Legal and Regulatory Environment for Microfinance in Bosnia and Herzegovina

A Decade of Evolution and Prognosis for the Future

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Introduction

THE EXPERIENCE WITH microfinance in Bosnia and Herzegovina[1] and particularly the evolution of the legal and regulatory environment for microfinance over the past decade do not separate easily from the wartime and postwar history of the country and the unique political and governmental structures that emerged out of the ashes of the conflict that preceded. This essay outlines: the historical background necessary to understand the legal and regulatory environment for microfinance as it has developed in postwar Bosnia; the early years of microcredit (1996 – 1999) and the adoption of the microcredit organizations laws put in place to cope with the institutions that developed in the immediate postwar period (2000 – 2001); developments in the broader Bosnian financial system that affected the position of the microcredit organizations (and changes in the legal and regulatory picture that accompanied these developments) (2002 – 2003); and the maturing of the microcredit sector, the emergence of the Central Bank as a likely dominant force in the future development of the Bosnian financial system and the implications of these facts for microcredit organizations, as well as the prognosis for future microfinance-related legal and regulatory reform (2004 and into the future).

1. "Bosnia and Herzegovina" is the legal name of the country that emerged from the break-up of Yugoslavia on the territory of the former Yugoslav Socialist Republic of Bosnia and Herzegovina following the implementation of the Dayton Peace Accord at the beginning of 1996. In this essay, the country is referred to simply as "Bosnia."

Postwar Historical Background

MICROFINANCE SURFACED as a topic of wide interest in Bosnia immediately after the end of the war surrounding the breakup of Yugoslavia. The reasons were clear: in the face of massive unemployment and no functioning social welfare system, self-employment and microenterprise were seen as important means for people to earn a living and start rebuilding their lives. The early focus, therefore, was on microenterprise credit.

On January 1, 1996, the Dayton Peace Accord[2] put into effect a complicated confederation between two so-called "Entities" – Republika Srpska ("RS") in the north and east of the country, and the Federation of Bosnia and Herzegovina (the "Federation") in the south and west (which is in turn made up of numerous ostensibly self-governing Cantons) – all under a weak central government.[3] Under the Constitution, the Entity-level governments exercise all basic economic powers and have jurisdiction over substantially all matters of commercial and economic law. The most significant institution assigned under the Constitution to the weak central government (referred to as the "state level" of government) is the Central Bank (although even this institution initially had relatively little unifying effect on the situation of retail financial institutions, as in the first years of its existence it functioned exclusively as a currency board, with bank regulatory functions remaining at the Entity level).

2. The Peace Accord encompasses the postwar Bosnian Constitution and sets forth other aspects of the governmental structure of the new country.

3. The tiny District of Brcko, which has a special status, is not discussed in this essay.

To this already complicated picture, another institution – unique to Bosnia – must be added. While military aspects of the Peace Accord were left in the hands of a multinational stabilization force, civilian aspects of the peace were entrusted to a rather vaguely defined international body set up for this purpose known as the "Office of the High Representative" ("OHR"). Among OHR's more important responsibilities is to monitor the many legislative and political bodies called for under the Constitution to make sure they honor the spirit of the Constitution and the Peace Accord in general. Over time, OHR has used its powers increasingly to impose legislation on legislative bodies that acted in ways deemed contrary to the letter and spirit of the Constitution and Peace Accord, and particularly in situations where one or the other Entity-level government took steps (or failed to take steps) resulting in a lack of harmony between the economic and commercial law applicable in the two parts of the country. Creating a workably unified "single economic space" – at various times resisted, particularly by the many nationalist politicians who remain a feature of the Bosnian political landscape – became a primary focus of OHR's interventions.

The Early Years of Microcredit (1996 – 1999)

THE TWO BOSNIAN ENTITIES emerged from the war with a confusing morass of basic legislation, including laws "received" from the former Yugoslav Socialist Republic of Bosnia and Herzegovina, wartime enactments (some of dubious legal effect following the adoption of the Peace Accord) and quickly crafted postwar measures intended to move the country in the direction of a market economy. The field of NGO law, not well-developed in socialist times, presented a particularly confusing picture.

This presented a particular dilemma for would-be sponsors of microcredit in Bosnia, who wanted to use an NGO legal form to serve as the lending entity. (This was not just because NGOs had pioneered microcredit in other countries, but because wartime NGOs had sprung up in Bosnia and proven their capacity to reach the targeted populations, whereas mainstream financial institutions were largely insolvent and widely mistrusted.) When the World Bank tried to agree with the Entity-level governments about the specific legal underpinnings of the nonprofit organizations that the Bank wished to propose as implementing organizations for a proposed large-scale project to introduce and fund the development of microcredit in the country (the "Local Initiatives Project"), the parties faced a large number of possible legal forms, none of which seemed sufficiently unambiguously and appropriately defined to carry out microlending as a primary purpose.

The suddenly burgeoning number of new microcredit operations being set up eventually hit upon several imperfect legal forms deemed the "least worst" vehicles for NGO microcredit: in RS,

registered offices of foreign NGOs and citizens' associations; in the Federation registered offices of foreign NGOs, citizens' associations and humanitarian organizations (although some argued over whether humanitarian organizations were truly a separate legal form or perhaps simply a specialized form of citizens' association under relevant Federation law). These were also the legal forms chosen by most of the organizations receiving funding from the two newly formed apex institutions (one in each Entity)[4] charged with implementing the Local Initiatives Project. Gradually the Entity-level governments grew acquiescent with their use as vehicles for carrying out lending activities.

