



The Development of Credit Unions in Belarus

Summary

This paper deals with the development of credit unions in Belarus. Our analysis reveals that inadequate regulation is currently the major problem hampering the development of this type of financial institution. Therefore the paper focuses especially on ways of introducing better standards for the reliable operation of credit unions, and looks at the optimal balance between prudential and non-prudential norms of regulation. In addition various issues related to the reliable operation of credit unions are discussed. We come to the conclusion that a range of amendments to the current legislation is needed. Specifically, it would be best to define financial cooperation as a type of activity that should be subject to prudential regulation and supervision only above a certain level of capital and/or membership. Furthermore we analyze the most effective approaches to supervision in this sphere. We recommend that the National bank of Belarus should be the body responsible for supervising credit unions, but we also suggest that there should be some different approaches compared to banking regulations. Finally, we point out several aspects in the non-prudential sphere that should facilitate the development of credit unions and increase the incentives for potential members to join.

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1. Introduction

Credit unions¹ are a widespread type of financial institution, found all over the world. In Belarus credit unions attract special attention mainly because they are treated as a type of micro-finance institutions (MFIs) that can improve access to financing for small businesses (SB), either small enterprises or individual entrepreneurs. The need to provide financial services for SB development is clearly announced in the "Concept of State Support for small business for 2006" and other state documents. Current Belarusian legislation allows the creation of legal entities that may be associated with credit unions as defined internationally. However, this special type of MFI that is supposed to be more attractive than other MFIs has not demonstrated any real trend for growth and development in Belarus. Belarusian officials and various researchers have proposed several reasons for this, ranging from a low real need for improved access to finance by SBs to the unlikelihood that MFIs can effectively compete with banks.

Thus, in this paper we deal with the perspectives for credit unions in Belarus and their possible impact on the development of small business entities. The structure of the paper is as follows: Section 2 briefly reviews how credit unions function and their role within financial systems in international practice. Section 3 deals with the Belarusian situation: we focus on an analysis of the demand for micro-finance products and services, consider the legal issues of credit cooperation in Belarus, and define the main problems and perspectives for credit union development. Section 4 analyzes the issue of adequate regulation and supervision of credit unions, while recognizing the necessity of their effective and safe development.

2. The function of Credit Unions as a Part of the Financial System

The main principles of credit union operation - and hence its clientele, portfolio and liabilities - exhibit strongly specific features (see Appendix 1).

One basic tenet of credit unions is that they should to a large extent be deposit-oriented institutions. Credit unions are supposed to be largely self-sufficient organizations, which assumes no (or a low share) of donor funds. The legal organizational form in which such an activity can be carried out varies from country to country, however its core mechanism and economic direction remain the same, irrespective of the legal framework. Credit unions exploit the mechanism of financial intermediation by supporting "poorer" clients that are otherwise "unbankable". Given this mechanism, we can list some further features peculiar to credit unions based on the experience within the Central and Eastern European and Central Asia (CEE and ECA) region.

1. The main source of loans is borrowed capital, i.e. deposits by the credit unions members².

¹ In international practice there are several forms/definitions for financial cooperative organization: credit unions, credit and savings cooperatives, cooperative banks, etc. WOCCU (World Council of Credit Unions) defines credit unions as follows: "A credit union is a cooperative financial organization owned and operated by and for its members, according to democratic principles, for the purpose of encouraging savings, using pooled funds to make loans to members and providing financial services to enable members to improve their economic and social condition". In the Anglo-Saxon world such organizations are generally called "credit unions". The term assumes physical entities (salary receivers) to be the owners of the credit union. They focus mainly on social purposes. The term "cooperative" is more widely used in continental Europe. This term assumes the form of an economic organization, where independent economic agents, who among each other are competitors, cooperate in one or several types of economic activities aimed at improving the effectiveness of all their enterprises. In this case, the owners may be either physical or legal entities (SBs, farmers, etc.).

