USAID BUSINESS ENABLING PROJECT

MARKET IMPACT ASSESSMENT OF INTRODUCTION OF NON-DEPOSIT-TAKING MICRO-FINANCIAL INSTITUTION (NDMFIS) IN SERBIA

EXECUTIVE SUMMARY

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I. Executive summary

Micro, small and medium-sized enterprises (MSMEs) are essential for Serbia's economic and social development. The MSMEs sector currently generates around 65.3% of employment, 65.5% of turnover and 55.2% of GVA[1]. But MSMEs are still not reaching their potential to be the engine of Serbia's economic growth. One reason is a lack of finance: USAID BEP's Annual Survey of Businesses found that only 36% of MSMEs had access to bank credit, and an OECD study found that the share of SME loans in total loans in Serbia in 2011 was 26.1% (compared with over 54% in Hungary and Slovenia).

Poor access to finance and its impact on MSME growth has serious implications for economic recovery and development in Serbia. Without means to finance operations or growth, and with liquidity problems mounting, they are not creating new jobs that Serbia urgently needs. It is clear that there is a significant gap between need and supply of credit for Serbian MSEMs. Non-Depository/Non-Bank Micro-Finance Institutions (ND-MFIs) can fill much of the credit gap, in particular to micro and small enterprises.

This report provides a market impact assessment of the introduction and development of Non-Depository/Non-Bank Micro-Finance Institutions in Serbia. The assessment of the impact of ND-MFIs on MSME sector growth and employment is based on an estimation of the projected micro-credit demand-supply gap and potential inflows of funds needed to establish and develop the Serbian microfinance (MF) sector. The report demonstrates that a new MF legal framework will lead to an increase inflow of micro-credit funds into the Serbian economy.

Research Methodology

USAID BEP employed a mixed-method approach to compile a comprehensive evidence base for the estimation of the micro-credit market gap and a realistic estimation of the potential impact of ND-MFIs on Serbia's MSMEs sector, economic growth and employment. We considered **quantitative and qualitative evidence collected from a range of sources,** desk research and collection of statistical data from specialised databases, semi-structured interviews with relevant officials of the Serbian Government, key stakeholders of the MF sector and potential investors in the Serbian MF sector, and **peer group analysis** comparing relevant indicators for the country or region under consideration (Serbia) and the same indicators for other countries or regions (Romania/Balkans).

Demand for Microcredit

Analysis of demand for microcredit in Serbia is based on the assumption that the following entities can benefit from micro-lending:

- **Unemployed and potential start-ups:**
    1. Start-up sole proprietors[2] /farmers seeking external finance, and
    2. Unemployed and individuals wishing to become self-employed/ farmers
- **Existing micro-businesses[3] and self-employed persons/farmers:**
    3. Self-employed persons seeking finance (less than EUR 25,000)
    4. Micro-enterprises seeking finance (less than EUR 25,000)

[1]Gross value added, Report on SMEs and entrepreneurship 2012, Serbia's Ministry of Economy, Ministry of Regional Development and Local Self-Government, National Agency for Regional Development.
[2] Start-up sole proprietors and unemployed include those located in rural areas aiming to become farmers.
[3] In Serbia, as in the EU, microenterprises are defined as those that are under two of the following three criteria: 10 employees, €700,000 revenue, or €350,000 net assets.

The expected number of micro-credit borrowers per year in Serbia is 140,000 sole proprietors, start-ups, and micro-enterprises.

The framework to calculate the market size is as follows: Expected number of borrowers[4] * Average loan amount. This method, presented in the second chapter of the report, is underpinned by relevant data from European and Serbian statistics for 2012/2013. Three scenarios were posited: the optimistic, with maximum market demand; the pessimistic, with minimum market demand; and the best- guess scenario. All three are outlined below:

- Optimistic maximum micro-credit market demand is estimated to be **EUR 461.3mn/year**, based on the average loan amount extended by Opportunity Bank Serbia is **EUR 3,300**;
- Pessimistic, minimum micro-credit market demand is estimated to be **EUR 153.8mn/year**, based on the average loan amount extended by Agroinvest Serbia is **EUR 1,100;**
- ‘Best-guess’ market demand is estimated to be **EUR 290mn/year**, based on the average amounts of financial products currently offered by SME-oriented banks and MFIs to their clients: EUR 2,076.

