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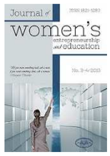
SCIENTIFIC REVIEW

Microfinancing in SMEs Development, Evidence from Serbia



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A B S T R A C T

SMEs constitute the backbone of entrepreneurship in the EU, as well as in Sough Eastern countries, as Serbia is, irrespective of national boundaries. From all enterprises active in the non-financial business sector in the European Union and in Serbia over 99 % are SMEs, but more than 92% of the total business sector consists of micro enterprises, which employ fewer than 10 persons. The ability of a financial system to reach these small entities is crucial for the achievement of general socio-economic improvement. Based on data of EU Craft and SME barometer (UEAPME), National Bank of Serbia, interviews of micro enterprises, EMN survey report, in the paper are discussed issues of the practice of micro financing and lenders experience, as well as the micro- financial services demand of specific target groups: small enterprises, entrepreneurs, small farmers, social enterprises, and supply potentials, and typical providers. The contribution of the paper are assessments on potential of the Serbian banking market, especially when it comes to micro-businesses and farmers in the rural areas which are underserved by other banks, and suggested essentials for a successful further market building in the purpose of SMEs development.

KEY WORDS: *mcrofinancing, social inclusion, institutions, SME*

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Introduction

Economic literature often discusses that in the area of access to finance for SMEs, a market imperfection/failure is not only present during a deep recession but also on an ongoing basis as a fundamental structural issue. The reasons for the market failure relate to insufficient supply of capital (debt or equity) and inadequacies on the demand side. This market failure is mainly based on asymmetric information (in the case of debt: information gap between lender and borrower), combined with uncertainty, which causes agency problems that affect debt providers behavior (Akerlof, 1970; Arrow, 1985). In the microfinance sector there is a trend towards efficiency, professionalization, and self- sustainability.

However, without the access to stable funding, the perspectives of the sector with regard to growth and self-sufficiency are limited. This report has reiterated the diversity and heterogeneity of the microfinance sector as current experience on the ground suggests - that support measures need to be flexible to fulfill the markets' needs. While the target groups of intervention measures need to be sufficiently broad in order to provide efficient support, the product range also has to be sufficiently wide in order to meet the target groups' needs. With regard to this specific mandate, market observers have already begun noting the positive impact of more substantial central EU intervention: "Microfinance in Europe is gradually being consolidated as an essential tool of social policy, for the promotion of self-employment, micro-enterprise support and the fight against social and financial exclusion. This is demonstrated by the initiatives that the European Commission has launched, such as the JASMINE initiative and the European Microfinance Facility for Employment and Social Inclusion (Progress Microfinance Facility), to promote and support the development of this sector." (Jayo et al., 2010).

Microfinance institutions have been affected by the adverse macro-economic conditions during the global financial and economic crisis, generally through significantly higher bad debt rates among their clients and in some cases through increased difficulties in accessing external sources of funding. With ongoing problems in the banking sector, the target group for microfinance, namely the financially excluded but economically active, might be faced with tightening credit supply by mainstream banks due to their higher risk aversion and increasing need to de-leverage their balance sheets.

This reluctance on the part of mainstream lenders creates an opportunity for microfinance but also underlines the paramount importance of credit risk management in an industry that, in Western Europe at least, continues to be driven by socially motivated investors and entities supporting microfinance as part of their social responsibility initiatives. This realization has a significant impact on the pricing of financing instruments to such types of entities and has arguably served to undermine the development of viable microfinance models in terms of self-sustainability. Self-sustainability of microfinance models is critical for the industry to ensure long term availability of microfinance products for microfinance clients. The economic sustainability of microfinance intermediaries comes as a result of the balance between the income and the costs, which in turn are a function of the pricing policy (interest and fees), cost management (operational and financial costs and provisions), economies of scale and level of available subsidies of a particular institution. In addition to the fundamental structural problems of the microfinance sector in Europe, public intervention has largely been justified and substantiated with positive externalities, i.e. that social and financial inclusion generates attractive economic and social returns. From an EU policy standpoint, public intervention has traditionally been made conditional upon ensuring "additionally", i.e. not crowding out private activities, but rather serving as a catalyst for the entry of private capital in order to create a self-sustainable market in the long run. There are wide spectra of final beneficiaries and intermediaries on European microfinance market (Kraemer-Eis & Conforti, 2009)and there is no common microfinance business model in Europe.

While findings on which is based this paper, suggested that the microfinance market is immature and fragmented, here is pointed its growing importance as a market segment with a potential to counter poverty and unemployment while fostering financial and social inclusion. This paper provides information about the definitions of microfinance and the European microfinance market, and Serbian case as South East Europe country which is supose to improve its practice and legal framework on its way to EU membership. As the impact of the crisis further increases the market failure – also driven by increased risk aversion on the supply side of microfinance - and underlines the need for public support for this emerging sector in Europe, some issues are given in discussion part of the paper too.

