrowers are typically self-employed, often household-based entrepreneurs. In rural areas, they are usually farmers, and others who are engaged in small income-generating activities such as food processing and petty trade. In urban areas, microfinance activities are more diverse and include shopkeepers, service providers, artisans, street vendors, etc.¹

The poorest are those who have limited consumption, or income that does not allow them to satisfy their basic needs (food, clothes, lodging), and does not give them possibilities to get necessary social services (health, education, etc.)

The ultimate goal of microfinance is in the reduction of poverty by means of financial and educational support of the poorest. For the last several years, some international microfinance institutions, the Russian government, and other beneficiaries have been starting programs for support of the poorest in Russia. Their activities are of benefit to the sustainable development of progressive economy and competitive environment, unemployment rate decrease, as well as goods and services market enrichment in Russia.

By now, MFIs have succeeded in defining and general understanding the goals and objectives of microfinance for the poorest, in developing innovation credit techniques, in price managing, and in obtaining political and financial support. Nevertheless, microfinance for the poorest is only on the first stage of its development in Russia. There is a great need in learning and elaborating innovation credit techniques, and risk management methods when working with the poorest.

1.2.Demand for microfinance

Due to several surveys, there is a big demand for financial and educational support of the poorest with entrepreneurial spirit in Russia. Many poor individuals want to start their own businesses in order to support themselves.

Despite of numerous economic obstacles, micro-business development is one of the ways to solve social problems, create jobs, and cope with poverty. According to the Russian SME Resource Centre survey (2000), there are several segments on the Russian microfinance market: individual private entrepreneurs with low

¹ "Microfinance industry," Consultative group to assist the poorest (CGAP), http://www.cgap.org/html/mi_faq.html

incomes, micro-enterprises, and economically active poor population with entrepreneurial potential (including part of unemployed and low-paid individuals). Sizes of these groups are presented below. See Table 1.2.1.²

Table 1.2.1. Assessment Of Microfinance Demand In Terms Of Clients

No	Groups which demand microfinance services	Sizes of the groups which demand microfinance services, in terms of clients
1	Unemployed, total	Maximum: 1,900 thousand people Minimum: 830 thousand people
	Including	
1.1	Men	Maximum: 700 thousand people
1.2	Women	Maximum: 1,200 thousand people
1.3	Young people	Maximum: 69 thousand people
1.4	Former military servicemen	Maximum: 28 thousand people
2	Low-paid employed	Maximum: 6.1 million people
3	Individual private entrepreneurs	Maximum: 2,502.8 thousand people Minimum: 1,781,8 thousand people
4	Micro-enterprises	Maximum: 610 thousand enterprises Minimum: 426 thousand enterprises
	TOTAL	Maximum: 11,112.8 thousand clients Minimum: 3,037.8 thousand clients

As we can see, the market base for microfinance is large. All the groups have a great entrepreneurial potential. Specially, a women group potential (63% of all unemployed) should be stressed. Low-paid employed also is a considerable part of total microfinance demand.

For certain groups the demand for microfinance service was considered numerically. See Table 1.2.2.

Table 1.2.2. Assessment Of Microfinance Demand

Groups which demand microfinance	Monetary assessment of microfinance demand
Unemployed, total	Maximum: 250,040 million rubles Minimum: 103,750 million rubles

² Galina Yermilova. Statistical Review of Supply and Demand on the Microfinance Services Market in Russia. Russian SME Resource Center, Moscow

Individual private entrepreneurs	Maximum: 278,159.8 million rubles
Micro-enterprises	Minimum: 197,289 million rubles
TOTAL	Maximum: 528,199.8 million rubles Minimum: 301,039 million rubles

The survey shows that microloans were provided to only 13,000 -15,000 clients on the amount of about 52,000,000 US dollars. In other words, MFIs cover less than 1% of the potential microfinance market in Russia. The microfinance portfolio has to be increased up to about 7 billion US dollars to satisfy microfinance demand. This amount shows the large deficiency of microfinance services in Russia.

As the number of unsolved social problems grows, necessity of further micro-business development is becoming more and more obvious. A micro-business sector has limited access to loan funds through the traditional bank system. Banks' main concern is to increase their profits. Working with micro-business clients is too risky and takes too many expenses, and in many cases non-profitable. Thus, about 70 % of all Russian entrepreneurs have to use informal, very often illegal, fund sources. The situation is much worse in distant regions and rural areas with the concentration of the poorest.

