



FLAG International, LLC

ENVIRONMENT AND DEMAND FOR MICROCREDIT IN SERBIA

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Abbreviations

Abbreviation	Name
AIS	AgroInvest Serbia (Serbian MFI)
CGAP	Consultative Group to Assist the Poor
CT	Consulting Team
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EU	European Union
EUR	Euro
FI / FLAG	FLAG International LLC
HO	Head Office
IT	Information Technology
IMF	International Monetary Fund
Law	Law on Microcredit Companies
LO	Loan Officer
MAP	Microfinance Action Plan
MDF	Micro Development Fund (Serbian MFI)
MFC	Microfinance Company
MFI	Microfinance Institution
MIS	Management Information System
MKD	Microcredit Companies (from draft Law text)
MoF	Ministry of Finance
MSME	Micro, Small and Medium Enterprises
MWG	Microfinance Working Group
OBS	Opportunity Bank Serbia
OL	EBRD Operations Leader
RB	Rural Business
SGS	Société Générale Serbia
SME	Small and Medium Enterprises
TA	Technical Assistance
ToR	Terms of Reference

TITLE: Microcredit in Serbia – Is it (Really) Necessary?¹

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Abstract:

This paper assesses the provision of microcredit in Serbia as an alternative source of financing to start-up entrepreneurs and poor people to facilitate their self-employment activities. The microcredit demand level in Serbia is estimated at an amount of EUR 267 million, relatively high due to a lack of appropriate lending products by the commercial banking sector and high provision requirements for these types of loans by the National Bank of Serbia. Additionally, microcredit borrowers in many cases lack access to commercial bank loans because of their small size, absence of collateral and perceived high risk. These constraints are only partially mitigated in Serbia by the existence of various government-subsidized credit programs, which have a beneficial impact on the targeted populations but at a large cost that is borne by the state budget. Microcredit providers are funded by social investors as well as international donors, offering the potential of easing the financial burden on the state by reducing subsidy levels to banks. Increasing the scale of microcredit with a regulatory framework that allows non-bank lending by non-depository institutions can increase Serbia's access to foreign direct investment, and also result in significantly higher credit access for job creation and entrepreneurship activities.

1. Introduction

The visit to Serbia in October 2010 of Mohammad Yunus, well-known for receiving the Nobel Peace Prize in 2006 for his work in developing the fundamentals of microcredit, provides observers with a useful opportunity to assess the benefits of microcredit and whether it is an appropriate tool for employment creation and poverty-alleviation in Serbia. The goal of this short paper is not to discuss his visit to Serbia, but rather to examine whether or not the business model of microcredit, pioneered by Mr. Yunus and others during the 1970's and 1980's, has a place in Serbia in terms of its potential contribution to employment creation and poverty alleviation. Microcredit is defined as the provision of loans to (usually) low-income borrowers, including the self-employed, who typically lack access to loans from the banking sector. In this paper, the term microcredit is used to specify the provision of micro-loans, and does not include provision of other financial services such as deposits, insurance, etc.

Microcredit has existed in Serbia at a small level for over 10 years, mainly supported by various international donors and social investors. Since 2005, the Serbian organizations involved in providing microcredit have been required to conduct their activities in partnership with a licensed bank, in accordance with the Law on Banks and other applicable legislation. The decision to restrict lending activities primarily to banks was justified, in the view of many experts including this author, in order to maintain high lending standards and to provide long-term financial sector stability during the economic crises of the past decade. Clearly the goal of financial sector stability has been achieved, to the credit of the National Bank of Serbia and Serbian policy-makers. It is now time to examine whether other non-bank lending models, such as those of microcredit providers, can have a beneficial impact on job creation and poverty alleviation in Serbia.

¹ This article, in slightly abbreviated form, is to be published in the September 2010 issue of the Quarterly Monitor, a Serbian economics journal.

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2. Background of Microcredit

Modern forms of microcredit were created to address market gaps in the provision of credit, primarily to poor and rural populations. In developing economies, banks seldom provide microcredit to serve the needs of low-income families and women-led households. These groups are often denied access to credit for any purpose, making the debate of the level of the interest rate and the other terms and conditions of credit irrelevant. The question of “access to credit” is the fundamental basis and the main justification of microcredit.

This lack of access to credit for the poor or for entrepreneurial start-ups is attributable to practical difficulties arising from the business model of banks. For example, commercial banks require that borrowers have a stable source of income out of which principal and interest can be paid back according to contractual terms. However, the income of self-employed and small enterprises is often not stable, regardless of their size. A large number of small loans are needed to serve the poor, but banks prefer dealing with large loans in small numbers in order to minimize their operating costs. Banks also look for collateral with a clear title - which many low-income households do not have. In addition, bankers tend to consider low-income households and start-ups a high risk, imposing very high information-monitoring costs on their operations.

