

**ASSESSMENT OF OPPORTUNITIES FOR DEVELOPING A
MICROFINANCE PROJECT IN ABKHAZIA**

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LIST OF ACRONYMS

CIS	Commonwealth of Independent States
DRC	Danish Refugee Council
GDP	Gross Domestic Product
GMSE	Georgia Microfinance Stabilization and Enhancement Project
GNP	Gross National Product
IDPs	Internally Displaced Persons
INGO	International Non-governmental Organisation
LNGO	Local Non-governmental Organisation
MF	Microfinance
MFI	Microfinance Institution
MSE	Micro and Small Enterprise
NBCO	Non-bank Credit Organisations
NGO	Non-governmental Organisation
RoSCA	Rotating Savings and Credit Associations
SME	Small and Medium Enterprise
SU	Soviet Union
UNDP	United Nations Development Program
UNOMIG	United Nations Observer Mission in Georgia

EXECUTIVE SUMMARY

This report is set against a background whereby international development actors are seeking to shift their assistance to Abkhazia towards more sustainable, developmental interventions, and to link humanitarian assistance with development assistance. The report has been produced following a visit to Abkhazia by an independent microfinance consultant between 17th January and 6th February 2005. It provides analysis and recommendations to UNDP on microfinance instruments that can help span the divide between relief and development in Abkhazia.

1 Overview of bank and non-bank finance in Abkhazia

The banking sector in Abkhazia is weak, comprising 15 small commercial banks and one Savings Bank. It is believed that only two banks meet the minimum capital requirements in Abkhazia and that the portfolio quality of banks is poor. Loan products are short-term (less than one year) and small (down to \$100), with relatively high interest rates (5-6% per month), and lending decisions rely on the personal relationship between bank managers and borrowers. Bank outreach to micro and small enterprises (MSEs) is insignificant and banks do not have an explicit pro-poor focus. Nevertheless, the market is such that future microfinance institutions (MFIs) would potentially be in competition with the banks. No local or international development agencies provide microfinance and subsidised agricultural loans from the *de facto* authorities have also failed to assist MSEs on a significant scale. This overall supply side failure has encouraged communities to respond with small informal individual loans for social purposes.

2 Market research results: Demand for microfinance

The rural household economy sits on a broad asset and income base. People are proud to be self-sufficient, from cash and non-cash income. As well as agricultural production largely for home consumption, their income is from the sale of cash crops, sale of milk products, trade, services, employment and State social support. The urban household economy sits on a narrower platform of assets and income. With the exception of Gali town, income is primarily from poorly paid employment and self-employment, as well as State social support. Expenditure is generally higher in the towns. Where agricultural income is combined with income from other sources such as trade or employment, households appear to be better off.

MSEs are under-capitalised. Among retailers (traders), this situation is compounded by a social obligation to make small loans for consumption to many needy customers from the local community, who repay slowly, if at all. There is no experience of MSE finance. In Gali town and Chuburkhi village (Gali District), informal savings and loans are larger, and loan terms longer, than in other areas of south east Abkhazia. This is probably because there is better access to more vibrant markets and linkages with Georgia. Tkvarcheli District has the lowest savings and loan size and is most isolated from markets.

Whilst 80% of respondents to a market research survey felt that informal loans would remain extremely important or important for managing household finances, 60% placed the same level of importance on loans from commercial banks, suggesting that there is demand for loans. However, expectations of loans may be unrealistic: generally people felt that the minimum useful amount they would wish to borrow would be \$1,000, at an interest rate of 3-5% per month, with a loan term of less than six months.

3 Initiatives to achieve accessible microfinance

Accessible and sustainable credit provision can be achieved by stimulating the development of a microfinance market. This means encouraging microfinance providers to offer sustainable microfinance services and potential microfinance clients to use the services and pay the appropriate interest rate. Given the context, microfinance market development requires more than simply transferring a loan fund to Abkhazia. It means addressing a range of factors including: unrealistic demand; inexperienced MSE borrowers, undisciplined borrower behaviour; threat of subsidised loans provided by microfinance non-specialists, obstacles in the banking legislation and lack of interest in Abkhazia from microfinance specialists. Responsible funders must take a broader and longer term approach which seeks to solve these intractable problems.

All stakeholders have an important role to play. Donors can help to stimulate microfinance markets; humanitarian NGOs can use their projects to help develop microfinance demand; microfinance specialists can support the development of sustainable MFIs and the *de facto* authorities of Abkhazia can develop an enabling environment. To be most effective, these need to occur simultaneously.

4 Framework for UNDP microfinance assistance to Abkhazia

Microfinance can help poor and marginalised people take advantage of economic opportunities. It has the potential to increase incomes and assets and to reduce household vulnerability. Experience shows that for these benefits to accrue and be sustained, a permanent, independent MFI seeking sustainability needs to be established. This must actively target poorer people who themselves must have realistic expectations.

In Abkhazia, developing a sustainable MFI first requires a legislative review to be completed to enable the organisation to be registered and licensed. Potential clients need to be sensitised to the benefits of taking loans and to their obligations to the MFI. To prevent the large scale undermining of the MFI by inexperienced subsidised credit providers, the project also needs to sensitise potential credit providers, too. The microfinance project proposed for Abkhazia therefore consists of three components: (i) Creating an environment more conducive to microfinance, (ii) Raising awareness and understanding of microfinance using a public information campaign and (iii) Encouraging the development of dynamic MFIs following good practices.

The MFI supported by UNDP should provide loans for trade, manufacturing and services, initially avoiding agriculture lending which is too risky. It should utilise a solidarity group methodology together with forced savings in a Rotating Savings and Credit Association (RoSCA) – a self-selecting informal group of normally less than 12 persons. Loan size should begin at \$100 per person and increase over subsequent loan cycles up to a maximum of \$1,000-1,500. Loan term should initially be less than 6 months. A sustainable interest rate must be charged, which ideally will be on a par with the lowest rates available from commercial banks.

5. Support and training required to successfully establish a microfinance initiative

Resources for capacity building must be invested in the local MFI, which should be a permanent organisation, created by the project. A locally recruited Chief Executive (CEO) and Accountant should have internationally recognised professional qualifications, but are unlikely to have knowledge and experience of microfinance. Similarly, Loan Officers will probably have experience of MSE or agricultural management but will lack experience of microfinance operations. In the first year, the CEO, Accountant and Loan Officers should attend training courses to increase their knowledge of microfinance, as well as gaining practical experience by shadowing the staff of a successful MFI in a neighbouring country.

6. The risks associated with a new microfinance initiative.

The most important risks to the microfinance project are (i) that conflict recurs, (ii) that legislation concerning microfinance activities cannot be changed or takes an excessively long time to change, (iii) that the donor places heavy pressure on the MFI to disburse funds quickly before the groundwork has been done and (iv) that the UN restrictions on travel become more constraining, preventing UNDP from operating efficiently. Though these are serious potential threats to the project, most have been experienced in other conflict affected countries and methods of mitigating the risk are thought to be adequate.

7. Conclusions

The outreach of financial services has deteriorated in the past twelve years since the conflict began, resulting in no financial support being provided to MSEs in Abkhazia. A further twelve years must not be allowed to pass without the development of a strong financial services sector (including microfinance) that can support economic development. The time is now well overdue for all stakeholders (the *de facto* authorities, donors and NGOs) to accept their respective responsibilities and begin to work together for the development of dynamic and sustainable financial services provision in Abkhazia.

1. INTRODUCTION

1.1 PURPOSE OF THE CONSULTANCY

Abkhazia has received minimal external assistance, characterised by emergency relief-style programming, over the past twelve years. As part of the international community's efforts to move towards development-orientated assistance in Abkhazia, UNDP is seeking to develop an area based recovery programme that addresses key economic and social issues, linking them with reconciliation. UNDP commissioned an assessment by an independent microfinance consultant, which took place between 17th January and 6th February 2005. The overall aim of the mission was to provide analysis and recommendations on the appropriateness of microfinance instruments specific to Abkhazia. The Terms of Reference are presented in Appendix 1.

The specific objectives were to:

- Provide a brief overview of the formal banking and credit sectors in Abkhazia.
- Outline what initiatives, if any, can be undertaken to achieve accessible credit for poor people.
- Undertake a participative village and urban-based research to better understand the dynamics of household economies and the nature of small-scale enterprise.
- Define and recommend to UNDP a specific microfinance product design and delivery mechanism that will reach the poor and marginalised in the programme areas.
- Investigate how microfinance instruments might be applied to relevant findings and recommendations arising from the recent agricultural consultancy.
- Produce recommendations as to the support and training required to successfully establish a microfinance initiative.
- Address the situation of women and identify opportunities for reconciliation.
- Analyse the risks associated with a new microfinance initiative.

Information was gathered using:

- A quantitative survey of 203 people in Ochamchira, Tkvarcheli and Gali Districts. Georgian language and Russian language questionnaires were administered by six researchers, who worked in four villages and three towns.
- Focus group discussions conducted by the international consultant on demand-related topics with a range of key informants in the same three Districts.
- Individual interviews with key informants, including representatives of the *de facto* Village, District and Central authorities, and staff of international and local NGOs.

1.2 WHAT IS MICROFINANCE?

Microfinance is the provision of banking services to a low-income target group. It comprises credit, savings, cash transfer, payment services, currency exchange, leasing and insurance. As an integral part of the financial sector, microfinance aims to draw the un-banked into the national financial system without compromising its social mission. Providers of microfinance are very diverse ranging from commercial banks, to not-for-profit local organisations, to informal village moneylenders. The beneficiaries of microfinance are normally called 'clients' signifying that they engage in a transactional relationship with the provider, having to pay for the service they receive.

Microfinance can help poor and marginalised people to increase their incomes, build household and business assets and manage risk better. It is most effective in reaching down to poorer segments of the community when twin goals relating to impact on poverty and sustainability are adopted. MFI sustainability is in turn dependent on keeping overhead costs low and achieving large scale outreach.

Good practice principles for microfinance have evolved and become more widely adhered to¹:

- **Poor people need a variety of financial services, not just loans.** Savings, for example, serve the same purpose as loans but are less risky and cheaper.

¹ Summarised from CGAP's 11 Key Principles of Microfinance <http://www.cgap.org/keyprinciples.html>

- **Microcredit is not the best tool for everyone in every situation.** Where people are not economically active and have no means to repay, giving a grant (and calling it a grant, rather than microfinance) might be the most appropriate assistance.
- **Microfinance must pay for itself to reach large numbers of poor people.** Subsidised services are permanently constrained by lack of donor funds. Grants and subsidised loans also fail to achieve the intended depth of outreach as more informed, powerful groups succeed in capturing the resources. Ironically, collecting repayments and charging interest is the best way to reach large numbers of the poor.
- **Microfinance is about building permanent local financial institutions.** Short-term projects that offer loans for a limited period find it difficult to maintain high repayment levels and damage peoples' perceptions and expectations of microfinance initiatives.
- **Interest rate ceilings make it harder for poor people to get credit.** Making one loan of \$100,000 is less costly than making 200 loans of \$500. Thus, the rate of interest required to cover the costs of a microfinance loan is generally higher than the rate required by a commercial bank. If governments place a cap on the amount of interest that can be charged it can prevent microfinance providers from operating and force poorer people to use informal moneylenders, with even higher rates of interest.
- **The role of government is to enable financial services, not to provide them.** Experience shows that government-funded loan programmes, which are often highly subsidised rarely reach the intended beneficiaries, their repayment rates are very low and the usual outcome is collapse of the lending programme within years.
- **Donor funds should complement private capital, not compete with it.** Donors need to be aware of and respect the range of microfinance providers operating in the financial sector. Funding should help to create a more diverse and dynamic banking environment for the poor, rather than attempting to stamp out competition.

