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**Legal and Regulatory Obstacles for
Scaling Up Microfinance in Serbia**

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Abstract

In order to scale up, the Serbian legislator should not bother with unlicensed NGOs or unlicensed commercial company lending. Instead, the legislator should concentrate on removing legal and regulatory obstacles which impede scaling-up the microfinance industry through the formal financial sector. These obstacles relate to collateral pledging, compulsory reserves with the National Bank, foreign exchange positions, high costs of court registration taxes and similar. Also, the Central Register of pledges as well as Credit Dossiers for companies, entrepreneurs and individuals should be introduced. The addressing parties to these issues are the National Bank of Serbia and the Ministry of Finance as well as other competent state authorities which are in charge of the commercial law reform.

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I. The background

The explanation of the microfinance¹ demand lies in the previous decade and a half. The Serbian economy has been devastated during the last decade of the 20th century. Today, officially 33% of the population is unemployed, but in reality, this figure is even larger². Due to the ongoing process of economic restructuring and privatization of previously state owned companies, there is a continuous downsizing of labor force, which will even more increase the unemployment rate and lead to further impoverishment. Ideally, this labor force would find their employment within the small and medium-sized enterprises sector or within micro-enterprises. The above parameters point out to the importance of micro financing in Serbia, not only for the economic, but also for the social and political development in Serbia. Gradually, the Serbian policymakers have realized that microfinance can be a vehicle to overcome such problems and increase employment.

Fifteen years ago, one third of the population did not live in poverty and in some sense Serbia had a functioning "middle class". Also, there was a very large growth of micro and small business during the Markovic reforms of 1992, but then the numbers stagnated and declined due to the wars and lack of reforms³. For that reason, in addition to adhering to the "old poor", the objective is also to tailor the project for the "new poor" in the attempt to recapture or reclaim the development which has already existed.

Today there are only four Microfinance organizations⁴ (MFIs) covering the population of 8 million. The existing MFIs, without bank microcredits, have covered around 10.000 clients and thus the microcredit market is unsaturated.

For comparison, in Bosnia, on the population of 3.5 million, there are 42 MFIs, with a 365 Mio Euro annual turnover and 61.000 active micro loans.

There is one Greenfield microfinance bank in Serbia (also one in Montenegro) and some commercial banks are involved in the downscaling process, which have covered around 20.000 clients. All these players they have not covered all the potential clients and there is vast space for attracting expanding the industry.

In order to satisfy the plurality of needs of microfinance clients, a pluralism of institutions and tools for their achievement should be considered. The recent regional study examining the state of microfinance in the SEE region⁵ shows that there is not one best institutional form of MFI that does best on all parameters. There are a lot of reasons to allow the full range of

¹ The CGAP "Guiding Principles on Regulation and Supervision of Microfinance" (www.cgap.org) define microfinance as the provision of banking services to lower-income people, especially the poor and the very poor.

² Information from the Serbian Ministry of Labor and Employment as of May 2004.

³ For detailed numbers see the World Bank report for the donor community for 1999 and 2000

⁴ The Microfinance Gateway (www.microfinancegateway.org) defines MFIs as organizations that offer financial services to the very poor. Gradually the term MFI has come to refer to a wide range of organizations dedicated to providing these services: NGOs, credit unions, cooperatives, private commercial banks and non-bank financial institutions and parts of state-owned banks.

⁵ Forster Sarah, Greene Seth, Pytkowska Justyna, 2003, "The State of Microfinance in Central and Eastern Europe and the New Independent States, MFC/CGAP"

institutional forms appropriately regulated given their role. Experience will show which one of them will survive.

This paper will focus on policies and regulation and recommendations on what the Government and NBS needs to do to scale-up the industry. It will: A) Describe the existing status quo and explain why not to bother with unlicensed NGOs or unlicensed commercial company lending, B) Question if the remaining vehicle under the Serbian law is where the action is, C) Point out barriers for specialized microcrediting banks, and D) Analyze whether commercial downscaling is an option. The conclusions will outline what could be the legal and regulatory obstacles to remove which would scale-up microfinance in Serbia.

II. The existing status quo

- **There are four types of microfinance actors in Serbia**
- **The demand for microfinance has not been satisfied yet and there is a playing field for new actors**

This section will discuss what the existing status quo on microfinance in Serbia and the existing institutional actors. In the beginning of the findings, it is necessary to mention that Serbia does not have regulations on Micro Finance Institutions (MFIs) laws governing specifically microfinance. The NBS has actively resisted such a decree due to their concern over proper supervision and the potential development of Ponzi schemes⁶. The issuing of micro loans is governed by existing banking regulations. Similarly, Serbia does not have a law on NGOs, and thus the existing Serbian MFIs have been registered as “Associations of Citizens” under the valid legislation. On the other side Montenegro, the second constitutive unit in the State Union of Serbia and Montenegro, does have microfinance legislation, that is, the: “Decree on Micro Finance Institutions”⁷, issued by the Montenegrin Central Bank, as well as the “Law on NGOs”. In Serbia, there is however a draft “Law on Microcredit Organizations” created with the Serbian Microfinance Policy Working Group with the support of experts from the Microfinance Center.

When mentioning that there is no specific microfinance legislation, one may ask how are the existing MFIs in Serbia operating? The Serbian MFIs have created a Strategic partnership with the Commercial Banks, *Micro Development Fund* and *MikroFins* (two of the four Serbian MFIs) commission their funds to commercial banks which issue the micro loans. The MFIs assess the potential clients and bear the risk of loan loss. The commercial banks are only paid a fee for the service and legally act as a Commissioner for the MFIs⁸. In addition, MDF has also devised a guarantee deposit scheme but is in the process of abandoning due to an unfavorable arrangement with the respective commercial bank. Supervision in these cases is satisfied since the commercial banks are supervised by the Serbian National Bank. These schemes are acknowledged by the governmental authorities more as an alternative solution for providing microfinance, than some new legal framework for microcredit operations.

On the other side, *World Vision* (the third of the four Serbian MFIs) applies the Guarantee-Deposit model. Technically World Vision deposits its funds into a Guarantee Fund operated by the bank. In this model the Bank is the lender and WV is the Guarantor for the credits, along with keeping its role of technical advisor. This scheme is legal according to the valid Serbian regulations, but is a little more expensive for the MFI. In all these cases we see a strategic partnership between MFIs and FFIs, which enables the provision of microcredit in Serbia.

⁶ National Bank of Serbia, October 2001, “Letter of the NBS Vice Governor to the Serbian Ministry of Economy”

⁷ The “Decree on Micro Finance Institutions”, (Official Gazette of RM no 1/2003)

⁸ A similar approach is the Company Service Model devised by Accion International. The NGO works as a for-profit service company to the bank, doing the marketing and credit evaluation of the client and the loan collection, but the loan is booked on the bank and the bank’s MIS is utilized, as well as its branch structure.

The fourth MCO, *Integra* is involved in group lending to women and has issued approximately 100 credits so far.

The major advantages of the strategic MFI - FFI partnership are the following: A) It provides a legal framework for MFI operations; B) It opens possibilities for further access to capital; C) It is easily applied, although it includes increased expenses.