From the demand side, access to credit is very important for poor people: it often provides a cushion that enables people to cope with unexpected events, as well as to gather usefully large sums of money for investment in livelihood activities, milestone social events such as weddings and funerals, or for payment of school fees. Credit also enables people to acquire income-producing and household assets and to cover major medical expenses, and to invest in production and trading activities that leverage their relatively low cost of labor (CGAP, 2003).

As access to financial services reduces vulnerability and helps poor people to increase their income, improving this access has become an important part of many development initiatives. Actors in the rural development and social assistance sectors that seek to improve livelihoods and reduce the risks of the poor often try to identify financial institutions that can provide these services. In many cases, no financial institutions can be found that are willing to fill this role. This has been the case in “developed” Europe for many years, but now European policy makers are taking a closer look at microcredit as a tool to reach marginal populations, start-ups, and other actors who are left out of the formal financial sector.

3. Microcredit in the European Union

In light of Serbia’s planned ascension to the European Union, this paper uses the definition of microcredit as defined by the European Commission. In general terms, the EC defines microcredit in Europe as addressing the needs of two groups: “micro-enterprises”, defined as enterprises employing less than 10 people (which includes over 90% of all European enterprises) and “disadvantaged persons” (unemployed or inactive people, those receiving social assistance, immigrants, IDPs, etc.) who wish to go into self-employment but do not have access to bank lending services.

While microcredit takes many forms and performs different roles in the European Union, in the Member States and regions it is often used as a means of encouraging the growth of self-

employment and the formation and development of micro-enterprises. In many cases this is linked to efforts to promote the transition from unemployment into self-employment. In the strategic vision of the European Union, microcredit is of particular importance for rural areas and can play an important role in helping to integrate minorities and immigrants both economically and socially.

Under EU legislation (Article 4 of Directive 2006/48/EC) microcredit institutions fall under the scope of EU prudential regulation only if they receive deposits from the public. If microcredit providers do not receive deposits or other repayable funds from the public and are not prudentially consolidated by a credit institution, the EU Capital Requirement Directive does not oblige them to be subject to specific harmonized capital requirements. EU policy is that regulation and supervision must be proportionate to the risks that microcredit institutions pose, so that it does not put a brake on the supply of microcredit.

The average microloan in the EU is in the range of EUR 7,000–7,500 (European Microcredit Network, 2008). While there is an active microcredit sector in many EU member countries, and a number of actions have been taken at the EC level to reinforce the growth of the sector, there are continuing efforts to do more to promote microcredit. In its “Communication on Financing SME’s” (2006) the EU drew attention to obstacles blocking the development of microcredit, calling on Member States: *“to ensure that national legislation facilitates the provision of microcredit (loans less than EUR 25,000). Such loans offer an important means to encourage entrepreneurship through self-employment and micro-enterprises, in particular among women, and minorities. This instrument favors not only competitiveness and entrepreneurship, but also social inclusion.”*

It is this realization in many EU countries that microcredit has a role to play in employment creation and social inclusion that is highlighted here. Large EU members such as France, Germany, Poland and Spain, among others, have come to the conclusion that their governments cannot meet all of the needs of their poverty-afflicted populations. Allowing for a mix of approaches including microcredit supplements the level of resources that can be brought to bear on employment and poverty alleviation.

4. The Environment in Serbia

Now we move to the Serbian environment. In comparison to other countries in the region, Serbia continues to struggle with unemployment and low economic growth. According to recent employment indicators there is over 18% unemployment rate in the country, which represents a significant increase in comparison to data of 2008 and 2009. The structure of the unemployed is unfavorable, characterized by long-term unemployment and with the dominant share being residents of rural areas. Additionally, there is a relatively high poverty rate, assessed at 8.8% of the population in June 2010.

The Serbian banking sector, with few exceptions, only rarely reaches start-up entrepreneurs and the poor population who request loans to engage in productive activities. The principal reasons that banks are *unable* to provide services to these groups are high transaction costs coupled with small transaction sizes. This makes it very difficult for the bank to cover costs; and without full cost recovery, long-term sustainability is impossible. At the same time, many banks are *unwilling* to provide services, in part because of the perceived high risk of financing poor clients and startups, but also because they would need to invest significant resources in changing their business model to serve this clientele.

In the Serbian case, banks are faced with reduced profitability on lending to these types of clients due to the provisioning requirements of the National Bank of Serbia (NBS) in its “Decision on Bank Balance Sheet Assets and Off-Balance Sheet Items.” This Decision requires banks, in most cases, to heavily provision for loans to those without formal income or employment. Although this Decision and similar regulation plays a strong role in ensuring bank health and overall financial sector stability in Serbia, it restricts the banks’ ability to reach out to the unemployed, start-up enterprises, and to ethnic minorities, among others, who wish to engage in entrepreneurial activities but whose lack of “official income” results in the high provisioning levels by the banks.