1.3. Poverty in Russia

Poverty is a multi-dimensional social phenomenon. Poverty means absence of choices and possibilities that lead to normal way of living. In general, there are three definitions of poverty – in terms of income, or consumption, basic needs, and human potential development possibilities.

Income, or consumption defines poverty in the narrow sense. Individuals are considered as poor when their consumption is lower than a certain level, or living wage. *In Russia, living wage average was \$ 41,13 US dollars, January 2001.* That is a real poverty line. Individuals, who are on this line and below, look as the poorest, feel themselves like the poorest, and others consider them as the poorest. Those, who are below the poverty line, are not starving; but they have hard life. In a case of increasing payments for housing and municipal, they are not able to pay for that. Those, who live 1/3 under the poverty line, can afford to buy only food. They cannot buy clothes, pay for housing, municipal, education, and healthcare.

From a basic needs conception, the definition of poverty is broader. The basic needs conception proceeds from possibilities that society may give to individuals in order to prevent them from poverty. The conception is based on the

assumption that low-income individuals have means to produce a part of necessary products, or receive them as natural transfers. While the government satisfies other individuals' needs as free basic social services in health, education, and etc.

Third way of defining poverty comes from human potential development possibilities. Individuals do not have means to satisfy their basic needs in food, clothes, and lodging. Moreover, their access to health, education, and other social services is limited. In other words, possibilities of individuals are limited. Accordingly, poverty is considered as total absence of basic possibilities and individual development choices.

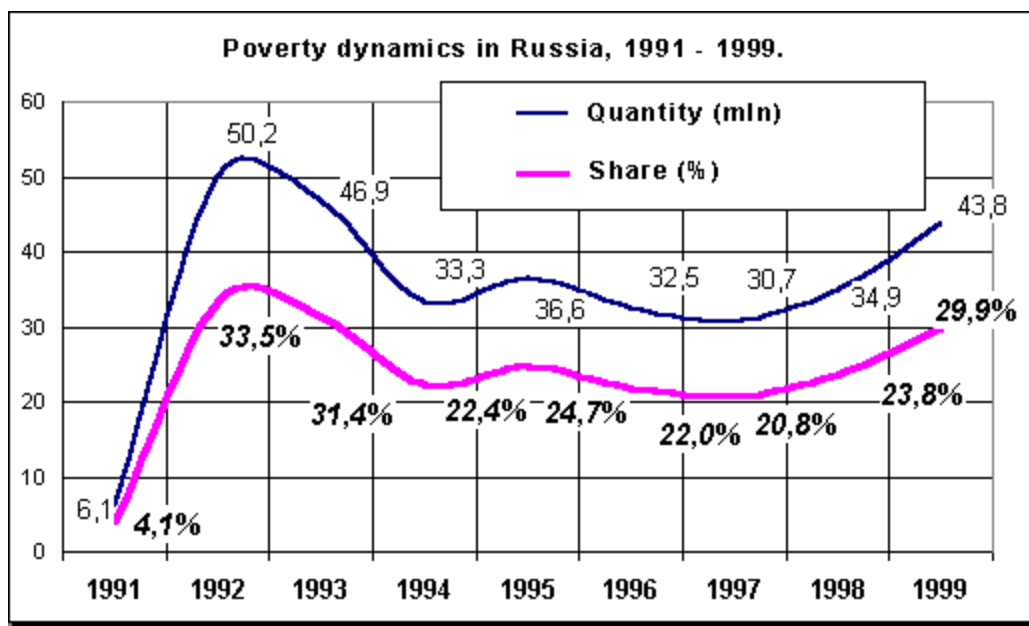
The third conception is the broadest definition of poverty. It takes into consideration consumption and basic needs as well as limited possibilities of individuals to satisfy their basic needs. From the human potential development possibility point of view, poverty can be defined as many-sided phenomenon.

As a result of economic disparity in distribution of GNP, poverty exists in any economic system. It only differs in terms of forms and extends.

In Russia, official poverty indexes represented by quantity and share of population with incomes lower than living wage. Living wage is determined on a quarterly basis in accordance with the Federal act "Living wage in Russian Federation."

