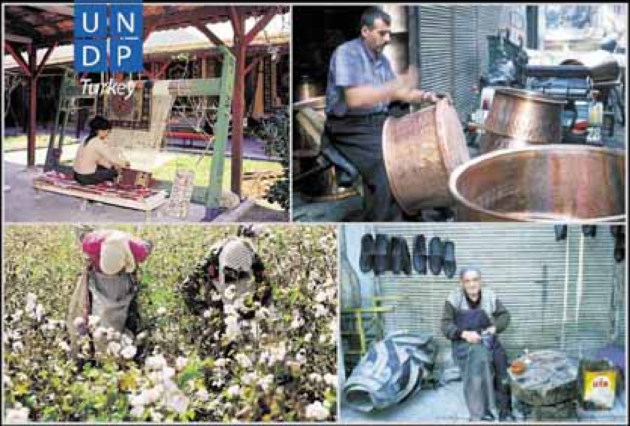

Microfinance in Turkey

A Sector Assesment Report

Prepared by
Kiendel Burritt (UNCDF)

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Boxes:

Abbreviations

BRI-UD	Bank Rakyat Indonesia-Unit Desas
BRSA	Banking Regulation and Supervision Agency
EBRD	European Bank for Reconstruction and Development
FMO	Netherlands Development Finance Company
GAP RDA	Southeast Anatolia Regional Development Administration
IDB	InterAmerican Development Bank
IFC	International Finance Corporation
IMF	International Monetary Fund
KEDV	Foundation for the Support of Women's Work
KfW	German Development Cooperation
MFI	Microfinance institution
NBFI	Non-Banking Financial Institution
NGO	Nongovernmental organization
SDIF	Savings Deposit Insurance Fund
SME	Small and Medium Enterprises
SRMP	Social Risk Mitigation Project
SSF	Social Solidarity Fund
TESK	Turkish Craftsmen and Tradesmen Association
TESKOMB	Association of Loan and Surety Cooperatives
TKV	Development Foundation of Turkey
UNCDF	United Nations Capital Development Fund
UNDP	United Nations Development Programme
WWB	Women's World Banking

Exchange Rate:
I USD =1,410,000 TL (July 2003)

Executive Summary

The primary financial service needs of people are shared across income groups. They include having a safe place to store money, the ability to transfer money, access to liquidity (either savings or credit), and mechanisms to decrease risk[1]. Correspondingly, microfinance includes the provisioning of a broad range of financial services including loans, deposit services, insurance, and remittances to those currently excluded from the formal financial system. In Turkey, large segments of the population do not have access to financial services.

This report assesses the microfinance sector in Turkey, and evaluates prospects for microfinance sector development that effectively extends the finance frontier. It provides recommendations to support sector development by strengthening the enabling environment, promoting innovation in financial markets, and supporting the establishment of institutions that demonstrate the commercial viability of microfinance service delivery.

Once isolated from the wider financial system, microfinance initiatives in many countries have shifted from shallow programmes designed to win political favor or implement development policies (for example, in agriculture) to the development of commercially viable institutions that comprise an important subsector of the financial system. Globally, microfinance services are provided by a range of institutions including (but not limited to) NGOs, mainstream commercial banks, savings banks, specialized microfinance banks, and credit unions. Once integrated with mainstream capital markets, microfinance institutions have the capacity to serve massive unmet demand for services.

The development of a microfinance sector is integral to the process of financial sector deepening necessary for continued broad-based economic growth, including the gathering of savings and their efficient allocation across a wide range of economic enterprises. Microfinance sector development also addresses structural issues that have led to growing economic disparity among segments of the population in Turkey. The "fault lines" of economic and social disparity can be overlay to a large extent on a financial system that serves only a fragment of the population.

The broader policy and macroeconomic environment enables or hinders the development of a microfinance sector. The assessment concludes that sufficient macroeconomic conditions exist now to support development of the sector. However, an uncertain economic future, a relatively fragile banking environment, the persistence of government-supported subsidized credit programmes, and weak credit culture may to some extent dampen demand for microfinance services and inhibit the emergence of new suppliers of microfinance services, at least in the short term.

However, the report concludes that even limited effective demand translates into significant market numbers. The market for microfinance services is estimated conservatively at roughly between 1 and 2 million potential clients, considering only loans. Estimated capital requirements to fund a microfinance loan portfolio are estimated at between US$ 2 billion and US$3 billion. Taking into consideration demand for a wide array of financial services beyond loans including savings, insurance and remittances, the potential market appears infinite.

The report concludes that the supply of microfinance services in Turkey is very limited, both in terms of the numbers of people served and the range of services offered. The primary suppliers of microfinance services currently are the state-owned Banks, Halk Bank and Ziraat Bank. Poorly performing loan portfolios and the legacy of directed and subsidized credit programmes, however, has rationed the delivery of credit through these channels, and resulted in supply-driven products and services that do not respond well to the financial service needs of clients. In contrast to most early stage microfinance sectors, NGOs are virtually absent from the market in Turkey. Several are experimenting with microcredit delivery, and at this time, only one, Maya Enterprise for Microfinance, appears to be on a potentially commercially viable path. Challenges posed by the legal framework and the operating environment, however, make profitability, and therefore extensive outreach, a distant goal. A limited number of commercial banks are attempting to downscale their service offerings to reach new market segments.

The entrance of new microfinance service providers may be stimulated by changes to the legal and regulatory framework. Recommended changes include establishing a clear and unambiguous legal framework for unlicensed MFIs, including NGOs; the finalization of the draft law that enables the emergence of specialized Microfinance Banks; and harmonizing legal frameworks across a range of institutional types (NGOs, Banks, Specialized Banks, etc.) to ensure a level playing field, and a fair competitive operating environment. The experience of mature microfinance markets indicates that healthy competition leads to benefits for clients, including better prices and services.

[1] Source: David Porteous

In addition to economic stabilization and banking sector reform, the development of a robust microfinance sector may be accelerated by support for broad policies that recognize the role of microfinance in economic growth, reduction of vulnerability and disparity among populations -- objectives reflected in the Government of Turkey's current Long-term Strategy and Five-Year Development Plan. Recognition may translate into specific actions that strengthen micro and small enterprise support and other social policy initiatives aimed at meeting these objectives. In particular, grant programmes that transfer capital to vulnerable segments of the populations should be sequenced to the greatest extent possible with long term access to capital provided through financial institutions. It is continual access to services, not one-time injections, that allow the poor to increase their asset base and reduce vulnerability.

Over the long term, efforts to restructure the banking sector, stabilize the economy and articulate policies that recognize the contribution of microfinance to broader national goals should support the development of an enabling environment. Given the emergence of a supportive legal and regulatory framework and institutions that demonstrate the commercial viability of microfinance, the long-term prospects for microfinance sector development and rapid commercialization are strong. However, those prospects may be weakened by the persistence of government-supported subsidized lending programmes that undermine a strong credit culture, inhibit the entrance of new suppliers, and hinder innovation critical to reach the massive, unserved market in Turkey.

Stakeholders can support and accelerate the process of microfinance sector development through coordinating donor and investor activities, and stakeholder education. These activities can be facilitated by donor/investor working groups, and industry roundtables, and may result in specific actions that support the enabling environment, for example changes to the regulatory framework, or the establishment of industry performance standards. Stakeholders can catalyze private sector participation in the microfinance sector by supporting the establishment of a number of financially viable demonstration models. Given the size of the market and limitations to donor and other public funds, private sector participation in the microfinance sector and access to domestic capital markets by microfinance institutions will be necessary to meet significant market demand. Demonstration models may include "start-ups", as well as current operators that have credible plans for financial viability. The establishment of diverse institutional types that can collectively serve a wide range of market segments will critical to enable broad outreach in the microfinance market in Turkey. While outreach by the state-owned banks may be limited over the short-term, with their massive branch networks both have a potentially strong role to play in serving markets in their future, restructured forms with both savings and lending services. Broad-based initiatives that support innovation, for example, the development of market-responsive products that benefit a wide range of players will be critical for financial sector deepening.

Chapter 1: An Introduction to Microfinance

1.1 What is Microfinance?

Millions of poor, vulnerable non-poor, and unbanked households want financial services. They seek a diverse range of services including loans, savings, insurance, and facilities for sending and receiving remittances. Households use financial services to build incomes, mitigate risk, and protect against vulnerability often exacerbated by economic crises, illness, and natural disaster. They invest in micro and small businesses, purchase assets, improve their homes, and access health and education services. Yet formal financial intermediaries like commercial banks generally do not serve these households. Conventional banks have failed to serve this market for a variety of reasons. First, their business models are generally unsuitable for managing a microfinance business, characterized by high-volume, low-value transactions. Secondly, they employ traditional lending technologies based on collateral requirements (to which the unbanked generally don't have access). And in many cases conventional banks believe, unjustly, that the unbanked are unwilling and unable to repay loans and save money.

In general terms, microfinance is the provision of a broad range of financial services to those excluded from the formal financial system. Systems of exclusion are not based just on lack of wealth but also on social, cultural, and gender barriers (Microfinance Distance Learning Course, UNCDF). Microfinance lending technologies are developed primarily around an analysis of clients' character, cash flows, and commitment to repay a loan, rather than on collateral requirement characteristic of asset-based lending technologies of traditional banks. A variety of institutional models have emerged globally to serve microfinance markets including specialized microfinance banks, non-governmental organizations (NGOs), credit unions, non-banking financial institutions, and commercial banks that develop new lines of business or specialized subsidiaries that focus on microfinance market segments. The spectrum of potential microfinance clients is great. In Turkey it may include a woman in the informal sector working part time at home to produce decorative boxes; it may include a grocer selling vegetables in an open-air market or a jeweler selling his products from a storefront. It may include a farming household that seeks access to credit to buy fertilizers, and savings services to bank post-harvest profits that can be drawn on during lean seasons.

1.2. Where does Microfinance Fit within the Financial Sector?

Globally, early efforts to provide financial services to the unbanked were overwhelmingly driven by economic and agricultural development policies and programmes. Governments supported subsidized credit programmes "targeted" at specific groups and tied to specific productive activities. These programmes have generally failed to reach the "target" groups or achieve intended objectives, and have not resulted in widespread and permanent access to finance. Efforts to reach the poor with financial services then shifted to the delivery of small loans to micro and small enterprises. This movement was largely driven by NGOs with social goals experimenting with new technologies to reach poor households with both financial and non-financial services. In some countries credit unions developed that mobilize savings deposits and provide lending services; often these institutions were not regulated under financial sector legal and regulatory frameworks. Microfinance was seen as a "development tool" and its activities were often isolated from the wider financial system.

Over time, in many countries, with the success of credit-led NGOs, their transformation into licensed banking institutions, and the entry of mainstream and specialized commercial banks into the business of microlending and savings collection, microfinance industries have evolved into powerful subsectors of the financial services industry. Successful microfinance institutions (MFIs) have shifted away from donor and subsidized funding to become commercially viable, profitable institutions – covering their costs and generating surpluses to fund growth and expansion of services to a growing number of clients. The institutional forms of suppliers of microfinance services have diversified to include NGOs, companies, nonbanking financial institutions (NBFIs), specialized microfinance banks, commercial banks, subsidiaries of mainstream commercial banks, credit unions, leasing companies, insurance companies, etc. Many high-performing institutions have managed to successfully source commercial capital (bank loans, savings, equity investments from both private and public sources) to expand their growth. In fact, absent commercial sources of funding, their ability to reach a growing number of clients would have been seriously curtailed.

It has become evident that demand for financial services by the unbanked is significant, if not massive. In early stages of industry development, NGOs, government aid agencies, and multilateral and bilateral donors and investment companies tend to be the dominant investors in the microfinance sector. Meeting significant demand, however, requires the engagement of commercial sources of capital, including the savings of many of these unbanked households. Engaging commercial capital requires consistently high performance on the part of institutions operating in the microfinance sector. In Latin America, many of the most successful MFIs have outperformed mainstream commercial banks. In the early days of the industry it was thought that profitable institutions would be unable to serve the poor – that there was an inevitable trade off between depth of outreach (reaching poor clients) and profitability. In fact, research indicates that there is no significant relationship between depth of outreach and profitability. Well-performing institutions serving a wide range of client groups from the poor to the vulnerable non-poor in a variety of contexts (urban and rural) can and have become profitable. At the same time however, it should be noted that not all institutions have achieved commercial success, and that the industry is relatively young globally. Of the 147 leading institutions reporting to the MicroBanking Bulletin, 62 are financially self-sufficient.[2]

Box 1: Average Performance of Financially Self-Sufficient MFIs

The following table shows averages for some key indicators for the 62 financially self-sufficient institutions. However, it should be noted that there are significant differences among regions and institutional types.

Key indicators: "average" financially self-sufficient MFI:

- Total Assets: $19.9 million (banks ($60 million) and NGOs ($10 million))
- Total number of borrowers with loans outstanding: 81,510
- Average outstanding loan size as % of GNP per capita: 83%
- Average outstanding loan: $752 (Africa ($350), Eastern Europe ($1,101))
- Adjusted return on assets (after tax and accounting for the cost of inflation): 5.5%
- Adjusted return on equity: 14.1%
- Portfolio at risk > 90 days: 2.3%
- Number of active borrowers per loan officer: 408
- Yield on Gross Portfolio: 40.6% (approximately equal to interest rates)

Source: *The MicroBanking Bulletin,* Issue No. 8, November 2002, MIX (Microfinance Information Exchange), www.mixmbb.org

Now that "microfinance" has proven itself in many contexts and it has become evident that satisfying massive demand requires access to capital markets, Governments, multilateral and bilateral organizations, and other public sector agencies are developing microfinance support strategies that situate microfinance institutions and their clients within the overall financial system. Microfinance is no longer seen as an isolated industry or development "strategy." Support for the development of a microfinance sector is driven by the aim to deepen the financial sector, including enhancing access to and gathering savings and their efficient allocation in the financial system. Deepening the financial sector requires extending the frontiers of finance[3] to reach those that have been excluded from formal finance, and to ensure ongoing opportunities for accessing finance.

Boxes 2, 3, and 4 at the end of this chapter provides three examples of successful microfinance operations. One is a licensed, regulated Bank in Peru, MiBanco. The other is a unit of a restructured, state-owned development Bank, Bank Rakyat Indonesia Unit Desas (BRI-UD). The third example is a microfinance subsidiary of a commercial

[2] A financially self-sufficient institution generates enough revenue to cover all its costs, including non-cash costs like the cost of inflation and the full costs of funds at commercial prices, and generates a surplus.

[3] The concept of extending the finance frontier is used by J.D. Von Pischke in Finance at the Frontier.

bank.