A consistent and prolonged effort by the existing microcredit providers in Serbia has been made to overcome these constraints and ensure that credit-worthy applicants are able to access loans for a productive purpose. Currently there are three non-bank microcredit institutions in Serbia (AgroInvest, Micro-Development, MicroFinS) that operate through a local bank and have a combined total portfolio of approximately EUR 16,600,000 in loans to over 19,500 borrowers. These institutions were founded during the 1999-2002 period with emergency funding from donors (UNHCR, ICRC, etc) or international NGOs (World Vision) in order to respond to Serbia's post-conflict economic collapse. They serve clients who have suffered from recent conflicts, such as refugees and the internally-displaced, as well as those without access to credit or economic opportunities in a wider sense.

The major characteristics of the non-bank microcredit institutions operating in Serbia (Lalovic, 2008) are the following:

- Microcredit is mainly entrepreneurial and production loans based on internationally-accepted methodologies, ranging from EUR 300 to EUR 3,000, with the average loan size in Serbia being between EUR 800 to EUR 1,100;
- The local microcredit institutions lend to their clients in Serbian dinars, with no foreign currency clause, due to their methodology of supporting clients and helping them by removing their currency risk. Thus, for the past decade the microcredit providers have been unknowingly facilitating “de-euroization” efforts;
- Microcredit institutions in Serbia are characterized by a very high repayment rate (over 95% up to 60 days). This is the combined result of very strict approval criteria applied at the client assessment stage, and the strong relationship maintained with their clients which significantly improves the collection of loan repayments. MFIs take great care not to over-burden their clients and work with them over long periods of time helping them to steadily develop their business activities;
- The microcredit providers in Serbia bear the currency risk and also provide training, and education that makes their credit products more expensive than bank credit, but result in better monitoring and repayment rates than the banking sector;
- Microcredit institutions must work through partner banks which charge high mediation fees, further increasing the interest rates charged by the institutions;
- Microcredit institutions also have a strong focus on their social mission, and devote a fixed percentage of their annual budgets to social causes. They engage in efforts to improve the lives of the poor population by undertaking various initiatives such as programs for children, donations to schools, hospitals, playgrounds, etc.

The fact that there is a large number of borrowers served by the microcredit institutions demonstrates that market demand exists for these types of credit products, despite the presence of commercial banks, bank-administered government subsidy programs, the

activities of the National Employment Agency, and other interventions that are presumably cheaper and more formal than microcredit. As these microcredit providers are externally audited, as such it is verifiable that they place needed credit products on the market and do so in accordance with the Law on Banks and the other legal requirements of Serbia.

5. Serbian Approaches to Increasing Credit

One of the causes of the high-level of poverty and unemployment in Serbia is that poorer citizens, particularly those in rural areas in central and southern Serbia, lack access to credit products that would facilitate self-employment and entrepreneurship activities. The Serbian banking sector, despite the support of various government programs, has been only partially successful in substantially increasing credit provision and resulting employment creation in these areas.

The availability of government subsidies to increase the provision of lending services has played a strong role in this partial success. In general, the main government instruments for increasing the financing and development of employment for individuals, agricultural households and SME's are the Serbian Development Fund, the Ministry of Agriculture, subsidized credit lines provided through banks supported by the Ministry of Economy and Regional Development and the National Bank of Serbia. Unemployed people are served through the National Employment Agency and other state institutions.

These instruments constitute by far the greatest financial volumes of support provided to SMEs, registered farmers, households, and the unemployed. Many of these schemes use financial resources allocated from the budget of the government of Serbia by facilitating loans at extremely low interest rates. Sources of this funding originate from the government budget and also from repayments of previously-given credits, sales of public property, as well as programs that the government decides to implement on a yearly basis e.g. start-up credits for financing new companies.

It is not the focus of this paper to provide observations on the effectiveness of the subsidized credit policies of the Serbian government. However, recent statements by the relevant ministries indicate that the level of this state support to subsidize lending will be reduced in the coming years. It is suggested here that expanding the provision of microcredit in Serbia, which is exclusively funded by non-state sources, can play a strong role in plugging this funding gap over the coming years. To examine this more closely, it is the current status of provision of microcredit in Serbia that is the topic of the next chapter.

6. Field Research on the Uses of Microcredit

The assessment of the potential benefits of formalizing microcredit institutions in Serbia cannot be completed without a detailed discussion of the microcredit that is being provided to its under-served citizens today. In this chapter, a closer look is given to the provision of microcredit and bank loans to the poor and to entrepreneurial start-ups in Serbia.

The Serbian microcredit providers, as mentioned previously, provide credit to over 19,500 people primarily located in the rural areas of Serbia. The question is - who are their customers? Why don't they take advantage of the (cheaper) offer of the commercial banks, or at the very least the government programs that are available?