The major problems in the strategic MFI - FFI partnership are the following: A) Bank's policy, which creates a dependency on the bank, i.e., the bank may unilaterally increase the interest rate; B) Bank's conditions, i.e. depending on the banks conditions, it may not be possible to disburse all the funds. For instance, in the arrangement of the Micro Development Fund with one of the local banks, the bank required a 18% compulsory reserves of the portfolio, which therefore, MDF could not distribute to beneficiaries; C) Increased expenses, which influence the MFIs sustainability; D) Duplication of administration, i.e. both the MFI and the bank create a database of clients containing the same information; E) Time consumption occurs when the a) administration is duplicated, b) client's are informed about the reimbursements, and in the c) actual travel to the bank.

When making a proposal for scaling-up⁹ microfinance in Serbia, one of the key policy issues is do we need to introduce new microcredit organizations or can we satisfy the need with the existing institutions, such as the Savings Credit Cooperatives, Savings Credit Organizations, Savings Banks and the Commercial banks?

A) Why not bother with unlicensed NGOs or unlicensed commercial company lending?

There is a general discussion as to whether NGOs should or not be the champions of microfinance. Opponents argue that banks should be the ones disbursing the loans, rather than NGOs. NGOs with their inability to take commercial equity and deposits and thus operate as banks are largely dependant on donors, and once the donor input dries out, NGOs have no more sources of financing. Furthermore, through NGO microfinance, the beneficiaries are not supported to act in an entrepreneurial-like behavior and are not trained to develop their business. Finally, the non-commercial behavior of NGOs can on the long run, negatively impact the banking sector. On the other side, proponents argue that the banking sector will not suffer since most of the MFI clients anyway cannot meet the banking requirements.

An important policy issue is the duration of NGOs which provide micro credits. The idea is that their mission would be completed once they have facilitated growth and replaced by other commercial institutions. To that purpose, one can argue that the NGO lending should only be permitted for some "limited time" to make certain that a faux market is not created and

⁹ Scaling-up means MFIs that NGOs are transformed into formal financial institutions (FFI), and besides offering loans expand to a number of other services such as micro-leasing, micro-insurance, savings, housing loans etc. Lieberman, Djankov et al. propose three groups of recommendations for NGOs going formal: 1) Ease operating constraints on the existing MFIs; 2) Examine and change the existing banking regulations to encourage small firms' lending; 3) Avoid state-sponsored financial intermediation. See Djankov Simeon, Lieberman Ira, Mukherjee Joyita, and Nenova Tatiana, April 2002, "Going Informal: Benefits and Costs", World Bank

sustained for the country's poor with the result that the poor are ghettoized and de facto denied any hope of entering the power structures within a country.

Another role of NGOs in increasing the access to financial services is creating databases and track records of clients. Secondly, NGOs could make interviews of clients in the informal sector. Through client's databases and client interviews, NGOs providing microcredit can assist previously un-bankable clients to come into the formal financial sector.

There is a realistic and existing need to expand the existing microfinance market in Serbia. Having in mind that the Serbian Parliament is very slow in promulgating laws (for instance, the new Bankruptcy or VAT laws have waited two years for their enforcement), it is unlikely that the eventual introduction of a new NGO law and a Micro Credit Organizations law will meet the realistic time requirements. On the other side, it is questionable whether the traditional microfinance schemes as developed in Bangladesh and India, or the neighboring Bosnia are the best solution for Serbia? Can microfinance be merged with formal banking and the development of the microfinance sector be combined with the restructuring of the banking sector in Serbia?

An EU country - France has amended the banking law so that Associations (MFIs) can on-lend to clients, but only from their own funds. The French Law on New Economic Regulations, which modifies articles of the Monetary and Financial Code, now allows “non-profit associations delivering loans for the creation of the development of enterprises by unemployed people, on their own funds and on loans borrowed from credit institutions, to deliver credits¹⁰. This means that, under certain conditions, a “microcredit association” will now be allowed to borrow and lend.

This paper argues that NGOs should not be the appropriate form of MFI for Serbia. NGOs do not have the adequate legal framework and it would take too much to overcome the regulatory and legal obstacle.

The policy in Serbia is hostile to NGOs for the following reasons:

1. Some influential Serbian policymakers misunderstand NGO MFIs and fear that they could threaten the clean-up of the mainstream financial sector;
2. NGOs are late in the game to be regularly developed into MFIs in Serbia;
3. Although NGOs are typically the vanguard for microfinance, in Serbia this is not the case as it is for instance in Bosnia.

To conclude, the current legal and regulatory conditions are unfavorable, as are the chances for education of the misinformed policymakers. They represent a significant obstacle. The lobbying extravaganza with the NBS will not have anything to do with microfinance policy. Too much time and effort will be wasted without any result.

¹⁰ For more details check www.european-microfinance.org The European Microfinance Network

Unlicensed commercial company on-lending does not exist as a form of microfinance in Serbia. Since the NBS does not allow for NGO on-lending, for the same reasons (i.e., misunderstanding of the risks involved) it will not allow for unlicensed commercial MFIs on-lending.

B) Savings Banks

So far there is only one Savings Bank - Opportunity International, which has been registered in Vojvodina. The registration process did not go smoothly and it has required lobbying extravaganza, which is not possible in the case of other NGOs or other organizations which wish to register a saving bank. Although the savings banks provide a regulated vehicle for operating microfinance in Serbia, they have their disadvantages which will be discussed in the next chapter. In this sense, Opportunity International Savings Bank has a limited scope of work in Serbia and on the long run is looking to register as a full fledged commercial bank.

Regulation is being slowed by the NBS due to the desire of the Central Bank to complete the privatization of its state owned banks and not to become to licence any new commercial banks for the moment.

C) Greenfield microfinance banking

The only Greenfield bank registered in Serbia is the ProCredit Bank. It started under the name of Micro Finance Bank as an IMI initiative for SEE and CIS countries. Now ProCredit Bank is operating in a number of neighboring countries and is expanding its activities. After three years from the initial investment, ProCredit Bank has already become profitable. This bank is specialized in microcredits and small business lending, and its disbursements are highly overcoming the disbursements of the existing Serbian MCOs. For instance, on a monthly basis, ProCredit bank disburses around 2.000 loans. From the beginning of its operations, until now, PCB has disbursed a total of 22.000 loans. All of these loans are below 10.000 Euros and thus fit into the microcredit criteria (the statistics does not include consumer loans).

In Montenegro, Opportunity International is registered as a full fledged bank under the name Opportunity Bank in 2002 and is successfully providing microcredits. OB started as an NGO in 1999 and so far is the only example of a scaled up microfinance bank in Serbia and Montenegro.

The performance of Greenfield microfinance banks so far show their capacity to grow in a short period and cover bigger portions of the client market then do the traditional MCOs. This is especially the case with both ProCredit bank and Opportunity International. Such a success shows that either these are the models to pursue in microfinance development, or perhaps that the success of ProCredit and OB is a result of the fact that they were the first to enter the

market hungry for micro loans. The authors' opinion is that the first option is true, but it is also true that the adequate timing has influenced the commercial success.

D) Downscaled Commercial Banks

Opening Greenfield banks specializing in microfinance and downscaling the existing and economically viable banks are two parallel processes currently ongoing in Serbia. LFS Financial Systems is performing the task of downscaling in Serbia together with KfW of Kulska, Eksim, Komercijalna and Zepter banks. According to their findings, from some aspects it is easier to start a Greenfield bank than to downscale the existing commercial banks. On the other side, downscaling has its advantages towards Greenfield banking. However, both downscaled banks and Greenfield banks are subject to the same restrictive banking regulations in Serbia. Speaking through numbers, in 2003 Serbia had 46 banks on the population of 8 million, and in the beginning of 2005 it has 39 banks.