Box 5 describes the Bolivian microfinance market, a "mature" market, and some of its challenges. A mature microfinance sector requires an industry infrastructure to support the development of microfinance institutions and their integration with capital markets. Box 6 describes the players that comprise this infrastructure.

1.3. How does Microfinance Fit within the Broad Policy Environment?

Extending the frontier of finance contributes to a range of policy imperatives including support for poverty alleviation and reduction of vulnerability, and broad-based economic growth. Effective macroeconomic policies, legal and regulatory frameworks, financial sector policies, and SME support policies influence the enabling environment for developing a microfinance sector.

While the number of people living in absolute poverty in Turkey is low (2.5% of the population), vulnerability to the threat of poverty remains high. 7.3% of the population cannot purchase the local minimum food basket and 36% of the population is considered economically vulnerable (World Bank, November 2000), with the rural poor being particular vulnerable. Microfinance helps decrease vulnerability by enabling people to build assets upon which they can draw to manage risk in the event of disaster or crisis. The extension of the financial system to include a strong microfinance sector that aims to reverse trends of social and financial exclusion has particular resonance in Turkey, where a number of programmes and policies have focused on addressing the challenge of growing economic disparity among population groups. The "fault lines" of economic disparity in the country can be overlay to a large extent on a financial system that serves only a fragment of the population.

1.4. Where does Agricultural Finance Fit within the Microfinance Subsector?

For the most part, the microfinance industry globally has focused on trade and industry in urban, peri-urban and densely populated rural areas. However, microfinance services are also relevant to businesses and households in agricultural and rural sectors. In Turkey, the farming sector constitutes 40% of total employment and 15% of GNP. As formal unemployment has risen in Turkey's economy overall, employment in the agricultural sector is on the rise. And as the overall economy has grown, disparity between urban and rural areas has increased. Within this context, focus on financial sector deepening in rural and agricultural markets, in addition to the more traditional microfinance markets, is critical.

Special challenges exist however in supplying rural and agricultural financial services. Additional challenges faced by rural lenders include greater exposure to systemic risk (such as droughts and floods), lower density of population, and greater seasonality of activities. Expanding the formal financial frontier to effectively serve these markets requires further innovation in product development and risk management strategies on the part of microfinance operators.

1.5. What are Some Characteristics of Successful Microfinance Institutions?

Microfinance is not conventional banking. Although MFIs employ general banking principles, successful MFIs have developed new, cost-effective business models and innovative lending technologies. Lending technology covers the range of activities carried out by an institution relating to developing products that respond to markets, marketing products, developing delivery channels, minimizing risk to the institution, and enforcing repayment of loans. Successful microfinance institutions share these practices:

- They develop innovative lending technologies that balance the needs of low-income borrowers and minimize risk to the institution. Loan evaluation is often based on cash flow of a household or business, and a client's character. Asset-based collateral is secondary; and non-traditional collateral like jewelry and household appliances may be used.

- They are located close to borrowers and loan disbursement and collection often happens on the borrower's premise rather than at the Bank.

- They price products to ensure that revenue covers the full costs of operations to enable profitability within a reasonable period of time. The relatively small loan sizes demanded by poor and low-income clients may result in costs per loan that require interest rates significantly higher than commercial bank rates (though generally lower than informal sector rates).

- They manage highly efficient operations to reach very large number of people. Each bank officer serves a significant number of loan clients (generally between 200 and 500, depending on the lending technology), and operating costs as a percentage of the outstanding loan portfolio are minimized.

- They attract rather than "target" clients. They design products that draw from a broad population (the poor, vulnerable non-poor, low-income unbanked populations), rather than very narrowly targeting to a particular group.

- They provide financial services exclusively. As a general rule, successful MFIs do not provide both financial and non-financial services.

Box 2: A Successful MFI in a Lower Middle-income Country, MiBanco, Peru

Accion Communitaria del Peru (ACP) began operations as a non-profit NGO focused on community development. In the early 1980s, ACP focused its activities on the provisioning of credit to microentrepreneurs in the capital city of Lima. As early as 1985, ACP began to consider transformation into a regulated, for-profit financial institution since its institutional form limited its ability to access capital and expand its services. While limited donor capital was available to NGOs, like ACP, a wholesale, second-tier institution in Peru had funding from a multilateral development bank, Intra-American Development Bank (IDB) for onlending to regulated financial institutions operating in the microfinance sector. As an unregulated NGO, ACP was not eligible to access this funding. In the 1980s however, Peru was hit by a financial crisis and ACP decided to delay its transformation plans. In the 1990s with the return of economic stability, ACP considered again transformation into a regulated financial entity. Several potential legal forms existed into which ACP could transform: 1) a full-service bank, regulated under mainstream banking law, 2) a financiera that required lower minimum capital ($3 million) than a full-service bank, but was limited in its product range, particularly for savings and current account services, and 3) Small and Microenterprise Development Entities (EDPYME), having very low minimum capital requirements ($250,000) but not allowed to offer any savings services. At the time ACP was considering transformation, a new legal form emerged allowing for the creation of a specialized microfinance bank with few restrictions on product offerings. This latter form was adopted by ACP, and the NGO was transformed into MiBanco, the first for-profit fully licensed and regulated bank dedicated to microfinance in Peru. Its mission was and continues to be promoting the economic development of Peru's low-income majority population through the provisioning of financial services. Mibanco operates in Lima, Callao, Chincha, Chiclayo, and Huancayo.

MiBanco is owned by a range of investors from the private and public sector. The majority of MiBanco's shares are owned by ACP (the founding NGO). Other investors include ProFund (an MFI equity investment fund owned by private foundations, multilateral investment funds, and individual private investors), Accion's Gateway Fund, Banco de Credito (commercial Bank), Banco Wiese (commercial Bank), and Andean Development Corporation. Banco de Credito and Banco Wiese are the two largest private banks in Peru. As a regulated institution, MiBanco has access to a range of sources of loan capital. MiBanco received significant amounts of financing from a second-tier financial institution, COFIDE, as well as private commercial banks.

Following transformation, MiBanco began offering savings services. MiBanco has also significantly diversified its product offerings in both urban and rural areas to include working capital loans, housing loans, credit lines, passbook savings, term deposits, remittances, fixed asset loans, and foreign exchange services. MiBanco uses a range of lending technologies including both traditional asset-based lending as well as non-traditional guarantees. MiBanco has a long standing technical relationship with Accion International, an international technical service provider, that provides MiBanco with technical support services. MiBanco also participates in a Women's World Banking network, Global Network for Banking Innovation in Microfinance.

As of the end of 2002, MiBanco had 99,121 active clients, accessing both credit and savings services. More than 50% of its clients are women. Loan sizes range from $100 to $100,000, and loan terms range from 3 months to five years. About 19% of MiBanco's loans are group loans and 81% are individual loans. 71% of individual loans are not guaranteed. In 2002, its outstanding portfolio was approximately $92 million with average loan balances of $931. The first loans ranged from $300 to $700. With a portfolio at risk of 3.1 % in 2002, MiBanco is one of the soundest banks in the Peruvian financial system, and is fully profitable.

MiBanco uses technology to improve performance. MiBanco has 35 branches in its network and ATM machines at many locations. Given the large number of clients per credit officer (characteristic of microfinance operations), credit officers use handheld computers to cut down on loan processing time and errors.

Sources: The Transformation of Microfinance NGOs into Regulated Financial Institutions, Anita Campion and Victoria White; Accion International Website (www.accion.org)

Box 3: A Microfinance Lending Operation of a State-owned Bank, BRI, Indonesia

Bank Rakyat Indonesia (BRI) is a state-owned commercial bank that began as an agricultural development bank. While it now maintains a commercial focus, it is still largely focused on rural banking services, particularly to the agricultural markets.

In 1996, BRI total assets were more than $12 billion. BRI has 320 branches located at the district or municipal levels and 3,600 retail outlets at the subdistrict level known as BRI Village Units (or unit desas). Microfinance services are offered through the unit desas (UD) for rural and urban clients and operates as an independent profit center. BRI-UD operates on a fully commercial basis, accounting for 25% of BRI's total assets and 70% of its total savings deposits.

BRI Unit Desas (BRI-UD) was initially established in the early 1970s to channel credit to farmers through a programme intended to promote national rice production (BIMAS). Interest rates were fixed at subsidized levels and losses were covered by Indonesia's Ministry of Finance. By the 1980s lending volumes were very low and default rates were greater than 50%. With the closure of BIMAS, the government decided to convert BRI-UD into a rural banking network that would offer a wide range of financial services to low-income clients. In 1984, the entire BRI-UD system was restructured and a single loan product was offered for general rural credit (KUPEDES). KUPEDES is neither targeted to specific client groups nor subsidized and is available for both working capital and investment capital. The maximum loan size for KUPEDES loans has been raised from $1,000 at product launch to more than $10,000 today.

After decades of focusing on cheap, subsidized credit, BRI recognized the huge demand for savings services among clients and developed appropriate services to meet that demand. With the success of this product and indications that BRI-UD could be financially viable, BRI-UD launched a savings products called SIMPEDES (rural savings). The popularity of the savings product was enhanced by a complete overhaul of BRI's public relations and marketing strategy. Savings deposits skyrocketed as money kept in people's homes and non-financial assets converted to money were deposited in the Bank. The unit desa itself is centrally located in a sub-district town, occupies one room serving 16-18 villages, and averages 4,500 savers and 700 borrowers.

As of the end of 2002, BRI-UD had total assets of $3.2 billion including a loan portfolio of $1.3 billion, and savings deposits of $2.6 billion. Its portfolio at risk > 30 days was 4.37%. It had a 6.58 % return on assets and 111% return on equity. BRI-UD accounts for the lion's share of BRI's total profit. BRI was one of the few banking institutions to have weathered the Indonesian financial crisis, largely due to the success of BRI-UD, and to have even expanded its operations at that time.

Sources: *Bank Rakyat Indonesia (BRI)* Case Study, Klaus Maurer; MIX Market statistics (www.themix.org)

Box 4.: Sogesol, a Microfinance Subsidiary of a Commercial Bank

With the lifting of interest rate ceilings, Sogebank, Haiti's largest commercial bank was interested in building a client base in the informal economy, since they represent more than 75% of the working population in Haiti and an estimated 1.6 million microenterprises. Sogebank has more than 25% market share in the Haitian commercial banking market. It has more than $300 million in total assets, is highly profitable, and has stakes in a number of subsidiary operations including a credit card company, a consumer credit business, a real estate business, a mortgage company, and its microfinance business.

Sogebank received funding from the IntraAmerican Development Bank through its Multilateral Investment Fund to explore the concept of developing a microfinance business, and in 2000 established an independent subsidiary microfinance operation owned by Sogebank (35%), Accion International's Gateway Fund (19.5%), Profund (a specialized equity investment fund for microfinance (20.5%), and a local individual (25%.)

Accion (also with an ownership stake) provides Sogesol technical assistance services. Accion works with Sogesol to develop products, train its staff in credit evaluation and risk management techniques and implement management systems that assist Sogesol manage its microfinance business. While Sogesol and Sogebank are independent from one another, Sogesol leverages the Sogebank infrastructure for its operations, primarily its technology and human resources. Sogesol also has some dedicated staff based in bank branches to carry out functions unique to Sogesol, for example product marketing. Sogesol originates loans, but Sogesol borrowers make their loan payments at Sogebank's 24 branches. An independent information system provides Sogesol specific information it needs to manage its portfolio. Sogebank provides capital to Sogesol for onlending, enabling Sogesol to leverage its equity. However, Sogesol must maintain the minimum capital requirements imposed by the Haitian Central Bank. Sogebank also provides Sogesol other administrative services including Human Resources, Legal Affairs, Auditing, and marketing. Sogesol's monthly payments to Sogebank include interest on capital used to fund the Sogesol portfolio, payments for management services, payment for branch and teller services and payments to maintain the loan loss reserve. By outsourcing services from Sogebank, Sogesol is able to grow its operations rapidly, and minimize its fixed costs.

As of December 2002, Sogesol had 5,657 active clients and an outstanding loan portfolio of $2.7 million. Average loan balances were $421. Sogesol plans to reach 30,000 clients by 2005.

Source: Accion website (accioninternational.org); *A Commercial Bank Does Microfinance:* Sogesol in Haiti, Guy Stuart).

Box 5: Lessons from a Mature Microfinance Industry: Bolivia

The experiences of maturing microfinance markets have lesson to offer newly evolving markets. In Bolivia, commercialization has enabled dramatically greater outreach to poor and low-income clients and increased competition leading to lower interest rates and better services for clients. However, the entry of new players, consumer lenders following unsound business practices, created destabilizing conditions for the market in the late 1990s. And while the number of clients has grown dramatically in Bolivia as the market has evolved, market growth in recent years has slowed significantly despite that a significant number of people remain without access to financial services. Of the estimated 600,000 microenterprises in Bolivia, only 1/3 have access to financial services.

The microfinance market in Bolivia is considered relatively mature, with most microfinance clients now served by formal financial institutions, even though the market itself was pioneered by successful NGOs. Among the "MicroRate 29", 29 successful microfinance institutions tracked by MicroRate (an industry rating agency), the two largest microfinance institutions are based in Bolivia. Banco Sol had a loan portfolio of $81 million and 61,368 clients in 2001, and Caja Los Andes had a loan portfolio of $52.6 million with 43, 530 clients. BancolSol, focused exclusively on micro and small enterprise finance, serves about 25% of the nation's commercial banking clients Other notable institutions in Bolivia include Prodem, FIE, and ProMujer. Bolivia is the home of "transformed" microfinance institutions, that is, NGOs that transformed into licensed regulated banks, for example, BancoSol. In Bolivia many microfinance institutions take the form of FFPs, which are private financial funds with minimum capital requirements lower than full-service banks and that offer a stripped-back array of services, with few offering savings services. The Bolivian market has also witnessed the entry of purely commercial microfinance players. Several commercial players include Fassil, founded in 1996, focusing on both consumer lending and more traditional enterprise-based microfinance operation, and Banco Economico, a full-service bank with an independent unit for microfinance clients. Given the number and range of institutional types, competition has emerged among players. Clients have benefited as competition brings lower prices, new products and better service. In response to competitive pressures, however, some institutions have been forced to drop out of the market.