² According to research conducted in 2004 by the Microfinance Centre for Central and Eastern Europe and the Newly Independent States, the share of member deposits in the liabilities of credit unions was about 80%. Another deposit-oriented MFI type – micro-finance banks – had a 48% share of deposits in liabilities (18% shareholders' equity, 14% concessional loans, 15% commercial loans, and 5% other sources).

2. Credit unions are leading deposit collectors among MFIs in absolute terms. They deal with 73% of all depositors attracted by MFIs in the region, which in absolute terms amounts of more than 3 m depositors. In 2004 they attracted 59% of all MFI deposits, or about USD 1.7 bn.
3. Credit unions are leading MFIs in terms of the number of borrowers and their gross loan portfolio. Credit unions in the region deal with 69% of all MFI borrowers, which in absolute terms amounts to more than 2.3 million borrowers. They have the largest gross loan portfolio with a share of 40% among all MFIs, or more than USD 1.6 bn in absolute terms.
4. Credit unions supply the most diversified range of financial products (mainly different types of loans) and they have the biggest share of consumer loans in their loan portfolio.
5. Credit unions are the most numerous type of MFI within the CEE and ECA region. Of 6541 MFIs in this region, 6342 were credit unions in 2004.
6. Credit unions deal with the smallest and most "unbankable" clients, which explains why they have the lowest average volume of transactions among MFIs. In this region in 2004, the depth of outreach³ value for credit unions was only 28%, while for NGOs and NBFIs it reached 80%, for micro-finance banks 209%, and for down-scaling banks 332%.
7. Interest rates for credit union loans might be higher rather than those of banks. Credit unions usually try to maintain interest rates on deposits close to those in the banking sector. In consequence, interest rates on loans usually need to be higher than those of banks. But the important aspect for the borrowers is that access to financing itself, as well as some of the conditions extended to members of credit unions, may be more economically significant than the exact level of the interest rate.

These specific features delineate the operations of credit unions. It must also be stressed that in contrast to other MFIs, credit unions do not only aim at (and certainly not exclusively) at promoting the access of SBs to finance. A range of social goals, such as: satisfying the financial needs of "unbankable" clients, establishing conditions for self-employment, promoting regional, local and rural development are also priorities for credit unions.

3. Credit Unions in Belarus: Problems and Perspectives

3.1. Recent Trends concerning Access to Financing by Small Businesses

The Belarusian financial system may be recognized as an almost 100% bank-based one. In recent years the banking sector has shown more interest in dealing with small business entities⁴. In part this was caused by the new instruction "On granting funds in the form of loans and their repayment" that took effect on July 1, 2004. This act now defines micro loans as loans of less than 7500 base units⁵, and gives banks the right to grant such loans according to simplified procedures, which the banks can define themselves. Nevertheless, the opportunities presented by this act have not eliminated the following problems when granting loans to SBs⁶:

As for non-governmental organizations and non-bank financial institutions belonging to MFIs, they based their activities on grants (47% of liabilities) and shareholders' equity (6%).

³ The relationship between average loan size and GDP per capita in a country.

⁴ The volume of granted loans (flow) during last years has increased substantially. In 2004, it was BYR 670 bn, in 2005 it amounted to BYR 1,406 bn, and for January to June 2006 it reached BYR 847 bn.

⁵ The ceil limit is about EUR 83,000.

⁶ According to an IPM poll of SBs carried out in 2003, entrepreneurs listed lack of collateral, inflexible loan contract conditions (the schedule for repayment of interest and principle) and high interest rates as the main obstacles to borrowing from banks.

- Lack of collateral;
- Flexible conditions for access to capital and more flexible borrowing conditions (i.e. the repayment schedule for interest and principle);
- A wider range of financial products with different charges and periods.

New institutional forms of lenders could be competitive if they were able to solve the problems peculiar to bank loans. We suppose that even in the Belarusian case of bank domination, at least an option to provide alternative sources of finance (MFIs) should be established, and then the market could determine the most competitive type of lender. In the case of credit unions, proper regulations, which are currently quite inadequate, must be enacted to enable such competition.