E) The impeding regulatory and legal policies

So far the existing regulatory and legal policies of the Serbian government have constrained the development of the Serbian MFI sector. This impediment has been supported by the conservative feature of the Serbian law and misinformed attitudes of relevant policymaker.

I) The official standpoint of the NBS is that MFIs, which are traditionally institutions that are unregulated by prudential legislation, may contribute to the destabilization of the financial sector¹¹. This fear was supported by the experience from the early 1990s when a number of pyramidal schemes and financial frauds have occurred. The Serbian legislator oversaw the fact that microfinance seldom accounts for a large enough part of a country's financial assets to pose serious risk to the overall banking and payments system.¹²

For instance, Montenegro has 650.000 inhabitants. It has a much smaller economy than the Serbian one but they have undertaken a radical turn. The Montenegrin Central Bank has enacted the "Decree on Microfinance Institutions"¹³ and thus legalized microfinance operations. This radical turn did not have an effect to destabilize the financial sector in Montenegro.

II The NBS has the discretionary right to license (or not) all legal forms of FFIs. This practically means that the NBS does not even need to bother to justify its refusal of a license on policy grounds (as it had done when it first refused a license to Opportunity International). If proposed, any of the other vehicles under the banking law, have to confront this significant

¹¹ National Bank of Serbia, October 2001, "Letter of the NBS Vice Governor to the Serbian Ministry of Economy"

¹² See CGAP "Guiding Principles on Regulation and Supervision of Microfinance" (www.cgap.org)

¹³ "Decree on Microfinance Institutions", (Official Gazette of RM no 1/2003)

obstacle that exists, unless the banking law were changed to require objective grounds for the refusal of a license.

III) The foreign exchange positions of the NBS impose restrictions of the open currency position. This means that banks engage only in dinar lending, which is indexed to foreign currency. This feature will be discussed more in the chapter on open issues with the policymaker.

IV). The NBS imposes burdensome reserves which decrease the on-lending portfolio of banks. So far they are 21%, with the promise of NBS that they will be lowered to 18%. The rationale of reserves is protection of depositors and they are regulated by prudential legislation.

The neighboring Romania was a tough partner in promoting microfinance. The banking sector was overregulated due to the Romanian's legislator to be in compliance with Basel 2 recommendations¹⁴. Among the difficulties, were the 40% hard currency reserve requirement, burdensome reporting, limitations on employing branch managers, etc. Gradually, microfinance was installed into the system, and is now operating smoothly. This was a result of a lobbying effort which was based on Romania's wish to enter the European Union.

¹⁴ The Basel Capital Accords

III. Are the existing FFIs in the Serbian law vehicles where the action lies?

- **The existing FFIs do provide a mechanism for microfinance, but these vehicles are burdened with demanding registration requirements and extensive reporting**
- **So far, not one of the existing MFIs have scaled up into an FFI**

This section argues whether the existing vehicles under the Serbian law are where the action lies for scaling up microfinance. So far there are four MCOs (Micro Development Fund, MicroFins, World Vision and Integra), one Savings Bank (Opportunity Savings Bank) and one Greenfield microfinance bank (ProCredit Bank). Other forms of organizations which are regulated in the Serbian law, such as the Savings Credit Cooperatives and Savings Credit Organizations have not been used for microfinance so far. This section will analyze each of the existing FFIs, highlight their restrictions and offer possible changes to make them more attractive to microfinance.

A detailed review of the Serbian regulations related to microfinance has been made by Lyman and Lauer, and the intention of this paper is not to duplicate the already existing, but to mention the latest changes and point out to new legislation, internal NBS decisions and regulations. See Lauer Kate and Lyman Timothy, April 2002 “Survey of the Legal and Regulatory Environment for Microfinance Institutions in the Republic of Serbia”.

A) Savings Credit Cooperatives

So far Savings Credit Cooperatives¹⁵ (SCC) are the closest formally regulated institutions which can serve as a vehicle for issuing microcredits. There are approximately 10 SCC registered in Belgrade. The obstacles for SCC’s to become a vehicle for microfinance are the following:

1. Very restrictive conditions for registration which include a big portion of conditions requested for banks,
2. Shareholders organization of SCC which complicates ownership,
3. No tax reductions and other alleviations,
4. As SCC are profit oriented, the question is in which scale would the donors contribute with their resources (on the other side, this will not represent a problem for commercial microfinance, as donors can still give grants),
5. Registration requirement of 200.000 Euros,

¹⁵ Articles 72 to 75 of the Serbian “Law on Banks and other Financial Institutions” (Official Gazette of RS no 72/2003)

The issue in this case is whether the state can provide alleviations for SCC which plan to go into microfinance activities. The issue for potential investors in the field is whether they can adjust to the above requirements and consider this form for their microfinance programs? So far, due to the above obstacles Micro Development Fund is not considering going into this direction. MicroFins is considering going formal in the future, depending on a number of issues and in that case, the SCC would be the preferred form of FFI they would chose.

B) Savings Credit Organizations

A similar form to the SCC are the Savings Credit Organizations¹⁶ (SCO). Originally, SCOs were conceived as organizations of large state corporate systems and used for financing the employees of such systems. In addition, the MFIs have not considered them as an option for their scaling up due to similar restrictions as foreseen for the SCC's and also the registration requirement of 1.2 Mio Euros. In case of depositing such a significant amount, a Savings Bank would be a better solution which would in addition provide a larger scope of microfinance activities.

C) Savings banks

So far only OI has registered itself as one of the FFIs and chose the form of a Savings Bank¹⁷. Following this example, World Vision is considering scaling-up to Savings Bank. As mentioned before, this form has its obstacles, and the following are the main ones hindering access to financial services:

1. Permission to on-lend only to private persons and not to enterprises.

As such, all micro loans issued by SB's are treated as consumer loans for reporting purposes. Nevertheless, this does not represent an obstacle for increasing access to financial services, since from the aspect of NBS, issuing consumer loans requires less paperwork as explained in the chapter before.

2. Inability to take deposits in foreign currency, but only in dinars.
3. Inability to take credit lines from abroad, which are by default in foreign currency.

Nominally a SB would look for additional financing from abroad to increase its on-lending portfolio, so this legislative requirement represents a restriction to accessing finance.

4. Permission to be involved in monetary transfers in the Serbian monetary market only in dinars and not in foreign currency.

For the time being, this restriction does not handicap SB's especially, since their primary goal would be issuing credits and not performing monetary transfers.

¹⁶ Articles 68 to 71 of the Serbian "Law on Banks and other Financial Institutions" (Official Gazette of RS no 72/2003)

¹⁷ Articles 64 to 67 of the Serbian "Law on Banks and other Financial Organizations" (Official Gazette of RS no 72/2003)

5. Ownership

Savings Banks in Serbia should be owned by a local company. In practice this does not represent a problem for registering. Namely, shareholders can purchase a local company which can serve as an investment tool.

In this sense, SB's have a limited scope of work in Serbia. For this purpose, Opportunity International in the long run is looking to register as a full fledged commercial bank.