At the same time that competition was taking off in Bolivia in the late 1990s, a group of institutions that focused on consumer lending also emerged. Consumer lenders offered loan sizes similar to that of microlenders, and focusing largely on salaried workers, and the best clients of established microfinance institutions. In Bolivia, consumer lenders were reckless, not enforcing strict repayment and lending to clients who were already indebted. Subsequently, default increased dramatically among both consumer lenders and traditional microlenders, who had up to then managed very strong portfolios employing strong delinquency control measures. The poor practices of consumer lending companies weakened the financial services market. This experience has highlighted the need for credit bureaus in mature markets, and the adoption of appropriate regulation where necessary to ensure that new institutions, like the consumer lending agencies in Bolivia, do not employ "reckless" practices that threaten the stability of the microfinance subsector and the financial services industry overall. In Bolivia, despite market factors, the microfinance industry has fared better than the mainstream banking sector overall. Portfolio quality of MFIs tends to be stronger than that of the mainstream banking sector, and microfinance institutions are more profitable than commercial banks. However, the fact that portfolio growth of major institutions has slowed considerably (from 54% in 1997 to 9% in 2001) at the same time than many segments of the population remain unbanked in Bolivia, suggests that yet new models of service delivery and products are required to push the finance frontier even further out.

Sources: The Finance of Microfinance, MicroRate and Commercialization and Crisis in Bolivian Microfinance, Elizabeth Rhyne.

Box 6: The Infrastructure that Supports Microfinance Sector Development

The microfinance sector in Turkey is currently in a start-up phase with few operators on the ground. A mature microfinance industry in Turkey will comprise a variety of institutional forms likely including commercial banks, NGOs, non-banking financial institutions, and specialized microfinance banks. Over time healthy competition will develop among institutions, and MFIs will serve a variety of niche markets with a broad range of financial services including loans, savings, money transfers, and insurance. An enabling legal and regulatory environment will promote sustainability and growth of the sector. A sector infrastructure will emerge that supports microfinance institutions and their eventual integration with commercial capital markets.

Sector infrastructure will include technical service providers, industry networks, credit bureaus, funders including equity investors and lenders, and rating agencies. The following describes the kinds of institutions that comprise this supporting industry infrastructure. This report does not promote any organization listed below; these are merely indicative.

Donor and Investor Consortia
Donor and investor consortia promote industry development globally, and enable coordinated action among donors. CGAP is a global consortium of 29 bilateral and multilateral donor agencies that serves MFIs, donors, and the industry through the development of technical tools and services, delivery of training materials, strategic advice, technical assistance and action research on innovation in the industry. The CGAP website (www.cgap.org) is a strong source of information on the industry with extensive links to other microfinance-related sites, including many of the organizations listed below.

Service Providers
Technical Service Providers include both consulting firms that specialize in microfinance technical support services to microfinance institutions, as well as practitioner organizations that also provide technical services to other MFIs (generally in markets where they do not operate and therefore don't compete with those MFIs). Support services include developing appropriate business models, lending technologies, new products, MIS systems, portfolio management systems, institutional policies, financial projections, staff training, development of incentive systems, Board development, etc.

One example of a specialized microfinance technical service provider is Accion International. Accion provides technical assistance and training to microfinance institutions globally. It also manages a regional network of organizations to facilitate sharing of knowledge and learning across organizations. Other firms that have been contracted by UNDP to provide technical support services to MFIs include Calmeadow, DAI, ECI, ICC, DID, etc. Practitioner organizations that provide services include Grameen Foundation, K-REP Advisory Services, Association for Social Advancement (ASA), Alexandria Business Association (ABA), etc. The CGAP website has links to many such organizations.

Industry Networks
Microfinance networks and associations play a role in facilitating the sharing of information across institutions. Network may operate on a national, regional or global basis. Networks also play a role in channeling technical support to MFIs and establishing common performance standards in the industry.

Women's World Banking is an example of a global network that provides technical support, and monitoring and networking services to financial institutions that support women's access to financial services. It works in 32 countries globally. The Association of Ethiopian Microfinance Networks is an example of a strong national network of microfinance organizations that provides technical assistance, policy advisory services, and knowledge sharing services to its members.

Research and Development
Industry research and development is promoted by both donor supported projects and independent centers. Even "mature" markets in many countries have limited outreach to unbanked populations indicating that significant new advances are required in areas such as product development and development of new business models for microfinance service delivery.

The Microfinance Center for Central and Eastern Europe and the Newly Independent States based in Poland is a membership-based resource center that promotes the development of a microfinance sector. It has created a regional network of MFIs, and provides technical assistance, training and other advisory services to MFIs.

MicroSave-Africa, based in Kenya, carries out "action research" within microfinance institutions and trains MFIs to develop market-led (not supply-driven) microfinance products and services.

Rating Agencies
Specialized microfinance rating agencies act as third-party evaluators of MFIs. Raters carry out rigorous evaluation of MFI operations and performance, and provide information to potential investors and lender to MFIs to attract investment to the sector. By using a standardized

approach they promote transparency and benchmarking in the industry. Two examples are Planet Rating (Planet Finance) and MicroRate.

Wholesalers

Wholesale microfinance institutions are often government or semi-autonomous organizations that refinance microfinance institutions. Successful wholesalers apply rigorous performance criteria to institutions that access their funding. They lend on commercial or semi-commercial terms. PKSF is a semi-autonomous wholesale financing institution in Bangladesh that provides loans to more 150 retail microfinance institutions. Interest rates to microfinance retailers (Grameen Bank, ASA, etc.) are slightly below commercial borrowing rates and funds come primarily from the World Bank. To access PKSF loans, MFIs must meet high performance standards and undergo rigorous institutional evaluations.

Debt and Equity Investors

Specialized debt and equity Funds enable MFIs to grow. These funds advance commercialization of the industry by demonstrating to commercial sources of capital (banks, private investors) the commercial and financial viability of microfinance operations. These Funds also draw in private, commercial investment by structuring their equity investment alongside national commercial bank debt.

Profund, is an example of a for-profit debt and equity investment fund that seeks commercial returns for investors and shareholders through investments in growth-oriented regulated micro finance institutions. Profund investors include private individuals, private foundations, multilateral investment banks, and development Funds. Profund has provided more than $22 million in both debt and equity in 11 institutions in Latin American and the Carribbean.

KfW is a bilateral investment Bank supported by the German government investing in 31 microfinance institutions primarily in Eastern Europe and Central Asia. Approximately $23 million is allocated to microfinance investments.

The Dexia Microfinance Fund, a private microfinance fund is based in Luxembourg. It lends to microfinance institutions including Banks, NBFIs, Rural Banks, cooperatives, an NGOs on a purely commercial, non-concessional basis. It has invested $20 million in 35 institutions globally.

Commercial Banks

In many countries, commercial banks are lending to microfinance organizations on purely commercial terms.

Sources: Policies, Regulations, and Systems that Promote Sustainable Financial Services to the Poor and Poorest *(in Pathways out of Poverty)*, Women's World Banking; MixMarket (www.themix.org)

Chapter 2: The Broad Policy Environment

Microfinance services can be successfully delivered in a wide variety of policy and economic environments. However, the policy environment influences the potential for development of the microfinance sector. Certain factors in the policy environment enable or make difficult the emergence and growth of sustainable microfinance institutions. This chapter examines macroeconomic, financial sector, agricultural, and social policy in Turkey to identify opportunities and constraints for microfinance sector development.

2.1 Macroeconomic Context

Economic stability is conducive to the growth of a microfinance sector. In times of economic growth micro and small enterprises tend to expand. Expanded economic activity stimulates demand for financial services, and stimulates the entrance of new financial service providers in the market. Very high inflation and/or unstable inflation rates can create difficulties for financial sector deepening. Inflation results in a real cost to MFIs (and their clients) that must be covered by the interest generated on loans. If interest rates do not cover the cost of inflation, the MFI's portfolio funded from equity will lose value equivalent to the inflation rate. If inflation is too high for an operation to guarantee a positive return to clients, mobilizing savings in local currency becomes costly to the saver (UNCDF Strategy for Policy Impact and Replication in Local Governance and Microfinance, 2002).

The level of development of the financial and banking sector depends on a sound macroeconomic environment. Volatility in the economy affects the risk and choices of financial institutions and microenterprises. In general, the stability of financial and other markets makes development of a microfinance subsector more viable.

At the beginning of the 1980s, the Turkish government shifted from state-directed development strategies to market-based economic development strategies, implementing policies to increase the role of the private sector in the economy and integrate with the global economy. Through the 1980s, economic growth rates averaged more than 5%. Since 1992, the economy has undergone a series of financial crises. A 1994 financial crisis led to significant increases in inflation and devaluation of the Turkish Lira throughout the 1990s. By 1999, following a series of devastating earthquakes, the "Russian crisis" (during which collapses in the Russian economy negatively impacted the performance of businesses serving Russia), and persistently high inflation, the country fell into recession. Living standards fell, unemployment increased and the economic vulnerability of segments of the population increased.

In efforts to restore economic growth and reduce inflation, the government adopted tight economic and fiscal policies in the context of an International Monetary Fund (IMF) agreed economic stabilization programme in 2000. Economic stabilization policies were also adopted to supports EU accession efforts. Since 1999, inflation has declined significantly. Averaging between 60-70% in the 1990s, it was 30.7% in May 2003. While the economy has contracted at points in tandem with the financial crises over the past five years, growth was positive in 2002 at 7.8% (compared to –7.5% in 2001). The 2000/ 2001 crises in the financial sector (described in Chapter 3), however, has hampered to some extent economic recovery prospects.

In interviews during the microfinance sector assessment, many expressed optimism about Turkey's short and long-term economic outlook. The Central Bank believes that the country will hit inflation targets of 20% agreed with IMF by year-end, and the economic recovery of 2002 has continued in the early part of 2003. However, the Economist's July 2003 Country Report, is not so optimistic. The Economist predicts that Turkey will not meet IMF agreed targets, ending the year with 30% inflation. In fact, the IMF Fifth Review which was to have taken place by now to enable a disbursement of $500 million under the IMF supported programme in mid-2003 has been delayed. The Economist predicts a "60% chance" of another financial crisis by early 2004, resulting in inflation of 90% by the end of 2004. The Economist predicts that a new financial crisis will be the result of the Government's inability to meet high debt payments (equal to 80% of GDP at the end of 2002) and a widening current account deficit. According to this source, GDP growth will shrink from 7.8% in 2002 to 3.3% in 2003, falling to –6% in 2004. Optimists, however, point out that even at 3.3%, GDP growth in 2003 is dramatically higher than that of the EU (predicted at 1.1% in 2003), and on par with world GDP growth rates. Generally speaking, interviewees among micro and small entrepreneurs generally agreed that demand for goods and services has weakened in the current economic context.

At present, the sector assessment concludes that sufficient macroeconomic conditions exist to enable the development of the microfinance sector. Lowering inflation, continued economic recovery and a drop in interest rates present opportunities for the economy and financial sector development. However, felt economic constraints at the level of micro and small entrepreneurs (despite the economic recovery figures) and uncertainty about the future, may limit the effective demand for microfinance services in Turkey and the entrance of potential new suppliers to the market. In fact if another financial crisis emerges in 2004, it would seriously hamper development of the market for microfinance services.

2.2 SME Support Policy

In many contexts, economic development policies favor large manufacturing or other industrial enterprises central to a government's export-led development strategies. In many contexts, bias exists against micro, small and informal sector enterprises, despite their contribution to export-led development objectives. The Southeast Anatolia Regional Development Administration's (GAP RDA) vision for economic development in Eastern Turkey, the region with the lowest GDP per capita, for example, focuses on large-scale projects, and mergers of small companies to support the competitiveness of Turkish goods in international markets. This strategy does not explicitly recognize a positive continued role of micro and small enterprises, nor development of financial systems to support them.

Turkey's Eighth Five-Year Development Plan explicitly recognizes the role of the SME sector in Turkey, and the need to expand their opportunities to finance. A number of government and donor financed programmes provide credit guarantees to commercial banks for SMEs loans. For better or for worse, many programmes support subsidized credit lines. While this assessment has not undertaken a detailed review of current SME policy, an EU supported study, Financial Services in Turkey, concludes that the Turkish government lacks an overall SME policy, rather supports "many disjointed efforts without reference to overarching clear objectives." In Turkey, SMEs contribute to less than 10% of exports, while they represent more than 50% of the work force and more than 95% of the number of economic enterprises in Turkey. Unfilled potential suggests that the enabling policy environment can be improved and/or systematically examined to identify constraints and opportunities for micro, small and informal sector enterprises, and the various efforts aimed at supporting them harmonized. As an example, as part of fiscal reforms, new tax law adopted in April significantly raised income taxes for the self-employed, at the same time that onerous tax requirements have been identified as a major constraint to development of microenterprises.

2.3. Financial Sector Policy

Until recently, lack of access to finance has not been recognized as a major constraint to development of the micro and small enterprise sector. Rather than focusing on policies to deepen the financial sector and widen access, financial markets have been used to implement other government policies, for example agricultural development policies or social protection policies aimed at supporting low-income sectors of the population. Until two years ago, subsidies to the agricultural sector were used to promote specific agricultural development polices. Government continues to support subsidized loans to small enterprises, provided through the state-owned Halk Bank. In July 2003, government significantly decreased lending rates to small businesses through its subsidized lending programme to significantly expand the number and volume of loans disbursed.

The Government of Turkey has taken serious measures to liberalize the financial sector including elimination of agricultural subsidies, and commitments to restructure the state-owned banks. However, the legacy of subsidies and frequent debt forgiveness, as well as the continuation and expansion of a number of subsidized loan programmes that offer below-market rates, has set norms and standards for the industry that will be challenging for MFIs seeking to charge cost-recovery interest rates and enforce repayment.

Over the long-term however financial sector reform policies should have a positive and significant impact on financial sector deepening. If financial sector reforms aimed at restructuring operations and improving the financial performance of state-owned banks are actually and effectively implemented, the state-owned banks in their future forms have the potential to be some of the most important service providers to the sector through their extensive branch networks. Over the long-term, reforms aimed at strengthening private banks and enforcing compliance with new prudential requirements should strengthen clients' confidence in the financial sector and stimulate the entrance of new players to the market.

2.4. Social Policy: Poverty Alleviation and Reduction of Vulnerability

2.4.1 Microfinance and Poverty Reduction

While the number of people living in absolute poverty in Turkey is low (2.5% of the population), vulnerability to the threat of poverty remains high. 7.3% of the population cannot purchase the local minimum food basket and 36% of the population is considered economically vulnerable (World Bank, November 2000), with the rural poor being particularly vulnerable. Income distribution among sectors of the population and regions are highly disparate. Social protection systems that might even those disparities are weak, and an increasing number of people are outside the formal social security system. Vulnerability is increasing with the rise in unemployment. In the first quarter of 2003 unemployment measured 12.5% compared to 11.5% one year ago.