In spite of relatively favorable changes in incomes of Russians at the beginning of 2000, poverty overcoming still remains one of the most pressing issues. Although economic stratification slowed down in 1998, a new crisis sharpened this problem once again. See graph 1.3.1.³

³ Marat Bargereev, "Poverty and means of social support for the poorest families," "Chelovek i trud" magazine, 01/2001.



Graph 1.3.1.

In comparison to 1998, in 1999 quantity of population with incomes lower than the living wage increased almost by 8,8 million people, and reached 43,8 million people (29,9% of total population). That is close to situation in 1992, when one third of total population became poor as a result of price liberalization.

Poverty is multi-dimensional. By providing access to financial services, microfinance plays an important role in the fight against the many aspects of poverty. For instance, income generation from a business helps not only the business activity expand but also contributes to household income and its attendant benefits on food security, children's education, etc.⁴

1.4. Reasons for poverty in Russia

Reasons for poverty lie behind a long socialistic period in the Russian history. Poverty existed in the soviet time as well. Main reasons for poverty in USSR were loss of a family provider, increased dependent burden on employed family members, poor health (disablement), and age. Also, low qualification, disparity of economic development among regions, and place of living (urban versus rural area). However, relatively full employment, free education and health systems softened the poverty problem.

Under the soviet system, the poorest individuals received different social benefits. *In total, 11% of the whole population was defined as the poorest in USSR (1985).*

⁴ "Microfinance industry," Consultative group to assist the poorest (CGAP)
http://www.cgap.org/html/mi_faq.html

As a result of transition to market economy, the poverty problem sharpened. The structural inadaptability of the Russian economy was one of the main reasons for poverty. Transition to market economy turned out as a difficult and traumatic process for population in Russia. It led to hyperinflation, decrease in GNP, and national income. Thus, society was divided into distinctive social classes.

Today, poverty in Russia differs from poverty in USSR not only by extent, but also by main characteristics. For many individuals, that is chronic condition, carried from one generation to another.

If in the Soviet period, mainly large families, youth, and rural population introduced the poorest. For the next ten years, the poorest pool replenished by unemployed, immigrants, marginal groups, students, pensioners, military personnel, employed by the government, and other employed.

Whole industries and regions are under normal life support conditions. In some cases, reasons for the poverty lay behind particular place of birth and living. As a result, in the beginning of the twentieth century, the poverty problem grew into society chronic condition in Russia.

1.5. Microfinance development

The idea of microfinance was transferred into Russia due to efforts of Organization for Economic Cooperation and Development (OECD), United States Agency for International Development (USAID), World Bank, European Bank for Reconstruction and Development, and others in 1996-97.

At the initial stages of transformation to the market economy, international organizations assisted in accelerating business growth. They supported legal privatization, and financial market development in order to reduce social problems and prepare basis for MFIs development.

Currently, MFIs provide both financial and educational services. Individual lending is more common for Russia. Some microfinance programs, besides individual, use a group-lending (or Grameen Bank) model. In many programs, group members independently determine structure of groups' participants, and even order of receiving loans. Exact forms of any program depend on a type of making decisions: under program manager supervision, or without it. Thus, microfinance programs not only include lending, but also benefit construction and development of society. Also, many programs provide technical support and consultation to their clients, such as trainings and seminars.

In spite of the various constraining factors, microfinance programs continue to start and develop in Russia. By now, that is already possible to speak about variety of such programs.

All microfinance service providers can be subdivided into banks, specific microfinance organizations, state funds for small business support, credit unions, and rural credit cooperatives. Program implementation through the Russian bank system is proceeded by European Bank for Reconstruction and Development, and is targeted on small business support, but not the poor. Thus, at the end of 1999, the total microfinance supply through the bank system is considered at the level of 40 million US dollars with 7.000 clients. These are loans, provided under the EBRD Program for Small Business Support in Russia. Most microfinance institutions are also interested in small, but not micro business support. Micro-business programs are less commercial, but more social. Therefore, micro-business programs meet more financial difficulties in their development since their objective is to receive social benefits. Due to the Statistical Review of Supply and Demand for the Microfinance Services Market in Russia⁵, currently, there are over 20 specific microfinance organizations operating. The total amount of their clients was about 13.100 (including commercial banks' data) in 2000.

Although many developing countries use microfinance for many years, Russia just started to adopt such a poverty reduction tool. There are several reasons for late microfinance development in Russia.