3.2. Current Regulations and Activities in the Financial Cooperation Sphere

The operation of credit unions is legally defined by the Civil Code, which specifies two major aspects: First, it permits two legal organizational forms: production cooperatives and consumer cooperatives. The former belongs to the range of commercial organizations and assumes joint working activity by its members. The second one belongs to the class of non-commercial organizations and assumes a merger of either physical entities, or of juridical entities with physical entities for satisfying their material needs by means of pooling their funds. Secondly, the Civil Code regulates the relationship of borrowing, defining it as belonging to the civil sphere, provided both agents are legal entities without bank status⁷.

The second level of legal regulation is a law "On consumer cooperation". It expands on the issues defined in the Civil Code and regulates the activities of consumer companies⁸ (other cooperatives and specialized cooperatives are not subject to this law), which are established in the legal form of consumer cooperatives. It also allows both physical and legal entities to be members of a consumer cooperative. The law does not mandate financial cooperation for consumer cooperatives⁹. The legal rights of such cooperatives are only limited by the statement that consumer cooperatives may "carry out any other type of activity that is not prohibited by legislation of the Republic of Belarus". Furthermore according to this law, consumer companies are allowed to: borrow funds from legal and physical entities; to create special company funds according to Belarusian legislation; to carry out other types of activities aimed at satisfying the needs of their members and of the population at large. On the one hand, the above-mentioned legal points allow consumer cooperatives to be established, which are credit unions in the economic sense. On the other hand, the rather universal legal

⁷ The Belarusian legislation makes a distinction between relationships of borrowing and loan agreements based on the criterion of the legal entities taking part in the transaction. The relationship of borrowing is broader and is defined as granting funds by the lender to the borrower, while the latter enters an obligation to repay. According to the Civil Code a relationship of loan exists when one of the entities taking part in the transaction is a bank or an NBFi. These loan procedures are regulated by the norms of both the Civil Code (in the parts relating to borrowing) and the Banking Code. Furthermore, a bank is defined as a legal entity established in the form of a joint-stock company or a solely entrepreneurship, which in accordance with its license has a right to perform deposit transactions, open and manage accounts of physical and legal entities, and enter into loan transactions. An entity carrying out a number of individual banking transactions (as defined in the Banking Code), but not all of those ones stated above could be recognized as an NBFi. Both banks and NBFis are treated as being subject to legal banking relationships and their activities are regulated and supervised by monetary authorities. Other legal entities are not treated as being subject to the Banking Law, and are free from all prudential or non-prudential regulation by monetary authorities.

⁸ The term consumer company is not treated as a legal form, but is used to characterize the directions and goals of the activity and hence should be a part of the name of the consumer cooperative. It could be organized only in the legal form of a consumer cooperative. Since the definitions of consumer cooperative and consumer company are completely identical this might lead to interpretation difficulties.

⁹ The mandates concerning consumer cooperatives are: establishing wholesale or retail trade, catering, production of agricultural goods, providing services and certain others.

tenor of the regulation of cooperative activities, which lacks any individual specification for financial cooperatives, leads to many operational ambiguities, and to a poor understanding of credit union activities. Furthermore, this weak legal base that does not point out that financial cooperatives are a special type of economic activity, causes certain other laws that are not concerned with the specific features of financial cooperatives to affect this activity. More specifically, article 20, part 8 of the law "On personal income tax" stipulates that if a legal entity loans funds to a physical entity, then the legal person must pay personal income tax for the physical person (20% of the borrowed sum) on the day after the funds have been borrowed. These tax payments will later be repaid to the legal entity according the schedule for repayment of principle and interest on borrowed funds.