1.3 MICROFINANCE IN CONFLICT-AFFECTED AREAS

Microfinance is increasingly called upon in areas of prolonged conflict to help people take advantage of economic opportunities. Experience shows that microfinance can be delivered effectively if economic activity exists, the client population is relatively stable and there is some degree of political stability. Lessons learned from other conflict environments include:

- **Take a long-term perspective.** Donors should commit to funding a microfinance project for three years or more, or co-ordinate with other donors to ensure the same level of commitment. Funds should not have rapid disbursement conditions attached and it should be expected that it will take longer for the MFI to become self-sustaining.
- **Focus on increasing the physical and financial security of clients.** Through the products that are offered and the delivery mechanism, work to reduce client vulnerability.
- **Co-ordinate economic development activities.** Gain acceptance among practitioners, donors and government for using a development perspective for all activities that support microenterprise, articulating strategies for moving from relief-style grants and food for work to development assistance.
- **Make a clear distinction between relief activities and microfinance.** Preferably have different organisations, staff and resources providing microfinance.
- **Develop specialised microfinance human resources.** The specialised skills and knowledge required of microfinance staff, and the relationships they enter into with clients, are quite different to those of NGO relief and development staff.
- **Be responsive to the distinctive needs of clients and the local environment.** Design products and a delivery mechanism that address conflict-related threats e.g. criminality, destruction of property used for loan collateral, low levels of trust, the resurgence of conflict.
- **Maintain portfolio quality.** There is no long term benefit to clients or the MFI in allowing the repayment rate to slide. The most effective way of maintaining good repayment is the continued incentive of future loans – even if there is a resurgence of conflict.

2. OVERVIEW OF BANK AND NON-BANK FINANCE IN ABKHAZIA

2.1 THE ENVIRONMENT FOR BANK AND NON-BANK FINANCIAL SERVICES

Actors and forces external to the financial sector impinge on its operations. Where actors on two sides of a conflict remain in deadlock, as they do over Abkhazia, their ability to initiate change that can provide for sustainable development is diminished. There has not been a single microfinance organisation operating in Abkhazia since the war and Abkhazia remains an extremely harsh context in which to develop sustainable microfinance initiatives. This section briefly assesses the dynamic external environment for microfinance in Abkhazia.

Economic

Abkhazia is a small territory of 8,700 Km², with a population estimated somewhere between 200,000 and 300,000. Historically, the economy has been based on sub-tropical farming and tourism. In 1998, gross national product (GNP) was US\$692M, but the collapse of the Soviet Union and the subsequent armed conflict caused GNP to fall to US\$60M in 1994 (Matveeva and Duncan, 2003). Market linkages were broken and the economy was exposed to market forces which made many State Enterprises unviable. Today it is estimated that gross domestic product (GDP)² is US\$150 – 200M, of which 65-70% comes from exports to Russia and Turkey³. In 2005, the budget of the de facto authorities is estimated at US\$20M, but Russian social security payments to people in Abkhazia with Russian citizenship will contribute a further \$15M³. The Russian Rouble, the currency used in Abkhazia, is now relatively stable. Inflation was around 10-12% in 2004.

The major challenge for Abkhazia's developing economy is finding markets for products, as the internal market is small and the Commonwealth of Independent State's (CIS) economic restrictions, or sanctions, make it difficult and costly to export goods. The *de facto* authorities concentrate on attracting inward investment from the Abkhaz Diaspora and Russia and do not have a comprehensive policy for micro and small enterprise (MSE) growth. However, in other CIS countries, MSEs account for over 90% of all enterprises (Smith, *et al.*, 2004) and are acknowledged to be the engine of economic development.

Political

Disintegration of the Soviet Union in 1991 broke Abkhazia's economic ties, worsened its political instability and culminated in the outbreak of conflict between the Abkhaz and Georgians on 14th August 1992. Since the end of the conflict, Abkhazia has functioned as a *de facto* independent state that is not recognised by any other country in the world. In May 1998, the situation in the Gali district deteriorated to a significant extent and resulted in armed clashes between the two sides. Peace negotiations with Georgia, underway since 1993, have been slow moving with neither side able to resolve important issues.

On February 12, 2005 Sergey Bagapsh was sworn in as de facto President of Abkhazia. This outcome of the 2004 de facto elections has brought to an end a long period of political uncertainty and there is some renewed hope for progress in the peace process.

Social

In Soviet times, many Abkhaz were highly educated and fully employed, with affluent lifestyles. Their expectations remain high but the reality is a deteriorating education system, chronic unemployment (35,000 people are registered employed) and a largely subsistence economy. In urban areas, women have become the main income earners through their trade activities, but self-employment, and MSE activity in general, is not highly respected. In rural areas, both men and women work according to more traditional gender roles. In both urban and rural areas there is a sense that generally members of the household contribute to shared goals and shared decision making. Men

² GDP and GNP cannot be directly compared. GNP measures the value of goods produced by Abkhaz enterprises in Abkhazia and in other countries, whereas GDP measures the value of goods produced by Abkhaz and international enterprises in Abkhazia.

³ Unverified estimate by anonymous non-government Abkhaz economist (*De facto* authority data unavailable)

usually manage the household finances, but women may be more mobile, as there are reports that it is less unsafe for them to travel than for men to do so.

Twenty-five percent of the population lives in the *regional* capital, Sukhumi, 35% in UNDP's Programme areas south of Sukhumi and the remainder north of Sukhumi. Since the conflict, Abkhazia has an ageing population: Approximately 45,000 people are pensioners⁴, receiving a pension from Russia (\$32/month), Abkhazia (\$2.5/month) or Georgia (\$6.5/month). State social support mechanisms which were universal in Soviet times are unable to protect the poor and vulnerable in Abkhazia today. Strong informal safety nets have developed, especially within rural communities. These encompass not only the social and economic spheres of life, but also security. Some villages have village militia that will come to the rescue of a household if an alarm is raised. When households lack money to buy food or fuel, they can easily take interest-free loans from others in the community.

Criminality is a particular problem in Gali District. Positioned on the cease fire line between Abkhazia and Georgia, it is divided into Upper and Lower Gali. The *de facto* authorities maintain some level of control over Upper Gali, but Lower Gali lacks any kind of police presence, receiving only Russian Peacekeepers and patrols in hard skin vehicles from the United Nations Observer Mission in Georgia (UNOMIG). Robbery, assault and kidnapping are common and criminal gangs from both sides smuggle high value commodities, such as petrol, drugs, arms and cigarettes.

Civil society has emerged in the past twelve years, but there is a significant overlap with the State which is still very dominant. A few local non-governmental organisations (LNGOs) operate in UNDP's Programme areas, run by charismatic, visionary leaders, with weaker staff members supporting. LNGOs have largely provided humanitarian support and have limited knowledge of developmental activities. Nearly all express a desire to begin microfinance activities in the future, in spite of having no capacity in the provision of financial services.

Legal and Regulatory

The challenge for future microfinance providers in Abkhazia relates to working amidst an unresolved conflict where Georgia does not recognise the independence of Abkhazia and Abkhazia rejects the authority of Georgia. The banking laws of Georgia and Abkhazia deal differently with microfinance, but both would require due consideration:

- In Abkhazia, there is no law dedicated to microfinance. The existing law concerning banks and banking activity states, "Only banks and non-bank credit organisations (NBCO) may extend loans" (including microfinance loans). Whilst there is a legal basis for NBCOs, no precedents have yet been set. At present, civil organisations (non-profits) cannot legally give loans under Abkhaz law.
- Georgia also does not have a microfinance law and microfinance providers have no legal status in law. However, under the terms of the Georgian Civil Code, NGOs can register as foundations or associations and provide loans for a socially useful purpose. There are many precedents and the USAID-funded Georgia Microfinance Stabilization and Enhancement project (GMSE) is providing expertise to help to develop Georgia's microfinance legislation.

Banking legislation in Abkhazia

The situation for microfinance providers in Georgia has been well-researched (See Appendix 2) and need not be repeated here. However, the situation in Abkhazia is less well documented:

- An organisation providing loans in Abkhazia must be registered as either a bank or a NBCO. There is not a legal option to register as a non-profit making civil organisation providing loans. Whilst there is a legal basis for NBCOs providing loans, there are no precedents.
- A NBCO must register with and receive a license from the National Bank of Abkhazia.
- The minimum capital requirements for a NBCO with foreign interests are 8M RUB (nearly US\$300,000).

⁴ Unverified estimate by anonymous non-government Abkhaz economist (*De facto* authority data unavailable)

- There are two ways of creating a NBCO: i) Joint stock company of closed type or ii) Limited liability company. There must be less than 49% foreign capital and more than 51% local capital. A minimum of three establishers is required. Each may possess a maximum of 33% of shares, which means that two establishers must be local and one establisher can be foreign.

The Abkhaz Civil Code is currently under review by Parliament. The old Civil Code from Soviet times does not allow for the development of private microfinance providers and the contents of the new code are unclear. However, MFIs in Russia and Georgia depend on the Civil Code and there would be obvious benefits to aligning the Abkhaz Code more closely with the code of Georgia.

Implications of the conflict for MFI Registration and Licensing

An organisation already registered in Georgia as an NGO microfinance provider might gain permission from the Georgian authorities to open a branch in Abkhazia. But this would not comply with Abkhaz law which requires the organisation to register as either a bank or NBCO. A branch with a head office in Tbilisi could also face rejection from local people, especially in Ochamchira and Tkvarcheli Districts, who are opposed to any form of ‘interference’ from Georgia.

To only register an NBCO in Abkhazia could put the supporting NGO into conflict with the Georgian authorities. In 1998, The Georgia Parliament Budget Office (*sic.*) stated, “Abkhazia is a part of Georgia and registering and licensing banks is the direct responsibility of the National Bank of Georgia (NBG). Without being registered by the NBG, no bank on the territory of Georgia has the right to carry out transactions”.

Meeting the requirements of both parties will require careful negotiation and diplomacy and probably an element of risk-taking. The Head of the National Bank of Abkhazia has a good understanding of microfinance and it appears that she could be a strong supporter of microfinance in Abkhazia.

2.2. SUPPLY OF FINANCIAL SERVICES

Bank Financial Services

In the Soviet period, the centrally planned, single tier banking system was owned and managed by the government⁵. The State Bank (Gosbank) acted as both the Central Bank and the only commercial bank, issuing money and monopolising financing of the entire economy. The State Savings Bank accepted deposits from wage earners. After the 1992 war, savers at the State Savings Bank lost their deposits and today the population remains distrustful of banks.

Today, the banking sector consists of the National Bank of Abkhazia, the Savings Bank and 15 commercial banks. Some of these Commercial Banks are little more than small enterprises themselves. Use of the Russian Rouble in Abkhazia means that the National Bank has little control over the supply of money in the economy and its actions have almost no influence on the value of the Russian currency. It does however register commercial banks and makes wholesale loans to them. It will not provide any substantive information on the performance of the banks.