D) Greenfield banking

In Montenegro, Opportunity International is registered as a full fledged bank under the name Opportunity Bank in 2002 and is successfully providing microcredits. OB started as an NGO in 1999 and so far is the only example of a scaled up microfinance bank.

The only Greenfield bank registered in Serbia is the ProCredit Bank. It started under the name of Micro Finance Bank as an IMI initiative for SEE and CIS countries. Now ProCredit Bank is operating in a number of neighboring countries and is expanding its activities. After three years from the initial investment, ProCredit Bank has already become profitable. This bank is specialized in microcredits and its disbursements are highly overcoming the disbursements of the existing Serbian MCOs. For instance, only in April 2004, ProCredit bank has disbursed 2.000 loans. From the beginning of its operations, until now, PCB has disbursed a total of 14.000 loans. All of these loans are below 10.000 Euros and thus fit into the microcredit criteria. Of course, all consumer loans are excluded from this statistics.

The performance of Greenfield microfinance banks so far show their capacity to grow in a short period and cover bigger portions of the client market than do the traditional MCOs. Therefore, they should be taken into account as an important and expanding actor in the field of microfinance.

Opening Greenfield banks specializing in microfinance and downscaling the existing and economically viable banks are two parallel processes currently ongoing in Serbia. LFS Financial Systems is performing the task of downscaling in Serbia together with KfW. According to LFS findings, from some aspects it is easier to start a Greenfield bank than to downscale the existing commercial banks. On the other side, downscaling has its advantages towards Greenfield banking. However, both downscaled banks and Greenfield banks are subject to the same restrictive banking regulations in Serbia, and their obstacles for microfinancing will be discussed in the next chapter.

E) Serbian Microcredit Fund

End of February 2005, the Serbian Finance Minister has announced the establishment of the Serbian Microcredit Fund. The loan size would be from 5 to 20 thousand Euros, maturity from 3 to 5 years, and annual interest rate of 1%. The estimated fund portfolio is 8 Mio Euros. This represents a radical shift of the government towards microcredit. However, the loan size is significantly larger than it is in a traditional micro loan.

The question with this fund is how will it affect the microfinance scene in Serbia? Will it distort the financial market and kill the existing four MFIs. Will it with its small interest rate distort loans from banks?

The second question is the sustainability of this fund. It is hardly possible for a fund with a 1% annual interest rate to be economically sustainable on the long run. Therefore, this fund will most probably be filled in from the state budget or other means of financing.

So far, the Ministry of Finance is closed to dialogue on this issue and relate to press releases and public announcements on the issue, which provide insufficient information.

New banking law in Serbia

In March 2005, the NBS Governor has announced a new banking law to be promulgated in 2005¹⁸. This may represent a unique opportunity to promulgate new provisions which will facilitate microfinance in Serbia. Besides, the new banking law should facilitate the reform of the banking sector, allow new foreign banks to enter the market with new investments and facilitate the restructuring / privatization of the existing state owned banks.

¹⁸ Presentation at the occasion of the inauguration of the White Book, organized by the Foreign Investors Council (FIC) in March 2005

IV. Barriers for specialized micro crediting institutions

- **Commercial banks have to handle heavy handed regulation**
- **Tough and burdensome requirements on uncollateralized lending require prohibitive reserve requirements**
- **The legal and regulatory barriers relate not only to banks, but to all other FFIs**

Below are the representative types of prudential and non-prudential¹⁹ regulatory barriers which influence microfinance development in Serbia.

An additional problem is that regulations relating to microfinance are stipulated in a number of laws and by-laws and it is hard to find one's way in the forest of regulations, i.e. NBS decisions.

A) Registration requirements

The National Bank foresees a number of requirements for registering banks and other financial organizations.²⁰ Below is the list of requirements with brief explanations:

- a. Authorization for the person with whom the NBS will cooperate in the process upon the request for issuing a license;
- b. Contract on establishing the bank;
- c. Statement from the local founder that the financial resources for the founding capital will be paid to the temporary account with the bank, or the statement of the foreign founder that the hard currency resources will be paid to a separate account with the NBS;
- d. Evidence that the founder of the bank will transfer non-financial resources to the founding capital of the bank;
- e. Evidence on the origin of foreign investment;
- f. Evidence on the existence of reciprocity, which means a confirmation of the competent body or excerpt from the legislation of the country of the foreign founder which proves that subjects from Serbia and Montenegro are allowed to establish banks on the territory of this state;
- g. Proposal of the banks' statute;
- h. Proposal of the decision for issuing the first emission of the bank's shares;
- i. Information necessary for establishing the solvency of the founder;

¹⁹ CGAP's "Guiding Principles on Regulation and Supervision of Microfinance" describe the difference between prudential (devised for the protection of depositors) and non-prudential regulation of microfinance. Prudential regulation issues are the: minimum capital, capital adequacy, unsecured lending limits and loan loss provisions, loan documentation etc. The non-prudential regulatory issues are the: permission to lend, consumer protection, fraud and financial crime prevention, credit reference services, secured transactions, interest rate limits, limitation of ownership, management, and capital structure, tax and accounting and feasible mechanisms of legal transformation which in effect is scaling-up.

²⁰ "Decision on the mode for implementing articles 8, 9, 10a, 12, 15, 19b, 19e, 28, 29 and 59 of the Law on banks and other financial organizations", (Official Gazette of RS no 129/04)

- j. Information on relations among the founders;
- k. Names and recommendations for the proposed members of the managing and controlling board of the bank, and for proposed persons with special authorizations and responsibilities;
- l. Program of the bank's work for the period of five years and the proposal for the basis of business policy of the bank for year in which the bank is being established;
- m. Information on qualifications of the bank's staff for performing the tasks from the contract and the documents on business policy;
- n. Information on the technical qualifications of the bank for performing the tasks from the contract and the documents on business policy.

Other financial institutions regulated under the Serbian law have to submit all of the above foreseen documents, except for requirements from the above points 3, 5 and 6.

B) Reporting requirements

The National Bank imposes reporting requirements for banks and other financial organizations on: a) balance sheets, b) income statement, c) cash-flow, and d) changes in the capital²¹.

The balance sheet contains information about liabilities and off-balance positions.

The income statement contains information about: a) income and expenses of regular business, b) irregular income and expenses, c) profit and loss before tax, d) income tax, and e) profit and loss after taxation.

The cash flow report contains information about payments and collection of payments in cash and cash equivalents through the giro account, current and hard currency account, including compensations, assignments, assignments made through these accounts in accordance to International Accounting Standards and other relevant standards.

The report on changes in the capital contains the following information on balance and changes: a) shares, b) emission premium, c) registered and unpaid capital, d) the bank's bought out shares, e) revalorization reserves, f) reserves from profit, g) profit, h) loss, i) remaining capital and j) total capital.

In addition, the National Bank imposes other reporting requirements for banks as they are defined in the "Law on Monetary Transfers":²² a) information about opened accounts of legal and private persons, which do business for a profit, b) cumulative information on turnover and balance of account according to the plan of the account for performing payment transfers from the charter of accounts established for the banks, c) information about the balance of resources on accounts of debtors which have unsettled obligations.

²¹ "Regulations on the models and content of positions in the models of financial reports for banks and other financial organizations", (Official Gazette of RS no 19/04)

²² "Decision on the types of information that the banks deliver to the National Bank of Serbia and on the mode and deadlines for delivering this information", (Official Gazette of RS no 111/03)

For the above reporting, the “Law on monetary transfers”²³ defines banks as legal entities which are established as banks and do business according to the law which regulates banks and other financial institutions. Therefore, the other, above mentioned financial institutions have also to comply with this reporting requirement.