Inflow of funds into the Serbian microfinance sector/potential investors

As the path towards EU accession becomes clearer, and assuming that the legal framework for microfinance improves, debt and equity finance will become available for start-ups and job creation in the form of donations (from UNDP, the Swiss Development Agency, etc.), grants (e.g. technical assistance through JASMINE) and funding from international agencies and development financial institutions (such as USAID, WB, EBRD, CE/EIF Progress Microfinance, etc.). MFIs can also attract Tier I and Tier II capital from international and national SME investment funds (e.g. the WB’s ENIF and ENEF, EBRD, EC/EIF microfinance programs, Coopest, OikoCredit, Deutsche Bank, etc.).

Since the onset of the global financial downturn, social and development-oriented investment funds have identified the microfinance sector as a safe and profitable avenue for investment. The MF sector is seen as a financially rewarding market due to the performance and quality of MFI portfolios, as well as in view of the social and financial inclusion impact of MFIs’ financial and Business Development Support Services (BDSSs) provided to targeted beneficiaries.

International social investors active in South-Eastern European MF sectors have already expressed interest in investing **EUR 40 to 60mn into Serbia’s MF sector**. However, they will not commit to making these investments and providing associated assistance to MFIs and their clients unless amendments are made to the current legal framework (which forbids direct lending by MFIs to targeted micro-credit beneficiaries).

In addition, Serbia could benefit from some **EUR 30mn under specialized EC/EIF microfinance programs** that will be made available within the current 2014-2020 programming period.

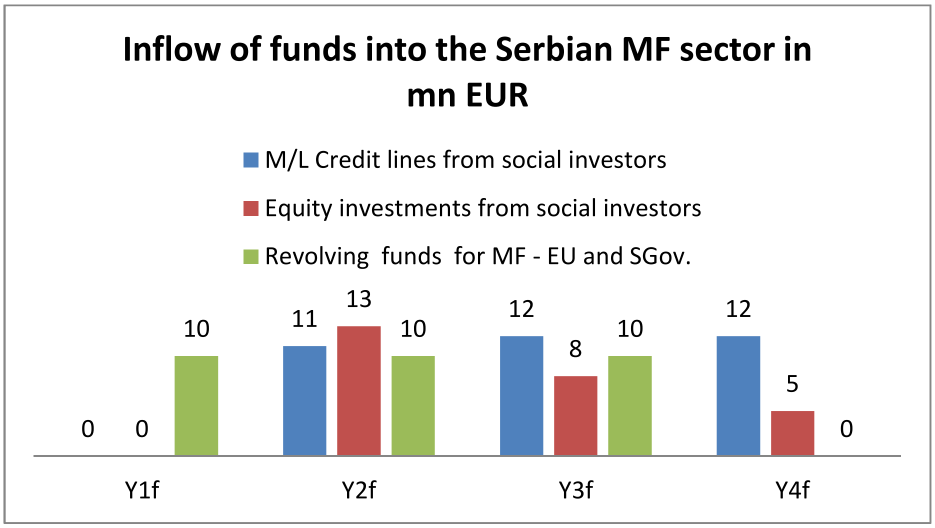
But, in order to attract investments (T1 and T2), MFIs need to achieve standards that will allow them to attract investor funds e.g. MFIs need to have financial and social audits, specialized Management Information System (MIS), procedures for risk management, impact studies, etc. All those prerequisite conditions could be fulfilled

[4] The latent demand (percentage of sole proprietors and micro-enterprises funded by friends and family), estimated at 31,393 micro loans (22.4%), has not been taken into account when market size was estimated.

with the support of TA funds for MFIs. The estimated value of **external sources of Technical Assistance (TA) and capacity building is EUR 0,5 mn[5].**

A mix of external sources, including EU Technical Assistance programmes (such as JASMINE); EU MF networks (such as MFC and EMN); equity investor contributions, especially to newly-established MFIs; and internal resources (such as reinvested surplus/profits, etc.) should be made available to ensure sustainable growth of the MF sector.