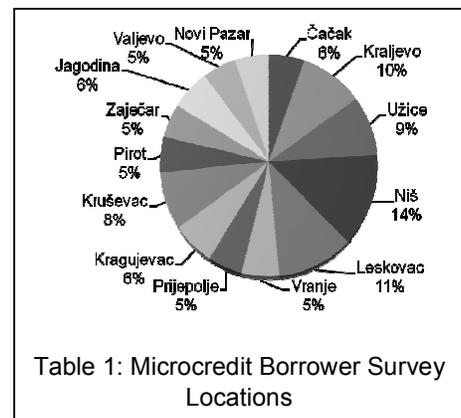
It is clear from even a cursory examination that the microcredit organizations place their loans at a much higher interest rate (up to 6-8% higher annual interest than the average commercial bank rate) and as such, one would expect that the demand on the market for these credit products to be low. However, as field evidence shows, the microcredit institutions cannot meet the demand for their credits, particularly in the more isolated communities of Serbia. Despite the higher cost of such credit, and the presumed lack of creditworthiness of the borrowers of these institutions, there continues to be a high demand for these products.

Why is this? To find the answer, a comprehensive survey of current microcredit clients was conducted in September and October 2010 by the author, consisting of physical interviews of over 500 households that recently accessed a micro-loan from at least one microcredit institutions in Serbia. This survey was supplemented by desktop research, high-level interviews and field observations in a number of rural areas, as well as discussions with various policy-makers in the Serbian government and banking sectors.³

The survey attempted to answer a number of questions about the background and status of the "average" user of non-bank microcredit services, his/her ability (or lack thereof) to access a formal bank loan, the reasons of their inability to access bank credit, their reason for approaching a microcredit provider, as well as their expressed purpose for the micro-loan.

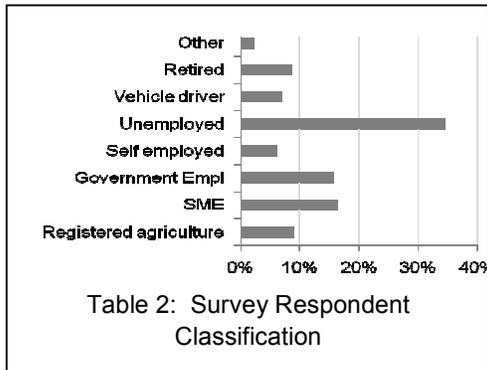
The respondents were exclusively those who meet the borrowing criteria of the Serbian microcredit institutions, i.e. those who were using the loan for a productive purpose related to self-employment, agricultural production, business start-up or other similar purpose. The survey itself was conducted in a random sampling of active microcredit clients in the villages surrounding the towns of Čačak, Kraljevo, Užice, Leskovac, Prijepolje, Vranje, Krusevac, Pirot, Zaječar, Jagodina, Valjevo and Novi Pazar.

The survey was conducted under the supervision of a US survey expert with significant microcredit experience, and the (Serbian-speaking) author of this article. A team of four Serbian surveyors / interviewers were involved in most of the data collection, supported by an IT expert for data sorting and cleaning. The results of the survey are quantified by topic, below:



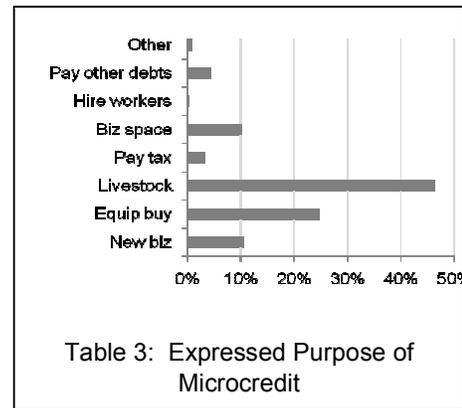
³ During the survey discussions were held with the Governor of the National Bank of Serbia, the Minister of Finance, and a number of senior figures in Serbian academia and the banking sector.

Gender: Of the 500 clients interviewed, 216 of the respondents were men (43.2%) and 284 were women (56.8%).



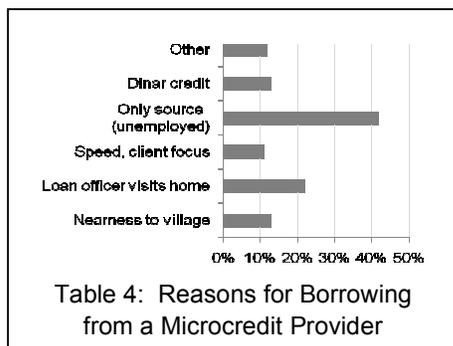
Status: The employment and livelihood status of the borrowers in eight response categories (listed in order of frequency) were as follows: Unemployed: 173 (34.53%), Small Business Owner: 83 (16.6%), Government Employee: 79 (15.7%), Registered Farm: 45 (8.9%), Pensioner: 44 (8.8%), Vehicle Driver: 35 (6.9%), Self-Employed: 31 (6.2%), and Other: 11 (2.2%).