C) Compulsory reserve

The banks as well as other financial organizations, as defined in the Serbian Law on Banks, are obliged to keep a compulsory reserve with the National Bank of Serbia. The reserve is one of the basic NBS instruments for leading the macroeconomic policy. Banks find this requirement especially burdensome since the compulsory reserve can otherwise be used for the on-lending portfolio. This makes the loans more expensive and the cost is born by the clients. There are five types of the compulsory reserve.

C.1. Dinar deposits reserve

This reserve refers to liabilities arising from dinar deposits, dinar assets acquired through issues of securities and used dinar loans disbursed²⁴. It is calculated using the rate of 21%, it is deducted in dinars by the bank and placed on the bank’s giro account²⁵.

C.2. Hard-currency deposits reserve

This reserve refers to liabilities arising from hard currency deposits and hard currency loans, as well as other hard currency liabilities²⁶. It is deducted by the bank in hard currency using the rate of 47% and placed on hard currency accounts of the NBS, either in Euros or USD²⁷. The rationale for this reserve is security for the depositors. Banks object that as a result of this requirement, their on-lending portfolio is decreased for exactly 47%. They argue that by waiving this legislative requirement, their on-lending portfolio would be increased thus providing increased access to financial services. The NBS on the other side argues that microcredit is risky and therefore such a large deposit on savings is very much justified in order to protect the depositors. Hence, it is unlikely that the NBS will waive the 47% compulsory hard currency reserve in the near future

C.3. Foreign credit lines reserve

Until the end of 2004, the NBS regulations have excluded liabilities arising from foreign currency loans with foreign legal persons with contracted maturity exceeding four years, provided that such loan agreements, including any annexes to such agreements, were registered in line with regulations governing international credit relations.

²³ Article 10, point a) of the “Law on Monetary Transfers” (Official Gazette of RS no 43/04)

²⁴ Article 2, point 1 of the “Decision on the compulsory reserve of banks with the National Bank of Serbia”, (Official Gazette of RS no 136/04)

²⁵ Article 6, paragraph 1 Ibid.

²⁶ Article 2, paragraph 2 Ibid.

²⁷ Article 6, paragraph 2 Ibid.

In 2005, this provision has been cancelled, thus practically imposing the compulsory reserve on foreign credit lines until December 2004²⁸. This compulsory reserve amounts to 21% of the credit line and creates an additional impetus for microfinance development.

C.4. Reserve on investments exceeding deposits

Parts of deposits received under transactions that a bank performs in the name and on behalf of third persons exceeding the amount of investments from such deposits by the bank are also subject to the 21% compulsory reserve with the NBS²⁹.

C.5. Uncollateralized lending reserve

Uncollateralized lending is regulated as a 100% liability of the bank. Thus the NBS imposes a 100% reserve for uncollateralized lending³⁰. This means that if a bank issues a loan to a start-up, there is a 100% physical reserve requested by the NBS. The rationale for this reserve is that start-ups usually have no collateral, no credit history and thus they are highly risky for banking.

This legislative is a good example of how complicated it is to find one's way in the current Serbian banking legislation. Namely, although there is a valid "Law on Banks", and a "Decision on compulsory reserves with the NBS", this requirement is stipulated in the which gives instructions on how to calculate the banks' liquidity, the "Decision on detailed conditions for the application of articles 26 and 27 of the Law on banks and other financial organizations".

One of the options through which the 100% reserves on uncollateralized lending can be avoided, is imposing big administrative burdens on them. However, having in mind the practice so far, it is unlikely that this administrative burdens be regulated in the new banking law, but rather in decision of the NBS, all under condition that there is will to impose such administrative burdens.

C.6. Liabilities exempt from the compulsory reserve

The obligatory reserve is not calculated on the following³¹:

1. Liabilities towards the NBS;
2. Amount of obligations towards banks which deduct the compulsory reserve with the NBS;
3. Liabilities on the basis of hard currency savings deposited with the banks after June 30, 2001;
4. Liabilities which arise from implementing the laws and other regulations governing the state public debt arising from the citizens' hard currency savings of the citizens, deposits and special purpose deposits for the purchase and sale of bonds issued to service such public debt;
5. Liabilities towards creditors of the Paris and London club;

²⁸ Article 3, paragraph 6 Ibid.

²⁹ Article 2, paragraph 3 Ibid.

³⁰ Article 14, paragraph 4 of the "Decision on detailed conditions for the application of articles 26 and 27 of the Law on banks and other financial organizations", (Official Gazette of RS no 129/04)

³¹ Article 3 of the "Decision on the compulsory reserve of banks with the National Bank of Serbia", (Official Gazette of RS no 136/04)

C.7. NBS interest rate on the reserve

The NBS does reimburse the banks with an interest rate for depositing this compulsory reserve, but the banks find it inadequately small. Namely, the interest rate for obligatory reserves in dinars is 35% of the discount rate,³² whereas the discount rate is established at 8,5% annually.³³ The NBS pays the interest rate in hard currency for the compulsory reserve in hard currency in USD and Euros which does not exceed the amount of the calculated hard currency compulsory reserve in the amount of 20% of the leading valid reference interest rate for USD and Euro³⁴.

As a comparison, the Central Bank of Montenegro imposes a compulsory reserve for deposits, using the rate of 23%.³⁵ No compulsory reserves on foreign credit lines are imposed.

D) Foreign exchange positions

The foreign exchange position imposes a restriction of the open currency position and borrowing on a preferential rate from IFIs.

In this case, consequently, the dinar lending is fixed to the exchange rate and the risk is borne by the borrowers. The fact the banks generally only engage in Dinar lending indexed to foreign currency shifts the exchange risk to customers and this means, that if borrowers are able to repay, a bank will have funds on hand to repay its foreign currency borrowing. There are also other macroeconomic/foreign exchange-related reasons why the NBS still wants banks not to have large open currency positions, aside from the risk that the clients bearing the currency risk may not be able to repay if the Dinar drops sharply.

E) Minimum Capital Requirements

In order to prevent the mission drift, it is necessary that minimum capital requirements for MFI establishment are imposed. Such a requirement is necessary in order to prevent the misuse of MFI establishment for purposes other than aiding the working poor and general socio-economic development. The amount varies from case to case. For instance, the Grameen Foundation recommends “that the minimum capital requirements for MFIs should be realistic”³⁶.

³² Article 4 of the “Decision on interest rates of the National Bank of Serbia”, (Official Gazette of RS no 90/04)

³³ Article 1 of the “Decision on the amount of the discount rate of the National Bank of Serbia”, (Official Gazette of RS no 133/03)

³⁴ Article 5 of the “Decision on interest rates of the National Bank of Serbia”, (Official Gazette of RS no 90/04)

³⁵ “Decision on the compulsory reserve of banks with the Central Bank of Montenegro”, (Official Gazette of RM no 50/04)

³⁶ Counts Alex and Sobhan Sharmi, Grameen Foundation USA, 2002, “Recommendations for the Creation of a Pro-Microcredit Regulatory Framework”

So far the Serbian “Law on Banks and other Financial Institutions”³⁷ foresees the following capital requirements: for Savings-Credit Cooperatives – 200.000 Euros, Savings-Credit Organizations 1.2 Mio Euros, for Savings Banks 2 Mio Euros and for full-fledged Banks – 10 Mio Euros. The Serbian Draft Law on MCOs proposed that the capital requirements for MCOs be capped at 100.000 Euros³⁸.