Poverty alleviation and social protection of vulnerable people and groups are important policy issues stressed both in Turkey's development plans and in government programmes. Organizations have been created to address these issues including the Social Solidarity Fund (SSF), the General Directory of Social Services and Child Protection, General Directorate for Women's Status and Problems, and Regional Development Programmes like the GAP RDA. There is widespread recognition that while government is committed to some minimum level of income support for the worst-off, that new and far-reaching solutions must be developed to address poverty and vulnerability issues.

Micro and informal sector activities play an important role in protecting population segments against vulnerability. Access to microfinance services helps decrease vulnerability by enabling people to take advantage of economic opportunities that allow them to diversify and increase their sources of income. It allows them to build assets upon which they can draw during periods of economic downturn or crisis to smooth out dips in income, and maintain consumption levels for food and other services, like education and health care. A temporary loss of income for vulnerable households can drop them deeper into poverty, and make it difficult, even impossible, to work their way out of poverty. In general, access to financial services enables poor and vulnerable households to strengthen coping mechanisms in the event of hardship. Deepening the financial sector can also address the structural issues that support income disparity, including lack of access to finance for segments of the population.

2.4.2 Rationalizing Strategies for Income Transfers (Grants) and Access to Finance (Credit and Savings)

The Social Solidarity Fund (SSF) recognizes lack of access to capital as a constraint to the development of livelihoods, and their MicroProjects strategy is one programme to provide capital to the poor and vulnerable. Programme beneficiaries receive long-term (5-year) interest-free loans to support small income generating projects. SSF noted however that it lacks the appropriate institutional framework to disburse and enforce repayment of loans on a significant scale.

Following the 2001 crises, the SSF budget, dependent on extra-budgetary resources, declined. To meet budget gaps, the World Bank has established the Social Risk Mitigation Project (SRMP) to strengthen SSF programmes. Under the SRMP, approximately $130 million is allocated to Local Initiatives destined for MicroProjects. Absent an appropriate institutional framework for the disbursement and collection of loans under the MicroProject scheme, it is likely that the project will result in one-time transfers to selected programme beneficiaries, rather than widespread and ongoing access to capital by the poor.

Global experience suggests that the poor and unbanked households want permanent access to financial services, rather than one-time grants. It is continual access to services, not one-time injections that allow the poor to increase their asset base and reap the poverty alleviation related benefits that access to finance promotes. To support income flow to poor and vulnerable groups, both grants and access to credit are potential legitimate responses. For the hard-core poor, grants may even be appropriate long-term solutions. However grant support can create long-term dependence and distort the market for microcredit "crowding out" commercial financial services. (Microfinance, Grants, and Non-financial Responses to Poverty Reduction: Where does MicroCredit Fit?, CGAP Focus Note, No. 20).

Careful coordination and sequencing of grant and credit programmes is important to preserve a strong credit culture and to ensure that the greatest number of people can be reached with public resources. Over time, the public resources invested in credit programmes can be leveraged by successful institutions to access commercial sources of funding to serve an ever-increasing number of clients.

Careful attention to implementation and sequencing of grant, "soft-credit" and fully commercial credit initiatives seems particularly important now given the desire of a number of different donors to disburse significant amounts of funding to market segments for productive purposes. Donors express frustration at the lack of financial infrastructure to support this process. Absent access to solutions that allow permanent access, donors are tempted to disburse funding as grants even if the target group has the capacity to repay. Donors and other stakeholders may want to consider investing a portion of their resources on initiatives that aim to build sustainable institutions, rather than exclusive support on quick fixes.

A formal recognition of the role of access to finance in reducing vulnerability and income disparity in formal policy may be critical to support actions and the flow of funds to enable development of a microfinance sector. Up to now, while many organizations in Turkey at governmental and non-governmental levels recognize the value of non-financial services programmes (for example, access to health care) and income transfers (for example, food aid for the destitute), very few recognize the role of access to financial services for poverty alleviation and reduction of vulnerability. Programmes that concentrate on transfer of capital to low-income groups, however, tend to use disbursement strategies that result in one-time grants, rather than ongoing access to finance.

Chapter 3: The Financial Sector in Turkey

Over the past 20 years, financial sector policies have focused on liberalizing markets. Interest rate controls were abolished and directed credit programmes, though still around, were vastly cut back. Barriers to market entry were removed and the number of banks increased significantly.

A handful of large domestic banks, including private and state-owned banks dominate the financial sector. Following a series of banking collapses, the banking sector has consolidated from 81 banks at the end of 1999 to 55 (41commercial banks and 14 development and investment banks) at the end of 2002. The consolidation of the banking sector is expected to continue through 2003 and the number of banks is expected to reduce further. (Country Finance (Turkey), The Economist Intelligence Unit, January 2003)

The huge majority of loan assets in the banking sector are concentrated in the portfolios of few, large and long established private banks (Akbank, Isbank, GarantiBank, and Yapi Kredi Bank) serving an estimated 85% of the financial market (Financial Services in Turkey, IBM Business Consulting Services). Many of the banks in Turkey (and in the region) have been described as "agent" banks. These banks issue loans primarily to the bank shareholders and businesses connected to the bank owners. Non-bank financial institutions including brokerages, leasing and factoring firms are also part of the financial landscape in Turkey, and a significant portion of NBFIs are bank subsidiaries.

Despite the proliferation of private banks, a significant portion of the banking sector total assets (33%) and total deposits (18.3%) are held by state-owned banks. As of the end of 2001, Ziraat Bank (serving the agricultural sector), was the largest bank in the country with $20.26 billion in assets with a 1,495 branch network. In 2002, Halk Bank (serving industry and trade) was ranked sixth in total assets ($12.3 billion[4]) with a 546 branch network (reduced from 897 in 2001).

Overall, loan assets make up a small percentage of banking sector assets. At the end of June 2002, the Turkish banking sector had total assets of $117.8 billion, of which $24.6 billion were loan assets. Deposits totaled $76.2 billion. Many Banks invest a significant percentage of their assets in Government Treasury Bills and Bonds, given their very high real returns. A large percentage (32.3%) of the sector's loan portfolio is non-performing, largely concentrated in the portfolios of state-owned banks. (Country Finance (Turkey), The Economist Intelligence Unit, January 2003)

Since the mid-1990's Turkey's banking system has been weakened by a series of crises and bank failures, and remains fragile. The most recent crises occurred in late 2000/early 2001. The strategies that banks used to be profitable in a high inflationary environment backfired when inflation fell. In short, banks had generated profits by borrowing in foreign currencies and investing in very high-return government bonds. With the introduction of the IMF supported stabilization plan, profits decreased dramatically. At the same time, the quality of banks' loan portfolios were deteriorating as a result of the economic downturn. With expectations of the withdrawal of foreign lines of credit, and fears of an impending liquidity crisis, a banking collapse ensued. In addition to excessive overexposure, eight banks were found guilty of malfeasance and bank management was transferred to the Savings Deposit Insurance Fund (SDIF).

As part of the Government's larger economic reform programme, strong policy measures have been taken to restructure the banking sector. In September 2000, an independent banking and regulatory authority, BRSA, became operational. In May 2001, a Banking Sector Restructuring Progamme was initiated. Key components of the restructuring programme include strengthening the regulatory and supervisory framework to meet Basle Committee standards, restructuring and privatizing the state-owned banks, and overall strengthening of the private banks. Some conclude that the Banking Sector is being supervised for the first time in Turkish history. The recent decision by government in July 2003 to increase its subsidy to micro and small enterprises served through the state-owned Halk Bank, however, calls into question elements of the restructuring programme, and future results. In addition to significantly lowering the interest rate, restrictions on loan disbursements through cooperatives with a high percentage of non-performing loans have been relaxed. Lowering interest rates and relaxing repayment incentives may enable a significant increase in the number of loans in the short term, but may result ultimately in higher default rates and limited long-term access to finance by the intended target group.

Compared to other countries with a level of per capita income comparable to Turkey, the level of savings captured by the banking system, and the level of financial intermediation is low. A low level of financial intermediation is partially the result of a lack of confidence in the banking system, given the history of financial crises in the country and high levels of inflation. Many people keep cash at home in the form of banknotes, gold and foreign currencies. With recent macroeconomic

[4] 17,401,275 Billion TL at exchange rate of 1,410,000 million TL to 1$US.

improvements, and banking sector reform, the volume of deposits in TL has risen from $30.5 billion at the end of 2001 to $35.9 billion by the end of 2002. Deposit in foreign currencies also increased. However, these figures are still considerably lower than the 1999 and 2000 figures, as a result of the financial crisis and lack of trust in the banking sector.

While incentives for Banks to intermediate have not been strong, banking reform and competitive pressures in markets have resulted in Banks pursuing more active lending operations, and in a few cases, new lines of business for SMEs, particularly on "liability-side" services, like current account management.

However, the Banking environment presents challenges that hamper innovation and financial sector deepening. Inflation rates have proven unstable, and despite significant decreases, inflation rates remain high. Banks in Turkey are heavily taxed, and there are frequent changes in tax rules. As a result of the instability in the banking sector, credit is generally available only at high real rates of interest and for short terms. In 2002, lending rates have consistently averaged 20 to 25% percentage points above the deposit rate. *(Country Finance (Turkey),* Economist Intelligence Unit, January 2003). At the end of 2002, the nominal rate of interest on bank loans was around 55%. The actual cost to borrowers is higher taking into account a 5% financial transaction tax on interest, stamp taxes, and bank fees and commissions. Interest rates appear to have fallen somewhat into 2003 parallel with Central Bank Rates[5], and demand for credit was up 15% in the first four months of 2003. However, even though interbank rates have fallen steadily over the past two years, high government debt and the robust market for Treasury Bills will mean that real lending rates will remain high.

General trends in the banking sector may have the following implications for the development of the microfinance industry in Turkey.

- As a result of a challenging operating environment, the entrance of a significant number of new commercially oriented players in the short term is unlikely given the absence of institutions that know the business of microfinance. With the advent of new laws enabling the establishment of foreign exchange businesses, many operators sprang up overnight. But most of them had been involved in the business before the new legislation emerged. While some banks are experimenting with new lines of business and new markets, they seem to be the exception rather than the rule, as risk taking behavior of banks seems lower than ever. This trend may continue and intensify with rumors about a fresh financial crisis in 2004.

- In the context of a period of recovery from banking collapse, BRSA may be conservative about licensing new banks under the microfinance law.

- The high percentage of non-performing loans reflects a weak credit culture. Information from interview suggests that the culture of non-payment is prevalent across market segments. New players looking to establish microfinance operations will have to thoughtfully confront the challenge of a weak credit culture in the establishment of systems, development of products, and market development.

- The persistence, in fact expansion, of government supported subsidized loan programmes undermines the potential for extensive market outreach to large numbers of people including the poor and vulnerable non-poor over the long-term. Global experience suggests that large scale subsidized programmes generally do not reach low-income households, often have high default rates (especially in state-owned institutions), do not effectively meet borrower needs (Robinson, *The Microfinance Revolution*), and inhibit the entrance of new players who cannot fairly compete with subsidized programmes. Furthermore, while the number of loans disbursed through subsidized programmes may increase significantly over the short-term, the total number of clients reached is generally low relative to the entire unserved market. Since programmes generally have high default rates, the number of clients with access to finance diminishes rapidly. In the long run, fewer clients receive financial services than would be the case in a liberalized market that supports market-based rates, results in innovation in financial markets, and the emergence of a diversified, competitive industry.

- Low levels of domestic savings and financial intermediation support the assertion in this report that very large segments of the population are without financial services, including limited use of savings services. Despite the challenges, there is both strong justification and new opportunity in the context of economic recovery for financial sector deepening in Turkey, and support for policies and programmes to accelerate the process.

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[5] On 7 August, Halk Bank reduced its non-subsidized rates to small enterprises from 55% to 50%. Interest rates from some commercial banks fell below 50%.

Chapter 4: Demand for Microfinance in Turkey

4.1. Who Demands Microfinance Services?

Demand for microfinance services can be understood from the perspective of micro and small businesses that seek access to finance to fund operations and growth. It can also be approached from the perspective of poor and low income households that seek a range of financial services including loans, savings and other services to invest in businesses, improve their homes, and meet other consumption needs.

4.1.1 Formal and Informal Sector Enterprises

Micro and small business in Turkey are a visible and productive part of the Turkish economy. SMEs account for between 95 and 99% of all enterprises in Turkey. Non agricultural SMEs employ more than 40% of the workforce, and produce 30-40% of exports.

The Tradesmen and Artisans Confederation (TESK) that deals exclusively with the enterprises of tradesman, service providers and craftsmen estimates that there are about 4 million businesses in Turkey with 1-10 employees. Two million of these businesses are registered with TESK, and the majority are self-owned. An additional 700,000 SMEs with independent legal status are registered with the Chamber of Commerce (Turkey Financial Sector Study, IPC). Because businesses registered in Turkey are subject to heavy taxation, it is likely that many businesses have remained informal. Estimates of unregistered or informal businesses range from 500,000 to 8 million. According to the National Report on Sustainable Development, there are 6.3 million self-employed individuals or employers in the informal sector. The number of self-employed and informal workers appears to be growing due to increases in formal unemployment rates. Formal and informal sector enterprises include a broad range of businesses like trading, production of textiles and rugs, shopkeepers, grocers, shoemakers, service providers, etc.

It appears that nearly 100% of formal sector loans are currently supplied to men through state-owned enterprises. Women, however, make up a significant proportion of the workforce representing 27% of total employment. An estimated 1/3 of all informal workers are women, and more than 50% of women's entrepreneurial activities are home-based. Home-based activities may in some cases be the only constant source of income for a family, particularly where male family members are employed in seasonal or part-time work. Anecdotal evidence suggests that an increasing number of women are being brought into the work force as reliable formal sector work continues to decrease. While not all home-based workers need or want access to credit, the Maya Enterprise for Microfinance estimates the potential demand for women borrowers (including but not limited to home-based workers) to be 1.7 million.

Box 7: Women's Entrepreneurial Activities and Home-Based Work

The majority of women's businesses are home-based. Products may be sold from the home or in markets or small shops. Examples of business activities are food production, clothing sales, handicraft production, sewing, and hairdressing. Many such producers earn between 1 and 4 times minimum wage (150 million TL), and profit margins vary with activity. In some cases, producers are dependent on middlemen to find markets for their goods and may have limited control over the prices they receive. The size of loans demanded by many producers in this segment is quite small (200 million to 1 Billion TL), with producers able to service debt with payments between 30 to 100 million TL per month.