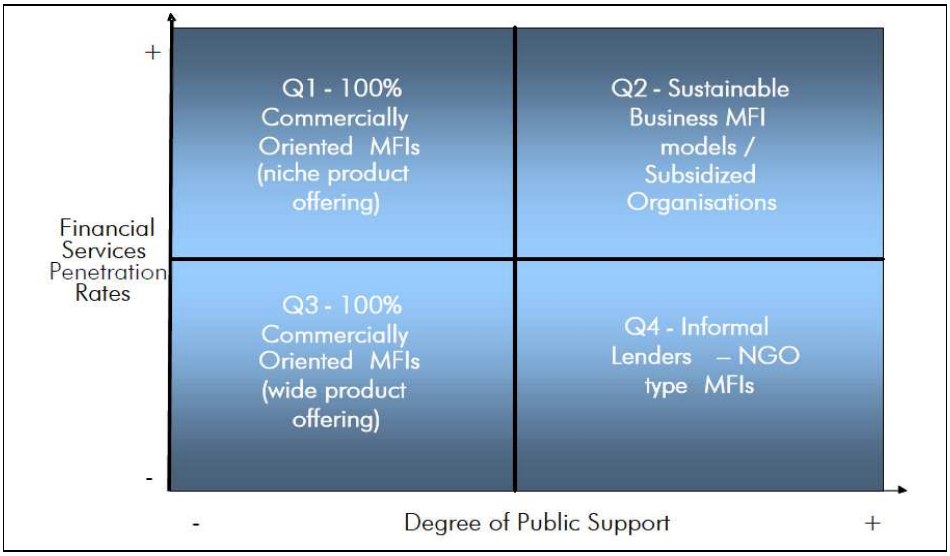
Literature Overview

According to Consultative Group to Assist the Poor Definition: Microfinance is the provision of basic financial services to poor (low income) people (who traditionally lack access to banking and related services). Micro-credit is defined by the European Commission (European Commission, 2010) as a loan or lease under EUR 25,000 to support the development of self-employment and micro-enterprises. It has a double impact (sometimes also referred to as 'the two sides of the microfinance coin'): an economic impact as it allows the creation of income generating activities and a social impact as it contributes to financial inclusion and therefore to the social inclusion of individuals. Persons are only counted once even if they are present in several sub-indicators. At risk-of-poverty are persons with an equalized disposable income below the risk-of-poverty threshold, which is set at 60% of the national median equalized disposable income (after social transfers). Material deprivation covers indicators relating to economic strain and durables. Severely materially deprived persons have living conditions severely constrained by a lack of resources. People living in households with very low work intensity are those aged 0-59 living in households where the adults (aged 18-59) work less than 20% of their total work potential during the past year (Eurostat tables).

1. Basic categorization of: Non-bank versus Bank MFIs, can be described as:

- *Non-bank MFIs* business model matrix has been defined as a function of financial services penetration rates in a given country and the degree of public/third party support to non-bank MFIs in a given country. In general, it is assumed that low financial services penetration rates combined with limited public / third party support (e.g. in most of the Eastern part of the EU) to individual MFIs create an environment where non-bank MFIs can deploy a commercially oriented microfinance business with relatively wide product offering alongside banks (figure 1).
- Bank MFIs are banks for which microfinance is a small part of their overall operations. Microfinance may be offered either: (i) as part of the financial intermediaries' social responsibility programme, or (ii) as part of the financial intermediaries' commercial activities.

Figure 1: Non-bank MFI business model matrix



Source: EIF

Micro-loans are usually offered with a special focus on social inclusion. Often, the interest rates on such micro-loans are not priced reflecting all costs and credit risk, and the underlying micro-businesses are not always profitable or viable in a commercial context. This allows the banks to clearly segment their activities and avoid any potential conflicts with its mainstream private banking business (e.g. negative reputational effects by pricing micro-credits high, which may taint the perception of the mainstream customer in relation to the banks' price competitiveness).

1. Categorization of "nature" of the MFIs can be done according to the following basic categories:

- For-profit Small / Mid-sized microfinance institutions ('Small / Mid-sized MFIs'). These intermediaries are privately owned financial intermediaries offering exclusively or mostly microfinance services (typically micro-loans). If the financial intermediary offers products other than microfinance, such would usually be SME lending products (i.e. up scaling). Such institutions usually have a balance sheet of less than EUR 100m (often no more than EUR 10 to 15m; although in exceptional cases it can be up to EUR 500m). Micro-loans are usually targeted at borrowers that operate profitable micro-enterprises, hence the micro-loans can be offered at commercial terms.

- Mainstream banks operating microfinance windows (Mainstream Banks' or 'Bank MFIs')
- Public entities operating microfinance windows ('Public Entities'), are entities that consider microfinance as part of their public enterprise promotion or social inclusion mandate, in a similar logic as that described in the section 'Bank MFIs'. Such institutions typically finance these activities with public funds, usually at relatively low margins (particularly if they are government guaranteed).
- Greenfield entities (Greenfield Entities). Start-up MFIs or MFIs with little or no track record, sponsored by private individuals or other investors.
- Dedicated microfinance vehicles often set up for a limited period of time, that invest in (usually Small/Midsized)

In terms of business model and client targeting, the above mentioned types of financial intermediaries can be summarized as follows (table 1).

Table 1: Types of intermediaries

Type	**Role of microfinance in business model**	**Target clients**	**Main products**
Small, Mid-size MFIs	Main (only) part of business model, possibly complemented by SME lending (i.e. Up-scaling)	Profitable micro-enterprises, with no or limited alternative access to funding	Commercially priced micro-loans
Mainstream Banks/Bank MFIs	Small (non-core) part of business model, either (i) as part of its social responsibility programme or (ii) as an extension of its commercial SME lending (i.e. down -scaling)	Depending on business model, either (i) individuals and micro-enterprises with certain socioeconomic attributes, may or may not be profitable micro-enterprises; or (ii) profitable micro-enterprises with no or limited access to funding	Depending on business model, (i) soft-priced micro-loans: or commercially priced micro-loans

Type	Role of microfinance in business model	Target clients	Main products
Public Entities	Varies	Varies	Soft-priced micro-loans
Greenfield Entities	Main (only)part of business model	Depending on mandate, usually as above (Mainstream Banks)	Commercially /soft-priced micro-loans
Funds and vehicles	Main (only)part of business model	Varies	Varies, depending on business model of intermediaries pooled I the indirect Investment

Source: EIF

Beside that there are:

- Senior loans: provided to well establish non-bank MFIs and in general to smaller banks active in the field of microfinance with the purpose to grow the micro-credit portfolios of the financial intermediaries over a predefined period of around 2 to 3 years.
- Subordinated loans are offered to regulated banks active in the field of micro-lending, either as part of their normal SME lending or through a dedicated microfinance down-scaling model.
- Portfolio risk sharing loans are hybrid instruments that combine the funding component of senior loans with the credit loss protection of guarantees. Such product is offered to good quality banks in the context of micro-credit pilot projects.
- Equity and quasi-equity, through ordinary or preferred shares, is provided to start-up non-bank MFIs to strengthen their capital base.
- Guarantees are provided to bank as well as non-bank MFIs. They grant up to 6 years of credit loss protection for new micro-credit portfolios to be originated over a period of up to 24 months.