The third level of regulation in regard to financial cooperation is Government Regulation No. 1972 "On mutual crediting organizations for small business entities". This Regulation does not origin from the legislation on financial cooperation, but relates to the problems of small businesses. This document has almost no connections with the law "On consumer cooperation", but concerns the law "On state support for small businesses in the Republic of Belarus" and is aimed at promoting and developing additional instruments for improving access to financing by small business entities. Regulation No. 1972 focuses explicitly on the idea of just financial cooperation. It stipulates the following issues:

1. Small business entities (either juridical persons or individual entrepreneurs) have the right to establish mutual crediting organizations (MCO) in the legal form of consumer cooperatives. There should be at least 20 members establishing an MCO;
2. The members of an MCO should belong to one administrative unity (city, area, oblast), i.e. a regional criterion is stipulated for MCO activities;
3. Financial cooperation is achieved through loaning funds (free or at interest rate) to the members of the MCO. Also, MCO members have the right to loan temporarily free funds to the MCO, i.e. to make deposits;
4. The maximum amount of funds loaned to individual member cannot exceed 20% of the MCO's equity;
5. The capital of an MCO is provided through the pooling of funds (initial deposits) by members. The minimum initial deposit for any member is EUR 300¹⁰. This deposit must be repaid to the member whenever he leaves the MCO.

This Regulation may seem to be rather useful, since it introduces needed regulations for financial cooperation, which are missing in the law "On consumer cooperation". However, the law "On consumer cooperation" and Regulation No 1972 are motivated by entirely different goals. The former aims to clarify issues concerning the Civil Code with respect to the activities of all legal entities established in the form of consumer cooperatives. It defines basic provisions for all types of consumer cooperatives, but does not contain specifics regarding financial cooperation. The Regulation, on the other hand, aims at promoting the access of small businesses to capital according to the law "On state support...", and here the idea of financial cooperation has been chosen as one means of achieving this. The Regulation focuses only on small business entities without paying any attention to the needs of the underlying physical entities. As stated above (see Section 2), and in contrast to other MFIs, the social goals to be achieved by credit unions and hence the role of households, are quintessential. This basic idea leads to the practice that household deposits are usually the major source

¹⁰ As of July 1, 2005 the Presidential Edict "On granting and using free (sponsor) assistance" makes the possibility of using other sources of capital like grants almost impossible for MCOs, since the edict limits the purposes and ranges of organizations that may receive such grants.

of the liabilities of credit unions. Yet, because of the way the Regulation is written, there exists a very peculiar situation in Belarus. On the one hand, there exists a legal opportunity to establish household credit unions - households are after all where the majority of potential savers are concentrated. On the other hand, small business entities can also establish their own credit unions (without households), and in these credit unions would be concentrated the majority of potential borrowers. This might indeed be a strategic mistake: an artificial barrier between borrowers and savers has been erected, while (see Section 2) the financial cooperation mechanism assumes that loans should be primarily granted at the expense of borrowed funds (deposits) rather than equity capital. Moreover, credit unions have limited access to large equity capital pools - their members are motivated by their own benefits. Creating large amounts of equity capital through initial deposits that does not generate an interesting level of interest income is an unlikely event.

3.3. Directions for Improvement

Belarusian analysts have enumerated the following main obstacles to the adequate functioning of credit unions¹¹: the large amount of initial deposits required, the large number of members needed, limiting the maximum loan to any one borrower, the low motivation of entrepreneurs to attract borrowed funds, the non-commercial juridical form of consumer cooperatives, which does not allow for profits to be shared out among their members, the low level of knowledge about this financial instrument among entrepreneurs, the limited financial products and services that are allowed to be supplied by credit unions, the regional limit principle (a few other joint characteristics should also be permitted), and unclear regulations. However, in our opinion it is more urgent yet to consider the strategic points that have been stressed above. These issues, reflected in the current regulations of credit union activities, hamper their further development. Hence we believe that proper regulation is the core necessity for credit union development in Belarus.

As shown in Appendix 2 the lack of resources for providing funds to SBs is peculiar to MCOs, and a concentration of consumer loans is peculiar to household credit unions. This situation reveals that the goals for financial cooperation in Belarus should be revised. We agree that the promotion of SB access to capital is a priority goal. But a similarly important goal should be to provide incentives to households. In our opinion, the possibility should be provided for households to possess an additional instrument for savings, i.e. deposits in credit unions. Furthermore credit unions should also satisfy the households' needs for financial products by promoting self-employment. Only in the case when both of these goals are united we can achieve the first goal. By uniting MCOs and households we link borrowers and savers, they can then both co-exist in one market. **Thus we strongly recommend that private households and small businesses be allowed to be members of the same credit unions, i.e. measures directed at abolishing their separation should be taken¹² through a number of legislative measures.**

¹¹ This discussion is primarily concerned with mutual crediting organizations, while the issue of promoting small business access to financing is more vital.