F) Minimum Capital Adequacy Requirements

The minimum capital adequacy requirement defines the amount of capital in relation to the active at risk. Both Basel 1 and 2 Capital Accords foresee the amount of 8%. In determining the capital requirement basis, as defined, the NBS should follow, in general, the concepts of risk weighting for assets and off-balance sheet items as given in the 1988 International Capital Convergence Agreement made by bank supervisors (Basel 1 Capital Accord) but shall simplify or modify as it deems necessary for Serbia and may from time to time adjust such risk weightings as circumstances call for. As the supervisory authority, it is the responsibility of the National Bank of Serbia, to ensure minimum capital requirements for financial institutions and the on-going capital adequacy requirements for financial institutions.

G) Tax incentives and policy and the financial sector

Tax policy may bring adverse incentives to microfinance actors, and that is why proposals will not be made with regard to it .in this paper.³⁹

Generally speaking liberal tax policy has a very broad tax base but it can tax exempt certain types of activities. The argument for a liberal tax policy is that the state should bring in more tax revenues which places more money for development.

Tax preferences from the economic perspective are always seen as a grant to an organization that does not have to pay tax, and its very market distorting. It is opposed by the likes of IMF and World Bank, EAR and other bilateral donors. One needs a very well reasoned and economically based argument why the market distorting effect of providing tax preferences is justified. The alternative would be to better to subsidize microfinance like in the US or UK, which set aside budgetary resources for community based microfinance. This would establish community development institutions.

³⁷ “Law on Banks and other Financial Institutions” (Official Gazette of RS no 72/2003)

³⁸ The Serbian Draft “Law on Micro Credit Organizations” was made in February 2003 by the Serbian Microfinance Policy Working Group

³⁹ The enclosed is a summary of discussion with Tim Lyman

H) Barriers for the extension of credits and investment activities

H.1. Additional measures for issuing consumer loans

At the end of 2004, the NBS has introduced additional measures for issuing consumer loans. The NBS has considered that the public is becoming too indebted and decided to impose restrictions for banks on issuing loans. Namely, the new regulations impose a requirement for banks to take 15% r 20% down payments of the loan value before they issue a loan to the clients.

H.2. Bank shares on the stock exchange market

The Serbian banks are not listed on the Stock Exchange market so new investments can not enter the banks. According to the existing practice, banks are sold to one or two investors and thus closed companies are created. New investors are reluctant to enter because there are no exit mechanisms.

G) Collateral

Issues relating to collateral significantly impede the microfinance industry development in Serbia.

G.1. Registration of collateral

The current Serbian legislation poses problems during the registration of collateral. Namely, a large number of real estate properties are not registered in the land registers and thus can not be pledged. Also, the court system foresees traveling from one city to another just to register collateral, which is consuming time-wise and also decreases the motivation. Thus, the time constraint is involved.

G.2. Estimating the value of collateral

The court approves the value of the assets when you pledge the collateral. When checking the value of assets pledged, the banks do not believe the court's statements, so they ask for more collateral. Sometimes, the value of collateral is even up to three times higher than the issued loan.

G.3. Costs of pledging

The costs of collateral registering are too high. The cost consists of the application cost, cost for certifying the contract and registering the right⁴⁰. Having in mind the small amount of the micro loan, the costs of collateral pledging can constitute a significant part of the loan. The court taxes could be easily lowered as they are unfairly high for the microcredit clients, i.e. the registration of collateral takes approximately 10 to 15 minutes of work for the court.

⁴⁰ "Law on Court Taxes", (Official Gazette of RS, no 29/04)

G.4. Central register of collateral

There is no central register of collateral yet, although it is foreseen in the law. This creates problems since a debtor can pledge the same collateral for more than one loan.

Namely, the “Law on Registered Pledges on Movable Assets”⁴¹ clearly stipulates that the Register of Pledges will be established to register pledges on the assets of individuals and legal entities. This Law also foresees that the Register of Pledges will be centralized, containing a unique electronic database and that it will be publicly accessible. The Law also foresees that the Pledge Register will be managed by the authorized organization, which will be determined according to the law⁴². This is where the problem starts.

The “Law on the Agency for Commercial Registers” is in charge for establishing the Register of Pledges⁴³. It is supposed to run it together with the Register of Business Entities and the Financial Leasing Registry, along with other registers if they are established by the Law. However, the Register of Pledges has never been established, despite the legal obligation to do so, and thus one of the policy recommendations from this paper is to establish it since it would contribute to the development of the microfinance industry.

In addition to the absence of the Central Register of Pledges, there is no central register of loans, so individuals may take several loans in different banks. The situation is a little better regarding when dealing with registered companies, since the bank has insight into the balance sheet and income statement.

To conclude, the regulatory environment in Serbia is prejudicial and adverse to microfinance institutions operating vs. commercial banks.

⁴¹ Article 56 of the “Law on Registered Pledges on Movable Assets”, (Official Gazette of RS, no 57/03)

⁴² Article 57 Ibid.

⁴³ Article 4, paragraph 2 of the “Law on the Agency for Commercial Registers”, (Official Gazette of RS, no 55/04)

V. Is commercial downscaling an option?

- **Downscaling has advantages and limitations**
- **The question is how to institutionalize downscaling**
- **Is the vehicle for microfinancing issuing microcredit to business through retail banking?**

A) Why downscale?

Downscaling is the process of training economically viable commercial banks to specialize for micro loans. In this process, the banks retain their other functions such as deposit taking and commercial transactions. Also other bank departments continue with issuing loans exceeding micro loans, which is especially useful when clients overcome the micro loan demand and migrate to small or medium loans. Downscaling is now being implemented in Serbia through KfW programs and LFS Financial Systems. The targeted banks are Eksim, Kulska, Komercijalna⁴⁴ and Zepter bank.

The question placed before bank management in the case of downscaling is why would a bank restructure itself to have a lower profit with a larger risk and less security? Below are the general reasons, as well as reasons adapted to the Serbian context:

- 1) Risk diversification. The existing banks like to finance large clients since it brings high returns with a good security. However, if one large client becomes insolvent, perhaps 5%, 10% or even 15% of the banks portfolio may be jeopardized. On the other side, if one micro client goes bust, only 0,000015 of the bank's portfolio is at risk.
- 2) Downscaling opens new markets, since it attracts clients that otherwise would not come to the bank.
- 3) Downscaling may also bring in a deposit base.
- 4) When the client overgrows the micro loan category, he/she can migrate to another department, still remaining within the same bank⁴⁵.
- 5) Downscaled banks provide non-financial services⁴⁶ to clients, which favors them with regard to the social mission of microfinance.

⁴⁴ Komercijalna bank is one of the rare big state owned banks which has remained in operation after the bank restructuring process has been implemented from 2001 to 2003.

⁴⁵ MFIs refer to these clients as “golden clients”. If their credit needs overgrow the MFI offer, they migrate to the formal banking sector.

⁴⁶ Generally, the cost structure impedes the providing of non-financial services portion necessary for the working poor since it makes the profits non-sustainable.