Many home-based activities are considered "piece work" and also involve multiple family members. Examples of piece-work include putting ink cartridges into pens, putting gum in boxes, attaching plastic sticks to candy, sewing slippers and shoes, and assembling toys. In the agricultural sector, home-based work may include breaking nuts or processing tobacco. For most piece-work, home workers are provided raw materials for production (by a company or middleman) and paid a set wage for each lot of materials produced. Monthly revenues for piece work is often below minimum wage (150 million TL); in a good month households may earn up to 300 million TL. Since inputs are supplied by companies or middleman, the majority of such home-based piece work do not require additional financing, though such households may seek deposit services to build up lump sums of cash over time.

Sources: Maya Enterprise for Microfinance; Interview with Organization of Home-Based Workers; *New Poverty and the Changing Welfare Regime of Turkey,* Bugra and Keyder)

4.1.2 Agricultural Sector

Small agricultural enterprises in rural areas also play a significant role in Turkey's economy. There are an estimated 4.1 million agricultural enterprises in Turkey, of which 95% are based on smallholdings. An estimated nine million people are employed in agriculture; agriculture accounts for 40% of the work force and 15% of GNP. The agricultural sector represents a major market segment for microfinance services. While traditionally, microfinance operators have focused technology and product development on trades and services in urban areas, the size and importance of rural, agricultural and non agricultural market segments demands the development of institutions, products, and technologies that serve this market.

4.1.3. Households

Demand for financial services goes beyond financing the operation and expansion of micro and small businesses. Individuals and households also seek access to finance to improve their houses, and meet other consumption needs. People seek access to savings services that can be used to build up lump sums to finance large purchases, and to provide a safety net during periods of crisis. Little information is available concerning demand for other kinds of financial services including savings services, remittances, and insurance services.

4.2. How is the Market Segmented?

The market for microfinance services in Turkey includes a wide range of potential clients. Due to its sheer size (see demand estimates in 4.4), and the scope of unbanked populations who reside beyond the finance frontier, the market has potential for significant segmentation. The following illustrates a scenario of potential market segments in the target market:

- At one end of the spectrum are the self-employed and unregistered, informal sector businesses owned and operated by family members. These may include people who have recently entered the informal market as a result of unemployment, or who have small income generating activities in addition to low paid wage employment or seasonal labor. These businesses may also be a household's sole source of income. Some producers in this segment engage in home-based productive activities; this segment includes both men and women. This segment currently has access only to informal sources of credit, if any at all.

- Another market segment includes more established micro/small businesses with one, perhaps more employees, or several partners working together. Many are registered with TESK, and some may also be members of TESKOMB, the network of TESK member cooperatives. These businesses may not own property, and also likely to do not have access to formal sources of credit. With limited access to informal finance and internally generated funds (profits), these are currently low growth businesses. They reside in both rural and urban areas.

- Another market segment includes established registered businesses, with assets that can be used to secure loans. Some rely on internally generated funds, others seek access to loans from banks, and are strong growth businesses. They seek financing from a number of different sources, and want other account services, like current accounts and credit cards.

- Another market segment is households employed in the agricultural sector. They have a range of agricultural and non-agricultural income generating activities, and seek both loans and other account services to manage variable income streams. They are members of agricultural cooperatives, but have no or unreliable access to Ziraat Bank services.

Reflecting significant market segmentation, demand for loans reflects a broad range of loan sizes from $200 up to $7,000. It is likely that the majority of demand for loans falls between $500 and $3,000. Wide segmentation of the market reflects significant income disparity between regions and segments of the population. According to the 2001 Human Development Report, GDP per capita at purchasing power parity averaged $6,486 in 1998, but varied widely among cities, with a high per capital GDP of $16,991 in Kocaeli, and a low per capita GDP of $1,603 in Agri. Generally speaking, microfinance services range anywhere from 20% of unadjusted per capita GDP for the very poor to 250% of per capita GDP for the vulnerable non-poor. Unadjusted per capita GDP in Turkey in 2002 was $2,605. The proposed range of loan sizes ($200 to $7,000) roughly correlates with average loan sizes of Maya Enterprise for Microfinance serving the lower spectrum of the market with the first average loan amount of 300 Million TL ($200) but ranging from 40 million to 400 million, and at the higher end of the spectrum, upper loan limits for Halk Bank loans to small enterprises through cooperatives (10 Billion TL). Halk Bank average loans sizes to microentrepreneurs are currently less than $2,000.

The conclusions drawn here are not based on rigorous data, rather a limited number of interviews enabled by the two-week mission that prompted this report. Significant additional research is required to understand the financial service needs of businesses and households in Turkey within various market segments. Financial service needs stretch far beyond loans, and include deposit services, insurance services, remittances, and even pension funds.

Box. 8: Microentrepreneurial Activities and Demand for Credit in Various Market Segments

- A jeweler, operating out of a small shop, currently has 25 billion TL in equity (about $17,700). The business owner seeks an additional 10 Billion TL to expand his business (about $7,000). He currently does not have access to formal sources of credit, but notes that the current economic environment makes it increasingly unlikely that he can support expansion. Monthly revenues are estimated at about 4 Billion TL with a net profit margin of 300 million TL, a 7.5% profit margin once he has paid for all expenses including operating expenses, rent and tax. This shopowner finds it increasingly difficult to compete against large-scale businesses that can buy inputs, like silver, at lower wholesale prices.

- A fruit and vegetable business owned by 5 partners earns about 750 to 800 million TL ($570) per day, and daily profits are about 50 Million TL ($35) split among 5 partners. Profit margins of 6% are slim. In the past, this business was able to access a loan from family members in foreign currency (equivalent to 4 Billion TL). Repayable in foreign currency, the business was forced to pay back 6 times its nominal value in TL following the 2001 crisis. At times, this business has been able to access credit through a credit card. It may be difficult for this business to service debt on a loan, and for now, will likely rely on its limited capital to continue operating its business.

- A hardware vendor operating on a busy downtown street in Ankara has taken a loan through a TESKOMB cooperative. But now, with uncertain economic times, he is reluctant to take a new loan because he is uncertain that he can service the debt on the loan. For now, he is relying on internally generated profits.

- A successful spice and candy vendor has recently taken out a 20 Billion TL loan from Halk Bank over a two-year period. He was able to take out this loan using his building and inventory for collateral. This business is doing very well and his profit margins are more than adequate to service debt on his loan.

4.3. Effective versus Potential Demand

The potential market for microfinance services in Turkey appears vast -- the number of self-employed, and micro and small enterprises in both the formal and informal sector is estimated at between 3.2 and 9.5 million, including agricultural enterprises. However, in the early stages of market development in Turkey, real demand for loan services may be limited by a) capacity to repay, and b) willingness to repay. Limited effective demand, however, still translates into very significant market numbers (see 4.4) that should be attractive to potential suppliers in the market.

4.3.1 Capacity to Repay

Many micro and small businesses in Turkey appear to be under significant competitive pressure from large scale, modern enterprises. This finding was born out anecdotally during a limited number of interviews during the mission. Small grocers noted the emergence of larger grocery chains particularly in urban areas that can undercut their prices. A self-employed jeweler referred to a much larger competitor that can buy raw materials in large volumes and undercut his prices. Interviewees quoted net profit margins of not greater than 10-15%. Businesses also remarked that profits are limited not only by squeezed margins, but in the current economic environment, less demand for goods. The performance of registered small enterprises has been further dampened by the high costs, both real and transactional, of tax and bureaucratic requirements.

In many markets in which a microfinance industry thrives, businesses in trade and services have very high rates of return and a very quick turnover of goods. High rates of return and rapid turnover of stock enables micro and small businesses to service the high rates of interest on microfinance loans. In Turkey, as a result of market pressures, many businesses may face difficulty servicing debt, or may not seek to grow businesses through debt financing at all.

Additionally, many micro and small businesses in Turkey have been operating for many years, passed down through generations. Many such businesses rely exclusively on internally generated funds, and are not interested in accessing debt. In fact, one survey found that inflation, taxes, and depressed demand for goods and services present bigger obstacles to business development than lack of access to capital. *(Turkey Financial Sector Study, IPC)*

Many small producers complain that revenue and profits are limited by poor access to markets. In many economies where microfinance thrives, good and services produced by micro and small businesses are sold in local markets.

In Turkey, there appear to be limited local markets for many products produced by the sector, particularly in manufacturing and agriculture.

4.3.2 Willingness to Repay

There appears to be a weak credit culture in Turkey, and selective willingness among borrowers to repay. This weak credit culture appears to exist across all market segments. Non-performing loans in the formal banking sector are high at both state and private banks. Weak credit culture has resulted from a variety of factors but largely because repayment commitments are weakly enforced. In the majority of cases, lenders lack systems, expertise and incentives to enforce repayment. On a frequent basis politicians are known to forgive debt to win political favor, particularly the debt of small farmers. In fact, one interviewee said that in his community few people bothered paying loans as the debt would be eventually forgiven.

Microfinance operators will likely have to pay significant attention to the application of tools and technologies that enable them to accurately assess both willingness and capacity to repay. Microfinance operators will also have to carefully develop and market their products. Businesses that have relied on internally generated funds, largely because they have not had access to loans, may be cautious, even reluctant, to seek formal sources of finance.

4.4 What is the Estimated Demand for Microcredit Services?

The following demand estimates have been made using two different approaches: 1) a "standard-of-living" approach, and 2) a "private- sector" approach. The estimates are not based on in-depth market research. They are merely scenarios that give some indication of the magnitude of the market. These are broad estimates that do not take into account differences in demand according to region.

4.4.1 Numbers of Clients

The standard-of-living approach looks at the number of vulnerable households in Turkey. Looking at the household as a unit of analysis is common since total household income is often used to determine repayment capacity on loan, versus simply business profits. Using this approach, the market is estimated at between 1,084,800 clients and 1,627,200 clients, assuming conservatively that between 20-30% of the market defined by vulnerable households will want services.

Box 9: Demand Estimates: Standard-of-Living Approach

Standard-of-Living Approach					
Total Population	Vulnerable Population	Average Size of households	Vulnerable households	% 20 demand	% 30 demand
67.800.000	24.408.000	4.5	5.424.000	1.084.800	1.627.200

The private sector approach attempts to quantify demand by looking at the number of micro and small businesses in the informal and formal sector, and in agricultural and non-agricultural markets. Demand figures for the agricultural sector are particularly sketchy, and may be underestimated. The figures used below are averages of low-end and high-end estimates of the three business types listed below.

Box 10: Demand Estimates: Private Sector Approach

Private Sector Approach			
		% 20 demand	% 30 demand
Micro and Small Enterprises (formal)	3.000.000	600.000	900.000
Informal Sector Enterprises	2.250.000	450.000	675.000
Small Agricultural enterprises	1.125.000	225.000	337.500
Total	6.375.000	1.275.000	1.912.500

Using this approach the total market is estimated at between 1,275,000 clients and 1,912,500. This range is not significantly different from the standard-of-living approach.

To give some idea of the total capital required by the sector, the market has been divided into 4 market segments with average disbursed loans of $500, $1,500, $3,500 and $5,500. Again, these figures are merely indicative, to give some idea of the potential magnitude of the market. They are based on nothing more than a solid guess.

4.4.2 Portfolio Size

Portfolio Estimates: Standard-of-living approach

Box 11: Loan Capital Needs: Standard-of-Living Approach

Loan Capital Needs: Standard-of-living approach		
Average Loan Size	% 20 demand (1.084.800)	% 30 demand (1.627.200)
%20 market ($500)	$108.480.000	$162.720.000
%50 market ($1.500)	$813.600.000	$1.220.400.000
%25 market ($3.500)	$949.200.000	$1.423.800.000
%5 ($5,500)	$298.320.000	$447.480.000
Total	$2.169.600.000	$3.254.400.000

Using this stratification, the capital requirements are $2.2 billion to $3.3 billion. Note that these amounts do not represent the outstanding portfolio. We can assume that at any given point that the average outstanding loan is less than the disbursed loan as people repay capital throughout a loan cycle. If we assume that at any given point that 55% of disbursed capital comprises the outstanding loan portfolio, the outstanding portfolio of the market ranges from $1 billion to $1.6 billion.

Estimated capital requirements using private sector approach figures, yields the following.

Box 12: Loan Capital Needs: Private Sector Approach

Loan Capital Needs: Private Sector Approach		
Average Loan Size	% 20 demand (1.275.000)	% 30 demand (1.912.500)
Formal M/S ($2000)	1.200.000.000$	1.800.000.000$
Informal ($500)	225.000.000$	337.500.000$
Agricultural ($2.500)	562.500.000$	843.750.000$
Total	1.987.500.000$	2.981.250.000$

Using this approach the total capital requirement is estimated at roughly $2 billion and $3 billion, also very similar to the standard-of-living approach estimates. Using the same logic as above, the total outstanding portfolio ranges from $1 billion to $1.6 billion.

These estimates attempt to quantify the market for loans, but do not take into account the wide range of financial services that the unbanked populations demand including savings, insurance, remittances. Taking into consideration the wide array of potential services, beyond loans, demand for services seems infinite.

Chapter 5: The Supply of Microfinance in Turkey

5.1. Who are the Current and Potential Suppliers of Microfinance in Turkey?

Globally, the following institutional models are the most prevalent providers of microfinance services.

- *Non-governmental organizations*. They are generally nonprofit, credit-only institutions.
- *Commercial banks or non-banking financial institutions* that have launched a line of business to serve the small business market. (Some commercial banks have established subsidiary operations that exclusively focus on the microfinance sector.)
- *Specialized microfinance banks* established to specifically serve micro and small enterprises.
- Member-owned *credit and savings cooperatives or credit unions*.

In Turkey, the concept of microfinance has recently emerged in public discussion. While recognition of microfinance as a subsector within the financial system is new, the state-owned banks, Halk Bank (which targets trading and service sectors) and Ziraat Bank (which targets the agricultural sector) have been providing services to small enterprises for decades. Despite severe limitations in service delivery, and limited depth of outreach given traditional asset-based collateral requirements, these banks are the overwhelmingly dominant players in the market now, and will likely remain so, at least in the short-term. Among civil society, a limited number of organizations have dabbled with credit delivery, both in-kind credit and cash. In 2002, the Foundation for the Support of Women's Work (KEDV) established the first microfinance institution in Turkey, Maya Enterprise for Microfinance. It represents the only NGO microfinance operation currently on a commercially viable path. Neither private commercial banks nor credit unions have played a decisive role in sector development. The following section explores each class of supplier in more depth, and their future prospects.