¹² One could argue that credit unions will not be able to compete for household deposits with banks under Belarusian conditions, because the banks have widespread networks of subsidiaries and greater possibilities to access any potential customer. The counter argument would be that banks and financial cooperatives deal with different segments of customers, and that financial cooperatives "develop" future customers for banks. In our opinion, there is no single answer to this question, and an actual experiment might be the best solution in this case. This means that providing the possibility of attracting deposits to financial cooperatives should not aim at creating competition between banks and financial cooperatives, but should create an environment for such competition whether it will take place or not, which is difficult to predict.

Having stated that there should be credit unions in which both SBs and households can be members we face the problem of adequate supervision, as attracting funds to deposits is a socially significant function that needs to be properly regulated and supervised.

4. Regulation and Supervision of Credit Unions

There are two types of regulatory measures: prudential and non-prudential ones. Prudential regulation is usually aimed at two purposes: (i) to protect the stability of the financial system, and (ii) to protect the depositors. Non-prudential regulation, which defines the accessible sources of funding, the mechanisms of activity, accessible operations, etc. is required to provide the legal grounds for safe and sufficient financial cooperation of the activities of credit unions. Non-prudential regulation is effective in this case (shaping the mechanisms of financial cooperation) and at the same time rather “inexpensive” since it does not presume permanent supervision and control. In addition to the above, prudential regulation also assumes certain economic norms and suggests criteria to define the meanings of solvency and profitability of the organizations. Prudential regulation as a rule assumes respective supervision to insure that these criteria are met and the goals pursued. If there is a danger that an institution does not meet its obligations, which could reduce the safety of the financial system or/and affect the depositors of the funds, then the regulated criteria should clearly signal this, and the supervisory body should take measures to limit the activities of the institution. Hence, prudential regulation is much more “expensive” than non-prudential one. At the same time it constrains certain other operating conditions of the institution (e.g. licensing). Since some of the goals of prudential regulation can also be achieved through non-prudential measures, it will be our task to define the optimal balance between prudential and non-prudential regulations with regards to credit unions in Belarus.

4.1. Prudential Regulation: Is it reasonable for Credit Unions?

Our belief in the necessity to attract deposits into Belarusian credit unions immediately raises the question of the expediency of establishing prudential regulation in Belarus. According to the internationally recognized “Guiding Principles on Regulation and Supervision of Micro-finance” issued by CGAP¹³, as soon as an MFI begins to attract deposits it should be subject to prudential regulation and supervision. There are two basic considerations: (i) once an MFI starts to collect deposits it can increase (up to a substantial level) its share in the whole financial system, and hence problems within the MFI may lead to problems in the entire financial system; and (ii) any depositor, irrespective on the sum deposited and the type of counteragent (i.e. the type of financial institution), has an equal right to protected savings. Moreover, there is the possibility of moral hazard when one type of financial institution is subject to regulation while another with similarly accessible operations is not. Yet, if every institution collecting deposits needs to be subject to prudential regulation this may lead to very expensive procedures for the supervisory body, especially so, since by common knowledge, the lower the scope of financial activity – the more expensive its supervision. Furthermore, the norms of supervision and certain requirements (say, regarding the minimum amount of capital) may lead to liquidation or may prevent the establishment of such institutions. In contrast, we are interested in developing credit unions exactly in those segments, where banks are not effective, and hence by default there should not be a high number of turnovers. Also, if this sphere is fully regulated by prudential norms, this may lead to informal financial cooperative mechanisms being established, in which the risks for depositors may be much higher than in formal, but not prudentially regulated MFIs. Thus the commonly accepted principle in this regard