The State Savings Bank is the largest bank in Abkhazia, in terms of assets, and it reports that it meets the National Bank’s minimum capital⁶ requirements. Shares in the bank belong to the State. Unlike the commercial banks, its branch network extends to all the major towns and it has a client base of 51,000. Many of these clients are probably inactive. The Savings Bank has a loan portfolio of US\$2.5M and states that its non-performing loans (value of loans where repayment instalments have been missed) represent less than 5% of the value of total loans outstanding. Ninety-five percent of its loans are made in Gagra and Sukhumi (*Pers. Comm.* Timor Bgamba, Manager of Savings Bank, Sukhumi). The remaining 5% are mainly in Gali, with a trace in Ochamchira and Tkvarcheli.

⁵ In a Western two-tier banking system a Central Bank regulates the national supply of money, the value of the currency, the lending policies of commercial banks and the soundness of the financial system and there is a second tier of commercial banks below.

⁶ A simple definition of capital is the value of assets minus the value of liabilities.

There are two forms of commercial bank in Abkhazia: those that simply become a client of a bank in Russia and register at the Ministry of Justice in Abkhazia as an Abkhaz commercial bank; and those that are branches of Russian banks. Proliferation of small commercial banks has been common in countries of the former Soviet Union that have liberalised their banking systems, but the outcome has eventually been a series of mergers and some bank collapses, which have undermined confidence in the banking system. In 2004, only two (Garant Bank and Gagra Bank) of the fifteen commercial banks apparently met the minimum capital requirements of the National Bank. Yet, meeting the capital requirements ensures a bank has the financial resources to absorb unforeseen losses.

Development of the banking sector in Abkhazia is primarily constrained by the banking legislation. One bank manager complained that under the existing legislation “borrowers have more rights than banks”. There are no sub-laws on collateral which means that it is nearly impossible to recover collateral if a borrower fails to repay a loan. Although banks do still lend against immovable property, they tend to rely upon guarantors.

The loans offered by commercial banks in Tkvarcheli and Ochamchira districts are few, small in size and must be repaid quickly. The Tkvarcheli branch of Garant Bank stated that finance is limited due to bad debt and therefore they are currently not giving any new loans, but ordinarily they might give a loan of US\$600-700 for one month. Their loans can be as small as US\$100. The branch currently has 20 loans outstanding. Ochamchira Commercial Bank provides loans of between US\$100 and US\$10,000 for around four months. It currently has 60 loans outstanding. The application process appears to be dependent on who you know; The manager of Ochamchira bank stated that she only gave loans to people she knows and trusts. Interest rates on loans at both banks are around 5-6% per month. Rates are relatively high and the loans are short term as the banks can only borrow funds from the National Bank for one year, at 3% per month.

Non-bank Financial Services

NGOs and microfinance institutions (MFIs) that give loans do not exist in Abkhazia. The population is largely dependent on informal loans for social purposes, primarily:

- Borrowing cash from private individuals at no interest. These loans are for social purposes, such as paying for food, clothes, funerals, celebrations and medical treatment. Most lenders feel a strong social obligation to lend the money.
- The purchase of goods on credit from local shops and kiosks. The owners of the shops and kiosks – the lenders - also feel obliged to lend food to neighbours who are without.
- Hiring a tractor and driver to prepare maize fields, though not strictly a form of finance is important for people in rural areas who can't afford to buy their own tractors.

The State Privatisation Fund is described by the Minister of the Economy as the main strategy employed by the *de facto* authorities to support micro and small enterprise throughout Abkhazia. In 2004, it provided between 100 and 150 loans ranging in size from US\$3000 to US\$10,000. The maximum loan term was 3 years and the interest was stepped from 6% in year 1, to 12% in year 2, to 24% in year 3. The fund has been suspended in 2005 due to financing problems.

The collapse of the banking system after the war will have a sustained negative impact on peoples' perceptions of formal banks: One respondent commented, “Do we save in a bank? Of course we don't. We're not stupid”. Most people use informal services instead:

- Making a loan without interest. This is perceived to be a way for the lender to save money.
- Rotating Savings and Credit Associations (RoSCAs)⁷, called *Pay Desks* in Abkhazia. Pay desks were more prevalent in the Soviet period when people had a predictable income.
- Saving cash at home is common. Particularly in Gali, people also save part of the hazelnut harvest until prices are higher.

⁷ RoSCAs are informal savings and credit funds. A group of 5-15 people meets and pays a fixed amount every month into a fund. Each month, one member of the group takes the entire savings and is free to use the money as they choose. Savings are made monthly until every member has taken the month's savings.

3. MARKET RESEARCH RESULTS: DEMAND FOR MICROFINANCE

This section summarises the results of research that was carried out to understand the banking behaviour and preferences of local people in Ochamchira, Tkvarcheli and Gali districts. The quantitative data is drawn from a survey of 203 people living in the three District towns and in the four villages of Kutol, Tkvarcheli, Chuburkhinji and Gup. Each questionnaire took between 20 and 40 minutes to complete and a team of six people was used to collect the information. Every twentieth household was sampled in order to collect information as randomly as possible, given the time and resources available. Qualitative information is also presented, which comes from focus group discussions in Tkvarcheli, Ochamchira and Gali towns, and Adzhubzha, Kindgi, Tamish and Markhunja villages.

3.1 CHARACTERISTICS OF HOUSEHOLDS

- The average household comprises 4 members, of which 2 are able to work.
- Livestock assets differ between urban and rural areas. In rural areas, the average household owns 3 cows, 2 pigs and 20 poultry, whereas in urban areas (the District towns) the average household has 1 cow and 6 chickens. In the post-industrial town of Tkvarcheli, the average household owns just 3 chickens.
- Trees are another important asset, cultivated on land leased from the *de facto* authorities. In rural areas, the average household has 24 citrus trees and 107 nut trees. This rises to 81 citrus trees and 128 nut trees in Chuburkhinji village. The average urban household has 11 citrus and 27 nut trees, normally grown on land leased outside of the town.
- Indebtedness to others is not a significant problem for most households as there are few sources of credit and those that do provide credit can only give small amounts.
- Rural household incomes are from diverse sources (such as the sale of milk and meat products, sale of maize, trade, some employment, social support payments and remittances) and non-cash items (such as food and wood fuel). Many households cannot produce surplus products for sale but have enough to satisfy household needs. They can lease additional land to grow crops and have access to common land for grazing and firewood collection. Some of the poorest people are those that lack labour or access to natural resources.

Case Study: A kiosk, but no working capital

In Kindgi village, Ochamchira District, stands a solitary kiosk with stock of three packets of cigarettes. The kiosk belongs to a household comprising a mother, her adult son, adult daughter and three grandchildren, two of whom are orphans. The mother is weakened by goitre and the son is an amputee who is partially sighted. Neither can do physical work and they must survive on the kindness of neighbours, social support payments and humanitarian assistance. The household cannot afford to buy stock for their kiosk so they rent it to their neighbour and make sales on his behalf. If they had capital, they would stock the kiosk with household goods and suggest it would be popular as there are no others in the vicinity.

- Urban household incomes are more dependent on a few sources of cash income and little non-cash income. In Tkvarcheli town, households remain psychologically and physically dependent upon employment, but there are few job opportunities and salaries are low (a shop assistant typically earns less than US\$ 3.5 per day, a secretary \$5.5 per day). However, in Gali, which is situated closer to markets, households take advantage of a wider range of employment and self-employment opportunities, and agricultural production.
- Rural household incomes (and also those in Gali town) probably receive a substantial boost from the sale of nut and fruit crops. As a rough indicator, based on the average holding in each village and town, Table 1 presents the hypothetical approximate income using the average yield and average price just after harvest. This assumes that all of the harvest can be sold.

Table 1 Estimated average annual income from citrus and nuts in each village/ town

Village/town	District	Average no. citrus trees	Approx. income (mandarins) (US\$) ⁸	Average no. nut trees	Approx. income (hazelnuts) (US\$) ⁹	Approx. average total income (US\$)
Gali town	Gali	28	598	65	1113	1711
Ochamchira town	Ochamchira	4	85	2	34	120
Tkvarcheli town	Tkvarcheli	0	0	15	257	257
Kutol village	Ochamchira	0	0	74	1267	1267
Tkvarcheli village	Tkvarcheli	1	21	104	1780	1802
Chuburkhinji village	Gali	81	1730	128	2191	3921
Gup village	Ochamchira	14	299	121	2071	2370

3.2 EXPERIENCE OF FINANCIAL SERVICES

Before the collapse of the Soviet Union, the people of Abkhazia had access to more sophisticated financial services than they do today; they were able to buy consumer goods on hire purchase and were used to making regular savings from their salaries into a bank savings account. In the past twelve years use of bank services has shrunk – both because of weak outreach and weak demand. The void has been partly filled by informal services, which provide a safety net for vulnerable people in the community, but do not meet the demand for microenterprise finance.

3.2.1 Experience of Borrowing

Experience of borrowing money is closely connected in peoples' minds to dealing with problems and emergencies. Loans are almost never taken for investment in microenterprise.

- Bank loans are needed by entrepreneurs, but only 1.5% of market research respondents (three people) have taken a loan from a bank in the past two years.
- Informal loans are more common. More than 80% of respondents have experience of *giving* short-term cash loans without interest charges to members of their community, and similarly more than 80% have *taken* cash loans. Normally loans are for food, clothes, funerals, celebrations and medical treatment.
- More than 50% of respondents have experience of buying goods such as food or petrol on credit from a shop or kiosk. The next most popular ways of borrowing are (in order of popularity) buying wholesale goods on credit for commerce, borrowing cash with interest, share cropping and pawning items.
- Loan size and loan term vary substantially between the different towns and villages that were studied in the market research (Table 2). Loans are largest in Gali District and smallest in Tkvarcheli District, suggesting that access to markets may affect the size of loans that can be given. A weak relationship may also exist between the size of the loan and the duration, suggesting that those that can afford to lend larger sums, can also do so for longer.
- Interest rates on loans from commercial are not less than 5-6% per month. When interest is charged on loans between private individuals, the interest rate is usually also 5% per month.

⁸ Calculation based on an average yield 75Kg per mandarin tree per year and average price of 8 Rub/Kg

⁹ Calculation based on an average yield 7.5Kg per hazelnut tree per year and average price of 4.15 Geo. L/Kg

Table 2 Average savings and loan size by village

Village/town	District	Av. Loan size US\$	No. days loan term	Av. Savings US \$
Chuburkhinji village	Gali	150	123	105
Gali town	Gali	125	33	65
Kutol village	Ochamchira	52	36	71
Ochamchira town	Ochamchira	47	42	25
Gup village	Ochamchira	22	19	16
Tkvarcheli village	Tkvarcheli	23	13	9
Tkvarcheli town	Tkvarcheli	18	19	17
Average		63	35	41

3.2.2 Experience of Saving

Experience of saving is coloured by the loss of substantial amounts of money from the Savings Bank in 1993. Today, people rarely use the Savings Bank but there are few satisfactory alternatives for safely accumulating a substantial lump sum from numerous unsubstantial deposits.

- Bank savings accounts have been used by 3% of market research respondents (six people) in the past two years.
- Informal savings are a more common way to save. Eighty-three percent of respondents have saved by making a loan to another person in the community. This locks money away, makes it work productively for the development of important social relations and demands reciprocal measures when the lender next needs to borrow.
- Home saving is the next most common means of saving. Fifty-two percent of respondents stated they had experience, though this figure may well be understated due to respondents' concern for household security.
- The next most common way to save was to play Paydesks (RoSCAs), of which 30% of respondents had experience.
- Average past savings are presented in Table 2. It is interesting to note the close relationship between the size of loans and the size of savings. A clear explanation for this trend was not found. However, the small size of average savings in Tkvarcheli District has important implications for the probable size of loans that potential clients would safely be able to absorb.
- Term deposits in a commercial bank attract monthly interest of 2.0-2.5%.