Microfinancing - Early Initiatives

Microfinance has long been recognised by European policy-makers as an instrument to support entrepreneurship and competitiveness on the one hand, but also social inclusion on the other (Kraemer-Eis&Conforti,2009). However, in view of the specific local legal and political environments, the development of the European microfinance sector is still in an early stage with regard to scale and broader impact, and faces a continuing gap between supply and demand.Over the past decade, the EU has promoted a series of actions in support of microfinance, among which the following can be highlighted:

- Risk protection to financial institutions (including banks, guarantee institutions and counter-guarantee institutions) for new micro-credit portfolios, under the Growth and Employment initiative (1998-2000), the Multi-Annual Programme for the promotion of enterprise and entrepreneurship ("MAP", 2001-2005) and, currently, the Competitiveness and Innovation Framework Programme ("CIP", 2007-2013), all managed by the EIF (Council Decision (98/347/EC) of May 1998 on measures of financial assistance for innovative and job-creating small and medium-sized enterprises – the growth and employment initiative. OJ L155, 29.05.1998. Council Decision (2000/819/EC) of 20 December 2000
- The Joint European Resources for Micro and Medium Enterprises ("JEREMIE") scheme, managed by the EIF on behalf of the European Union for the period 2007-2013, aims at improving access to finance, including micro-credit using European Structural Funds.

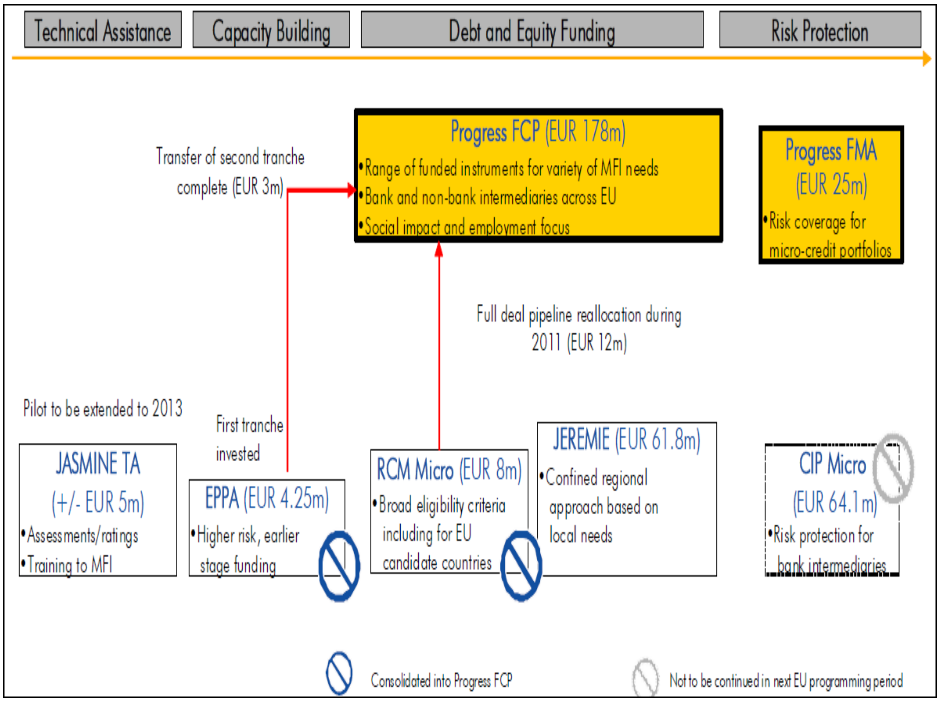
A broader EU policy move to use public funds to contribute to the development and long-term sustainability of the sector was initiated with the European Commission Communication, on a "European initiative for the development of micro-credit in support of growth and employment". Its objective was to promote the development of micro-credit in the European Union through actions along the following strands:

- Improving the legal and institutional environment in the Member States;
- Further changing the climate in favour of entrepreneurship;
- Promoting the spread of best practices;

– Providing additional capital for micro-credit institutions.

Motivated by the adverse effects of the financial crisis, the Commission Directorate General for Employment, Social Affairs and Inclusion and the EIB made each available EUR 100m to the benefit of micro-enterprises and self-employment, with a particular emphasis on social inclusion and groups with limited access to the traditional banking system. Progress Microfinance represents the first ever EU-wide dedicated financing programme for the European microfinance sector, and in addition to financing capacity it also provided for the structural framework needed to absorb the various smaller microfinance pilot predecessors and evolve towards a much-called for ´one-stop-shop´ for EU supported finance measures. An indicative EU budget of EUR 25 million has been allocated to the guarantee instrument. An overview of the development of the EIF-managed programmes and pilot initiatives under a financial product perspective is shown in figure 2:

Figure 2: Development of EIF-managed microfinance programmes



Source: http://www.eif.org/news_centre/publications/eif_wp_2012_13_microfinance.pdf

Progress Microfinance has become the central platform for pan European EU supported microfinance programmes. Deeper regional support to microfinance is provided under Structural Funds through the JEREMIE mandates to certain Member States or Regions.

The Europe 2020 strategy provides the overarching policy framework in which EIF's microfinance strategy is determined for the coming years. Formally adopted at the European Council in 2010 (European Council, 2011), the political and economic objective of Europe 2020 is to deliver "smart, sustainable and inclusive growth" for the EU as a response to the crisis and as a means to maintain and strengthen Europe's competitive position in the global economic order. Against the backdrop of widely differing national and regional microfinance markets across the EU, central EU support to microfinance can help to build up specific competencies locally which, in turn, are instrumental for further development of a more coherent market. Within the EU, the largest aggravation was observed in Lithuania and Spain. Noteable improvements were recorded for Bulgaria, Romania and Estonia, however, they can still be found on the right-hand side of the diagram (meaning higher risk of poverty or social exclusion) which is the case for most parts of Eastern Europe as well as for those West and South European countries which are suffering most from the impacts of the current sovereign debt crises (Greece, Ireland, Portugal, Spain, and Italy**).**

SMEs and Micro - Financing

SMEs constitute the backbone of entrepreneurship in the EU, irrespective of national boundaries. *From 22 million enterprises active in the non-financial business sector in the European Union, 99.8% were SMEs. About 92% of the total business sector consists of micro enterprises, which employ fewer than 10 persons*. The ability of a financial system to reach these small entities is crucial for the achievement of general socio-economic improvement. Typically, microfinance is provided by either small organizations or bigger institutions (where microfinance represents only a small part of the overall activities). The EMN survey reports that 24% of the responding lenders focus only on microfinance; for almost half of the respondents the activity represents only a small portion of the overall activities. In terms of numbers of employees, the biggest organizations are in France, Romania, and Hungary.