¹³ Consultative Group to Assist the Poor, http://www.cgap.org/docs/Guideline_RegSup.pdf.

is that **credit unions that attract household deposits should be subject to prudential regulation, except that small regional organizations with fewer members and/or lower capitalization than defined by the regulatory body should be exempted.**

According to the practice of financial supervision a credit union attracting household funds should be licensed by a regulatory and supervisory body. This means that credit unions above a defined level of capital and/or membership will have to be licensed. The thresholds beyond which a credit union should be licensed and be subject to prudential supervision should, in our opinion, be defined by the potential supervisory body. In choosing this threshold two criteria might be considered: (i) above which level of capitalization of the credit union will this body be able to supervise them, without a substantial increase in the cost of supervision; and (ii) above which level of credit union capitalization would the entire financial system be significantly affected? As for the second goal of prudential regulation – the protection of savers – we believe that all depositors of unlicensed credit unions must be provided with detailed information to the effect that their savings are not supervised and that the government or any other bodies are extending no guarantees. As for the question of who should provide the regulatory and supervisory functions, we believe the answer is rather evident: only the National bank of Belarus (NBB) has sufficient competence and experience, especially in its banking supervision department. **Hence we recommend that the regulatory and supervisory body for credit unions should be the NBB.**

One more question in this regard is vital for Belarus: how to provide these norms within the Belarusian legal environment. As stated above the Belarusian Banking Code defines two types of legal entities subject to banking regulation and supervision: banks and NBFIs. For both of them there is a minimum authorized fund requirement of EUR 5 m (for banks accepting household deposits it is EUR 10 m). Certainly, credit unions cannot have the status of a bank or NBFIs under this definition, since the scope of their activities and the amount of equity capital held is much less. We therefore support the CGAP's "Guiding Principles..." recommendation that in certain cases it is more practical to legislatively define not the agents under regulation, but the activity under regulation. In our opinion, all the requirements mentioned may be implemented through the following scheme: **First, to introduce a special regulation under and within the law "On consumer cooperatives" to define financial cooperation as an economic activity that provides micro-loans to SBs and households and collects deposits either from households or SBs. Second, the banking legislation should stipulate that legal entities whose main activity is financial cooperation will be subject to licensing and supervision by the NBB above a defined minimum level of capitalization and/or membership.**

4.2. General vs. Special Prudential Regulation for Credit Unions

There is a much discussion about which prudential norms should apply to credit unions, whether the same ones that apply to banking supervision or specifically designed standards. The main argument for identical standards is that should the regulations for financial cooperation be less strict, then opportunities might appear for fraud and moral hazard by other agents in the financial sector. At the same time the evident specifics of micro-finance and financial cooperation should be recognized by special prudential norms. The general consensus is that for credit unions there should be a narrower range of prudential norms, which assumes simpler reporting rules because of their smaller scale, i.e. only the most urgent prudential norms should apply to credit unions. The importance of each of these norms should be based on the experience of credit union activity and may be either more rigid or less so than for banking activities. According to the CGAP "Guiding principles..." the following criteria for prudential regulation should relate to financial cooperation:

- Minimum capital requirements. As stated above, this level should be set high enough so that the supervisory authority is not overwhelmed by more new institutions than it can supervise effectively. At the same time it should cover all institutions that may cause substantial financial system distress or socially significant deposit crises;
- Capital adequacy. This is one of the most important indicators and there may be two strictly opposite approaches: Its value may be set more rigidly than for banks – or alternatively softer than for banks. The main argument for the first approach is that the credit portfolio of credit unions is more poorly collateralized and even blank loans may take place in this case. Because of this a very rapid and dramatic worsening of the credit portfolio may ensue. We also showed above that the costs of micro-finance technologies are as a rule higher than are standard banking administrative and overhead costs. These higher costs may have to be offset by substantially higher interest rates. In turn, higher interest rates may be the cause of higher credit risks, which may lead to faster de-capitalization of credit unions as compared to banks. Also any member of a credit union may leave the organization at any time, which means he has to be repaid his part of the capital, which again decreases the capitalization. And finally, this sphere is rather new for Belarus, which means that experience and competence for managing credit unions is lacking, which also undermines their reliability. On the other hand, one could argue that non-performing loans are less common in credit unions, due to the trust principle. Also high capital adequacy standards may undermine the competitiveness of credit unions. Considering all these arguments together we propose that the value of capital adequacy should initially be set at a level somewhat above the banking level. Once credit unions have gained experience and can demonstrate their abilities to operate profitably, this level could be lowered;
- Special reserves for non-performing loans. Because many credit unions loans have limited collateral or are based on sureties it may be necessary to create adequate reserves analogue to banking practice. International practice shows that the requirements for creating these reserves and norms and the allowable risk values for loans should be less strict than for banks. This follows from the specifics of financial cooperation (See Appendix 1). It is thus more expedient to define the moment at which it is necessary to create such reserves at the time when a borrower has failed to pay according to schedule (and not earlier), while the coefficients for different groups of loans should remain less strict.

