

**Scaling Up Microfinance to Increase Access to Financial Services in the Republic of Serbia**

**Project Objective**

Today, more than one third of the population in Serbia lives on the verge of **poverty**. The Serbian **economy** has been devastated during the last decade of the 20<sup>th</sup> century. Officially 28% of the population is **unemployed**, but in reality, this figure is significantly larger. 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.

This project's objective is to conduct a research and propose the approach to the issue of scaling up microfinance while still adhering to the social purposes of reaching the working poor which have little or no other access to financial services in Serbia. However, it is important to say that ten years ago, one third of the population did not live in poverty and in some sense Serbia had a functioning "middle class". 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.

**Plan of Fulfillment**

In the start of the project, it is necessary to explore the existing framework for issuing micro credits. This will include both academic and field research. The field research would comprise of contacts with the National Bank of Serbia, microfinance banks, NGOs and other MFIs. After this initial research, it is necessary to compare regional and international MF experiences.

The plan is further to explore should and how can NGOs become more involved in the microfinance scene in Serbia. 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. Further, there is a large demand for micro credits and it would alleviate the difficult economic situation. These issues create space for establishing a coherent plan for scaling up Serbian NGOs.

So far, scaling up, that is, the transformation of NGOs to commercial banks has two successful examples in Serbia and Montenegro. The Montenegrin case is the Opportunity bank, previously an NGO operated under the auspices of Opportunity International. This bank successfully provides micro loans for beneficiaries for over one year. It has been transformed from an NGO into a bank and its evolution will be explored in order to help creating a general framework for scaling up.

The other example is the Opportunity International from Novi Sad, Serbia, which has recently, with the consent of the National Bank of Serbia (NBS), been transformed into the Opportunity Savings Bank. This case was somewhat an exception from the rule, and other Serbian NGOs interested in providing micro credits complain that this NBS permit gives a de facto monopoly to Opportunity International in Serbia. However, they doubt that this may have been the intention of NBS. In adverse, Opportunity Savings Bank has a high income tax and therefore the micro credits are expensive. This research will show how much of the accessory activities for providing help to the poor have remained and how many have been lost due to their scaling up and commercialization.

The big issue in scaling up is to prevent the cost structure to impede the sustainability of the non – financial services portion. Cost structure in general impedes the providing of non-financial services necessary for the working poor since it makes the profits non-sustainable. On the other side, in the process of scaling up, we want to make economically viable MFIs. Microfinance banks provide deposit facilities, money transfers and checking services in order to support rapid growth of the assets. Furthermore, income is taxed. In such a scheme, MFIs would have to limit their developmental activities in order to become sustainable. This again brings us to the question if this way we can create viable MFIs without a substantial mission drift?

The foreseen research in Serbia would explore and provide an answer to the possibilities of scaling up and potential adverse effects to increasing the access to financial services. In order to secure that MFIs will fulfill their mission, several mechanisms can be applied: supervision, maximum loan size and maturity, minimum capital requirements, taxation etc.

Microfinance supervision would have to be performed by governmental bodies. Perhaps the idea of creating the Serbian Financial Service Authority, following the U.K. example could serve this purpose. Since the supervision process would start with the registration process, only MFIs which have the goal of supporting the economy and reducing poverty could be registered. The practical establishment of supervisory processes will be explored within the respective Serbian ministries as well as the NBS.

MFI lending should be limited with regard loan size and maturity. Through not exceeding the loan size and maturity, MFIs will be prevented in slipping to a mission drift. They will be directed in a way to stay focused on their primary goal and target the working poor. The duration and size of loans with regard to the targeted impact and concrete clients in Serbia shall be explored.

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. This amount of this pre-condition which would satisfy the development goal of MFIs shall be explored and proposed.

Furthermore, the issue of taxation should be carefully approached. NGOs are on one side non-profit organizations. As they have no profit, there should be no taxation. However, some NGOs distribute their loans through the existing commercial banks. In that case, the banks should be taxed. MFIs on the other side, should be taxed, but keeping in mind that an increased cost structure will impede the sustainability of non-financial services and thus impede the primary micro credit aim of social and economic development. The plan is to research the optimum tax requirements for MFIs having in mind the aim of increasing the access to financial services by the working poor.

An important role of MFIs in increasing the access to financial services is creating databases and track records of clients. Through client's databases, MFIs can assist that previously un-bankable clients come into the formal financial sector.

Another 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 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. The plan of this research is to explore this issue and propose the period(s) of duration.

### **Practical Application of the Project Results**

1. Influence the new MFI legislation. Discussing policy issues regarding the micro crediting in Serbia should be approached with full vigor, since the new "Law on Micro credits" and the new "Law on Micro lending Organizations" are currently being drafted. Having in mind this momentum, this study on scaling up micro finance could impact the micro crediting legislation in Serbia in one way or the other, and positively influence the access to financial services in Serbia. In the field of legislation, crucial issues are in the fields of MFI supervision, taxation, minimum capital requirements, maximum loan size and maturity, registration etc.

2. Influence the creation of the Serbian Financial Service Authority, which would have the role of MFI lending supervision. This institution was initially approved and afterwards halted by the Serbian Ministry of Finance.

3. Scale up NGOs into commercial banks. This result would be achieved through using the existing examples of scaling up, such as Opportunity International and promoting new solutions through a general framework. A practical application of this research would be to help create new viable MFIs providing increased access to the working poor and integrate them into the financial market. So far, the Serbian governmental authorities promote loans through banks, which primarily target the SMEs, rather than micro enterprisers.

4. This research will explore and propose solutions for the development of a cost structure that does not impede the sustainability of the non – financial services portion. It will therefore contribute to preventing the mission drift coming as a result of scaling up.

5. Propose solutions to hurdles appearing on the NGO micro financing scene. The practical application of this project would be to point out pros and cons for NGO micro lending and respectively propose solutions for the regulation of the market where NGOs would be involved in micro lending. In general, NBS is in favor of NGOs providing micro loans aimed at refugees, whereas providing loans to domestic citizens is not encouraged, nor is their a general legislative framework. Furthermore, NGOs do not have a legal ground for registration and instead, they are registered as "Associations of Citizens".
6. Substantially influence the future policy making as an active member of the Serbian Microfinance Policy Working Group.
7. Regional-wise, the positive scaling up experience from Serbia can be used within the countries of the Region.
8. World-wide, this research could be applied on the respective grants and donations or credit lines to MFIs with regard to their legal status, tax exemption, international MFIs taxation of income etc.

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