The following chart presents estimated the **inflow of funds into the Serbian MF sector** based on the assumptions presented in the third chapter of the report.



The total inflow of funds in the form of investment into the MF sector and medium-/long-term credit lines provided to existing and newly-established MFIs is estimated to reach EUR 91mn over the next four years. Due to the revolving nature of this funding and the multiplying factor of 1.3 (for extension of short-term micro-credit), the investment into the MF sector portfolio and the inflow of micro-credit finance into the Serbian economy will increase from the current EUR 14mn to EUR 138mn in year four, for a grand total of EUR 352mn.

Impact assessment of legislation aimed at improving microfinance in Serbia

The potential impact of sustainable MF sector development under an enabling legal framework and foreign direct investment into the sector is presented through the following indicators: a) market penetration rate/access to MF services, and b) decrease in the market gap, between demand and supply for micro loans, that will lead to c) greater turnover and profitability of targeted beneficiaries and job creation/greater self-employment, and d) savings in social costs (unemployment benefits).

a) Mainly due to the low number of MF providers, the **MF market penetration rate/access to MF services indicator** reveals the need for policy intervention to properly exploit the potential growth of the MF sector. Considering the increase in the number of MF providers due to improvements to the legal framework and

[5] The EU-funded JASMINE TA programme is presented in greater detail in Appendix IV, Part 2.

investments in the sector, this indicator's value is projected to approach levels seen in Romania and EU27 in the fourth year after enactment of a legal framework for ND-MFIs.

b) If the legal framework for micro-lending does not improve to an extent that enables the sustainable growth of the Serbian MF sector and the inflow of funds from international social investors and EU/Government MF funds, the **market gap, currently estimated to stand at 54% (EUR 161mn), is projected to increase to 63% in the following four years, reaching EUR 233mn** and affecting the contribution of the MSMEs sector to the Serbian economy

c) Microfinance has a direct impact on **job creation and promotion of self-employment**, but economic policy and the legal environment, especially taxation and administrative policies, may influence the umber of jobs created. According to USAID BEP's 2013 Business Survey, the Serbian Government has been making progress in reducing tax and administrative burdens faced by business, but general administrative procedures and the burden of regulatory compliance remain a significant constraint on business.

The potential impact of sustainable development of the Serbian MF sector in terms of supply of microcredit, new jobs and self-employment opportunities created, and savings in social expenditures, is presented in the tables below.

Indicator /Period (2014-2017)	**2014 *f***	**2015 *f***	**2016 *f***	**2017 4 *f***	**Total 2014-17**
Supply of microcredit in the Serbian economy from MFIs/SME banks and EU/GoS - MC portfolio (EUR mn)	**149**	**199**	**246**	**276**	**869**
Supply of microcredit with inflow of social development funds from MFIs[6]	**27**	73	114	**138**	**352**
Supply of microcredit with inflow of social development funds from SME banks[7]	120	121	127	133	501
Supply of microcredit from EC-EIF/GoS SME development programmes	2	5	5	5	17
Total number of micro-loans extended/year (average micro-loan amount: EUR 2,076)	**71,767**	**95,705**	**118,367**	**132,868**	418,708
Number of full-time/self-employed jobs created (2 micro-loans create one full-time job)	35,884	47,853	59,184	66,434	209,354
Number of part-time jobs created (5 micro-loans create one part-time job at 1/3 working hours) in full-time equivalent	3,588	4,785	5,918	6,643	20,935
Total number of jobs created and sustained by micro-companies (full-time and part-time equivalent)	39,472	52,638	65,102	73,077	230,289
Savings in social transfers for unemployed/socially assisted (EUR 180/person / 60% of median salary)[8] (EUR mn)	**25.2**	**34**	**42**	**47**	**149**

Years 1 to 4 following enactment of MF legal framework

[6] This represents a sum of existing MFI portfolio and reinvested surplus/profit from operations plus new MFIs and increased portfolio due to investment/equity and debt (multiplying factor 1.3 -1.5) formula: 1.3*(inflow of funds to the Serbian MF sector) cumulated with the previous years.