Purpose of Microcredit Loan: Of the 500 respondents who received a loan from a microcredit provider in Serbia in the past six months, the following were the primary purpose of the loan use: To establish a new business (start-up): 10.4%, To Buy Equipment: 24.6%, To Buy Livestock: 46.2%, To Pay Communal and Other Taxes: 3.4%, To Acquire Business Space: 10%, To Hire Workers: 0.2%, To Pay Other Debts: 4.4%, Other: 0.8%.



Average Loan Size: Of the 500 respondents who received a micro-loan, only 29 received a loan in excess of RSD 500,000. The overall average loan size for the 500 survey respondents was RSD 108,235.

Reasons for Selecting the Non-Bank Microcredit Provider: Of the 500 respondents who received a microloan, only 489 responded to the question of why they selected the microcredit provider for their credit needs. Of these, 264 (54%) said that the microcredit provider “best met their needs” and 171 (35%) said that “they could not access credit from a commercial bank” while 54 (11%) indicated “branch location” as their prime reason for using the microcredit service.



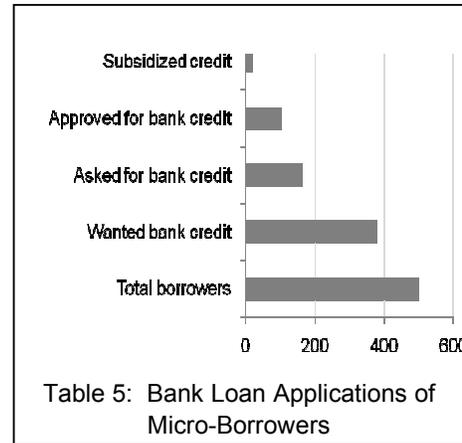
Desire for a Bank Loan: Of the survey respondents, all of them (by definition, as only current microcredit borrowers were surveyed) indicated that they needed a loan for productive activities. Of these, 377 (75.4%)

indicated that they would be open to a bank credit if the terms and conditions met their requirements. These 377 individuals estimated their credit needs as varying from RSD 60,000 to RSD 750,000 with the average credit demand being a total of RSD 309,420 (EUR 2,892). The remaining 123 respondents (24.6%) indicated that they were satisfied with the offer of the microcredit provider and would not approach a bank under any circumstances.

Eligibility for a Bank Loan: Of these 377 respondents who would approach a bank to apply for a loan (in most cases to access lower interest rates than available from microcredit providers) only 162 (43%) actually did so and spoke to one or more local banks about a credit application. The remaining 215 of the respondents (57%) did not approach a bank due to the

complexity of the application, lack of a nearby bank branch office, because they believed that they were not eligible for a loan, or another reason (see below).

Receipt of a Bank Loan: Of the 162 respondents who actually approached a bank with a credit application, a loan was approved for 102 (63%) of them, and rejected for 60 (37%) of them. Of the 102 approvals, 26 (24.5%) loan disbursements had been made in the past year, while 22 (20.8%) of them had occurred in the past 12-24 months, and 58 (54.7%) of them had been disbursed over 2 years ago.



Level of Indebtedness: Of the 102 respondents who have received a bank loan in the past 24 months, the loan was still current for 68 (13.6% of all respondents) of them, indicating a possible state of overindebtedness. This is a strong concern of the microcredit institutions, although the effects of lending to the overindebted are usually mitigated by increased client analysis and the use of the Credit Bureau by these institutions. The current level of microcredit repayment (94.6% on-time repayment at 60 days) is a strong indicator that debt levels are not overly burdensome for the clients of the microcredit institutions.

Government-Subsidized Bank Loan: Of the 102 respondents who actually received a bank loan, only 19 (18.63%) of them received a loan under a government-subsidized program. In priority order, the programs or institutions sponsoring the 19 subsidized loans (out of 500 borrowers) were the Ministry of Agriculture (63%), Ministry of Economy (21%), National Employment Agency (10%) and other (5%). The rate of subsidized loans accessed against the number of actual credit seekers surveyed (19 out of 500) was 3.8%.

During the survey, the top three factors that were identified during the interview process by the borrowers as the advantages of non-bank microcredit compared to bank credit were the following:

- a) **Accessibility.** In accordance with the microcredit methodology currently used in Serbia, rural loans are propagated by village counselors who conduct outreach and client education so that borrowers are very acquainted with loan terms and procedures. Also, the loan officers regularly visit the villages and usually have good communication with current and potential clients (28%).
- b) **Loan currency and size.** Microcredit providers in Serbia lend exclusively in dinars and bear 100% of the currency risk of such loans (when it exists on the basis of their EUR-denominated assets). The clients surveyed also indicated that they are satisfied with the currency and loan size amounts, and would not be willing to make a change (24%).
- c) **Quality of services.** Many microcredit clients indicated that they appreciate the relationship with the loan officers and their help in collecting monthly payments (they come to the villages and take the funds to pay it into the bank). In most cases the village counselors are highly-trusted by the clients as a result of their specialized training in microcredit methodology, more so than bank personnel (18%).