3.3 ATTITUDES TOWARD FINANCIAL SERVICES

The attitude of clients to financial services is largely influenced by their lack of choice and lack of experience in the past twelve years. Consequently, expectations of service quality and preferences for particular product characteristics cannot be articulated. When they experience an emergency, the lack of choice of service provider also places borrowers in an uncomfortable position as they are dependent on one loan provider to agree to lending them money or food. In general the attitude towards taking a loan for microenterprise development was enthusiastic, but people appeared to have a slightly fatalistic and disbelieving attitude, expecting that they would not be the ones who would be given the opportunity to take the loans.

3.3.1 Attitudes Toward Borrowing

In focus group discussions, owners of existing MSEs most commonly stated a wish to borrow around \$1,000, and the maximum was around \$3,000. The minimum amount requested (by a very poor family) was \$300. People are used to paying relatively high interest rates and generally suggested that a monthly rate of 3-5% would be acceptable. Preferred loan term was normally less than six months.

- The main reasons for choosing a particular lender highlight the under-development of the microfinance market: either the borrower knows the provider will give a loan for free (in the case of interest-free cash loans) or the lender is the only one available (in the cases of buying goods on credit and taking loans with interest from private individuals).

- The most common reason (nearly 40%) for not taking a loan from a bank is that loans are not available in the area. The next most common reason (25%) is that the respondent perceives themselves to be too poor.
- The most common reason for not taking informal loans (buying goods on credit and also taking cash loans, with and without interest) is that respondents don't need to borrow. Additional reasons relate to poverty and lack of availability.
- Looking towards the future, over 80% of respondents felt that both interest-free cash loans and buying goods on credit for personal consumption were 'extremely important' or 'important' for the management of the household economy.
- Future loans from commercial banks and the Savings Bank were given the same rating by 60% of respondents. In contrast, limited importance is attached to loans between private individuals with interest, perhaps because paying interest on emergency loans is unaffordable, given that they do not help to boost income. Only 15% of respondents felt that the State Privatisation fund was 'extremely important' or 'important' to them; most didn't have a view.

The influence of social and cultural factors on borrower attitudes should also be considered:

- Small entrepreneurs in Abkhazia are rarely prepared to start small and grow their business – even when they currently have low income and few assets. Indeed it has been suggested that to begin a small business may be shameful. The history of massive state enterprises (of which people felt very proud) and their inexperience of developing microenterprises may also contribute to this attitude. However, microfinance normally requires that inexperienced entrepreneurs take small loans at the beginning which gradually get larger as it is proved that the business is profitable and the borrower, trustworthy.

Case Study: Financial services provided by a kiosk in Kindgi village

Juliet owns a small petrol station and a kiosk on the M27 highway. Today, her kiosk is one of the largest in the village. She states that most people in the village try to help each other. She helps by allowing people to buy food and petrol for ploughing maize fields on credit. The term is normally about two months, but she finds some people “will have money in their pocket and still not pay you back”. Her brother-in-law is the Village Administrator and he often asks her to make loans to help vulnerable people. Juliet calculates that her working capital ranges between US\$180 and US\$ 360 but this is small in comparison to the amount of money owed to her by her customers: US\$ 720 to the kiosk and US\$2200 to the petrol station.

- The strong social ties which encourage mutual support within communities are an important asset. However, the loans provided by small businesses such as kiosks are an example of undisciplined and uncontrolled lending which results in business stagnation for the lender and in some cases, collapse. These loans are valued by borrowers and therefore it is surprising that they jeopardise access to future loans by not repaying. One explanation may be that the social obligation to lend far outweighs the reciprocal obligation to repay.

3.3.2 Attitudes Toward Saving

- When choosing a way to save, the absolute priority is trust in the deposit taker. This applies for every method of saving that was explored – other than home savings where it is a given. Having instant access to home savings is valued and the fact that RoSCAs are free is also perceived to be important.
- The reason for not saving is normally that people are unable to do so or that bank deposit services are unavailable in the area. It is important to note that 12% of respondents didn't use RoSCAs because they didn't trust the group members enough to save with them.
- Future importance of saving services revolved around the use of informal financial services: 93% rated home saving as 'extremely important' or 'important', 72% gave the same rating to RoSCAs and 62% gave the rating to interest-free cash loans. Interestingly 26% were unsure if

saving in a bank would be important for them, though over 50% did feel that it would be 'extremely important' or 'important'.

Social and cultural influences on savings behaviour need to be considered:

- Helping others in the community is not only a personal trait that is valued, but a positive obligation and anyone with money to spare normally has a large extended family with many urgent needs that must be taken care of. Furthermore, there is a strong and proud tradition of providing the best hospitality one can to guests, which also places frequent and substantial demands on savings. Thus, for many in Abkhazia the concept of a person quietly squirreling away money is not a positive trait or one that they would wish to emulate.
- Lack of trust in banks did not emerge from the quantitative market research survey but did during in-depth qualitative interviews.

3.3.3 Variations in Attitude to Financial Services, by District

The level of enthusiasm for a future microfinance service varied substantially between the three districts studied. In the towns and villages of Ochamchira and Gali, a large portion of people were keen to take loans for business activities – existing or planned. The important thing was that they had vision, initiative and hope, but lacked capital. The local administrations were also enthusiastic to be involved in the development of a project which could have long-term, sustained benefits in the area. In Tkvarcheli District¹⁰, the reaction to the concept of microfinance was more muted. The District Administration suggested that people in the area were not ready for loans and would be unable to save as they were too poor and instead required grants from NGOs. The market research suggests that poverty levels are higher than the other two Districts and that there are substantially fewer business opportunities or business ideas, particularly as the area is more remote from markets.

Discussion

The limited availability and choice of service provider makes it difficult at this stage for respondents to articulate their financial services needs or to make a realistic assessment of a safe level of debt. Even in Gali district where loans have been largest in the past, the average informal borrower has experience of managing loans worth just US\$150. This conflicts with the widely held view among respondents that US\$1,000 would be the minimum useful loan amount. MFIs will require evidence that borrowers can manage loan repayments - loans will need to start small and gradually increase.

Ownership of fruit and nut trees alone does not appear to be a good predictor of the level of wealth or borrower experience. People in Tkvarcheli village own relatively large numbers of hazel trees but lend and borrow relatively small amounts between each other. It is possible that where the economy is most depressed (such as Tkvarcheli district), investment opportunities are few and any cash income is immediately used to purchase essentials, so none is left for making loans to others. In contrast, in a place like Gali town or Kutol village, there are more opportunities to generate cash and a surplus exists that can be used for lending. Thus, borrower experience appears to be more a function of the location of the lender and borrower in relation to major roads and markets, and to their linkages with Georgia.

There is no evidence to suggest that agriculture-based livelihoods are any more vulnerable than livelihoods dependent on employment (predominantly in the towns). Indeed, it may be the case that many people in rural areas are in fact less vulnerable because of the diverse sources of cash and non-cash income that they exploit. However, investment in individual agricultural enterprises remains a risky undertaking both for the microfinance lender and borrower. Those areas with a combination of agricultural incomes as well as income from other sources, such as trade (especially import-export) or employment, appear the least vulnerable and least poor overall. This would be the case in Gali town and in Chuburkhinji village and to a lesser extent, Kutol village and Ochamchira town. Microfinance could potentially reduce vulnerability by diversifying income sources.

¹⁰ It was not possible to gain access to villages that are more distant from Tkvarcheli town because of security restrictions. However, it is understood from the staff of Action Contre el Hambre that villages such as Bedia and Agubedia may be more economically active than those close to Tkvarcheli town.

4. INITIATIVES TO ACHIEVE ACCESSIBLE MICROFINANCE

Achieving accessible (and more importantly, sustainable) microfinance for poor and marginalised groups in Abkhazia requires the creation of a *microfinance market*. This means stimulating the effective interaction between microfinance providers, willing to offer services for a fee, and microfinance users, willing to pay for the services. A supportive environment is a critical requirement for this relationship to develop. This section draws together the main findings from the foregoing sections to describe the initiatives that need to be undertaken *in parallel* by different stakeholders to ensure that accessible microfinance can be achieved in Abkhazia. The role of four main stakeholders is considered; donors, local and international NGOs that already provide relief-orientated activities in Abkhazia, specialist microfinance providers and the *de facto* authorities.

4.1 DONORS

Current Situation

The existing legislation for registration and licensing restricts the development of a range of microfinance providers and also differs substantially from the rest of Georgia and from Russia. However, when encouraging the development of ‘a range of providers’, it must also be remembered that Abkhazia’s small population cannot support more than a handful of sustainable microfinance institutions (given that each will need to have achieved substantial outreach)¹¹. There is growing interest among local humanitarian NGOs to start microfinance, but the capacity does not exist – partly because of the past isolation of Abkhazia. At present, there is no co-ordination of NGO economic development activities, such as business grants, food for work and microfinance. There is potential for those organisations that normally support microfinance to further develop their roles. The *de facto* authorities have little understanding of how they can most effectively support microfinance: their efforts to support agriculture with subsidised loans have failed. Similarly, banks are small, vulnerable, and in need of technical and financial support themselves. In the future, some of the smaller ones may not be viable and others could be in direct competition with MFIs.

Initiatives: Stimulating Microfinance Markets

Donors should look beyond simply providing funds for lending. The microfinance market in Abkhazia is so under-developed that donors serious about creating sustainable pro-poor microfinance mechanisms need to invest in a range of initiatives that together help to develop microfinance.

- **Raise awareness of, and demand for, microfinance services.** Support existing local NGOs to develop a new generation of (non-microfinance) economic development projects that have clearly articulated developmental objectives. The aim should be to reduce the vulnerability of households, but critically, there should be a link to businesses becoming profitable and in a position to successfully take loans from an MFI. This will require substantial work on the attitude of beneficiaries and include awareness raising and education.
- **Lobby for legislative reform.** Fund legal work to investigate precedents set in Georgia, as well as in nearby countries such as Russia¹². Based on these, amendments to the legislation (probably to the new Abkhaz Civil Code) could be proposed. It may be helpful to create a working group comprising the *de facto authorities*, legal advisors and potential microfinance providers to work on proposals for amendments to the legislation. This will be a long-term project as legislative reform is generally slow.
- **Use social marketing campaigns.** These should involve a range of mass media, festivals and shows, to provide the same messages which help to increase knowledge and awareness of market economics and microfinance.
- **Engage with a donor working group on economic development in Abkhazia.** Use experience from other conflict affected countries to create good practice principles that can be adhered to by all donors involved in food for work, business grants and microfinance.

¹¹ In Armenia in 1999, Save the Children and Catholic Relief Services merged their MFI projects to survive the competition from fifteen MFIs competing for the same clients, among a population of 2 million people.

¹² The microfinance community in Azerbaijan, led by AMFA, is currently working to address restrictions similar to those in Abkhazia whereby MFIs only have the possibility to register as NBCOs.