[7] In the region of Central and South Eastern European countries, the suppliers have recognized clear need for small-scale sensible loans and additional support for enterprising individuals, making financial services more accessible to previously 'under banked' individuals and businesses. In that sense, commercial banks have established new commercial non-bank non-deposit financial institutions to develop innovative solutions for breaking down the barriers to financial inclusion across the region.

[8] For purposes of estimating the financial impact on the unemployment/social assistance budget, the average social transfer is considered to amount to 60% of the median salary in Serbia (EUR 180), while 60% of the new vacancies are assumed to be filled by those previously unemployed or receiving social assistance from the Serbian Government.

The cumulative inflows of microfinance funds from MFIs, SME banks and EU/GoS financial instruments into the Serbian economy over the following 4 years are estimated to stand at EUR 869mn.

d) It is estimated that, during the four years covered by the projections, a **cumulative total of over 230,000 jobs,** both full-time equivalent and self-employed, will be created with the contribution of the MF sector (Non-Bank Non-Depository MFIs and SME Banks), and **savings to the social assistance budget may reach a cumulated value of EUR 149mn, with an average of EUR 37mn per year.**

The impact of micro-lending is not only limited to job creation. Microfinance impact assessment studies reveal that microcredit helps beneficiaries grow and prosper and increase their production/services base, productivity, and sustainability.

Conclusion

The conclusions of the market impact assessment in the context of introduction and development of Non-Depository/ Non-bank Micro Finance Institutions in Serbia may be summarised as following:

- The unmet demand for microfinance in Serbia is substantial. This **market gap** is estimated at **54% (EUR 161mn); in the absence of appropriate and affordable microcredit and associated business development services,** the market gap will **increase to 63% over the following four years to reach EUR 233mn.**
- The current legal framework that prevents existing MFIs from lending directly to businesses should be amended. Alternatively, a new legal framework for MFIs should be created to allow sustainable development of the MF sector. The draft should consider the **European Code of Good Conduct for Microcredit Provision**, the EU quality standard, especially its Chapter I: Relationship with Clients and Investors, as well as SMART client protection principlesin order to ensure social and development impact of MF activities in the targeted market.
- With a new legal framework, the Serbian MF sector itself may attract up to **EUR 90mn in** investment. Specialised social investors have already committed to investing **EUR 40 to 60mn** into Serbia's MF sector along with technical assistance for MFIs and their clients. We expect another EUR **€30mn** of EC/EIF MF programs e.g. the EASI program, Serbian Government and Donors funds for SMEs development, and microfinance, to be invested.
- In the context of an enabling legal framework for micro-lending, the **estimated cumulated inflow of microfinance funds from MFIs, SME banks and EU/GoS financial instruments into the Serbian economy over the following four years, after the legal framework is enacted, is estimated to stand at EUR 869mn**.
- The main impact of development of the Serbian MF sector will be **creation of 230,000 full-time and self-employed jobs over the following four years;** the estimated amount of savings in social transfers may reach an average **of EUR 37mn/year**
- A sustainable Serbian MF sector with the infrastructure to reach underserved entrepreneurs, and provide know-how, and appropriate financial and BDSS offerings may be considered a suitable partner for **EU/GoS** financial instruments to channel the funds for MSME innovation and competitiveness, as Serbia qualifies for the EU programing period 2014 to 2020.
- The development of a sustainable MF sector will lower the cost of micro-credit and improve MSMEs' access to finance, and will contribute to sustainable growth of the MSME sector and development of entrepreneurship.

- MSME access to finance and BDS (MF penetration rate) are projected to reach levels seen in Romania, Serbia's neighbour and EU member state, where the enabling legal framework allowed the MF sector to grow from a portfolio of EUR 40mn (2005) to EUR 100mn (in 2013).