The results of the household survey were illustrative because they provide a sampling, albeit relatively small, of why a non-bank microcredit product is of interest to a specific segment of the Serbian population. A number of conclusions can be drawn from this study, of which one conclusion is that there is clearly a large body of unemployed and marginalized populations in Serbia who chose to access microcredit rather than bank credit for their self-employment activities despite its higher cost.

Recommendations on how to expand credit access for these groups, on how to lower the interest rate for these types of borrowers, as well as how to facilitate their entrance into the formal economy, are provided in the last chapter of this paper.

7. Determination of Microcredit Market Demand in Serbia

Building on the results of the survey in terms of “why” and “for what purpose” the microcredit borrowers in Serbia take a loan from a microcredit provider, the total demand in Serbia for microcredit borrowers can be extrapolated from publically-available data. The scope of this estimation will focus on the total demand for microcredit by micro-enterprises, based on current microcredit borrower data compared against the population and employment statistics provided by the Statistical Office of the Republic of Serbia.⁴

In this paper, micro-enterprises are defined as units that are employing up to 10 people, including the owner. They can be: physical (unincorporated) entities, legal (incorporated) entities and registered farms. Many unregistered workers are employed as part-time or even full-time employees. The Serbian Statistical Office data from April 2010 shows that 641,712 people are in the full-time self-employment category (not counting members of their families) and that 573,348 people are unemployed.⁵

At the end of 2009 there were over 70,000 active incorporated MSE units. In the range of small enterprises, there were 66,051 units (employing up to 50 people), medium size enterprises of 2,123 units (employing from 50 to 250 people). The average number of employees in small enterprises is six (four in private and 25 in non-private legal entities), while in medium enterprises it is 131 (85 in private and 167 in non-private legal entities). If one takes into account registered small farms as micro-enterprises, then 439,973 farmers can be classified as self-employed. Hence, the total level of self-employment encompasses 641,712 people or over 26% of total level of formal employment in Serbia.

Since microcredit in Serbia is focused on providing small loans to existing or future entrepreneurs who engage in a productive activity, the survey results of these categories provides a useful basis for estimating the total market demand for these types of loans. In this case, the goal of this analysis is to use the survey in order to estimate the possible size of the microcredit market demand for microcredit products (up to EUR 25,000) in both number and amount of loans.

Extrapolating from the survey results, 73.1% of the respondents indicated that they were interested in microcredit either as small business owners, self-employed, or unemployed but looking for work. Of these, 35% indicated that they “could not access credit from a commercial bank.” This totals 25.5% of total number of respondents who, in the majority of

⁴ Data only includes those actively looking for work, and does not include the population of the province of Kosovo and Metohia

⁵ This does not include the inactive population, such as the retired disabled, etc.

cases, could not access a bank loan due to the fact that they do not meet bank collateral requirements for a loan, or do not have a steady source of employment that would serve as a guarantee of repayment (and without a steady source of employment, a bank must provision 100% of the loan amount in accordance with NBS regulations).

Working from the labor and unemployment statistics of the Republic of Serbia, if one assumes that that 25.5% of all self-employed and unemployed in the country wanted to access credit at a micro-level (less than EUR 25,000 as per the survey) but were unable to do so, this would be a group of 310,873 potential microcredit borrowers. As a fraction of the Serbian population, this would be a substantial percentage (4.15% of the total population of 7,482,722). Although the raw number seems high, it is significantly lower as a percentage than the actual number of current Bosnian and Montenegrin microcredit borrowers, which are 10.2% and 10.3% of the total population, respectively. Additionally, it does not include current employed people who may decide to leave their jobs and start their own business.

In these two countries, the number of microcredit clients is over 10% of the population and the portfolio sizes represent between 7-8% of GDP. Applied to Serbia this would amount to a microcredit clientele of over 750,000 borrowers and a portfolio of approximately EUR 2.5 billion (Lalovic, 2008). Indeed, the client penetration rate of just AgroInvest Montenegro, the sister institution of AgroInvest Serbia, is over 5% of the Montenegrin population. This indicates that such a level of market penetration for Serbia is not completely unrealistic as these countries have somewhat similar economies, although of course the actual penetration rate would depend on the MSE lending supply of the commercial banks.

However, this author will make a number of qualifications to the data that will reduce this estimated market demand to a more conservative figure. As a first step, the estimate should be adjusted to “weed out” the number of potential microcredit borrowers who would prefer to access a bank loan. In accordance with the relevant survey question, above, 75.4% indicated that they would prefer to access (cheaper and more formal) commercial bank credit if only they were able. Therefore, of the population extrapolation requiring a micro-loan, the adjustment to drop 75.4% of the population from the market estimate would result in a total of 76,474 potential borrowers.