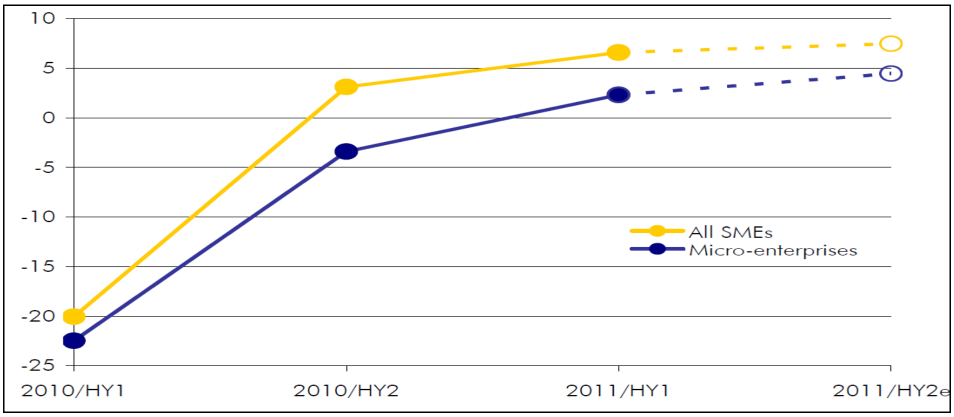
- 57% of the microfinance organizations provided fewer than 50 loans in 2009 (typically in France, Germany, and Spain); only 13% provided more than 400 loans (largely in Eastern Europe, i.e. Bulgaria, Hungary, Romania, Poland).
- Micro-loan sizes vary between EUR 220 and EUR 37k8 with banks, non-bank financial institutions and government bodies offering larger loans than credit unions, NGOs, savings banks, and foundations. The average loan size across the sample in 2009 was EUR 9.6k.
- 59% of respondent lenders do not require guarantees; the remainder require either collateral or participation in a guarantee programme.
- There is a tendency of cross-selling as around 50% of respondents offer other financial services to their microfinance clients (debt counseling, savings, insurance, mortgages, money transfer).
- The most pressing problem for the microfinance providers is the lack of access to long-term funding.
- The EU microfinance market is immature and fragmented, but of growing importance as a market segment with a potential to counter poverty and unemployment while fostering financial and social inclusion. One reason for the fragmentation is the diversity of underlying regulatory frameworks (see also box 1 below).
- The European microfinance market presents a dichotomy between Western Europe and Central/Eastern Europe in terms of intermediary profile, target beneficiaries, loan size, etc.
- In general, there is no common microfinance business model in Europe.
- Lenders which focus on SME support and job creation tend to lend larger sums, whilst those focusing on social and financial inclusion tend to issue smaller micro-loans.
- Ratings of MFIs are gaining importance in the microfinance arena but, so far, with a focus on developing countries.
- Often, MFIs follow a transformation process: they start as NGOs and finance their business via donations and/or public money; over time they “grow” towards formal financial institutions and regulated entities. Social performance assessments and ratings are also developing, reflecting the growing need (and wish) for accountability of institutions in this field. In the frame of the

JASMINE Technical Assistance programme financed by the European Union and managed by the EIF, financial ratings and assessments of European non-bank MFIs have been actively promoted since 2009. On the basis of its success, the programme will be extended until 2013.

- Not only the financial support of microfinance in Europe is crucial – non-financial support measures for MFIs and final beneficiaries are important for the sector as well (i.e. mentoring, training, and counseling for final beneficiaries; technical assistance and capacity building for MFIs).
- The main challenge for MFIs in the EU is to develop and maintain a flexible and sustainable funding model for microfinance operations that allows them to realize their individual approach.

When looking at the business climate of micro-enterprises, the EU Craft and SME barometer (UEAPME, 2011) shows that micro-enterprises on balance estimated their overall situation somewhat less favorable than all SMEs in the first half of this year (figure 3). Nevertheless, the weighted difference between positive and negative answers increased, and the outlook for the second half of the year was even a bit better. Similar results were reported for the survey questions on turnover, prices, and orders. However, expectations for investments were on balance lower than their actual situation, and employment expectations resulted largely in balance with the current situation. All in all, the figures reveal more difficulties for micro-enterprises than for other SMEs.

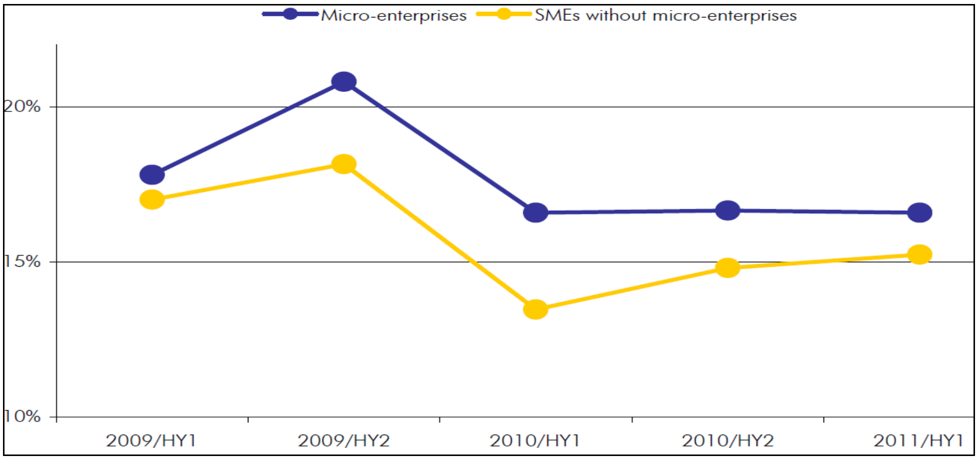
Figure 3: Overall situation of European micro-enterprises



Source: UEAPME Study Unit (2011)

According to the latest ECB survey on the access to finance of SMEs in the Euro area (ECB, 2011), access to finance remained a more pressing problem for Euro area SMEs than for large firms, and the share of enterprises which see access to finance as their most pressing problem is larger among micro- enterprises than among other SMEs (figure 4).