By providing non-financial services, downscaled banks attempt to prevent the social mission drift of bank: 1) Formulation of the business plan together with their clients, which can also serve as the credit analysis of the client; 2) Information on new legislation in order to maintain the portfolio quality. This is a favor for the clients, but also for the banks and their attempt to minimize the risk of credit default.

6) As it is important that the general public has trust in the Serbian banking system, it is therefore necessary to work with the existing banks, both domestic and foreign. This will lead to an increased trust towards the banks and an increased stability of the banking system.

B) The Serbian context

Bank downscaling has been a big thing happening in microfinance in Serbia. This is interesting to correlate with global trends, as mainstream FFI downscaling is a very big deal. Littlefield⁴⁷ found that worldwide "microfinance is melting into the financial sector": unregulated MFIs report to national credit bureaus, MFI clients access international ATM networks, MFI banks issue credit cards, there are 62 partnerships between banks and MFIs in 36 countries, etc. So far in Serbia credit cards are mostly used for short-term consumer loans and not as a tool for microcredit.

Furthermore, Littlefield⁴⁸ predicts that commercial and state banks will become core providers in building the financial services for the poor. This can be correlated to the latest initiative from the Serbian Ministry of Finance on establishing the Serbian Microcredit Fund, but not at 10 Mio USD and 1% annual interest.

In Serbia, the NBS has restricted the establishment of Greenfield banks. The NBS says that if you wish to go into banking in Serbia, then you should buy one of the existing banks. The reason for such a position is that the State is the majority stakeholder in most of the Serbian banks, which has happened in 2002 after the "Decree on Debt to Equity Swap". In this process, as all the Serbian banks were largely indebted to the State and insolvent, that is unable to service their debt, the State converted its debt into equity and thus has become the majority stakeholder in most the Serbian banks. Now the State has a clear interest to sell its property as opposed to allowing the establishment of new Greenfield banks. Therefore, downscaling is for the time being a likely and plausible solution for microfinance banking.

The consolidation of the banking sector is ongoing. Serbia has too many banks compared to its population, i.e. in , 2003 Serbia had 46 banks on the population of 8 million, and in the beginning of 2005 it has 39 banks. The general trend of consolidation, as opposed to bank expansion, will continue in the future as well.

⁴⁷ CGAP, Littlefield Elizabeth, May 2004, "Building Financial Systems for the Poor", Presentation at the MFC Conference, Warsaw, Poland

⁴⁸ CGAP, Littlefield Elizabeth, May 2004, "Building Financial Systems for the Poor", Presentation at the MFC Conference, Warsaw, Poland

Lieberman⁴⁹ mentions that the following factors could further facilitate downscaling in Serbia:

- Technical assistance support to the bank
- Equity or quasi equity investment in the bank
- Long-term line of credit
- Long-term subordinated loan
- Education about microfinance

An alternative approach for Greenfield investors is to purchase a bank to be privatized. Currently the state owned banks are being sold for the purpose of settling debts with the Paris and London Clubs of Debtors. The key is that the Bank takes on microfinance as a product line and does not give-up its other lines of business. The commercial bank through its separate division or profit center can do micro and small business loans, between 10.000 to 100.000 Euros, at an average of 30.000 Euros, as a part of its core business but not its only business.

Below are 7 parameters⁵⁰ investors should consider when deciding to either downscale a commercially viable bank or start new, with a Greenfield bank:

1. Initial Investment/Setup costs
2. Training/Education effects n the staff
3. Access for particular target groups of clients
4. Efficiency of the bank
5. Profitability
6. Implementation of principles
7. Internal control

C. Is downscaling successful in Serbia?

How has bank downscaling worked in Serbia? What are the legal and regulatory barriers that have caused it not to work better, and can any of those be proposed for a changed policy?

C.1. Experience so far

The banks involved in downscaling have found the following obstacles:

1. For downscaling you need a lot of employees, as microcredit is labor intensive. This increases the cost structure of the loan.
2. Follow-up of micro loans can be difficult (due to unduly repayment, improperly registered collateral etc.) For this purpose, the banks' internal procedures should be adapted, under condition that there is a willingness to additionally train the staff.

⁴⁹ Lieberman Ira, opinion based on comments to the downscaling process in Serbia

⁵⁰ Information on downscaling in Serbia was acquired with the assistance of LFS Financial Systems

3. Security. Usually micro credit clients have none or insufficient collateral. In this case, it would help to know the clients' credit history. By establishing the Centralized Register of Pledges
4. Long duration of the execution procedure. In average it takes 1027 days in the Serbian courts to collect your debt⁵¹. There is a new Law on Execution, we will see in practice how will it protect the creditors.
5. Disproportional value of the loan and collateral. The debtor pledges two or three times the value of the loan. In case of default in loan repayment, a disproportional value of collateral is to be sold.
6. Repayment problems. The downscaled banks have started issuing consumer cash credits in the amount of one thousand euros. There have been significant problems in repayment, as the clients can take a credit in another bank. The solution to this problem would be establishing Client Dossiers, and credit scoring systems for the clients' applications.
7. There are high costs for starting the court procedure for repayment.

Also, the banks involved in the process of commercial downscaling have a different categorization of micro loans. For them, the average loan size of 10.000 which is the usual limit for microcredit categorization is increased for double, triple or even more times.

Generally, the success of downscaling largely depends on the management team. If the management changes too often, the downscaling process is less successful, since new management needs to be trained continuously and presented with the advantages of downscaling.

Although it has its advantages, downscaling can be a difficult job, due to the banks unwillingness to downscale, un-readiness of the staff to be trained etc. However, it largely depends on the bank which is chosen. To conclude, in order to be successful in downscaling, the bank needs dedicated staff, and it's done best as a Service Company or a separate division or Profit Center of the bank totally dedicated to downscaling.

C.2. Proposals for removal of legal and regulatory barriers

Below are some proposals for a changed policy which would enhance downscaling. These proposals can also be applied to Greenfield banking, and explanations are given in the next chapter.

- 1) Removing collateral pledging constraints,
- 2) Decreasing the costly court registration taxes
- 3) Introducing the Central register of pledges, maintained by the NBS
- 4) Introducing Client's dossiers for companies, entrepreneurs and individuals, maintained by the NBS
- 5) Abolishing the compulsory reserve on foreign credit lines

⁵¹ CLDS, December 2004, "Inefficiency and Corruption in Judiciary and Investment Climate in Serbia Building Poor", WBI Investment Climate Program

C.3. Interim alternative

Within micro on-lending, we distinguish between consumer and business on-lending. The interim alternative is issuing microcredits for business through retail banking (up to 2.000 Euros), as this would satisfy the NBS loan classification requirements. The consumer loans have less requirements than the loans for micro and small businesses.

1. The required documentation for issuing a consumer loan is minimal.
2. There are no balances, statutes, registrations of companies, etc., to be checked prior to issuing the consumer loan.
3. There is no checking whether the loan has been used for a specific purpose.
4. Consequently, there is less work for the loan officers, which affects the cost structure.

However, on the long run, it is questionable whether the downscaled commercial banks would institutionalize microfinance through issuing micro loans for business through retail banking. Also, the previous adverse results point out that this will not be a definitive alternative applicable for downscaled banks.