5.1.1. State-Owned Banks

The largest players in the microfinance sector in Turkey are the state-owned banking institutions, Halk Bank and Ziraat Bank. As a result of legislation passed in 2000, both Halk Bank and Ziraat Bank are currently restructuring their operations, and cleaning up largely non-performing loan portfolios in preparation for eventual privatization. While lending to micro and small enterprises has not ceased during this process, it appears to be seriously curtailed, particularly loans channeled through agricultural cooperatives to small farmers. Given economic uncertainties and lukewarm interest in the purchase of other state-owned banking enterprises and banks taken over by SDIF in 2001, it is not likely that either Halk or Ziraat Bank will find private buyers in the near-term.

Halk Bank channels loans to the micro and small enterprise sector primarily through a subsidized loan programme supported by the Treasury. Strict criteria for accessing loans and limited "supply-driven" products has resulted in the rationing of credit to this sector. According to TESKOMB and Halk Bank, as of June 2003, between 120,000 and 130,000 micro and small entrepreneurs had loans through this window. The total outstanding loan portfolio was approximately 300 trillion TL (approximately $200 million), resulting in an average outstanding loan size of approximately 2.3 Billion TL, or $1630. Subsequent to the sector assessment, TESKOMB reported that the number of borrowers had more than doubled following a government decision in mid-July to significantly increase subsidies to TESKOMB borrowers [6], although according to their figures, the size of the loan portfolio has not significantly increased. Halk Bank also provides a limited number of loans to small businesses through non-subsidized windows.

Ziraat Bank claims an established client base of nearly 2 million clients, including 1.5 million members of agricultural cooperatives. On June 6, Parliament approved a bill to partially pardon and restructure over TL 3,000 trillion TL worth of farmers' debts to the Bank (worth about $2.1 Billion) representing 900,000 loans to farmers[7] through the cooperatives and 210,000 individual loans. Preoccupied with cleaning up its loan portfolio, current supply is limited.

[6] Halk Bank has reduced interest on loans to borrowers through TESKOMB from 44% to 30%. The unsubsidized, "market rate" to small enterprises through Halk Bank is 50%.

[7] All dollar conversions use a calculation of 1,410,000 TL to $1, the TL exchange rate in late July 2003.

While the original mandates of state-owned banks was to raise funds from the public and channel them to specific sectors, a very low percentage of savings is actually intermediated. Loan portfolios represent a minor portion of banks' total assets. The preponderance of asset-based lending technologies requiring traditional collateral, usually property, likely limits supply of services to the "better off" segments of the vast target population. Subsidized lending programmes that attempt to channel credit to specific target groups end up "rationing" credit to a limited number of borrowers due to product constraints and strict criteria for accessing funds.

While structurally weak and reaching only a small proportion of the target market, the state-owned banks are the dominant players in the sector now, and will remain so for the foreseeable future. Both banks will continue to struggle with the process of restructuring and portfolio cleanup. At least in the short term, new lending will likely be limited. With massive branch networks, both Ziraat Bank and HalkBank have a potentially great role to play in serving this market in their future forms, not only providing lending services but also savings services. As such, both banks must figure prominently into any microfinance sector development strategy in Turkey.

Nearly 80% of Halk Bank's 4 million savers have account balances of less than 1billion TL ($700). In a highly inflationary environment, it is not surprising that savings balances are low. However the large number of savers with relatively low balances may indicate high potential for Halk Bank to expand its offering of appropriate savings services to the target market if and when inflation stabilizes.

Box 13: Halk Bank

In December 2002, Halk Bank was the sixth largest commercial bank in Turkey measured by total assets (17.4 million billion TL) or about $12.3 billion . Halk Bank has 546 branches (reduced from 897 in 2001). Its original mandate was to raise money from the public to channel loans to artisans, tradesman and SMEs at subsidized rates in economically underdeveloped parts of the country. While its 2002 financial statements show a profit, HalkBank has been heavily loss making and its losses were covered by the Treasury. (HalkBank 2002 Annual Report)

The total net loan portfolio at the end of 2002 was $887 million, representing only 7% of its total assets. HalkBank has a significant percentage of non-performing loans. In 2002, 47% of its total loan outstanding loan portfolio of $1.7 billion was provisioned. In 2002, 65% of its loan portfolio was SME loans (544,932). 18.4% of its total loans (153,053) went to members of TESK cooperatives (artisans and tradesmen businesses with less than 10 employees.) The majority of loans were distributed to textile, food and construction sectors. In 2002, Halkbank had nearly 4 million depositors, including public and commercial savers. 78% of outstanding balances in deposit accounts are less than $700.

Since November 2000, Halk Bank has undergone a process of restructuring in preparation for privatization. Despite the restructuring programme, HalkBank continues to support subsidized loans to some clients; according to the 2002 financial statements they represented 18.4% of the number of performing loans in the loan portfolio or 153,053 loans. Until July 2003, clients borrowed at 44% and Treasury provided Halk Bank with an additional 11% of interest to compensate for the commercial cost of borrowing, considered 55% in June. (TESKOMB borrowers are also exempt from the 5% transaction tax on loans raising effectively raising the subsidy to 16%.) In July 2003, the interest rate was dropped to 30%, with Treasury covering the additional 20% to Halk Bank to compensate for the commercial cost of lending.

As of the end of June 2003, according to TESKOMB and Halk Bank total loans disbursed by Halk Bank through the TESK cooperatives under this subsidized credit programme by the end of June was between 120,000 and 130,000 totaling approximately 300 trillion TL (about $200 million), resulting in an average loan of 2.3 billion TL ($1,630). The upper limit on loans to cooperative members is 10 Billion TL ($7,092). 90% of loans have two-year terms.

HalkBank subsidized loans are only available to members of the TESK cooperatives. There are two levels of guarantee on each loan. TESK cooperatives provide a guarantee on the loan using members savings. In addition to the TESK cooperative guarantee, members must provide either property collateral of about 200% of the value of the loan or guarantees of two other members in good standing. Halk Bank claims that 90% of these loans are repaid. Given the collateral requirements and apparent rationing of credit, it is likely that the small and micro business clients of HalkBank are the better off among the microfinance target market.

Each year the Treasury allocates funding to support the subsidized loan programme (until commercial rates are 30% or lower). In 2002 the Treasury allocation was set at 50 trillion TL; in 2003 it was set at 75 trillion. This allocation should enable a total loan portfolio to this market segment of nearly $1 billion, more than the value of the Bank's current total performing loan portfolio. As of the end of June, approximately 1/6 of the allocated subsidy had been used. Interviewees noted that the limited use of the funding available to micro and small entrepreneurs was not a reflection of limited demand. TESKOMB noted that for 70% of its 1.1 million members, lack of access to capital was a major binding constraint. Rather, limited use of capital was the result rather of product constraints and criteria for accessing credit.

The policy of subsidizing credit to HalkBank's target market appears to effectively ration credit to the market. Clients must meet strict criteria and adhere to rigid borrowing policies that stem from requirements of the subsidized loan programme. Interviewees note particular limitations on the use of credit for working capital. The most effective way to develop more client responsive products and increase outreach may be the offering of products outside the framework of the Government backed subsidized credit programme. One source notes, "the greater the subsidy the greater the potential for political intrusion over credit allocation." Offering products outside the current framework may enable Halk Bank to design and market financial services that that meet demands of clients, and develop a true banking relationship with clients.

Box 14: Ziraat Bank

Ziraat Bank provides agricultural loans to farmers through 1,136 branches. Its current client base is estimated at around 1.9 million farmers. 1.5 million clients belong to the 2,200 agricultural cooperatives in Turkey. Unlike Halk Bank which lends directly to end users, Ziraat makes loans to the cooperatives which then onlend to cooperative members. In addition to cooperative loans, and estimated 350,000 clients receive individual loans.

Following a law passed in 2000, Ziraat Bank is in the process of restructuring. Loans that were once heavily subsidized across market segments are now offered at "market-based" rates of 55%. Like Halk Bank, a low percentage of assets are invested in its loan portfolio. As of end 2002, the net loan portfolio made up 13% of total assets, while Treasury Bills and Bonds represented about 50% of the total assets. At the end of 2002, $1.7 billion of the $3.4 billion in outstanding loans was considered non performing. On June 6, Parliament approved a bill to partially pardon and restructure over TL 3,000 trillion TL worth of farmers' debts to the Bank (worth about $2.1 Billion) representing 900,000 loans to farmers through the cooperatives and 210,000 individual loans. Clearly the problem of non-performing loans remains massive. With its significant non-performing portfolio it is not likely that Ziraat Bank is making many new loans. While Ziraat Bank has embraced market-based rate, large subsidies prevail through loan default.

Note: The rate of conversion used is 1,410,000 TL per $1.

5.1.2. Specialized Microfinance Banks

Draft legislation is currently under consideration to allow for a new class of licensed banking institutions that focuses solely on the microfinance market. Section 6 contains a discussion of the legal and regulatory framework for microfinance in Turkey including the draft law for specialized microfinance Banks. This legislation allows for both deposit-taking and non-deposit taking banks. In the region, the EBRD has been the primary driving force behind the creation of 10 specialized banks and two microfinance companies in Albania, Bosnia, Bulgaria, Georgia, Kosovo, Moldova, Romania, Russia, Ukraine, and Serbia. Coinvestors with EBRD include International Finance Corporation (IFC), German Development Cooperation (KfW), Netherlands Development Finance Company (FMO), as well as a German investment firm called IMI that provides the technical expertise in addition to providing some start-up capital. (Microfinance in Turkmenistan, Judith Brandsma)

In the short term, it is possible that a Bank will emerge likely majority financed by multilateral and bilateral development banks, as is the case throughout the Eurasian region. Given the difficult conditions in the banking sector, it is unlikely that significant amounts of private investment will support start-up microfinance banks now. However, the emergence of additional specialized Banks in the future financed by private commercial capital following a compelling demonstration model is possible.

5.1.3. Commercial Bank "Downscalers"

Up to now, the formal banking sector, like those in many countries, has not effectively served the SME market or low-income households. A number of commercial banks however have begun to focus institutional resources on developing lines of business that serve the small and medium enterprise sector, with the expectation that it is a significant growth market. One Bank pointed out however that the lending business in this market has been limited up to now. Rather its potential currently as a business opportunity lay with the delivery of fee-based, "liability-side" services (management of current accounts, savings accounts, etc.). The depth of outreach (income level of clients) by commercial banks to clients in the micro and small enterprise sector is not available.

Commercial banks will not likely be major players in the microfinance market at least for some time to come. In Latin America, competitive pressures in the market have forced banks to push the finance frontier. In Turkey however, pressure to extend the frontier appears limited, at least in the short and medium term. For the time being, banks still continue to generate significant net margins from investments in Government Treasury Bills. Pressure to focus resources on development of new markets is, overall, not significant. Nevertheless, a number of "downscaling" commercial banks are meeting the financial services needs of a market segment that has had limited access to services in the past.

In some countries, commercial banks have entered the market through subsidiary institutions with a different business model and lending technologies to serve low income and micro and small business markets (for example, the Sogesol subsidiary of Sogebank in Haiti). While no banks in Turkey are considering the establishment of subsidiaries to serve the microfinance market, it may remain a potential institutional form for service delivery in the future, contingent on the legal and regulatory framework.

5.1.4. NGOs and Civil Society Organizations

In many countries, the majority of players in the microfinance sector, particularly in start-up or early stage microfinance sectors, are non-governmental organizations (NGOs), both local and international, sometimes in partnership. NGOs play an important "demonstration" role in an emerging sector. NGOs demonstrate new lending technologies and business models to prove that the poor are bankable, and can be served profitably. In some cases, some NGOs eventually transform into licensed financial institutions.

In Turkey, only a limited number of NGOs or other civil society organizations have experimented with the delivery of microfinance services. This is in part the result of a weak NGO movement in Turkey, and lack of clarity regarding the permissibility of such organizations to lend money.

Among the experiences of NGOs, the initiatives of the Development Foundation of Turkey (TKV) (Box 15) and Foundation for the Support of Women's Work (KEDV) are the most notable to date. In June 2002 Foundation for the Support of Women's Work established the Maya Enterprise for Microfinance, the first and only microfinance institution established in Turkey with the objective to become financially viable (Box 16). As of June 2003, Maya had 200 clients and an outstanding loan portfolio of 55 Billion TL. Maya finances its operations through a grant and a loan from the international NGO CRS. In June 2003, the Waste Reduction Foundation of Diyarbakir launched a Grameen Replication Project to test the Grameen Bank lending methodologies (Box 17).

While NGOs have not played a significant role up to now, following their strong performance in the wake of the 1999 earthquakes, NGOs appear to be gaining strength in civil society, and have earned new popular support. With the emerging role of NGOs in Turkey, NGOs may become active suppliers in the microfinance market in the future. The legal status of NGOs in the microfinance sector, however, is unclear. In many contexts, legal ambiguity has given NGOs extensive scope for experimentation. In Turkey, however, the absence of a clear legal framework for NGO activity makes it risky for them to operate. (The current framework for NGOs is explored in more detail in 6.2.3.)

Furthermore, the Draft Banking Law currently under consideration restricts NGOs, Foundations, Associations, and like-organizations from owning equity in a licensed Microfinance Bank. In many countries, NGOs establish operations with a limited amount of donor capital or other source of public funds. Over time, as operations grow, NGOs may accumulate enough capital and experience to obtain a license under Banking law. In some cases, NGOs will merge with other players to meet minimum capital requirements to get a banking license. In other cases the NGO will trade its loan portfolio for an ownership stake in a licensed institution. Some NGOs choose this path – transformation into a licensed institution – to access opportunities to leverage its capital by collecting savings deposits or accessing bank loans (See Box 2, MiBanco). Through leverage, a licensed microfinance institution can expand its operations dramatically, ultimately serving a greater number of people. To donors, the opportunity for an institution that it supports to leverage funds at some point in the future is very attractive. It means that for each unit of funding that it provides an MFI, the institution can use its donated capital (and accumulated earnings) to attract additional sources of funding from the commercial sector. A legal framework that inhibits the opportunities for NGO MFIs to eventually leverage its funds may also hinder the channeling of donor capital into the NGO sector. An environment which discourages the emergence of NGOs can stifle development of the sector as NGOs are often the source of innovation adopted by larger scale players with different institutional models.

Box 15: Development Foundation of Turkey (TKV)

TKV is a Foundation established in 1969. Its initial mission was to promote agricultural development. TKV has provided in-kind credit, for example beehives, linked with agricultural extension services. Repayment periods were generally long (more than 5 years), and often also in-kind. TKV considered the progamme to be successful, with success measured by repayment and successful establishment of beehive producers. Programme success was attributed to intensive training and monitoring, and the cost of running its programmes was high. While successfully meeting some of TKV's agricultural development objectives, the model itself however did not enable sustainability of the programme or broad outreach.