Figure 4: Share of enterprises reporting access to finance as their most pressing problem



Source: European Central Bank

There is also diversity with regard to final beneficiaries: many providers target people excluded from mainstream financial services (47% of respondents of the latest EMN survey) and women (44%); moreover, ethnic minorities and/or immigrants (41%), young (29%) and disabled people (21%) are amongst the top ranks (Jayo et al, 2010). Priority outreach to these specific target groups show the high social focus of microfinance in Europe. The causes and consequences of financial exclusion can also contribute to social exclusion: Those unable to access finance for enterprise creation/development, have greater difficulty in integrating into the financial system; this reality can also affect their participation in mainstream social activities and events specific to their cultural reference group. On the other hand, those who are socially excluded - particularly with respect to networks, decision making, and an adequate standard of living may also become excluded from mainstream financial services in so much as they are unable to provide the types of professional and personal references needed to access finance. In times of personal hardship, socially excluded persons may rely on predatory “door step” lenders, further exacerbating their vulnerability and exclusion.

SMES Microfinancing-Evidence from Serbia

Serbian Banking Sector (with the exception of Opportunity Bank Serbia (OBS) and Procredit Bank), focuses mainly on corporate and retail customers with higher income in urban areas and only rarely reaches micro, start-up entrepreneurs and the vulnerable population who request loans to engage in productive activities; due to high risks and costs associated with serving this type of clients. The branch network distribution of banks in Serbia is very uneven, with high a concentration in the towns and cities and an absence in some parts of the countryside (towns of up to 6,000 inhabitants without any bank branch being no rarity). The state-owned banking sector is struggling, with two banks – Agrobanka and Razvojna Banka Vojvodine – placed into administration in the past two years. In addition, the market share of assets by Greek-owned banks is close to 20%. About half of the banks have a market share of less than 2% each, and Belgium owned KBC has sold the banking license and capital in Serbia to Norwegian telecom company Telenor, while the local subsidiary of French bank, Société Générale, is buying most of the assets and liabilities (client loan portfolio and deposits). Funding position is a big challenge for banks in Serbia - the sector as a whole has a loan-to-deposit ratio of about 125%, and in the absence of a local corporate bond market, most foreign banks are dependent on parent funding for at least some of their business. The exception is Italian-owned Banca Intesa, the country’s largest bank, which enjoyed a 20% rise in deposits in 2012 and has a loan-to-deposit ratio of less than 100%.

The existence of financial infrastructure, such as Credit Bureau of the Serbian Banking Association and the Solvency Center in the National Bank of Serbia, has been of major importance to allow the introduction of modern credit risk appraisal techniques into Serbian banking. In addition to assistance with risk appraisal, the Solvency Center has also been used as part of the SME targeting process.

The Serbian Government is allocating government subsidies for entrepreneurs and SMEs mainly through The Ministry of Regional Development and Local Self-Government. In 2013, a total amount of RSD

100 million was allocated as support to SME for procurement of necessary equipment, but there are additional smaller projects including start-up businesses, women businesses, returnees into rural areas, etc. EBRD recently announced that they have so far invested more than €3 billion into Serbia, mainly focused on rejuvenating the public sector, but that in the future it will switch to private sector and SMEs.

Regulatory Framework. According to current Serbian regulation (Law on Banks), banks are the only financial institutions allowed to engage in acceptance of deposits and granting loans. As a result of this, there are no non-banking financial institutions, MFIs or any other creditors on the market besides the banks. This kind of regulatory approach is a consequence of negative experience from the 1990s and a number of pyramid schemes that were present on the market during that time. In 2005, the Republic of Serbia adopted three laws that collectively represent major steps forward in the intention to establish a stable and reliable banking sector: Law on Banks (amended in 2010); Law on Bankruptcy and Liquidation of Banks and Insurance Companies (amended in 2008 and 2010), and Law on Deposit Insurance (amended in 2008 and 2010). Opportunity Bank J.S.C. Novi Sad (OBS) operates as a fully regulated bank in accordance with the Law on Banks and with a banking license issued by the NBS. Although OBS is primarily focused on credit related products, financing small businesses and clients with limited access to financial services, as a regulated banking institution OBS is obliged to adhere to all relevant banking standards and regulations including:

- Capital requirements, bank ownership and control, corporate governance, system of internal controls, external audit, risk management, banking secrecy, preventing money laundering, customer protection, NBS supervision etc.

Since 2009 and the beginning of the harmonization process with Basel II standards and further harmonization with EU directives in Serbia, National Bank of Serbia (NBS) has been implying the possibility of introducing the new Law on Credit Institutions which would replace the current Law on Banks and set the regulatory environment for non-banking financial institutions as well. However, in 2013 the NBS and competent Ministry have not yet presented even a draft of the new Law. Until then the Law on Banks remains the supreme law when it comes to credit institutions i.e. banks and banking business. However, current lack of regulatory framework for non-banking financial institutions restricts possibilities for more efficient financial inclusion process and development of small businesses.

Microcredit has existed in Serbia at a small level for over 10 years, mainly supported by various international donors and social investors. Since 2005, 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, which eventually curbed their growth and made traditional microfinance in Serbia almost nonexistent.