- **Create fast growing, specialised and permanent MFIs.** These should be backed by experienced international partners with a proven capacity in microfinance. Regional experience suggests that supporting a proliferation of small MFIs that ‘learn by doing’ wastes resources – many close or merge after a few years. If suitable local organisations do not exist (as appears to be the case) local partners will need to be created. Having established strong foundations in terms of human resource capacity and good performance on a small scale, there should be plans for rapid but steady scaling up of microfinance operations. Adherence to microfinance good practices should be expected. Funding can influence whether or not an MFI is successful; it needs to be long term (at least a three-year commitment). A substantial portion of the budget (up to 60% of total MFI budget) should be allocated to start-up and overhead costs (including capacity development and technical support), instead of loan capital. As the clients have no experience of microfinance and their preferences will develop quickly, it is important that the MFI carries out frequent market research and it should be expected that the loan product design will develop over time.
- **Develop and disseminate information on microfinance lessons learned from Abkhazia.** Encourage other donors and microfinance specialists to become involved in microfinance in Abkhazia by sharing lessons learned on an international platform.
- **Develop capacity of *de facto* National Bank, Commercial Banks and Savings Bank.** Support the *de facto* National Bank to more effectively oversee the operations of the retail banks. Assess interest in, and training needs of, the retail banks.

4.2 LOCAL AND INTERNATIONAL HUMANITARIAN NGOS

Current Situation

A segment of the population in Abkhazia lacks the skills, knowledge and attitude to engage in entrepreneurial activity, instead harking back to Soviet days when employment was the norm. These people remain very vulnerable as they rely on subsistence farming and low paid employment, or else they reluctantly try to manage micro-enterprises in harsh economic conditions and without the appropriate capacity. Past humanitarian support has played an important role in helping beneficiaries to meet their short-term basic needs. Now, donors and NGOs have reached a turning point as they focus on more developmental ways of working. From the donors’ perspective finding appropriate partners in Abkhazia with strong proposals is difficult. Many NGOs are interested in beginning microfinance – both as an additional way to support their beneficiaries and to generate income for the NGO - but they have no experience and little knowledge of the complexities of microfinance. Contrary to popular belief, having experience of giving business grants does not equip an NGO to start giving loans¹³.

Initiatives: Developing Microfinance Demand

- **Project management and governance within local NGOs.** Strengthen LNGOs so that they are better able to develop and manage sustainable projects that will be attractive to donors.
- **Microfinance awareness-raising.** With the purpose of making informed decisions about whether or not microfinance is an appropriate tool, send key decision makers to training in Abkhazia on microfinance. If NGOs choose to get involved in microfinance, they must be prepared to charge market rates of interest, maintain excellent repayment rates, separate relief and development activities (creating a separate organisation with board, management and staff), focus on achieving large scale operations and engage in transactional, business relationships with clients.
- **New generation of market-orientated micro-enterprise support projects.** These projects should more effectively bridge the gap between relief and development activities for those beneficiaries who may be totally dependent on emergency aid, but have potential for independence. They should use a combination of some or all of the following: food aid, food for work, skills and business training, business grants and microfinance. For example, the

¹³ Relief agencies that provided loans during the humanitarian crises in Azerbaijan (caused by the Nagorno-Karabakh conflict) and in Georgia (caused by the Abkhazia conflict) did not follow best practices and programme failures damaged financial discipline.

most vulnerable families who nonetheless have capacity for work may be provided with three to six months food aid, as well as skills and business training and a small business grant which together allow the family to concentrate on developing a profitable microenterprise. It is important that the inputs are linked in a way that propels beneficiaries from dependency on grants through to independent microenterprise management and membership of MFIs. Business training, grants and food for work should be time bound and there should be a well-articulated expectation and realistic mechanism for graduating beneficiaries to the next level of self-sufficiency. Microfinance should be provided by independent MFIs, not by the NGO and the beneficiaries should qualify in their own right as clients of the MFI; the MFI will not be able to make large concessions. The success of these projects should be judged on profitability and integration of new microenterprises into the local economy.¹⁴

- **Social marketing.** Promote the concept of small enterprise in areas such as Tkvarcheli District, where small enterprise barely exists and demand for microfinance is currently very low. Promotion would aim to change perceptions of microfinance and demonstrate how one can become a successful entrepreneur.

4.3 INTERNATIONAL ORGANISATIONS WITH EXPERTISE IN MICROFINANCE

Current Situation

A number of challenges exist for providing microfinance that adheres to good practices in Abkhazia: inappropriate microfinance legislation; limited human resources in microfinance; poor security in some areas (especially Gali District); the history of handouts given by humanitarian agencies; the habit of borrowing and not repaying loans; the limited understanding among potential borrowers of market principles; inexperience in assessing the level of debt that can comfortably be serviced; the lack of local MFI/NGO partners and weak banking infrastructure through which to channel microfinance funds. In addition to these, a new microfinance provider needs to address the centralised and deeply embedded power structures, which have created dependency - and the expectation from local administrators that they will help to decide who gets loans. Donor funding has traditionally centred on rapidly-disbursed, short-term humanitarian relief in Abkhazia, which is inappropriate for microfinance.

Initiatives: Developing the Sustainable Supply of Microfinance

- **Legislative reform.** Work with microfinance legal experts and the *de facto* authorities to reform legislation. If possible try to obtain a waiver to enable operations to begin prior to change in the legislation.
- **Development of permanent local MFIs complying with microfinance good practices.** Support the development of local organisations, and in the early stages invest in human resource development at credit agent, management and board levels. Ensure that the lending mechanism adequately assesses business feasibility and includes a strong guarantee mechanism. Particularly at the beginning, clients will require training to sensitise them to the principles of microfinance and market principles. Loan size should be small to begin with and increase in steps. Product design should also respond to the security concerns of clients.
- **Co-ordination with other stakeholders working in economic development.** Share information with other UN agencies and NGOs involved in other areas of economic development, such as food for work and business grants. Try to develop links if the organisations are creating credit-worthy potential clients. Create best practice principles for Abkhazia which can be adhered to by all stakeholders.
- **Microfinance education and awareness raising campaigns.** Develop public information campaigns to raise awareness of the benefits of microfinance and to generate demand.
- **Lessons learned on microfinance in Abkhazia.** Share lessons learned from experience of developing an MFI in Abkhazia through international web sites.
- **Long-term funding.** Secure long-term funding from a donor that does not require rapid disbursement of loans in the early stages, since experience from other contexts shows that this can have a damaging effect.

¹⁴ IGVGD project of BRAC Bangladesh is a successful example of this kind of initiative (see Bibliography).

4.4 DE FACTO AUTHORITIES OF ABKHAZIA

Current Situation

Legislation is the main factor constraining the development of microfinance, and financial services in general, in Abkhazia. Yet experience from other Caucasus countries shows that substantial sums of donor funds can be attracted by MFIs. The *de facto* authorities (Central, District and Village) also have limited experience of microfinance and no awareness of the large body of knowledge on microfinance good practices that has developed. Consequently, they are unclear of the positive role they can play in supporting microfinance. Their attempts to provide subsidised loans to agriculture have failed, but as these were on a small-scale they are unlikely to have substantially damaged the microfinance market. The formal banking sector is weak and unstable. It also requires technical and financial support (though this is outside these terms of reference).

Initiatives: Creating an enabling environment for microfinance

- **Legislative reform.** Fast-track changes in the legislation applying to microfinance to enable large numbers of people to have access to microfinance. Supervision of non-deposit taking MFIs should be light.
- **Microfinance training.** Support staff from the National Bank, Ministry of Justice, District Administration and Village Administration to attend training in microfinance.
- **Capacity development of National Bank.** Further develop the bank's ability to effectively supervise licensed banks that accept savings deposits from the public.
- **Capacity development of Commercial Banks and Savings Bank.** Allow public scrutiny of the annual results of the retail banks in Abkhazia. Encourage donors to provide technical support to promising commercial banks. These banks will be part of the microfinance infrastructure in the future and it is important that they are reliable and strong.

Discussion

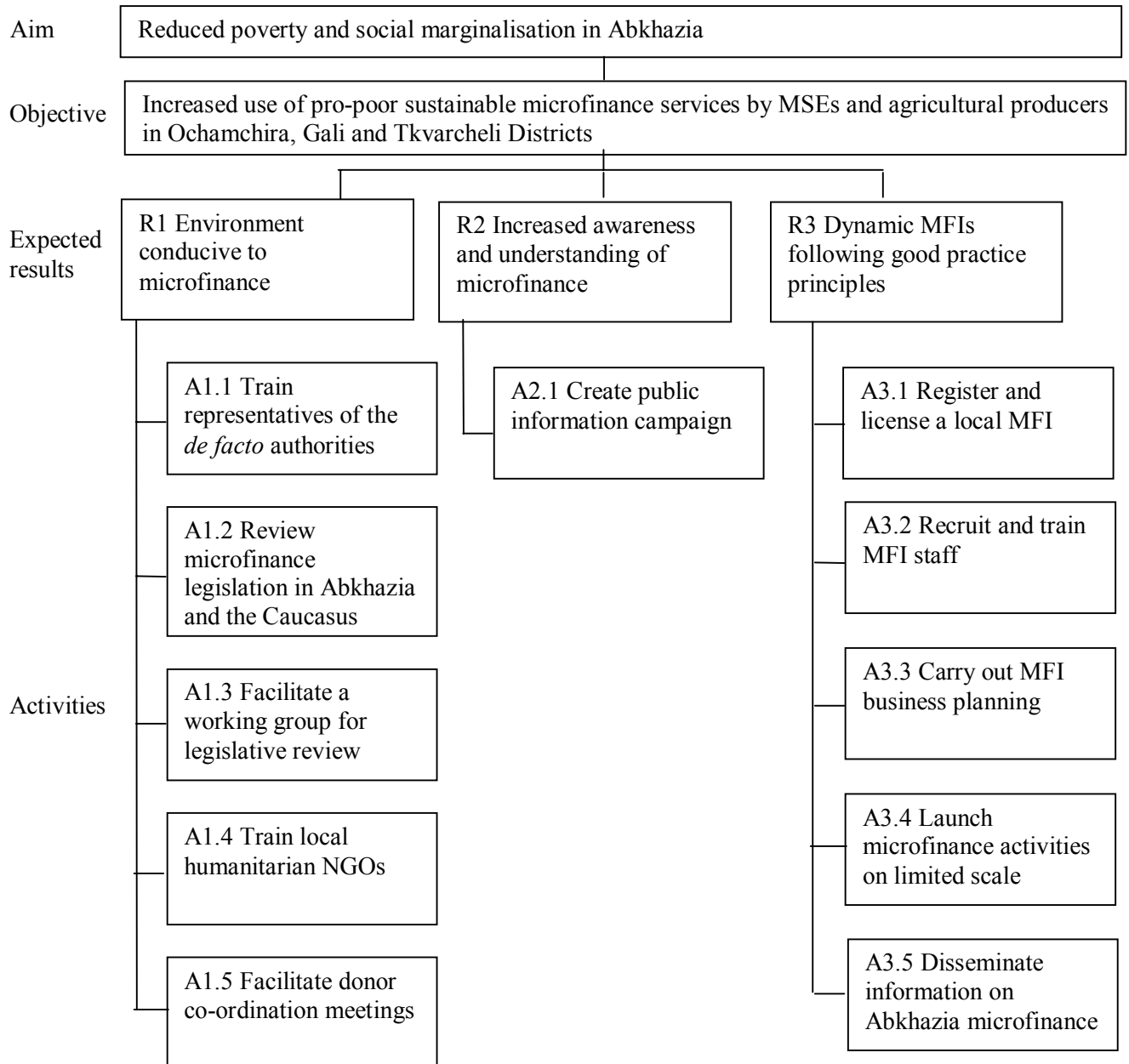
The microfinance environment in Abkhazia today is under-developed and lacking any sense of direction for its future development. At present, no stakeholders are taking responsibility for its development and there is significant confusion over who should do what, when and how. A range of actors – donors, humanitarian NGOs, international microfinance NGOs and the *de facto* authorities - have important roles to play in developing access to microfinance and each should focus on their core competencies. Excessive overlap in roles and responsibilities wastes resources and means that organisations are doing work for which they have limited capacity.