More recently, TKV has shifted its in-kind lending and technical support programmes to more urban contexts, with in-kind loans ranging from $300 to $3,000, to finance shopkeepers, and small producers. However, the challenges of outreach and sustainability remain.

Box 16: Maya Enterprise for Microfinance

Maya Enterprise for Microfinance, an independent for-profit NGO, was established in June 2002 by KEDV, Foundation for the Support of Women's Work. Maya provides financial services to low-income women entrepreneurs. KEDV began experimenting with microfinance services in 1995 when it became apparent in their community development activities that women sought access to loans and savings services to manage business and household activities. For legal reasons, KEDV established a separate for-profit company to run its microfinance business. Maya is the only microfinance institution in Turkey currently with a strong Business Plan that demonstrates a credible path to financial viability. Absent a clear legal framework, KEDV underwent a time-consuming process to get legal permission to operate. Even though Maya is not a licensed Bank it is required to pay all banking taxes.

Lending operations began in August 2002. As of June 2003, Maya was lending to 200 clients in Kocaeli with a loan portfolio of 55 billion TL. Maya targets low income women with already established micro businesses. Business activities include small scale trading in markets and shops, and home based production, for example, in textiles.

First loans in Kocaeli range from $30 to $300. On-time repayment has been 100% to date. Maya will begin operations in Istanbul soon, and first loans will start at $500 reflecting different market conditions. Loan cycles are from 4-6 months depending on the loan size, and the annual interest rate is set at 4.9% a month charged on a declining basis. This is the minimum interest rate that Maya must apply in order to break even in 2005, its fourth year of operations. In addition, typical to the banking sector, Maya charges a 3.75% up front fee on loans including a 3% administrative fee and .75% stamp tax on contracts. Maya is subject to a bank tax of 5% on all interest income, and this fee is also passed on to the client. The annual effective rate to the borrower has been calculated by Maya to be 83%.

By 2006, Maya aims to provide financial services to 8000 women (active borrowers) in the urban and peri-urban areas of Istanbul, Ismit, and Duzce/Adapazari with an outstanding portfolio of US$1.1 million. Maya estimates that it will make a net profit by 2005. Even though Maya plans to plough profits back into operations to enable further expansion to a greater number of clients, under its current operating framework, Maya will be required to pay taxes in 2005 once it breaks even. Profit tax has not been figured into its current interest rate schedule; Maya will have to adjust its rate upwards if it is subject to taxes on profits. It aims for full profitability by 2008 when it will have covered its full costs including the cost of equity erosion due to inflation, and the shadow cost of funds (the cost of funds if Maya were sourcing capital at commercial rates). Maya estimates total financing needs of $1.78 million to cover operating losses and loan portfolio through 2006.

Maya has confronted a number of challenges in its first year of operations. So far, clients have been slow to access services. Reluctance has been due to lack of experience with loans, and lack of trust for an organization unknown to them. Given the recent financial sector crises people are distrustful of organizations that appear to operate as banks. Over time, business has picked up, but marketing the product and developing the market has proven much more laborious than Maya had anticipated. Nine months into lending operations, Maya had only 200 active clients at the end of June making it unlikely that they will reach their goal of 1000 clients by the end of September. Maya has also found that developing the market among women has its challenges. In some segments of the market, women have been discouraged from accessing credit, and in some cases even participating in markets, if it means leaving the home. Because Maya operates in the informal sector, the huge majority of its clients businesses are not registered. Reluctance to take out loans may also be linked to fears that their informal status may be jeopardized.

Taking a market-driven approach, Maya has invested significant time in product development, Maya lends to individuals within a group of 3, in which each member guarantees the loans of other members. In operation for less than a year, Maya has already modified its products reducing the group of guarantors from 5 to 3. Maya believes that significant additional market research is required to understand the financial service needs of clients.

In addition to establishing Maya, a formal financial institution, KEDV manages a programme supported by Citibank to organize informal savings groups that collect savings from members and onlend to members. Group members use money for consumption purposes, total amounts collected and onlent range from 2.5 million to 5 million TL per month.

Box 17: Grameen Replication Project

The Foundation for Waste Reduction has also initiated a microfinance project with the assistance of the Grameen Trust. The Project will initiate its activities in Diyarbakir and plans to reach 4,400 clients primarily women within three years. Grameen Trust plans on building the operations using Grameen Bank trained management staff and local programme officers. It plans to transfer management of the operation to a local organization at the end of three years. The project plans to target the poorest of the poor in its service area.

5.1.5. Limited Role of Credit Unions and Cooperatives

Turkey does not have a credit union or financial cooperative presence. However many tradespeople and farmers are members of trade cooperatives (TESKOMB and Agricultural Cooperatives) that enable their members access to the financial services of HalkBank and Ziraat Bank. These cooperatives are not financial institutions. Agricultural cooperatives, however, do onlend loans from Ziraat Bank to their members. While the cooperatives will not likely directly manage financial service operations in the future, cooperatives may have an important role to play in the development of the microfinance sector. TESKOMB members are an organized and sizable client group with significant accumulated savings. They represent an attractive and easily accessible market to new players.

5.1.6. Other Suppliers: Informal and Formal

In addition to formal sources of credit, credit is available to some market segments in the form of supplier credit at rates as high as 10% a month. Some people access credit through family and friends, usually in foreign currencies. Credit is also available through money lenders, though they may not represent a consistent source of credit. Some segments of the target market have access to credit cards. Credit may also be available through retailers. For example, a borrower may purchase a refrigerator to be repaid in installments with interest. In some cases a buyer will sell goods purchased on credit in the parallel market to access quick cash.

Box 18: Characteristics of Products in the Market

Ziraat and Halk Banks rely heavily on traditional asset-based lending technologies. The majority of loans require collateral, usually property, often equaling 200% of the value of the loan.

Products tend to be supply-driven, not market-driven products, with loan characteristics determined by loan subsidy programmes or development polices. According to anecdotal evidence the majority of credit available is for purchase of assets, and access to working capital is limited. Loans for assets are often directly remitted to the accounts of suppliers.

Many complained of slow delivery of loans through the established channels. In an extreme case, one interviewee described the case of animal husbandry loans to two coops that had taken four years to receive from the date of application.

Interest rates range from 4-5% a month for credit from formal sources. At the end of the June the prevailing market rate for Halk Bank subsidized loans through TESK cooperatives was 44%; the prevailing market rate ranged from 52% to 55% annually, with some rates falling below 50% by July. The lending rate through TESK cooperatives was reduced to 30% in July 2003, and rates to small enterprises through non-subsidized windows was lowered to 50%. Consumer credit was as low as 3.7% a month. Informal money lenders lend at 6-10% a month; the effective rate is increased by the fact that the interest is often subtracted from the loan up front. Friends and family usually lend to each other in hard currencies given fluctuations in the exchange rate from 0% to 3% a month.

The average Halk Bank loan is two years. Ziraat Bank loans range from 3 months to one year for credit for operations; while "investment credits" range from 3-5 years. The average outstanding loan to TESKOMB members was estimated at 2.3 Billion TL or $1,630, and the upper loan limit was $6,600.

First loans offered by Maya range from $30 to $300 in Kocaeli, and $500 in Istanbul. Loan cycles are from 4-6 months depending on the loan size, and the annual interest rate is set at 4.9% a month charged on a declining basis. Because Maya abides by banking sector tax laws, Maya charges a 3.75% up front fee on loans including a 3% administrative fee and .75% stamp tax on contracts. Maya is subject to a bank tax of 5% on all interest income, and this fee is also passed on to the client.

5.2. What is the Current Supply in the Sector?

Supply information relates almost solely to the supply of loans through the formal sector, and primarily through the analysis of loans to enterprises rather than households with diverse financial service needs.

Nearly all microfinance loans through formal operators are supplied by the state-owned banks. As of the end of June, Halk Bank was providing loans to about 130,000 micro and small enterprises registered through TESK (all of which have less than 10 employees). Average outstanding loan sizes were approximately 2.3 Billion TL (about $1,630). Given that these borrowers are registered in the formal sector and can meet collateral requirements they are likely among the better off in the target market. It is likely that nearly 100% of these loans go to men. Maya provides loans to 200 women micro entrepreneurs operating in the informal sector. Average loan sizes are about $350, a different market segment than that currently reached by Halk Bank. The total demand for microfinance services in the non-agricultural sector is estimated conservatively at 1 to 1.6 million clients. Supply estimated as of the end of June at 130,000 clients meets an extremely limited portion of demand. [8]

Ziraat bank serves nearly 2 million clients in the agricultural sector, although more than 50% of these loans are non-performing or restructured. This report provides no information concerning the depth of outreach in the Ziraat portfolio. Given the fact that few if any new loans are being disbursed, given the high number of non-performing loans, it is not likely that a significant percentage of the agricultural market is currently being served.

Currently, poor clients and informal sector businesses, especially women, are unable to access loans through the formal sector. Most micro and informal businesses must rely on informal finance, if they can access it.

5.3. How May the Market Evolve?

In the short term, the emergence of new players in the microfinance sector in Turkey may be limited due to a difficult operating environment for banking, uncertainty about the future, and an unclear legal framework for NGO and other civil society organizations. Due to restructuring and portfolio clean up activities, the capacity of Halk Bank and Ziraat Bank (the largest players in the market now) to expand operations in a sustainable way will be limited. Due to challenges in the operating environment, including weak credit culture, and the need to develop true market-driven products, it will take some time for emerging (Maya Enterprise for Microfinance and Grameen Project) and new players to establish operations, and cultivate markets. Subsequently, over the short term (next two years) the overall increase in the supply of services may be very limited. The entrance of new players may be further limited given the government's decision in July to increase subsidies to micro and small enterprise borrowers through Halk Bank, resulting in a dramatic decrease in lending rates through specialized windows that new players may have difficulty competing with, at least over the short-term.

Over the medium and long term, however, the entrance of new players and the supply of services has the potential to expand rapidly if 1) a Microfinance Bank emerges enabled by the new draft legislation that provide a compelling demonstration model attracting private sector players to the market, 2) the enabling legal and regulatory framework becomes less ambiguous for NGOs, and 3) state-owned banks have the freedom and capacity to innovate products and services to meet market demand, including charging market-based rates for all its products and services. In order for a competitive microfinance industry to develop with extensive geographic and market coverage, the emergence of strong players of each institutional form will be critical. Over the long term, licensed institutions will likely become the major service providers, but NGO models will be critical to promote innovation and new business models in the sector.

In many environments the sector takes a predictable evolutionary path. Organizations begin experimenting with microfinance and the journey towards commercialization may be a slow one. Conducive regulatory frameworks and the interest of commercial capital in the microfinance sector is slow to develop. In Turkey, however, under the best conditions, the sector may be able to short-circuit this relatively slow process of industry development once one or more strong demonstration models have emerged. The Draft Microfinance Law in its final form may provide the enabling legal framework that allows for rapid commercialization.

[8] Subsequent to the sector assessment, TESKOMB reported that the number of loans had significantly increased by the end of July following a further reduction to the subsidized lending rate.

Chapter 6: The Legal and Regulatory Environment

6.1 What are Legal and Regulatory Frameworks?

Legal frameworks refer to the laws that govern organizations operating in the sector and permit them to offer financial services. In general, microfinance services can be provided by a wide range of institutional models permitted under different legal frameworks: for example, Banking law, Cooperative law, or NGO law. Regulations to which microfinance institutions adhere are prudential and non-prudential. Prudential regulation is designed to ensure the financial soundness of licensed institutions that collect public savings deposits, and is designed to preserve the integrity of the financial system. Non-prudential regulation may include non-prudential reporting requirements, for example, disclosure of interest rates, or performance reporting. Generally, only institutions that collect the public's savings are subject to prudential regulation. In June 1999, Banking Law 4389 created an independent Banking Regulation and Supervision Agency (BRSA) to oversee the implementation and supervision of banking regulations.

Development of a regulatory framework for microfinance institutions often comes at a latter stage of microfinance sector development. Operating outside a licensed context, it is often MFIs themselves that lobby for new legislation that legitimizes their status and enables them to more easily leverage their capital to get bank loans, mobilize savings, and attract new investors. Increasingly, governments are choosing to establish appropriate legal and regulatory framework early on to support the development of a broad range of institutional models, and create a secure operating environment. This is not without its dangers however as establishing a framework in the early stages of microfinance sector development without in-depth knowledge of the markets to be served can result in rigid and difficult-to-change laws that do not suit the needs of the sector.

Given the small number of microfinance operations on the ground in Turkey, this report looks at the extent to which the legal and regulatory framework supports the emergence of new microfinance institutions, including a range of institutional models.

To support the entry of new players, legislative efforts in Turkey should focus on the following activities.

- Establishing a clear and unambiguous legal framework for unlicensed, non-depository MFIs, like NGOs, to operate in the sector.
- Revising and finalizing the draft Microfinance Bank Law currently under discussion. Key issues raised by stakeholder are highlighted below.
- Ensuring harmonization among laws and regulations that govern diverse players in the microfinance sector (NGOs, Specialized Banks, mainstream commercial banks) to ensure a level playing field and the emergence of a diversified and competitive industry.

6.2. Current Legal Frameworks

6.2.1 Framework for Banks

The state-owned banks, Halk Bank and Ziraat Bank, offer financial services within the framework of mainstream banking law, Banking Law 4389. A number of private commercial banks also offer services to small and medium enterprises under this law. The law requires that banks be registered as joint stock companies and have minimum capital of TL 20 trillion (US$14 million). Recently the Banking Law was amended as part of the Banking Sector reform programme to comply with prudential norms established by the Basle Committee.

6.2.2 Draft Act to Enable Specialized Microfinance Banks

To enable the entrance of a new kind of banking institution, focused solely on microfinance services, BRSA has submitted a Draft Act on Micro-financing institutions enabling the licensing of both non-depository and depository MicroFinance Banks. The draft law also permits the lending activities of Associations and other charitable institutions, but does not define the secondary legislation to which such organizations will adhere.

The kinds of financial solvency and other ratios monitored under this regulation are similar to traditional banks, but are more conservative. For example requirements on minimum capital are lower, and capital adequacy is higher. Like traditional banking law, the regulation establishes what products the bank may offer and sets parameters on ownership structures.

Key components of the draft law are listed below.