Table 2: Micro-finance outreach comapred-Serbia, Montenegro, Bosnia and Herzegovina

	Scenario-better environment			
	Serbia	**Serbia**	**Bosnia& Herzegovina**	**Montenegro**
No of microcredit clients (2007)	19.600 (0.3% of pop.)	100.000 (1.3% of pop.)	400.000 (10.4% of pop.)	70.000 (10.3% of pop.)
Size if microcredit portfolios (2007)	€ 23,4 million (0.01% of GDP)	€ 185 million (0.6% of GDP)	€ 1 billion (9.3 %of GDP)	€ 144 million (7% of GDP)

Source: Authors compilation from NBS data

Three non-bank microcredit institutions in Serbia (AgroInvest, Micro-Development Fund, MicroFinS) had a combined total portfolio of approximately EUR 12 million in loans to over 18,500 borrowers at the end of 2012 (last data available by MixMarket). Credit activity of MFi in Serbia in last three years were declining mostly due to declining credit activity of AgroInvest as the biggest Serbian MFI Institution.

The main problem for MFI in Serbia is NBS decision on retail lending which prescribes that retail loan can be given only if the installment is up to certain percentage of registered income (salary, pension, etc.) If loan is given to retail customer without registered income it has to be provisioned 100% unless it is 100% cash covered. In order to bypass strict banking regulations in the country, all three institutions are registered as consulting companies and have contracts with a bank registered in Serbia (in all three cases, using Privredna Bank Belgrade – PBB, and during 2012 Agoinvest started to also to cooperate with Societe General Bank) which actually disburses loans to MFI clients, while MFIs secures the loan with 100% cash deposit amount and appears on the loan contract between client and PBB as the loan guarantor. Banks charge MFIs a loan disbursal fee. At one moment in 2008 OBS was discussing the option to be partner bank for Agroinvest, but the further negotiations were dropped due to increased reputational and regulatory risk for OBS. MFI nominal interest rates go up to 48% on annual basis.

There are three non-bank microcredit institutions in Serbia (AgroInvest, Micro-Development Fund, MicroFinS) that operate through a local bank. These institutions were founded during the 1999-2002 period with emergency funding from donors (UNHCR, ICRC, etc.) or international NGOs (World Vision). Their operations are field-oriented and focused on rural areas of Serbia but have many regulatory and financing difficulties which make their product expensive. In addition, high interest rates that these organizations are charging clients and the fact that they bypass the laws allowing only banks to disburse loans in Serbia has recently attracted attention of the public and National Bank of Serbia, which has performed several controls of their operations.

Significant financing gaps most probably exist or where microfinance's intervention have a clear added value in Serbia are further taget groups:

Small enterprises:

- starting entrepreneurs and young enterprises (up to 2 years of existence) form the traditional core group in need of finance. One needs to distinguish though between:
  - entrepreneurs whose development phase or type of activity mainly requires limited working capital;
  - entrepreneurs whose activity requires investment capital, which itself needs to be distinguished in different risk categories;
- the self-employed and all types of non-incorporated enterprises in general who are either categorised by banking regulation as risky (hence requiring high reserves when serviced) or amalgamated to plain consumer needs (likewise highly penalised with high capital ratios).

In 2012 there were in Serbia micro, (*Micro: businesses with up to 9 employees, Small businesses: 10 – 49 employees, Medium businesses: 50 – 249 employees*) small and medium-sized businesses (including individual entrepreneurs (Entrepreneurs are natural persons who perform business activities as individuals):

- 105,000 registered companies + 218,000 individual entrepreneurs

- Over 95% of these are micro-businesses with less than 10 employees, most situated in Belgrade and Vojvodina
- 7,355 companies and 32,853 entrepreneurs have been closed in 2012
- 8,648 new companies and 30,200 new entrepreneurs have been registered in 2012
- 36,909 companies and 43,900 entrepreneurs are active loan users
- 20% of all business loans are NPLs

The main concern of small and medium-sized enterprises (SMEs) in Serbia at the moment is financing their survival, and not investing in development, as they mainly worry how to provide salaries to employees and settle obligations to the state. Most new companies are closed within three years from foundation.

Social groups:

- young people in general, but in particular a. university graduates with little alternatives on the job market and likely to leave the country, especially the best among them (brain drain); the new generation, young families, who are newcomers on the credit market and cannot rely on the capital base of their parents (no real estate or other capital as a guarantee);
- women in general, whose chances of finding a job are generally lower than men's, but in particular, women (with children) who have the opportunity to launch a home-based business requiring limited working capital, spouses who can develop their small scale activity gradually at low risk, women launching activities in typical service sectors whose financial needs can either be in the form of limited investment capital or working capital, women benefiting from governmental training and support programmes, women's support networks or support from traditional entrepreneurial families to launch a company and in need of add-on investment or working capital;
- experienced and skilled workers made redundant, usually older workers (45+) living especially in areas of industrial decline, who have professional skills and are home-owners (guarantees) but who lack working capital;
- refugees and internally displaced people (IDP) who remain a large target group mainly located in urban areas (about 182.000 people

around Belgrade and about 120.000 people around other cities) whose needs, though, go beyond microfinance and inside micro-finance go beyond the presently proposed credit services (for entrepreneurship and housing, as delivered by both MDF and Mikrofin-S). Their economic alternatives are poor, which is why many of them are already involved in economic activities in the grey economy.

- ethnic minorities, in particular the Roma community which represents 6% of the Serbian population (over 500.000 people), are a significant part of the internally displaced people and need very targeted support in addition to finance;
- the long term unemployed, representing an impressive 75% of the unemployed, need likewise to be targeted with support going beyond micro-financial services, and whose financial needs require well designed low-risk financial instruments.