A number of other criteria may need to be determined (especially in the early stages of development of credit unions): liquidity ratio(s), expansion control ratios, maximum risk with any one borrower, etc. **However, it is strongly recommended that prudential regulation criteria should be introduced based on the activities of existing and developing credit unions, and that they should be corrected to reflect their performances.**

4.3. Non-prudential Regulation

The function of non-prudential regulation for credit unions is to provide the legal background and incentives for their activities. According to our strategic recommendation it should be permissible for SBs and households to co-exist within the boundaries of the same credit union. Two options are available: to introduce a new regulation replacing Regulation No. 1972, which will authorize this type of organization, or to enact an additional Regulation that allows MCOs and household credit unions to establish joint upper level institutions (both being juridical persons). In our opinion the first option more closely coincides with the main idea of credit cooperation. Establishing credit unions of the upper level somehow maintains the artificial barrier between savers and borrowers, only partial allowing them the possibility for mutual transactions.

Furthermore, the way of how to subject credit unions to supervision and how to insure safe and effective operation would be more difficult to establish in the second case. **Therefore we recommend canceling Regulation No. 1972 and enacting a new Regulation "On financial cooperation", probably under the Law "On consumer cooperation", which would define financial cooperation as an economic activity, which supposes granting micro loans and collecting deposits, and in which both households and SBs have a right to be the members.**

According to the suggestions of those agents who are currently involved in this activity we also support that a few additional features be introduced in the new regulation. **First, to avoid the problem of forming a capital base, the minimum amount of EUR 300 should be repealed. Rather, the limit should be determined individually by each credit union, subject to a minimum of EUR 100. For the same reason we propose to reduce the current minimum membership from 20 to 10.** Also, other criteria for membership in any one NGO should be added to the regional criterion (e.g. entrepreneurships, unions, etc.). **Finally, to decrease volatility we strongly recommend that the new regulation mandate that a member's initial deposit may not be reimbursed immediately upon leaving the credit union, but only after a certain period of time (preferably one year, which is adequate according to international practice).** This measure is unlikely to substantially lower the motivation of potential members, as credit unions are seen to be based on trust between members who are entering into a long-term financial cooperation. At the same time it would significantly strengthen operational security, prevent a possible sudden decapitalization, and help the credit union to maintain its capital adequacy requirements.

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Appendix 1. Aims and Main Principles of Credit Union Operations

Credit unions are not aiming at maximizing their profits but at providing economic stability and ongoing development through a relevant capitalization of assets. This principle of "servicing" the capital is one of the main characteristics of credit unions, which distinguish them from other juridical forms. Their priority goal is to facilitate the economic activities of their members. However it should be stressed that they are nevertheless financial institutes same as many other agents within the financial sector of the economy.