VI. The legal and regulatory obstacles to be removed to scale-up microfinance

- **There is a number of legal and regulatory obstacles to be removed in order to scale-up the microfinance industry**
- **The topics should be addressed predominantly to the NBS and the Ministry of Finance, but other actors should be involved as well**

The concluding part of this paper outlines the legal and regulatory changes advisable for scaling-up microfinance. Downscaling has been implemented with adverse effects in Serbia, due to a number of legal and regulatory barriers. The below are the proposals for a changed policy which would facilitate the microfinance industry development.

I. Link microfinance scaling-up to bank restructuring and commercial bank downscaling

Involve the same actors in the process, i.e., the National Bank of Serbia, Ministry of Finance, Bank Restructuring Agency, etc.

II. Continue with commercial law reform

Addressed: To all competent state authorities which are in charge of the commercial law reform

Facilitate collateral registration: Due to the regional division of tasks, some courts are competent. As a result, debtors are required to travel from one city to another just to register collateral, which is consuming time-wise and also decreases the motivation. Ideally, the court system should be adapted. As this is not so likely in the near future, in order to solve this problem, the NBS establish a Central Register of pledges which would have branches in all of the major cities.

Decrease the court taxes for registering collateral: The costs of collateral registering are too high. Having in mind the small amount of the micro loan, the costs of collateral pledging can constitute a significant part of the loan. The court taxes could be easily lowered as they are unfairly high for the microcredit clients, i.e. the registration of collateral takes approximately 10 to 15 minutes of work for the court.

Introduce the Central register of pledges: There is no central register of collateral yet, although it is foreseen in the law. This creates adverse incentives with the debtors, as they can

pledge the same collateral for more than one loan. The Central register of pledges should be operated and monitored by the NBS

III. Lobby with NBS to facilitate microfinance

Addressed: To the National Bank of Serbia

Decrease the compulsory reserves with the NBS: The banks as well as other financial organizations, as defined in the Serbian Law on Banks, are obliged to keep a compulsory reserve with the National Bank of Serbia. Banks find this requirement especially burdensome since the compulsory reserve can otherwise be used for the on-lending portfolio. This makes the loans more expensive and the cost is born by the clients. There are five types of the compulsory reserve.

Alleviate foreign exchange positions: The foreign exchange position imposes a restriction of the open currency position and borrowing on a preferential rate from IFIs. In this case, consequently, the dinar lending is fixed to the exchange rate and the risk is borne by the borrowers. The fact the banks generally only engage in Dinar lending indexed to foreign currency shifts the exchange risk to customers and this means, that if borrowers are able to repay, a bank will have funds on hand to repay its foreign currency borrowing.

Introduce Credit Dossiers for all debtors: companies, entrepreneurs, physical persons. There is no central register of loans, so individuals may take several loans in different banks, which creates problems in repayment. Also, the Credit Dossiers would provide information about the credit history of the debtors. The situation is slightly better regarding when dealing with registered companies, since the bank has insight into the balance sheet and income statement. The Credit Dossiers should be operated and monitored by the NBS

IV. Adopt the new banking law

Addressed: To the NBS and the Ministry of Finance

Include provisions that would facilitate microfinance development in Serbia: Besides the above mentioned points addressed to the NBS, the new banking law should facilitate the reform of the banking sector, allow new foreign banks to enter the market with new investments and facilitate the restructuring / privatization of the existing state owned banks.

List the Serbian banks on the Stock Exchange market: In this way new investments could enter the banks. According to the existing practice, banks are sold to one or two investors and thus closed companies are created. This is a proposal for the new banking law, but at the same time, it is also conditioned by the readiness of the Serbian capital market to list the banks.

V. Adapt internal regulations in Downscaled Banks

Addressed: To commercial banks in the process of downscaling

Create a scoring system for clients' loan applications: The scoring system would facilitate the work of loan officers and provide less arbitrary decision making on loan applications. It should be created through the banks' internal regulations, using the banks' policy as a guideline.

Establish and review periodically internal procedures for granting credits and making investments: In order to establish an appropriate and properly controlled credit risk environment the following components should be included: A) Sound and well-documented credit granting and investment; B) Maintenance of an appropriate credit administration, measurement and ongoing monitoring/reporting process (including asset grading/classification); C) Ensure adequate controls over credit risk. This should be done through the banks' internal by-laws.

VII. Legislation consulted

Bosnia

Bosnia and Herzegovina, “Draft Law on Microcredit Organizations” February 2004

Federation of Bosnia and Herzegovina, “Law on Microcredit Organizations”, (Official Gazette of F B/H)

Republika Srpska. “Law on Microcredit Organizations”, (Official Gazette of Republika Srpska)

Montenegro

“Decision on the compulsory reserve of banks with the Central Bank of Montenegro”, (Official Gazette of RM no 50/04)

“Decree on Micro Finance Institutions”, (Official Gazette of RM no 1/2003)

Serbia

Serbian “Draft Law on Microcredit Organizations”, February 2003

“Decision on detailed conditions and the mode of performing the control function of the National Bank of Serbia”, (Official Gazette of RS no 100/2003, 133/04)

“Decision on detailed conditions for the application of articles 26 and 27 of the Law on banks and other financial organizations”, (Official Gazette of RS no 129/04)

“Decision on issuing the permission for opening a branch office of a foreign bank in the Republic of Serbia”, (Official Gazette of RS no 136/04)

“Decision on interest rates of the National Bank of Serbia”, (Official Gazette of RS no 90/04)

“Decision on the minimum content of the reports on audits of financial reports for banks and other financial organizations”, (Official Gazette of RS no 86/04)

“Decision on the method for implementing articles 8, 9, 10a, 12, 15, 19b, 19e, 28, 29 and 59 of the Law on banks and other financial organizations”, (Official Gazette of RS no 129/04)

“Decision on the compulsory reserve of banks with the National Bank of Serbia”, (Official Gazette of RS no 136/04)

“Decision on the basic principles of organization and work of internal control of banks and other financial organizations”, (Official Gazette of FRY 39/02)

“Decision on conditions and the mode of depositing the surplus of liquid resources of banks with the National Bank of Serbia”, (Official Gazette of RS no 48/04)

“Decision of conditions and the mode of opening, maintaining and closing the accounts with the bank”, (Official Gazette of RS no 57/04)

“Decision on the conditions and method in which the National Bank of Serbia is conducting operations on the open market”, (Official Gazette of RS no 133/04)

“Decision on establishing the Program of the Monetary Policy of the National Bank of Serbia for 2005”, (Official Gazette of RS no 134/04)

“Decision on the types of information that the banks deliver to the National Bank of Serbia and on the mode and deadlines for delivering this information”, (Official Gazette of RS no 111/03)

“Decision on the amount of the discount rate of the National Bank of Serbia”, (Official Gazette of RS no 133/03)

“Decision on the requirements and procedures in the foreign exchange market operations”, (Official Gazette of RS no 108/04)

“Instruction on the information that the banks and other financial organizations deliver to the National Bank of Serbia for involving this information into the credit-information system of the National Bank of Serbia”, (Official Gazette of RS no 58/04)

“Law on the Agency for Commercial Registers”, (Official Gazette of RS, no 55/04)

“Law on Banks and other Financial Organizations”, (Official Gazette of RS, no 72/2003)

“Law on Court Taxes”, (Official Gazette of RS, no 29/04)

“Law on Financial Leasing”, (Official Gazette of RS, no 55/2003)

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