Activity sectors:

- the grey economy and informal sector, estimated to be equivalent to a third of GDP is a big reservoir of potential micro-finance demand to which bridges could be built to help them formalise as they develop. This is traditionally considered to be secure market, as there is already a business history with established clients and existing income streams (share of Serbia’s informal sector employment is around 30%);
- the services sector (neighbourhood services, etc) and know-how based sectors (IT, design, etc) that are not based on big material investments are at a disadvantage in the banking sector which looks for formal and conservative guarantees.
- Flexible and activity-based financial instruments are what is most useful in these cases;
- the recycling sector has been identified as one sector with a major development potential in the context of municipality's needs to modernise their waste management systems. This represents a unique opportunity of connection with the informal recycling activities mainly organised by the Roma communities. The needs here too go beyond (micro-)financing alone and would require a targeted programme delivering capacity building as well

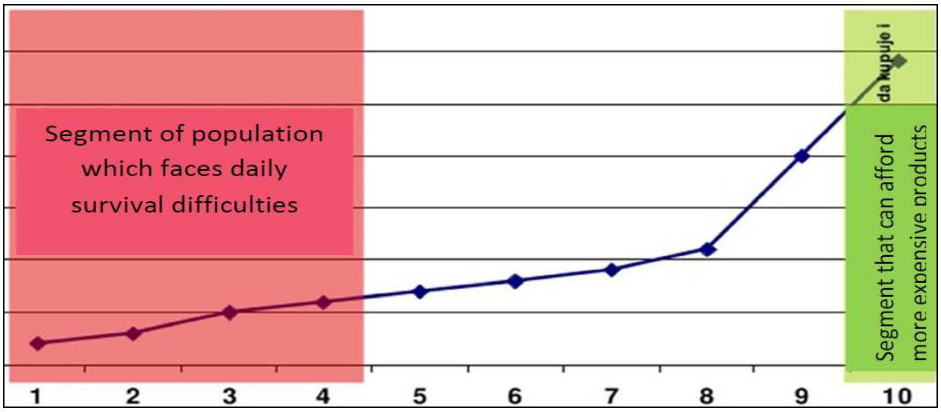
Geographical targets:

- rural areas in general, as serviced by AgroInvest mainly so far, are yet neither covered extensively nor serviced in depth with any proper diversity of financial services. Towns with up to 6,000 inhabitants without a single bank branch are reported to be a frequent phenomenon throughout Serbia, but in particular in the South of the country.

Small agro producers (agricultural households): Farmland comprises 70% of the total surface area of Serbia, 631,000 registered agro households, 99.6% are family households while rest are legal entities/registered entrepreneurs, 48% have less than 2 hectares of land, 17.3% of the total population comprise agricultural labor force (rapidly aging population), 39,513 agricultural households have active loans, 26% of all agricultural loan users are in default over 90 days. Agriculture has long been the mainstay of the Serbian economy. Traditional family-owned small farms and private estates prevail, with the average commercial farm occupying 500-700 ha. Family farms consist of small plots and are based on subsistence production, being turned over to commercial use to a smaller degree than European farms. Rural mixed-income households (rural areas): 85% of Serbia's territory is classified as rural, 55% of Serbia's population lives in rural areas, the poverty rate in rural areas (9.8%) remains twice the poverty rate in urban areas (4.3%), 86% of villages in Serbia are witnessing depopulation, there are about 4,800 villages in Serbia, average age in most of them is around 60.

- suburban areas or city hinterlands are geographical core areas with entrepreneurial potential and reliable markets but not yet covered appropriately with credit services are recognised to be economically serviceable;
- the municipalities identified as the poorest of Serbia, mainly located in the South of the country and close to Kosovo, with high concentrations of unemployment, poverty (close to 20% of the population) and grey economy (up to 80%) lack most of the basic financial services;
- areas with declining industries or areas hit by closures of large enterprises are other areas where there is a potential micro-finance demand, though probably often to be delivered with accompanying services to fledgling activities.

Figure 5: Consumer segmentation in Serbia (IPSOS Strategic, 2012)



Source: Authors calculation

Financial Services Demand

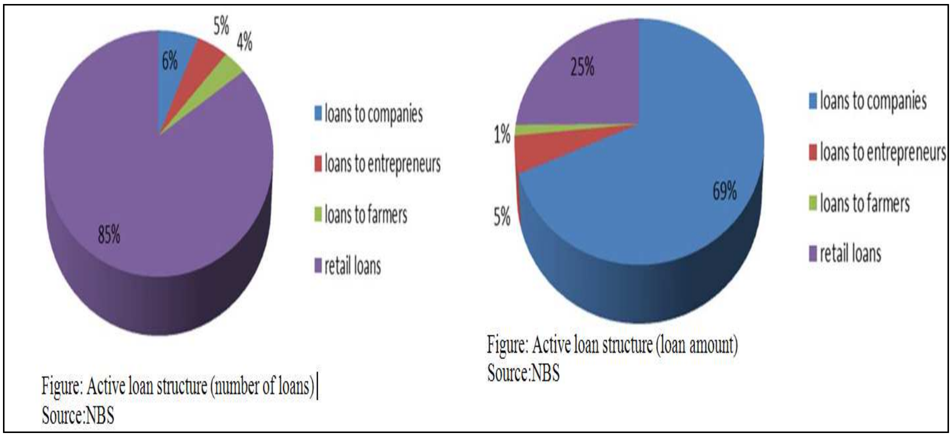
At the end of Q2 2013, inter-annual growth of credit activity in Serbia barely reached 1%, which brought it very close to the stagnation zone. Factors that limit credit activity demand-wise were slow economic recovery, high unemployment and interest rates. At the same time, at the supply side, deteriorated creditworthiness of the private sector and more risk-averse banking behavior coupled with limited funding sources, did not help either. In the first half of 2013, 8% less new loans were disbursed as compared to the same periods in 2012 and 2011 (loans to businesses which have much bigger share in total loans dropped by 15%, while retail loans grew by 20%). Total net loans in Serbian banking sector at the end of Q1 2013 amounted to 1,737 billion RSD, with dominating loans disbursed to state-owned and private companies (share of 53.9%), followed by retail loans including private individuals and farmers (30.3% share). 72% of loans are in foreign currency (of which 62% are EUR-indexed). Share of loans with remaining term over one year is 62% (28% with term over 5 years). Total deposits amounted to 1,677,505 billion RSD at the end of Q1 2013, 48.7% of which are retail deposits. 76.9% are foreign currency deposits i.e. 70.1% are EUR-indexed deposits. Sight and short-term deposits (up to 1 year) represent over 90% of deposit structure in Serbian banks, while 7.1% are deposited for periods exceeding one year.