This extrapolation, however, is at the low end because it is very unlikely that 75.4% of all potential micro-borrowers would be able to access a bank loan even if the NBS relaxed its provisioning criteria and the commercial banks also became more permissive in their credit decisions. In estimating a “potential” market size for microcredit, the estimate remains at 310,873. But in estimating a realistic potential market size, the 76,474 number is increased by including those microcredit borrowers surveyed who are unable to access a loan. Since only 43% of these borrowers were able to access a bank loan, the ratio of those preferring a bank loan but forced to take a microloan because they cannot get a bank loan is accordingly 32.4%. Therefore, if the majority of the sampled population prefers a bank loan but only 20.4% of these can actually secure a loan, the result is a potential market size of 247,454 clients for (non-bank) microcredit in Serbia.

Now that the total number of borrowers has been determined, it is a simple calculation to determine the overall potential portfolio size. The average credit demand of the 500 survey respondents was EUR 1,021 per borrower (RSD 108,235). This is within range of the average loan sizes of the two microfinance organizations⁶ in Serbia, which were EUR 1,080 and EUR

⁶ Those NBFIs in Serbia that report to the Mix Market, a central clearinghouse of microfinance information. Banks are not included in this data.

1,103 for AgroInvest and MDF respectively (Planet Rating 2008). Using the figure from the market extrapolation, if 247,454 borrowers desire to access a micro-loan of EUR 1,021 (average from the survey), the **total potential portfolio size would be EUR 267 million**. Of note, the current level of non-bank microcredit in Serbia is roughly EUR 19 million (7.1%).

Due to the constraints listed in the body of this paper, the Serbian commercial banks have only scratched the surface of the potential microfinance market. While the survey findings do not necessarily point to specific solutions, they provide clues that merit discussion and follow-up by policy-makers. With an estimated size of EUR 267 million, microcredit can play a significant role in credit access for the population although it would remain only a small fraction of the total level of bank credit provided to individuals and small businesses in Serbia. In the author's view, this high level of demand justifies further action on this issue.

8. Recommendations for Microcredit Provision in Serbia

The research conducted has shown that Serbian banks have not been completely successful in terms of increasing credit outreach to vulnerable sectors and populations. The research also shows that alternative lending models that have been successful in other countries, such as microcredit, may offer Serbian policy-makers additional resources toward increasing access to finance as a tool to reducing unemployment. This tool is being increasingly used in the developed countries of the EU, particularly as specialized microcredit institutions can be found in Belgium, Finland, France, Germany, Hungary, Ireland, Italy, Poland, Romania, Slovakia, Spain, Sweden, and the United Kingdom which currently serve over 1,500,000 micro-borrowers (European Commission, 2007).

Should such a regulatory regime be supported by Serbian policy makers, a number of recommendations are posed here in the context of international "best-practice" for microcredit, adapted to the Serbian context (source: EBRD Microfinance Policy Advisory). The starting point of the below recommendations for establishing an efficient system of microcredit to poor citizens and start-ups in Serbia is a need to establish necessary legal regulations. The regulatory regime would need to determine the level of supervision, regulatory control over business activities, evaluation of the impact and effectiveness, etc. Recommendations to facilitate best practices (CGAP, 2006) include the following:

MINIMAL Regulation of Microcredit Organizations: The regulation of non-depository micro-lending needs only a minimal approach for the following basic reason - there are no deposits to lose and no risk to the broader financial sector if a poorly-managed institution fails. Microcredit regulation should focus on transparency and consumer protection, instead of attempting to prevent the failure of the institutions by over-regulation. However, the inclusion of "truth in lending" and prevention of money laundering (AML) clauses will provide for better transparency and should be mandated in the same way as for the banks.

LACK of Interest Rate Ceilings / Caps for Microcredit Organizations: It is usually the case that interest rates charged by microcredit organizations are, on average, higher than that of commercial banks. But interest rate ceilings can damage poor people's access to financial services simply because no organization will be able to afford to lend to them using the interest rates of commercial banks or government-subsidy programs. Microcredit organizations will not be able to cover their costs, will not be able to grow and will be not become financially sustainable unless they can charge adequate interest rates.

ROLE of Government as an Enabler, not a Direct Provider of Microcredit Services:

Experience has shown that private providers of microcredit are more efficient than state providers. Governments should play an important role in setting a supportive policy environment that stimulates increased development of financial services while facilitating poor people's financial inclusion. The key things that the Government can do for microcredit are to maintain macroeconomic stability, avoid interest-rate ceilings, and not offer unsustainable, subsidized, (often high-delinquency) loan programs which distort the market for the banks or microcredit providers.