1.6. Reasons for late microfinance development

A transformation process to the market economy started with the collapse of the Soviet Union and the socialist system in early 1990's. The socialistic system prohibited private businesses and claimed to provide social equality. Therefore, there was no possibility for microfinance institutions to start. Also, the poverty level was not as high, as today. During the transition period, poverty has been growing. Russian and international communities began to feel the need for microfinance as a substitute for less effective state social programs. Though political and legislative environment is still not ready to let microfinance programs operate properly and effectively. Political uncertainty in Russia prevents international cooperation.

Today, microfinance organizations meet following constraints in their development.

First, lack of exact state policy and legislative regulation. This reason determines others. Federal program for entrepreneurship support considers a wide variety of

⁵ Galina Yermilova. Statistical Review of Supply and Demand for the Microfinance Services Market in Russia. Russian SME Resource Center, Moscow

sanctions to small business support. However, microfinance activities are less regulated; therefore, less protected. Contemporary system of legislative regulation does not give a definition and a status to microfinance.

Although many organizational forms are used by MFIs, formally only banks, state funds, and mutual credit unions are permitted to give out credits. Thus, MFIs have to deal with two important issues: necessity to get operational license and possibility to provide loans using credit sources.

Second, unfavorable tax climate. The Russian tax system defines grant funds as profit. Therefore, microfinance organizations have to pay taxes from received grants together with other duties. Formally, MFIs, as non-profit organizations, are unable to receive profits from their major activities. As soon as microfinance will be officially defined as a kind of social programs or non-profit activities

Third, lack of funds is also a serious issue. International foundations sponsor almost all Russian MFIs. Grant funds are very common on the first stage of MF-system development and they have a great advantage. They can cover huge initial costs of market entrance and administrative establishment. Though, grant funds also affect on competition environment since self-sustainable organizations have to compete with those non-sustainable, which receive grants. However, in the mid-term MFIs need to search for a source of credit funds. Therefore these MFIs have unbalanced position on the market. Especially, micro-loan programs for the poorest will hardly become self-sufficient using international donations. They need financial and governmental support from local and federal authorities.

Russian MFIs suffer from complexity of legislative and taxation systems. Some of them, sponsored by international organizations, are able to hire experienced lawyers and supervisors. Nevertheless, young MFIs that do not have such an opportunity, work in a minor position. Their operational expenses would dramatically increase with hiring professionals. Thus, there is obvious necessity to create microfinance resource centers. This center could process the whole amount of legislative information, concerning MFIs activities, to improve political and legislative environment for MFIs in Russia.

1.7. Entrepreneurship and microfinance in Russia

Entrepreneurship is a form of social relationships that contributes to economic and spiritual potential of any society, creates favorable conditions to practical realization of individual capabilities and talents, and favors nation unity.

Microfinance for the poorest is closely related to entrepreneurial spirit and entrepreneurship as a whole. In order to get credits for developing and implementing any business ideas from MFIs, individuals should have enough entrepreneurial potential.

Degree of entrepreneurial potential is complicated to measure. That is an aggregate form of given education, knowledge, skills, risk-taking, creativity, and inborn talents of individuals. Entrepreneurial potential risk is hard to manage. In most of cases, MFIs take great risks giving out credits to the poorest in terms of entrepreneurial uncertainty.

In comparison to other developing countries, Russia has much higher rate of education. Many poor individuals have high enough education to start and manage their own small businesses successfully. Certainly, in order to get credits they need special educational support from MFIs; particularly, in procedures of getting credits, general understanding of how to start and run businesses.

Lack of education in crediting issues among poor individuals in Russia should be stressed. Many of them consider microfinance as a troublesome way of getting necessary financing, which takes much time and efforts. However, through the process of educational support the poorest get into close contact with MFIs and obtain basic knowledge necessary for starting their businesses.

Not all poor individuals have practical skills in business activities. A long period of the socialistic planned economy slowed down entrepreneurship development in Russia. Individuals were not allowed to have private property and business. Entrepreneurship was considered illegal and reproached. However, for the last ten years of transformation to the market economy, many Russians have learned basic skills in business activities.

For this period of time, Russia has been facing changes in mentality. Market economy changed people on a personal level. Many individuals became more market and business oriented, individualistic, rational, and obtained entrepreneurial spirit.

Most of the poorest are risk takers by nature in Russia. Also, they do not have much to lose; therefore, they have higher degree of risk taking.