Table 3: The structure of bank credit clients, 2013

Loans	No. of active loans	Outstanding (in mil RSD)	Average loan amount (in EUR)
Loans to SMEs	95,183	1,577,460	144,112
Loans to entrepreneurs	71,852	111,841	13,535
Loans to farmers	54,439	32,437	5,379
Retail loans	1,234,229	577,426	4,068
Total	1,453,703	2,299,164	13,753

Source: Serbian Credit Bureau data, 2013

Figures: 6-7



Source: NBS

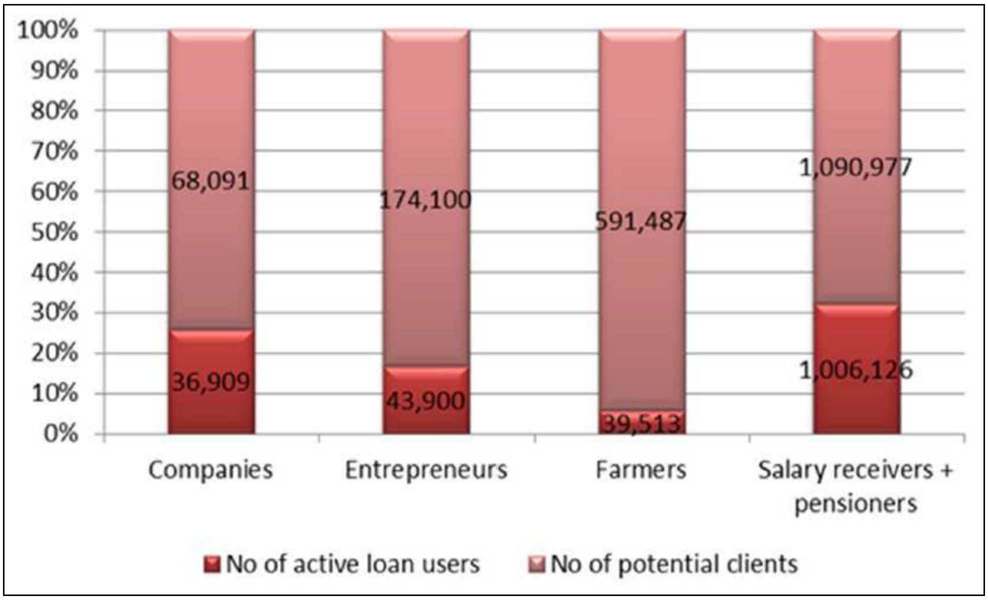
There are a significant potential of the Serbian banking market, especially when it comes to micro-businesses and farmers in the rural areas which are underserved by other banks:

Table 4: Potential of the Serbian banking market

	No of registered as per official data	No of active loan users (as per Credit Bureau)		No of potential clients
SMEs	105,000	36,909	65	68,091
Entrepreneurs	218,000	43,900	80	174,100
Farmers	631,000	39,513	94	591,487
Salary receivers+ pensioners	2,097,103	1,006,126	52	1,090,977

Source: Serbian Credit Bureau data

Figure 8: Active loans and potential micro credit clients



Source: *Authors calculation*

Discssion and Conclusions

Based on the developments and insights into the European microfinance market so far, the following four pillars could be disscused as essential for a successful further market building:

1. Availability of financial instruments with a balanced focus on social impact objective and financial sustainability of the intermediaries;
2. Non financial technical assistance as well as financial capacity building support to bring the smaller MFIs onto the growth curve, and other MFIs to enhance their standards, upgrade operational models, expand and improve outreach further;
3. Financial education and mentoring of final beneficiaries and entrepreneurs especially in their start-up phase is also key for reducing default rates for MFIs. Such business services are offered by intermediaries, or in cooperation with dedicated service providers and is also supported by the European Commission through the European Social Funds programmes.

4. Spreading of best practices, standards and transparency to create a basis for informed investor decision-making by allowing to filter the profit-only MFIs and, more importantly, predatory lenders from the institutions targeting social impact in a long term sustainability perspective. Part of the market building efforts also come from databases and other initiatives enhancing the transparency of the market and the development of a common language and set of performance metrics (CAF, 2011).

Microcrediting can be concered for SMEs and other mentioned target groups in this paper very good financial support for theri development, especially in Balkan countries as Serbia. Regualtory framework would be very important to be adjusted in this sector to EU legislative, to become an positive precondition for microcrediting potential clients.

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Mikrofinansiranje razvoja malih i srednjih preduzeća, na primeru Srbije

A P S T R A K T

Mala i srednja preduzeća čine stub preduzetništva u Evropskoj uniji, kao i u zemljama jugoistočne Evrope, kao što je Srbija, bez obzira na državne granice. Od svih preduzeća koja su u nefinansijskom poslovnom sektoru u Evropskoj uniji i u Srbiji preko 99% su mala i srednja preduzeća, ali više od 92% ukupnog poslovnog sektora se sastoji od mikro preduzeća, koja zapošljavaju manje od 10 osoba. Sposobnost finansijskog sistema da dopre do ovih malih preduzeća je krucijalan za postizanje generalnog društveno ekonomskog poboljšanja. Na osnovu podataka EU Craft-a i barometra malih i srednjih preduzeća (UEAPME), Narodne banke Srbije, dobijenih iz upitnika za mikro preduzeća, EMN izveštaj, rad razmatra probleme prakse mikro finansiranja i iskustava pozajmioca, kao i potražnju za uslugama mikro finansiranja od strane posebnih ciljnih grupa: malih preduzeća, preduzetnika, malih farmera, društvenih preduzeća i potencijale ponude i tipične provajdere. Doprinos ovog rada su procene potencijala srpskog bankarskog tržišta, posebno kada je reč o mikro biznisima i farmerima u ruralnim oblastima, koje ne pružaju dovoljno druge banke i predlozi neophodnih aktivnosti za dalje uspešno gradjenje tržišta u cilju razvoja malih i srednjih preduzeća.

KLJUČNE REČI: *mikro finansiranje, društvena inkluzija, institucije, mala i srednja preduzeća*

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