It is important to build solid foundations for a permanent and dynamic microfinance industry in Abkhazia. This means taking a long-term approach, which includes beginning the lengthy process of lobbying for legislative reform. It also means changing attitudes toward MSE development, supporting people to create MSEs that are loanable and raising awareness of the benefits of microfinance. The microfinance industry would be more effective if these were to take place on a large scale and involve co-operation between all stakeholders.

5. FRAMEWORK FOR UNDP MICROFINANCE ASSISTANCE TO ABKHAZIA

Abkhazia's political isolation over the past twelve years - and the minimal external developmental assistance received during that period - has resulted in an exceptional situation whereby the people of Abkhazia have no experience of microfinance. Donors serious about achieving sustainable economic development cannot simply assign a loan fund to Abkhazia and expect that loans will be disbursed in weeks, as they might be in neighbouring Caucasus countries. In Abkhazia, the foundations for sustainable microfinance initially need to be laid.

Firstly, a more conducive environment for microfinance needs to be created to ensure that microfinance (adhering to good practice principles) is offered within an appropriate legal framework. In other countries, substantial damage has been done by inexperienced providers who have not understood the principles of microfinance when they have begun projects. However, in Abkhazia microfinance is so under-developed that donors are in the unique position of being able to prevent this happening. Secondly, information on microfinance needs to be disseminated to potential clients to create realistic expectations and to generate demand. Once the groundwork has been laid, the probability of a successful microfinance institution being established – and others following it – is substantially increased.



R1 ENVIRONMENT CONDUCTIVE TO MICROFINANCE

In Soviet times, loans were given to State Enterprises which employed the majority of the population. The collapse of the Soviet Union proved that most of the large enterprises were unviable in a market economy. This together with the conflict with Georgia caused the collapse of the economy, followed by a steep fall in GDP. Unemployment has led to poverty and social marginalisation in Abkhazia. Today, there is no coherent support from *de facto* authorities for MSEs and limited understanding of the critical role that MSEs can play in developing economies. Instead the Ministry of the Economy focuses on inward investment from the Abkhaz Diaspora and Russian business.

MSEs and agricultural enterprises suffer from a lack of capital investment: it is almost impossible to get credit from banks, which are small and under-capitalised. The State Privatisation Fund, like the majority of State-subsidised agricultural credit projects, has failed. Humanitarian NGOs are planning to provide credit in tandem with economic development activities, but this is also likely to fail. There is no microfinance available in Abkhazia, no legal precedent for microfinance and an unsatisfactory legal environment.

Removing barriers to the introduction of microfinance services by lobbying for legislative reform would increase the supply of microfinance in Abkhazia. Ensuring that stakeholders (*de facto* authorities, humanitarian NGOs and donors) are aware of the vast experience of microfinance good practices which has developed over the past thirty years can help them to make a positive contribution by adopting roles that support the development of the microfinance market.

Activities:

A1.1 Train representatives from the *de facto* authorities in microfinance

- Organise a one-day high level conference on the role of government in microfinance, with guest speakers from Caucasus countries and international microfinance organisations. Invite senior representatives from the *de facto* National Bank, Ministry of Justice, and District and Village authorities. Representatives from the Commercial Banks and Savings Bank should also be present.

A1.2 Conduct a review of microfinance legislation in Abkhazia and other Caucasus countries

- Hire a Russian speaking microfinance legal expert to analyse regional legislation for microfinance (Law on Banks and Banking Activity and the proposed Civil Code). Obtain recommendations for the fastest way to register the proposed MFI and recommendations for legislative and regulatory review.

A1.3 Facilitate a working group to lobby *de facto authorities* for legislative review

- Put together a working group, preferably with representatives from the *de facto* Ministry of Justice and the National Bank, as well as microfinance legal experts and potential microfinance providers. Prioritise changing legislation critical for beginning microfinance operations. Subsequently, work on legislation and regulation that facilitates the development of sustainable MFIs.

A1.4 Train local humanitarian NGOs on the basic principles of microfinance

- Organise a three-day workshop on microfinance to explore good practice principles.

A1.5 Facilitate donor co-ordination meetings on economic development activities in Abkhazia

- At co-ordination meetings, share information from other countries transitioning from emergency to development on good practice for economic development activities, including microfinance, food for work and business grants.
- Develop good practice principles to which all donors in Abkhazia can agree.

R2 INCREASED AWARENESS AND UNDERSTANDING OF MICROFINANCE

High levels of unemployment and under-employment are pushing people to seek alternative self-employment in the MSE and agricultural sectors. But negative attitudes and perceptions generally affect the development of MSEs: a dependency culture and ignorance of the market economy discourages people from taking advantage of market opportunities. Similarly, reverence for large scale industry of the Soviet period, antipathy towards small-scale enterprise and the perception that entrepreneurs are ‘wheeler-dealers’ operating on the borders of legality discourages proud people from becoming entrepreneurs. Recently, NGOs have encouraged the development of MSEs, but the impact has been limited since their strategies have depended entirely on providing free training and free grants, which require substantial and sustained donor funding.

MSEs are normally under-capitalised and suffer from weak domestic market demand and limited opportunities for export. MSE owners can be afraid to take loans with interest, having no experience of how (when carefully used) an injection of capital can increase business profitability, even after a loan is repaid with interest. The ultimate effect of this situation has been to suppress demand for microfinance. Undisciplined borrowing and a culture of not repaying loans in the community is of concern to future lenders aiming for sustainability.

Raising awareness and understanding of microfinance and changing perceptions of self-employment will help to increase the demand for microfinance services. It should also improve the performance of borrowers which benefits both the MFI and the client.

Activities:

A2.1 Public information campaign in the programme areas on microfinance and microenterprise

- Recruit a local marketing expert with practical experience of designing low-cost integrated advertising campaigns (preferably social marketing).
- Make a baseline survey of the level of understanding of microfinance and attitudes towards self-employment and understanding of the market economy.
- Use mass media (e.g. radio, television and newspapers) special events (e.g. concerts, plays and festivals) and posters and flyers on local transport to provide information that (i) increases understanding of the benefits of microfinance (ii) changes attitudes toward self-employment and (iii) increases understanding of the market economy. Create Russian language information for Oчамchira and Tkvarcheli, and Georgian language information for Gali, and be aware of possible cultural differences.
- Assess the impact and cost-effectiveness of the campaign on understanding, attitudes and knowledge.

R3 DYNAMIC MFIS FOLLOWING GOOD PRACTICE PRINCIPLES

The microfinance market in Abkhazia is quite unique in its level of under-development. Abkhazia has suffered from political isolation since the war in 1993, which has resulted in little external support over the past twelve years – a situation that may now be changing. Obtaining a loan for investment in MSEs or agriculture is almost impossible as banks are able to make few loans and choose low risk borrowers. Informal providers lend only for social purposes and over a short-term and there is not a single MFI or NGO credit project in the territory.

Abkhazia is perceived by microfinance providers to be a risky place to begin microfinance operations because of its unresolved conflict and the consequent risk of renewed conflict. The costs and time involved in establishing microfinance in Abkhazia will also be high because of current levels of insecurity which influence operations and the lack of capacity in microfinance requiring substantial training and support to staff in the early years. In addition, there is no clarity over the procedures for registering an MFI.

Supporting the creation, launch, management and monitoring of a local MFI that targets poor and marginalised clients will encourage the growth of MSEs and agricultural production. It is also likely

to increase household income and reduce vulnerability. A promising MFI that demonstrates rapid growth whilst maintaining high portfolio quality would create a precedent and encourage other microfinance providers to enter the market. This would increase microfinance coverage and would also provide valuable competition for the UNDP supported MFI, spurring it on to higher performance levels. To give the MFI the best possible chance of success in the harsh conditions of Abkhazia, it should begin in an urban centre where markets exist. Ochamchira town is considered preferable to Gali as the security situation is better.

Activities:

A3.1 Register and license the local MFI

- Prepare the appropriate documents required to register the MFI and, if necessary, obtain the banking license.

A3.2 Recruit and train staff

- Recruit local CEO with qualifications in banking and finance and an Accountant with internationally recognised qualifications.
- Recruit loan officers that are keen to learn and open-minded. Loan officers should be based close to the areas they will work in, though preferably not from the area.
- Conduct capacity assessment of staff and design training plans for each person.
- Hire consultant or organisation e.g. Microfinance Centre, Poland or Danish Refugee Council, Georgia to provide separate microfinance training to management and loan officers. If appropriate, send the CEO and Accountant to international microfinance training courses.

A3.3 Carry out MFI business planning

- Create MFI business plan which describes in detail the macro-environment, vision and mission, target group, product design, lending methodology, systems, growth strategy and projections, funding strategy and operational structure.

A3.4 Launch microfinance activities on a limited scale in Ochamchira town

- Create performance objectives for management staff and loan officers.
- Monitor performance closely and respond immediately if objectives are not achieved.
- Review objectives and refine product, lending methodology and staff capacity.

A3.5 International dissemination of information and lessons learned in Abkhazia, targeted at international organisations that specialise in microfinance.

- Write articles for international publication on microfinance websites and attend conferences to speak about microfinance in Abkhazia. Target competent NGOs specialising in microfinance with the aim of creating valuable competition for the MFI.

RECOMMENDED LENDING METHODOLOGY AND PRODUCT DESIGN

It is critical that the local MFI invests in its own research to design a product and lending methodology over which it feels ownership and which supports its vision, mission and strategic objectives, as well as being manageable for the capacity of its staff. The risks associated with this project should be carefully assessed as it will involve the provision of an untested loan product, through an inexperienced partner, in an unfamiliar context, to unknown clients, managing unproven MSEs.

There are valid reasons for microfinance providers being risk averse. The first is that every loan that cannot be repaid represents another seriously indebted borrower who has lost status in her community and become more economically vulnerable. The second is that loans that are not repaid reduce the size of the loan fund, reduce opportunities for others to take loans in the future and increase the cost of borrowing (if sustainability is taken seriously by the MFI). The third is that when members of a community notice that some borrowers are not repaying their loans, they lose confidence in the MFI

and also choose not to repay, creating a situation where non-repayment of loans snowballs and projects collapse.

The loan product outlined below would finance trade, services and manufacturing, which are less risky activities than agricultural production. It is a fairly standard, proven design, which is important, given the range of other ‘unknowns’ that exist in Abkhazia. As such it is safe, but inflexible. Over time, as the market is better understood, the design can be adjusted to make it more client-friendly. However, it is better to err on the side of caution in the early stages.