MODEL of "For-profit" Microcredit is Superior to "Non-profit" Models: The majority of microloans dispensed throughout the world today come from for-profit microcredit institutions, rather than donation-dependent non-governmental organizations (NGOs). Sustainable (i.e., profitable) microcredit providers can continue to serve their clients without needing ongoing infusions of donor/government subsidies, and can fund exponential growth of services for new clients with commercial financing sources. This is important because the main argument for microcredit profitability is to give private-sector financiers the incentive to invest in microcredit institutions. Governments and donors, particularly in Serbia, will not have the financial resources to invest into a non-profit microcredit sector. Without private-sector funding and a profit motive, sustainable expansion will not be possible.⁷ It is difficult to estimate how many generations it would take to reach 250,000 poor households in Serbia if funding would come only from donors and NGOs.

Facilitating the expansion of non-bank microcredit providers offers an additional potential benefit for Serbian policymakers. Using the case of Bosnia-Herzegovina as an example, in 2009 the asset base of the BiH microfinance sector constituted 6.6% of the total assets of commercial banks, roughly EUR 770 million out of EUR 11.5 billion (MixMarket 2009). Of this amount, over 90% was provided by international donors and social investors, the provision of which has led to significant growth in credit provision to the rural areas and to marginalized populations.

Although the microcredit experience for Bosnia has not been without problems (and the causes of these, such as the microcredit lending bubble, the lack of a Credit Bureau and the resulting overindebtedness of micro-borrowers, are beyond the scope of the article) it has led to very high levels of credit provision to struggling and marginalized populations of Bosnia. This has contributed significantly to economic growth and employment (Hartarska and Nadolnyak, 2007) and an increase in investment levels into small enterprises.

In this context, best practices in microcredit regulation (if pursued) will be propagated by the activities of the Microfinance Working Group (MWG), formed in Serbia in mid-2010. This is a 15-member group of local government officials, international donors, microcredit institutions and other stakeholders. Its mission is to support the development of microcredit in Serbia through the facilitation of an appropriate regulatory environment, and by increasing public knowledge and awareness of microcredit. Members of the MWG include EBRD, World Bank, USAID, AgroInvest Serbia, as well as senior representatives of the Ministry of Finance, Deputy Prime Minister's office, other microfinance institutions, and numerous other local and international stakeholders. EBRD and the World Bank are supporting the

⁷ One example of this is Grameen Bank. Grameen Bank reaches over 7 million clients globally, which is quite impressive. On the other hand, it took Mohammad Yunus (Grameen Bank's founder) over 35 years to achieve this.

development of microfinance in Serbia and are working closely with the Ministry of Finance to facilitate the development of best practices in microcredit regulation.

Assuming that a microcredit regulatory regime can be implemented for Serbia that will come close to meeting market demand, the domestic microcredit practitioners interviewed believe that it is not unrealistic to assume that a high level of resources, well over EUR 100 million of direct foreign investment, could be mobilized from donors and social investors for Serbia's MSE and other marginalized populations in the upcoming 2-3 years. This could have a significant effect on job creation, poverty alleviation and that could equal or exceed the resources currently provided from the state budget to achieve these goals.

9. Conclusion

With the vast majority of current microcredit borrowers from the survey not able or not willing to access bank credit, the survey supports the hypothesis that Serbia needs and would benefit from microcredit. The Serbian government's activities to promote access to finance has been a series of government-subsidized loan programs targeting mainly larger entrepreneurs, which operate through banks and have lengthy application procedures. These programs make it possible for entrepreneurs that already have access to loans to access them at lower cost. At the same time, poverty and unemployment is addressed through social programs that cannot possibly reach all eligible populations due to government resource restrictions. This is particularly true today as the IMF and other international observers believe that Serbia needs to significantly reduce government expenditures in the near term.

Adding a new non-bank and non-depository financial institution legal form into the financial system would expand the institutional basis for the provision of microcredit, and would significantly encourage a more competitive and consequently more efficient credit market for micro and small businesses. Expanding microcredit will create a positive situation for the system: low income borrowers will receive access to finance, and banks will gain new clients who graduate from microcredit institutions and increasingly seek more formal banking and payment services.

Implementation of a microcredit regulatory model will also reduce the extent of unregulated private moneylenders who are often the only option for microenterprises to access credit. If designed properly, such a system will also facilitate the entry of these borrowers into the formal economy, resulting in increased tax receipts. Over-exuberant lending to Serbian citizens and micro-businesses can be mitigated by the microcredit institutions having a very strict, tried and tested methodology, reporting to the Credit Bureau, designed specifically to prevent client overindebtedness.

The results of this survey and desktop research show that microcredit, already existing in Serbia, is meeting the demand by Serbian borrowers and low-income households for credit products that they cannot access from the formal banking sector. Increasing the scale of this model with a regulatory framework that allows non-bank and non-depository microcredit can increase the level of foreign direct investment into the sector significantly. This will result in increased access for those in Serbia who lack access to bank credit, and presents little threat to its overall financial sector stability.

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