Credit unions are established and work according to the following principles:

- Self-assistance, self-government, self-control.
- Voluntarism (voluntary entrance and leaving the union).
- Local principle (the sphere of activity usually is regionally limited).
- Free membership (anyone can join the union if his/her interest complies with the interests and aims of the union).
- Identity (all members are owners and clients at the same time; products and services of the union may be consumed only by owners; minimization of service costs).
- Democratic principle (independence and self-governance; the union is based on the democratic principle of "one member – one vote"; the governing bodies are elected and subject to general meetings open to all members).
- Solidarity (subsidiary responsibility of the owners for the union's liabilities).
- Cooperation within the built system* (united in unions and associations, establishing their own cooperative banks and cooperative insurance companies).

* A cooperative structure is at the core of organizational and economic power of such systems. The following specific features are characteristic of it:

- Self-governance;
- Decentralization and a widely branched structure;
- Close relations inside the system within local and regional levels;
- Integration into a joint system based on the principles of mutual assistance and mutual control.

Appendix 2. Present Practice of Belarusian Credit Unions

Mutual crediting organizations. The Ministry of the Economy provided the impulse for developing such organizations in the interest of developing small business. However, since 1999 when Regulation No. 1972 was enacted, there have only been 4 attempts to establish MCOs: two in Minsk, one in Hrodno and one in Vitebsk. Both the regional MCOs and one of those in Minsk (the MCO of Minsk Capital Union of Entrepreneurs) encountered the problem of attracting the needed minimum amount of funds for the equity capital. The only success story is the MCO "Stolniy". It succeeded to attract the equity capital needed, and began to grant loans to entrepreneurs. In 2002 it granted 19 loans (totaling BYR 24.8 m), in 2003 also 19 (BYR 21.7 m), in 2004 21 loans (BYR 64.4), and in 2005 7 loans (BYR 23.1 m). In 2005 the borrowings averaged BYR 3.1 m (about USD 1500) for an average period of 3.5 months. The peak activity event of "Stolniy" in 2004 was the free-of-charge borrowing by the Minsk City Executive Committee of BYR 35 m, for a period of one and a half years. After the repayment of this liability there was an influx of entrepreneurs who desired to borrow funds and thus became members of "Stolniy". But after these loans had been repaid, the majority of these new members becoming aware of the lower possibilities for future borrowing quit "Stolniy" and their initial deposits were paid back to them. Thus, "Stolniy" now has a very limited number of members (the minimum of members according to the legislation is maintained) and very limited possibilities for providing funds. That is why "Stolniy" has now substantially reduced its activities and is not growing.

Providing funds to MCO members: an example. Assume we establish a new MCO according to the current legislation, i.e. with 20 members and each of them investing EUR 300. Thus, the equity capital of the MCO will be EUR 6000. Since entrepreneurs are primarily borrowers rather than savers (this assumption is fully confirmed by the experience of Belarusian MCOs) this amount of equity capital might be the only source for borrowings. Now assume that the average loan requested is EUR 1000 and the average period is 4 months (these figures are close to those experienced by "Stolniy"). In this case and applying the most flexible scheme of providing funds (i.e. repayment is made in equal parts every month starting with the month after the funds have been loaned) the MCO will be able to provide only up to 30 of such loans per year. This means that on average a member of the MCO will be able to obtain 1.5 loans of EUR 1000 for 4 months in one year. To take advantage of this opportunity the member must however set aside EUR 300, i.e. his initial deposit, on a constant basis. While the main incentive for the entrepreneur is the possibility to obtain funds and to overcome the obstacles peculiar to banking loans (these problems are not solved in this case), it quite evident that this scheme will not be attractive for most SBs.

Household credit unions. Some household credit unions have been established in recent years. Among them the "Capital Club for Self-Assistance", the "Center for Self-Assistance", the "Self-Assistance Club "Komarovo", and "Arlteks". The largest of them is the "Capital Club for Self-Assistance", which currently has about 200 members. Its equity fund amounts to BYR 9 m. Since its inception (it was established at the end of 2004) it has provided loans (almost totally for consumer purposes) totaling about BYR 240 m (flow) and attracted about BYR 123 m of deposits (flow). Its profits over the two years amounted BYR 3 m. The interests on deposits and on loans are higher than within the banking system, but a number of specific conditions (personal income taxes, schemes for providing funds, etc.) affect the effective real interest rate.