Product terms and conditions	
Guarantee	Group guarantee – solidarity groups of 4 to 8 homogeneous members. Loans are given to individuals, but the entire group promises to repay the entire loan amount. A maximum of 50% start-up businesses per group (because of the high failure rate of MSEs in the first few years). No immediate family members in the same group.
Forced savings	The MFI will not have a license to collect savings deposits. However, prior to taking a loan, clients should save in the community using a RoSCA mechanism. This will provide them with a lump sum for emergencies; prove group cohesiveness and the ability to service a loan. Forced savings are considered important in this context – if clients don’t trust their group members enough to save with them, then it is unlikely that the group guarantee mechanism will work effectively when they start borrowing, either. As women are more often members of RoSCAs, the forced savings may encourage more women to take loans.
Minimum savings	The loan size should be related to the amount of money that clients are able to save prior to the loan. Clients should be encouraged not to spend their RoSCA money but to save it in the house in case they need it to help repay their loan.
Loan term	Loan term should be suitable for trade, services and manufacture and should be kept as short as possible so that the fund turns over frequently. The term could be between two weeks and five to six months, depending on group needs. Loan term may increase in subsequent cycles.
Loan size	Loan size should be stepped so that it increases as (i) the relationship between borrower and lender develops, (ii) the vulnerability of the borrower reduces and (iii) the business experience of the MSE owner increases. In spite of requests for larger sums, loans should start at between \$100 and \$300 and increase gradually.
Repayment structure	Simple fixed repayment schedule. Repayment should be made fortnightly or monthly depending on the loan term and business needs of the borrower.
Price	
Interest rate policy	A sustainable interest rate should be charged on loans. This is determined by calculating the market-related cost of loan funds, cost of inflation, expected loan losses, administrative expenses and the intended rate of loan capital growth. It is important that the interest rate does not undercut the commercial banks which are already in a fragile state and competing in the same market. This product will be attractive to clients because of its accessibility, not because it is ‘cheap’.
Non-financial costs	In addition to the financial costs, there will be non-financial costs associated with the group having to meet regularly, to attend pre-credit training and to save prior to loan disbursement.
Place	
Meeting place	Groups will meet in their own homes and loan officers will visit the groups. The loan officers will be crucial in creating an open relationship between the MFI and borrowers.
Loan disbursement and repayments	Ideally, loan disbursement will occur through the nearest branch of the Savings Bank or a commercial bank. Similarly, repayments will be deposited in the MFI’s account at the nominated branch by a group member. Further investigation is required into the security implications of group members travelling with cash, the financial strength of the banks and the ability of any bank branches in Abkhazia to handle transactions honestly and efficiently. An alternative approach would be for the MFI to hire a tellers desk e.g. for one day a week in each branch so that groups can draw down loans and make repayments direct to an MFI representative, who would then deposit the funds in the MFI’s account at the bank. Using a bank branch for cash transactions removes the danger to MFI representatives (who are easily identified and targeted by thieves) of having to carry cash.
Promotion	
Communication	Promotion should be targeted at women since they are proven to use a greater proportion of profits to support the household and are normally better re-payers than men. Investment in promotion need not be made at the beginning: Enough demand is created by people hearing about the product by word of mouth. In the early stages, the product, the systems and the

	new staff need to be tested using a small number of groups e.g. between fifteen and twenty. These should be monitored very carefully to ensure 100% repayment. If clients delay repayment they should be followed up immediately and the group guarantee mechanism should come into force.
People	
Target group	More than 60% of clients should be female. Typical clients: aged 20-40, 2 children, rural and urban, educated past secondary level, running or establishing micro-enterprises in trade, services and manufacturing, loans for working capital and asset acquisition, repayment capacity \$25-100 per month.
MFI human resources	Loan officers will be people from the area, who are young, self-motivated and eager to learn. They must have a basic level of education, but understanding MSE needs is equally important. Their enthusiasm for working with the different ethnic groups in Abkhazia and their openness to peace-building should be a selection priority.
Performance rewards	Rewards for outstanding performance should exist from the beginning and can later be formalised into a performance related pay scheme based on loan portfolio quality and size.
Leadership	MFI leaders will also probably be young and educated to a high level in either business or banking. They will be backstopped by microfinance experts from the international NGO.
Process	
Group formation	A defined process of group formation and preparation will be undertaken to create legitimate, cohesive groups. Each group will have a leader, an accountant and a secretary. During the formation and preparation process, group members will meet regularly, save together in a RoSCA and receive training from loan officers to prepare them for managing their groups, and appraising and managing loans. As well as having completed the RoSCA cycle and being able to prove that the money has been saved, a defined level of competency will be required and tested before groups will be allowed to take loans.
Application procedure	Business proposals will be assessed by group members, the loan officer and, if it is judged helpful, the Village Administrator or town administration. This needs to be carefully thought through since it would be difficult to change the arrangement once it is in place.
Pre-credit training	Training should be provided to new clients on identifying and exploiting market opportunities, calculating profitability, basic bookkeeping, marketing and loan management.
Loan disbursement	For security reasons, loans can be drawn down from the bank in tranches when needed by the client.
Monitoring	Loan Officers follow up with clients immediately after loan disbursement to check that the loan has been invested as planned. This is one area that may be relaxed once discipline has been established (some MFIs do not concern themselves with loan use, concentrating instead on ensuring that repayments are made on time).
Physical evidence	
Transport	The standard of transport used must provide a minimum acceptable level of protection for staff and allow them to work efficiently. However, transport can be one of the largest expenses for MFIs. Assuming that Loan Officers will never carry cash, the MFI should expect them to use public transport where they can. Russian cars could also be purchased rather than the usual NGO vehicles.
Offices	The MFI should rent a small office for staff to work from, but as clients will not visit this office, it need not be designed and decorated to front office standards.
Teller desk in bank branch	Investment should be made in developing the hired teller desk in each branch using MFI branding and literature to make it attractive and distinguish it from the rest of the bank.

Future Development

Phasing of the activities in the first eighteen months is presented in the table below. Beyond the initial funding period, development of the project should include:

- Development of the MFI in Ochamchira town and subsequently in every District in Abkhazia.
- Development of new microfinance products e.g. (i) an agriculture loan, with longer term and a balloon repayment (i.e. a lump sum repaid after sale of the harvest), (ii) an individual loan, using a personal guarantor, which is common practice in Abkhazia, though its efficacy is unknown. An alternative form of collateral is hazelnuts, which increase in value after the harvest and are already a common way of saving, especially in Gali.
- Development of mass media social marketing campaign on microfinance and microenterprise.
- Creation of NGO scheme to certify business activities of IDPs in Georgia in preparation for, and to encourage, their return.
- Continued lobbying for legislative review.

Phasing of activities

Activities	Timeframe (months)																		Responsible
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	
R1 Environment more conducive to microfinance																			
A1.1 One-day conference on role of government in MF																		INGO/UNDP	
A1.2 Review of microfinance legislation																		INGO	
A1.3 Facilitate working group on microfinance legislation																		INGO	
A1.4 Organise 3-day microfinance workshop																		INGO	
A1.5 Facilitate donor co-ordination meetings																		INGO/UNDP	
A1.5 Develop donor good practice principles																		INGO/UNDP	
R2 Increased awareness and understanding of microfinance	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	
A2.1 Make a baseline survey of MF attitudes and understanding																		INGO	
A2.1 Create flyers, posters and local enterprise festivals																		INGO	
A2.1 Use mass media for public information campaign																		INGO	
A2.1 Assess impact and cost-effectiveness of campaign																		INGO	
R3 Dynamic MFIs following good practices	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	
A3.1 Prepare appropriate documents and register MFI																		INGO	
A3.2 Recruit local CEO and accountant																		INGO	
A3.2 Recruit loan officers																		MFI/ INGO	
A3.2 Conduct capacity assessment of staff																		MFI/ INGO	
A3.2 Arrange training																		INGO	
A3.3 Carry out MFI business planning																		MFI/ INGO	
A3.4 Create performance objectives for staff																		MFI/ INGO	
A3.4 Launch MFI																		MFI/ INGO	
A3.4 Monitor performance																		MFI/ INGO	
A3.4 Review and refine																		MFI/ INGO	
A3.5 Write articles for international publication																		INGO	
Cross-cutting Activities	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	
Launch tender for international NGOs																		UNDP	
Select NGO																		UNDP	

6. SUPPORT AND TRAINING REQUIRED

Human resource requirements for the project are presented in the Table below:

Organisation	Required Capacity	Persons required	
		Yr 1	Yr 2
Local MFI			
Accountant	International accounting qualification, 3 years experience, English speaker		1
CEO	MBA or banking degree, English speaker		1
Branch Manager	Business, finance or accounting experience		
Loan Officers	Secondary education, experience of managing MSE		3
Driver (if necessary)	Drivers license		1-2
International NGO			
Social marketing expert	International marketing qualification, 5 years experience	1	
Microfinance expert	More than 10 years experience inc. 5 years managing MFI	1	1
Programme Assistant	Secondary education, English speaker, computer skills		1
MF legal expert	Law degree, Russian and English speaker	1	
UNDP			
Economic devpt. expert	More than 10 years experience in economic development	1	1

It is a difficult task to assess the capacity building requirements of staff that has not been recruited. However, given the lack of microfinance experience in Abkhazia, it is likely that the following will be required by the staff of the MFI:

MFI Accountant and CEO

- Intensive training in microfinance at international microfinance training course to increase technical knowledge of microfinance.
- Secondment to successful MFI in Caucasus country to gain experience of microfinance at management, board and operational levels.
- Intensive day-to-day support from the INGO microfinance expert who may need to start as the manager of the MFI.

MFI Loan officers

- Intensive initial training. This could be provided by the Danish Refugee Council (DRC) Georgia which has a course for Loan Officers. Alternatively, they could attend a course at the Microfinance Centre, Poland.
- Shadowing successful loan officers in successful MFI.
- Monitoring and support by the MFI management and the microfinance expert.

When choosing training providers, it is important to (i) assess the ease with which staff can travel to the venues and (ii) the opportunities that can be created for reconciliation. Possible sources of training and consultancy support include:

- DRC Georgia – Offers three separate courses for microfinance boards, loan officers and management. Also consultancy services, with practical orientation.
- Microfinance Centre, Poland – Range of training courses – some in Poland but will also tailor courses and provide *in situ*.
- Boulder Microfinance Course, Italy – World recognised international course run annually.
- Bankakademie Frankfurt – International course run annually.
- Independent Consultants and Consultancy companies.

Capacity development of the staff of the international NGO and UNDP is not addressed here since it is expected that both would be able to put forward strong candidates for the positions.

7. RISKS

The risks faced by the project are presented in the table below, beginning with the most serious. Each threat is analysed based upon the probability of it occurring and the likely effect that it would have on the project if it did. Methods of mitigating the risk are suggested in the final column.

Potential threats to achieving objectives	Likelihood	Impact	Methods of risk mitigation
Recurrence of armed conflict between Georgia and Abkhazia, or between Georgian and Abkhaz militia groups.	Medium	High	Have contingency plan for recurrence of conflict. Try to keep MFI operational and continue extending loans to maintain confidence in MFI. Consider use of UNOMIG vehicles. Open temporary branch in the nearest safe town if necessary.
Legislation cannot be changed or takes an excessively long time to change.	Medium	High	Develop close working partnership with National Bank and Ministry of Justice, including them in the working group on microfinance legislative review. Hire legal staff with experience of MF. Organise international conference in Abkhazia to increase understanding of the appropriate role of government.
Donor pressure to rapidly disburse loan funds causes inadequate training and assessment of groups and results in high levels of default	Medium	High	Plan and agree with the donor a realistic timeframe for disbursing funds. Build solid foundations first, beginning the programme slowly and following a controlled expansion plan.
UN restrictions on travel intensify	Medium	Medium	Have branch offices in main towns which tend to be less affected by insecurity.
LNGOs and donors support subsidised microfinance or mix grants and microfinance, causing confusion among clients	Medium	Medium - low	Provide a training workshop for LNGOs to raise awareness of the complexities of microfinance. Facilitate donor co-ordination of economic activities.
Law and order deteriorates	Low	High	Manage risk by working in areas that are known to be safe. Staff should adopt precautions such as travelling in pairs, changing work patterns, not wearing uniforms, and never carrying cash.
Local <i>de facto</i> authorities require excessive involvement in management and decision making of MFI activities	Medium - low	Low	Organise international conference in Abkhazia to increase understanding of the appropriate role of government.
INGO tenders are unsatisfactory	Low	Medium	Compile list of potential partners and provide detailed information on Abkhazia and the microfinance model prior to the tender.