> Licenses two kinds of commercial joint-stock companies: 1) companies that take deposits and micro-lend, and 2) companies that can only micro-lend.
> Establishes minimum capital requirements at 5 trillion TL for non-deposit taking companies ($3.5 million) and 10 trillion TL ($7 million) for deposit taking.
> Prohibits Microfinance Banks from issuing credit cards, managing current accounts, or carrying out foreign currency based transactions.
> Prohibits Foundations, Political parties, Cooperatives, Associations, or companies established by such organizations to own shares, directly or indirectly, in the Bank.
> Limits loan sizes to TL five billion ($3,500).
> Restricts depository MFIs from accepting deposits at more than three times the value of their equity.
> Exempts Microfinance Banks from Stamp duties, taxes on banking transactions, and banking insurance.

Stakeholders comments on the law focus primarily on removing restrictions that limit Microfinance Banks' markets, service delivery opportunities and potential shareholders.

<u>Capital requirements</u>

Stakeholders have suggested further analysis on the minimum capital requirements to see if proposed requirements create barriers to entry to the market, particularly for deposit-taking institutions. Minimum capital requirements are usually established to ration the number of new MFIs that enter the market in contexts where supervisory agencies have limited capacity. In Turkey, given the robust capacity of BRSA, a high threshold for the minimum capital requirement may not be necessary, particularly in an environment with few institutions on the ground providing microfinance services.

<u>Ownership requirements</u>

Because an NGO (and other like organizations) are prohibited from having an ownership stake in Microfinance Banks, the current law makes it impossible for an NGO to transform into a licensed Microfinance Bank once it has achieved financial viability, or to exchange its loan portfolio for shares in a Microfinance Bank. Transformation is sometimes necessary for an NGO MFI to raise capital to expand and serve growing numbers of poor and low-income clients. Rather than prohibiting NGOs or other institutional forms from taking an equity stake in a Microfinance Bank, the law might consider submitting potential owners to a screening to determine their "fitness" for ownership.

Based on global experience in evolving microfinance industries elsewhere, stakeholders suggest that the law allow more flexibility on maximum ownership shares, and diversity requirements.

<u>Limitation on markets</u>

Looking at global experience, stakeholders suggest that strict definitions of microentrepreneurs and the establishment of upper loan limits are too restrictive. Stakeholders suggest waiting to set such limits, if at all, until more is known about the market. According to the proposed law, the current maximum loan amount is 5 Billion TL ($3,500). This sector assessment suggests that the needs of the microfinance market extend beyond 5 Billion TL (Section 4.2.). Capping loan amounts may leave clients without services once they have established a banking relationship with a Microfinance Bank.

<u>Restrictions on product offerings</u>

In some cases, microfinance legislation restricts the kinds of products that Microfinance Banks may offer in order to clearly differentiate their business from mainstream banks, and minimize the potential for "regulatory arbitrage". Regulatory arbitrage happens when existing or new players attempt to adopt the new legal form to take advantage of what they perceive to be more lightly regulated institutions without the intention of reaching the target market. Clients however seek a broad range of products and services. While restrictions on product offerings may minimize opportunities for regulatory arbitrage, clients may have the most to lose from restrictions on product offerings.

6.2.3 NGOs

Currently, there is not a clear legal framework that permits Foundations, Associations, NGOs or other non-licensed organizations to provide microfinance services. In fact, there appear to be restrictions on organizations like Foundations and Associations to collect money from the public. To support a lending operation, KEDV established an independent for-profit company, Maya Enterprise for Microfinance. While Maya has received permission to operate from appropriate governing authorities following a protracted application process, its legal status and the secondary legislation to which it must adhere appear unclear. Though not a Bank, Maya must pay banking insurance and adhere to bank tax laws including payment of appropriate transactional and stamp taxes, which are passed on the client.

Absent a clear statutory or regulatory framework that ensures the legality of NGO activities and defines the rules to which they must adhere, the long term viability of these organization appears to be at risk. This is bad news for the development of a microfinance sector in Turkey. Often, NGOs are at the cutting edge of developing the industry. They tend to be largely responsible for innovations. While over the long term, licensed banking institutions have the greatest potential to serve the largest numbers of the currently unbanked, NGOs have an important role to play in catalyzing the process of financial sector deepening and drawing players more effectively into the market. Article 19 of The Draft Act on Micro-financing institutions allows associations and charitable foundations to provide non-depository services to microentrepreneurs. Clarifying the secondary legislation to which they must adhere in a timely way, including the government body responsible for administering the law, and ensuring harmonization with other players in the sector will be critical.

6.3. Developing a Level Playing Field

Legal and regulatory frameworks designed to attract new entrants to the microfinance sector should ensure a level playing field that draws in a range of players of different institutional types and allows them to compete fairly with each other. Further analysis and action is required in Turkey to ensure the development and harmonization of regulatory frameworks for the delivery of microfinance of the various institutional types, including mainstream commercial banks, specialized microfinance banks, and NGOs. An important area of focus in Turkey are tax laws. Currently, operators in the sector (state-owned banks, for-profit NGOs, Microfinance Banks, mainstream banks) are not equally exempt or subject to stamp taxes, transaction taxes, and taxes on profits. Experts suggest that favorable tax treatment should be based on the lending activity (for example, lending to low-income clients), rather than an institutional type. Similarly, regulators may want to consider banking amendments to current standard Banking law (for example, laws that govern collateralization of loan portfolios) that enable Banks to offer microfinance services using innovative lending technologies and business models.

Chapter 7: Developing the Microfinance Sector in Turkey

The Sector Assessment was carried out to identify ways that stakeholders (donors, government, policymakers, private sector organizations, microfinance institutions) can support the of process of extending the finance frontier to build a strong microfinance sector. This Assessment is "bearish" on sector growth in the short term, due to an uncertain economic outlook and the fact that the fruits of financial sector reform will take some time to bear. However, given the significant size of the market and the potential for several demonstration models to catalyze the entrance of many new players in the sector over the long term, the prospects for long-term growth are strong. Experience suggests that the following are necessary for microfinance sector development.

7.1. Creating an Enabling Environment at the Policy Level

An enabling environment is critical to the development of a microfinance sector. Factors in the macroeconomic environment, the legal and regulatory framework, and broad policies (financial sector policy, agricultural development policies, SME support policies, social policy, and other economic development policy) can either hinder or support the development of a microfinance sector.

Official policy positions that recognize the positive role of microfinance in vulnerability reduction and disparity among population segments, as well as economic growth contribute to the enabling environment and provide a platform for action. In some environments, the development of a National Policy on Microfinance and a corresponding Action Plan for implementing that policy can further strengthen the enabling environment.

Specific Action items within the policy arena identified in this assessment include:

<u>Legal and Regulatory Framework Issues</u>

- Ensure a clear legal framework for the activities of microfinance operators in the NGO sector
- Finalize the Draft Law on Microfinancing modifying current restrictions on ownership, markets, and services.
- Ensure that legal and regulatory frameworks among institutional types are harmonized to create a level playing field.

<u>Social Policy</u>

- Develop clear policy positions that recognize the role of long-term access to savings, loans and other financial services in poverty alleviation, reduction of vulnerability and economic disparity.
- Ensure that grant programmes that aim to transfer productive capital to vulnerable populations are sequenced to the greatest extent possible with long term access to capital provided by financial institutions.
- Practically speaking, given the absence of financial structures on the ground, support the development of new microfinance institutions that can eventually be replicated widely in the country.

<u>Support for SMEs</u>

- Develop an overarching policy that recognizes the positive contribution of SMEs to economic growth, and rationalizes individual SME initiatives supported by government and donors.
- Recognize the role of access to finance of all market segments (micro, small, and medium) in increased productivity and growth.

<u>Financial Sector</u>

Within the context of financial sector reform and the restructuring of state banks, and support for banking innovation:

- Understand the impact on microfinance sector development of the continued subsidization of loans to micro and small enterprises through government-supported programmes, and eliminate subsidies where market distortions threaten sector development, including the emergence of new institutions, significant growth in the supply of services and long-term access to finance.
- Support the process of product innovation to enable the development of market-responsive products and services. Current products and lending technologies are largely supply-driven. They are often the result of agricultural development policies or policies stemming from subsidized lending programmes, rather than a response to the financial service needs of clients.
- Support efforts to develop effective loan portfolio and delinquency management systems, particularly at the branch level.
- Support capacity building of banking officers to market new products and use innovative lending technologies.

7.2. Building an Enabling Environment through Donor Coordination and Stakeholder Education

To promote the development of a microfinance sector and an enabling operating environment, donors and governments increasingly recognize the need to coordinate their activities to ensure that the results they seek, both individually and collectively, are achieved. Through established mechanisms – a donor/investor working group, including government participation and industry roundtables -- consensus is reached about a path for optimal development of the microfinance sector, and awareness is raised about issues influencing the enabling environment. Currently, there is very little information about microfinance in Turkey and limited communication among stakeholders. Focused forums on specific issues result in action agendas for which various stakeholders take responsibility according to their interest and comparative advantage. The agenda for roundtables are developed in consultation with industry stakeholders. Actions may include changes to policies that influence sector development, for example, changes to regulatory and legal framework, amendments or additions to financial sector policies, support for innovation, bridging the gap between an emerging industry and commercial sources of capital, etc. In some cases, this process may result in the development of a microfinance policy and corresponding strategy that spells out specific actions that should be taken to support the development of the microfinance sector. The strategy for sector development must also be based on a shared understanding of the demand for financial services and gaps in supply of appropriate products. An assessment of the demand for financial services among unbanked populations including an understanding of how people use financial services to manage households, businesses and self-employment activities will be critical to the process of developing a common vision

This kind of process is consistent with the multi-partner model supported by the EU's aquis communitaire, whereby solutions are created with the involvement of all parties, instead of using a centralized approach.

7.3. Creating Demonstration Models

A mature microfinance sector that serves the highly differentiated market segments in Turkey will comprise a range of institutional models. Given even conservative market estimates of between 1 and 2 million potential clients, national coverage will require a significant number of institutions.

7.3.1. Support New Entrants

The emergence of successful institutions that demonstrate the commercial viability of microfinance are critical to catalyze new entrants to the market. Demonstration models can take a variety of institutional forms—NGO, Specialized Microfinance Bank, "downscaling" commercial bank, etc. Demonstration models create new business models, carry out market research to understand the financial service needs of clients and develop market-driven products, innovate lending technologies, charge adequate interest rates to cover the full costs of operation, and operate efficiently and profitably to meet the objectives of commercial and institutional viability. Demonstration models draw new entrants into the market or "teach" established players in the financial sector new ways of doing business. The eventual establishment of a range of players that eventually compete to serve the market will be critical for the long-term development of the industry.

7.3.2. Support Current Players

State-owned Banks

In addition to supporting new entrants to the market, stakeholders should not turn their backs on current players in the market. Halk Bank and Zirat Bank, even in their troubled states, are the dominant players in the market, even though depth and scope of outreach are weak. They will likely remain the dominant players in the near-term. Pending a positive outcome of the current long-term restructuring exercise, given their extensive branch networks, they have the potential to be important players in the long-term in delivering savings and loans services. In tandem with the restructuring exercise, stakeholders may consider supporting focused interventions that assist these players to understand their market, and innovate financial service delivery products and technologies that respond to those markets. Developing the capacity of these banks, particularly branch operations, should advance development of the industry. Areas of focus may include new product development, portfolio management, and product marketing.

NGOs

The limited number of NGOs currently operating will require additional financing and technical support over the long term. Operations that demonstrate strong potential for financial viability should be considered for support. Efforts at securing clear legal frameworks for operations should also be supported. Absent clear frameworks, their institutional and financial viability is at risk.

Commercial Bank Downscaling

A number of commercial banks are attempting to downscale businesses to reach small enterprises. A number of donor initiatives have supported credit guarantees to support banks efforts to learn this new business. While these efforts are important financial sector deepening initiatives, most downscaling efforts support larger enterprises than is the target market of this study. Effort to ensure harmonization of legal frameworks to ensure that banks can continue to pursue downscaling efforts are necessary. In addition the possibility of commercial banks establishing subsidiary institutions to develop new business models to reach microfinance markets may be explored. In recent years, commercial bank branch networks have grown extensively, and represent a potential infrastructure for the delivery of both savings and lending products to the target market.

7.4. Providing Finance

Development of a microfinance sector will require financing from investors including donors, government, development banks, and the private sector. Loan capital requirements alone are estimated at $2-$3 billion. Donor financing can be used flexibly by an institution to cover start-up costs, operating shortfalls until breakeven, and the loan portfolio. In early stages of industry development, it is not likely that the sector will attract significant amounts of private capital. In Turkey however, there may be significant opportunities for private sector investment in specialized Microfinance Banks, supervised and regulated by BRSA. Once institutions including non-licensed MFIs have established a track record, they will seek additional commercial sources of capital from Turkey's capital markets to fund growth. Stakeholders should support efforts to draw in commercial sources of capital to the microfinance sector early on.

7.5. Supporting Innovation

In addition to supporting new institutions, broad-based efforts to support industry development are critical. Broad based initiatives include support for the development of *performance standards, and the process of innovation* that enables the extension of the financial frontier and from which a broad range of institutions can eventually benefit.

Establishing Common Performance Standards and Best Practice Approaches

Industry working groups should agree on sound practices and industry performance standards to ensure consistency in performance of and support to microfinance initiatives.

Supporting Innovation

Extending the frontier of finance is the result of innovation in current financial service delivery practices. Initiatives that support this process of innovation particularly in the areas of market research and new product development are critical. Such initiatives should include

- *Market research to support the development of new, market-responsive products.* Information gathered during the sector assessment indicates that there is very little information about the real financial service needs of clients. More information is needed about the kinds of financial services that the target groups seeks, their capacity to repay, and the extent to which current providers are able to meet their needs. Given the sophisticated banking system in Turkey, research initiatives in electronic banking products may be interesting for both rural and urban sectors.
- *Market research in rural and agricultural markets* is particularly critical given limited information about the kinds of products that agricultural households need.
- As part of the product development process, the market will require the introduction of *new lending technologies that enable institutions to meet clients needs while appropriately and cost effectively managing risk* in both rural and urban environments.
- Given high inflation and low confidence in the banking sector, demand for savings services is unsurprisingly weak, and the financial sector is notably "shallow". Recent increases in TL national deposits indicates that new opportunities exist for developing the market for savings services. The use of savings services is particularly relevant for very poor and vulnerable groups. *Support for development of demand driven savings services and development of supply side systems (marketing, information systems, etc.) to manage them is another* potential area for stakeholder support.

- *Developing adequate portfolio management and delinquency management systems* is critical. The high ratio of non-performing loans suggests inadequate products as well as systems for managing portfolios.
- *Building the capacity of loan officers* to market new products and implement new products will be critical. In its 2002 Annual Report, Halk Bank notes that weak marketing abilities are its chief vulnerability.

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