In terms of inborn talents, the Russian nation always was extremely talented and creative. Currently, a great number of talented people live under the living wage. Although concatenation of unpredictable circumstances lead many of them to poverty, they possess and ready to implement their innovative ideas.

Therefore, taking into account the current aggregate form of given education, knowledge, skills, risk-taking, and inborn talents of the poorest in Russia, there is a great potential for microfinance development.

1.8. Business ethics and microfinance in Russia

The worldwide economy development corresponds with principal concerns to business ethics aspects. Developed countries, which had high economic and legal standards, were the first in the reinforcement of an “ethics component” in business relations.⁶ Gradually, other countries became aware of business ethics importance.

The level of business ethics in Russia interconnected with the development level of Russian economy, society and culture. For the last ten years, Russian people experienced big changes in economical, social and cultural aspects. That eventually resulted in decreasing business ethics standards.

For many Russians, business ethics lost significance at some point. In many cases, the meaning of trust and honesty, responsibility and obligations did not take into consideration. People did not know whom they might trust. For example, most micro- and small business organizations asked for full prepayment for any transaction. Transactions entailed a great deal of paper work in terms of attested contracts and agreements.

During initial stages of transition to the market economy, low business ethics standards slowed down economic and social development, as well as impeded investment flows into Russia. Foreign investors, particularly in microfinance, had huge risk investing their money into creating mutual MFIs.

However, society does not stay in stagnation in Russia. For the last several years, situation has changed for the better. Most micro – and small business organizations learned advantages of trust and honesty, responsibility and obligation performance in business. They became more consumer oriented, and entered into relationship with permanent partners. Thus, awareness of ethical aspects in business meets interests of micro- and small businesses, as well as society as a whole.

Business ethics plays an important role in relationship among MFIs and their borrowers. Business ethics, in terms of mutual trust, honesty, responsibility, and obligation performance, is closely related to microfinance. Borrowers, especially the poorest, need to prove their high standards of business ethics in order to get financial support.

Taking into consideration current changes to better business ethics climate, MFI’s still should be aware of unethical behavior possibilities, especially, with the poorest. In order to eliminate risk of unethical behavior, MFI’s should use personal approach to their borrowers. Russian borrowers tend to be more receptive on a personal level. That’s why involving family and relatives, as

⁶ Alexander Pavlenko, “Business ethics: USA experience,” 2001
http://www.rbcnet.ru/comm/tpv_news/2903011804/31.htm

guarantees in the process of could be a positive factor for borrowers' ethical behavior.

Therefore, positive changes in the Russian business ethics climate lead to favorable environment for MFIs. Taking into account Russian mentality, MFIs personal approach to their borrowers decrease risk of unethical behavior.

1.9. Microfinance in Russia: resume

Based on the analysis of microfinance for the poorest in Russia, following conclusions are made:

- Microfinance means providing poor individuals with small credits, or loans to help them engage in productive activities or to grow their tiny business.
- Microfinance for the poorest is the relationship between microfinance institutes (MFIs) and poor borrowers, based on distribution of credits, or loans under terms of repayment, recurrency, and time.
- MFIs for the poorest are aimed on the reduction of poverty by means of financial and educational support of the poorest. Their aims have social rather than business nature.
- Typical microfinance borrowers are low-income individuals that do not have access to formal institutions.
- The poorest are those who have limited consumption, or income that does not allow them to satisfy their basic needs (food, clothes, lodging), and does not give them possibilities to get necessary social services (health, education, etc.)
- Ultimate goal of microfinance for the poorest is the reduction of poverty by means of financial and educational support of the poorest.
- There is a great need in leaning and elaborating innovation credit techniques, and risk management methods when working with the poorest in Russia.
- There is a huge demand for microfinance in Russia.
- Poverty is a serious problem in Russia; one third of total population lives under the living wage.
- Main reasons for poverty in Russia formed in the socialistic period.

- Structural inadaptability of the Russian economy was one of the main reasons for poverty.
- Late microfinance development in Russia is due to lack of state policy, legislative regulation, funds and unfavorable tax climate.
- In order to get credits for developing and implementing any business ideas from MFIs, individuals should have enough entrepreneurial potential.
- MFIs' borrowers, especially the poorest, need to prove their high standards of business ethics in order to get financial support.
- Positive changes in the Russian business ethics climate lead to favorable environment for MFIs.
- Taking into account Russian mentality, MFIs personal approach to their borrowers decrease risk of unethical behavior.