8. CONCLUSION

This study provides an analysis and recommendations on microfinance instruments in Abkhazia. Preliminary analysis indicates the rather unique nature of the microfinance market and the microfinance environment in Abkhazia. It is difficult to think of anywhere else in the world where there are absolutely no microfinance providers targeting MSEs. Similarly, Abkhaz MSE owners' lack of understanding of small business finance is relatively unusual.

Genuine demand for microfinance services does however exist and some of this segment would perform well as borrowers. This demand is not being met by the suppliers of financial services. The bank sector is extremely weak and lacks credibility, so it is currently failing to attract capital either from Abkhaz depositors or from external investors and consequently lending operations are almost insignificant. The political and physical isolation of Abkhazia, its unresolved conflict with Georgia, together with the slow pace of legislative reform only worsen this situation.

Weak civil society in Abkhazia, together with the legacy of Soviet-style centralised control, has meant that informal and semi-formal community-owned and managed microfinance organisations have failed to spontaneously develop, as they have done in other countries. Furthermore, the effects of the conflict and the economic dislocation occurring as a result of the collapse of the SU have compelled international and local organisations to concentrate their resources on meeting the short-term humanitarian needs of the poorest and most vulnerable. In the past twelve years, no organisation in south east Abkhazia has seriously addressed development issues in a sustainable manner. In response to this situation, communities have themselves evolved strong safety nets involving in-kind and cash lending for social purposes, but lending that could strengthen economic development has never evolved and savings services are also unavailable.

From a supply perspective, some of the characteristics of borrowers not only cause concern, but are substantial enough that they should influence the design of future microfinance projects: (i) the culture of non-repayment of loans to others in the same community because the borrower is "too poor" needs to be addressed in the knowledge that far poorer people in developing countries successfully repay loans, but do so in more disciplined lending environments (there is little doubt that the high levels of loan default experienced by banks is a further factor dampening the supply of financial services). (ii) Whilst acknowledging the cultural issues driving demand for large loans, the folly (both for the microfinance provider and the MSE owner) of investing large amounts into unknown initiatives and markets needs to be born in mind. (iii) The psychological dependence of some segments of society in Abkhazia on the state and NGOs suggests that they are unlikely to successfully identify opportunities for business and this makes them unacceptable risks for microfinance suppliers.

MSE business performance (and consequently loan performance) is also strongly influenced by the harsh market conditions in which MSEs operate. The small size of the market in Abkhazia, as well as the difficulties associated with accessing international markets, creates additional costs and risks for inexperienced MSE owners. In some countries microfinance providers can make loans without concerning themselves with how the funds are invested by the borrower, thus reducing their own lending costs. However, in Abkhazia, assisting MSE owners to identify and assess potential business opportunities and markets will be critical.

This report began by describing the fundamental principles that underpin microfinance – which have undoubtedly contributed to its phenomenal success in other countries. These include: building permanent, independent financial institutions; making microfinance pay for itself by levying interest on loans; allowing higher interest rates for lenders involved in (more costly) microfinance lending; ensuring that other financial service suppliers are not undermined by donor subsidised loans and supporting government to create an enabling environment for microfinance, without becoming a provider itself.

Having considered the Abkhazia context, what relevance do these principles have for a small *de facto* state, with few people, an as yet unresolved conflict and high levels of unemployment and poverty? Might subsidy and grants assist more effectively? The answer is that these principles of microfinance are as critical to the future success of microfinance in Abkhazia as they have been to the success of

microfinance in for example, Bolivia, Poland, South Africa and the home of microfinance, Bangladesh. Microfinance is not a magic bullet for Abkhazia and in cases where people are not economically active, grants may well be more appropriate. However, we know that MSEs are important for the economic development of CIS countries. In tandem with other development activities, microfinance can contribute to economic development on a larger scale than can grants, by providing much needed business capital that helps MSEs to take advantage of business opportunities.

If microfinance is to succeed in Abkhazia, a range of stakeholders will need to support its development:

- The *de facto* authorities – Driving legislative reform, avoiding direct provision of subsidised microfinance, investing in supervisory capacity for licensed deposit takers (but not credit-only institutions).
- Existing humanitarian NGOs – avoiding direct provision of microfinance; supporting potential clients to become clients of MFIs through training, grants etc., lobbying MF providers to provide services in their areas.
- Future microfinance providers – creating a clear organisational distinction between relief and development; building permanent local financial institutions, developing specialised microfinance human resources, responding to the distinctive needs of the vulnerable and inexperienced clients in Abkhazia, maintaining borrower discipline, focusing on dual objectives of self-sufficiency and poverty reduction.
- Donors – making a long-term commitment to MFIs, not placing pressure on MFIs to rapidly disburse loan funds, not undermining weak banks by encouraging retail loan subsidy.

UNDP can begin to encourage the development of the microfinance sector with an integrated package of activities that jointly supports government as well as encouraging the demand (client) and supply (microfinance provider) sides of the market. The proposed project expects to create the following results:

- An environment conducive to microfinance, by training representatives of the *de facto* authorities, reviewing microfinance legislation, facilitating a working group for legislative review, training local humanitarian NGOs and facilitating donor co-ordination meetings.
- Dynamic MFIs following good practice principles, by creating a public information campaign.
- Increased awareness and understanding of microfinance, by recruiting and training MFI staff, registering and licensing a local MFI and providing microfinance services, carrying out MFI business planning and disseminating information on microfinance in Abkhazia to an international audience.

The imposing Soviet bank branches with, for example a line of twenty teller counters are a reminder of better times in Abkhazia, but nowadays they lie unused and gathering dust. Today, such grandeur is unnecessary. But a further twelve years must not be allowed to pass without the development of a strong financial services sector (including microfinance) that can support the economic development of Abkhazia. Indeed, the time is now well overdue for all stakeholders (the *de facto* authorities, donors and NGOs) to accept their respective responsibilities and begin to work together for the development of dynamic and sustainable financial services provision in Abkhazia.

APPENDIX 1 TERMS OF REFERENCE

Micro Finance Consultant for the UNDP Abkhazia Programme

Background: UNDP is in the preparatory phase of starting an area based recovery programme in the breakaway region of Abkhazia, Georgia. Since the break up of the Soviet Union, Abkhazia has been subject to two periods of extreme conflict in 1992 and 1998. The situation in the region is currently tense but reasonably stable. As a result of conflict there has been a massive reduction in population from 550,000 to probably well under half that figure. Most of those who have left have been displaced to Georgia. Abkhazia was one of the richest regions of the FSU, now it is now probably the poorest in the Former Soviet Union. Infrastructure has severely deteriorated. Social welfare and education are weak to non-existent.

Abkhazia has received minimal external assistance over the past 12 years. UNDP is seeking to address key economic and social issues and link them with reconciliation. High on the agenda are the development of agriculture and urban regeneration. Within an economic context this means the development of small business initiatives by means of micro-finance. To this end UNDP Georgia is seeking the advice of a suitably qualified consultant with experience in working in post-conflict situations to assist in the development of appropriate micro finance instruments and assess the potential risk factors in developing micro finance initiatives in Abkhazia.

The financial consultant will be required to undertake the following tasks:

1. Provide a brief overview of the formal banking and credit sectors in Abkhazia.
2. To outline what initiatives, if any, might be undertaken in the foreseeable future to achieve accessible credit for poor people through the formal banking and credit sectors.
3. To undertake participative village and urban-based research to better understand the dynamics of household economies and the nature of small-scale enterprises in the three programme districts. This research is expected to be primarily qualitative, however circumstances permitting, it is envisaged that a limited quantitative study be undertaken.
4. To define and recommend micro financial instruments which will reach poor and marginalised sections of the community in the Programme areas. Detailed information is expected in respect of the organisational aspects of credit delivery.
5. To investigate how micro finance instruments might be applied to relevant findings and recommendations arising from a recent agricultural consultancy in Abkhazia commissioned by UNDP.
6. To produce recommendations as to the support and training that will be needed to successfully establish a micro credit initiative in three programme districts.
7. In the research, analysis and formulation of recommendations the consultant should ensure that proper attention is paid to the situation of women in the programme areas and that wherever possible opportunities for reconciliation are identified and utilised.
8. To provide a risk assessment of proposed micro-credit initiatives, to include consideration of labour availability, a weak to non-existent banking system, problematic ethnic relations, restraints on trade and poor security.
9. To undertake other duties relating to micro finance as required by the Project Management.

Qualifications and Experience

1. Appropriate higher-level university degree.
2. At least 10 years experience working in micro finance or closely related areas.
3. Knowledge and experience of applying micro finance instruments in post-conflict circumstances.
4. Experience of working in the Caucasus region.
5. Fluent English. Knowledge of Russian would be an asset.
6. Proven experience of participative methodologies.
7. Good knowledge of quantitative techniques.
8. Good team building abilities.

APPENDIX 2 BIBLIOGRAPHY

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APPENDIX 3 PERSONS MET

- George Gaganidze, Programme Analyst, UNDP Georgia
- Thi Van Hoang, Programme Officer, World Food Programme, Tbilisi
- Rezo Beudilliani, Business Ideas, Tbilisi
- Jose Mejia-Gomez, Delegate Food Security Programme, ICRC Sukhumi
- Jason Porter, Delegate Food Security Programme, ICRC Sukhumi
- Stephan Sakalian, Head of Mission, ICRC Sukhumi
- Michael Chalmaz, Manager Garant Bank
- Daur Arshba, District Administrator, Tkvarcheli
- Manager Tkvarcheli Branch, Garant Bank
- Appolo Dumava, District Administrator, Ochamchira
- Manager Ochamchira Commercial Bank
- Diana Pilia, Lawyer
- Kiosk owner, Kindgi
- Poorer lady, Kindgi
- Shopkeeper, Kindgi
- Baliko Arshba, Tkvarcheli Village Administrator
- Amiran Dzhindzholia, Head District Agriculture, Tkvarcheli
- Zurab Kishmaria, Deputy Village Administrator, Chuburkhinji
- Market traders, Ochamchira town
- Shop owner, Ochamchira town
- Large shop owner, Ochamchira town
- Business women, Tkvarcheli town
- Maria Van Ruiten, Project Manager, Conflict Rehabilitation, Mine Action and Energy
- Group of women, Adzuzbza village
- Group of young men, Adzuzbza village
- Group of women, Kindgi village
- Group of men, Kindgi village
- Poor family, Kindgi village
- Kiosk owner, Kindgi village
- Leonid Osia, Chair of the Union of the Industrialists and Entrepreneurs of Abkhazia
- Emma Tania, Head of National Bank
- Konstantin Toshba, Minister of the Economy
- Timor Bgamba, Manager, Savings Bank Sukhumi
- Tamaz Ketsba, President Civic Initiative – Man of Future Foundation
- Group of women, Markhunja village
- Niall Brennan, CIMMIC Officer, Gali
- Tsira Kakubava, Cultural-Educational Association of Women
- Celebration Catering business grant group, Gali town
- Beekeeping business grant group, Gali town
- Dr. Antje Bühler, Human Rights Officer, UNOMIG
- Julia Gumba, Chairman, Abkhazian Union of the Business Women
- David Gauthier, Head of Project, Accion Contre el Hambre
- Gerlof de Korte, Executive Director, Credo Tbilisi