4. In both Entities, the apex functions were given to specialized departments of newly formed foundations controlled by the Entity-level government, each housing a number of unrelated World Bank-funded projects. In practical terms, however, the two Local Initiatives Departments have functioned with considerable autonomy from the Entity-level governments.

The banking sector in both Entities had emerged from the war with a large number of insolvent institutions with large volumes of uncollectible loans to collapsed or ailing state-owned industries and had long since stopped most normal retail lending activity with ordinary citizens and small businesses. The focus of the newly created Banking Agencies in the two Entities was appropriately focused on cleaning up the banks and closing down the insolvent ones, while building the capacity and independence of supervisors chosen for the task. They had no time for (and no interest in) monitoring the behavior of the new microlenders (whose failure, at the worst, would only waste foreign donor resources). Also, the Banking Agencies developed an early healthy respect for nonprudential monitoring being carried out by the Local Initiatives Project apexes (even though the monitoring did not extend to microlenders not participating in the Local Initiatives Project).

A credit-starved populace provided the conditions for rapid development of microcredit. Extreme mistrust of conventional financial institutions (responsible for the loss of most families' prewar savings) meant a commensurately low savings rate and little liquidity in the banking sector. During this period, the payment system remained under the control of a government-run sole provider, a separate one in each Entity, that grew directly out of the earlier similar Yugoslav state-run payment services monopoly, although commercial banks provided the main interface with the state-run system for ordinary citizens.

Besides the independent donor-funded NGO microlenders and those funded by the Local Initiatives Project, one other institution commenced operations during this period that also made smaller loans to micro- and small enterprises: the Micro-Enterprise Bank ("MEB") – the first of the network of greenfield microfinance banks created by Internationale Project Consult GmbH with funding from the European Bank for Reconstruction and Development and International Finance Corporation that would grow to cover more than a dozen countries in the region.[5] MEB was formed under the Federation banking law and licensed by the newly created Federation Banking Agency.

5. MEB and its sister institutions in neighboring countries now operate under the name "ProCredit Bank."

The Microcredit Organizations Law (2000 – 2001)

Recommendations of the Local Initiatives Project

The begrudging acquiescence of Entity-level policymakers to the use of a hodgepodge of different kinds of NGOs as vehicles for microlending was not an adequate legal basis on which to build a strong start for microfinance in Bosnia. The legal reform component of the Local Initiatives Project (which sought to create the preconditions for a strong microfinance sector at a national level) recommended the development of four new legal forms:

- a form of nonprofit, NGO microcredit organization;
- a form of commercial finance company capable of serving as a vehicle for specialized commercial microlending, but not restricted to this activity;
- a form of member-owned and governed savings and credit association (a feature of the former Yugoslav financial system, although somewhat discredited in the eyes of some who had lost their savings to failed employer-linked savings and credit associations from before the war); and
- possibly a specialized form of microfinance bank (if banking legislation and regulation developed in such a way as to prevent the use of conventional commercial banks for a full range of microfinance services).

Drafting of the microcredit organizations laws

The legal and regulatory aspirations of the Local Initiatives Project proved grandiose in light of the political realities of early postwar Bosnia. The new draft banking law for the Federation (on which, it was hoped, a new law for the RS would be closely patterned) initially included a provision that would have permitted the four proposed legal forms to be defined under the banking law as nonbank financial institutions (NBFIs) described in normative acts adopted by the Banking Agency. However, the provision permitting such regulatory exceptions for NBFIs was dropped from the version of the law finally adopted. Instead, consultants to the USAID-financed Banking Supervision Project drafted proposed legislative text and amendments to the new banking law aimed at describing the four planned legal forms on Local Initiatives Project's behalf.

As the project progressed, however, it became clear that only a more limited legislative agenda would have any hope of adoption by both Entity-level parliaments. A choice was therefore made to focus only on legislation to clarify the legality of NGO microcredit of the type already widely in practice throughout the country. Because of the chaotic and ambiguous state of NGO law in the two Entities (and the lack of harmony between the legal

forms in question), the draft law called for the introduction of a wholly new form of ownerless nonprofit legal entity set up solely for the purpose of microlending: the microcredit organization ("MCO").

A Federation Ministry of Finance lawyer, who also advised the Local Initiatives Project, together with Local Initiatives Project staff and advisors substantially revised the draft MCO law before it was introduced in the Federation parliament. The goal was a law that could be adopted in substantially identical form in the two Entities, with provisions for reciprocity between the two Entities so that MCOs registered in one Entity could also open offices and operate freely in the other Entity. The goal was also a simple system of registration and minimal ongoing nonprudential regulation of MCOs (which, although they were to be permitted to borrow commercially for onlending, were not to be permitted to mobilize retail deposits). The Ministry of Finance was identified as the most suitable Entity-level regulatory body for the light regulatory responsibilities envisioned.

The MCO laws as adopted

The MCO law passed the Federation parliament in 2000 and the RS parliament in 2001. Unfortunately, during parliamentary debate in the Federation, parliamentarians replaced the Ministry of Finance with the Ministry of Social Affairs as the regulatory body responsible for MCOs – a ministry entirely without any relevant competence or personnel knowledgeable about finance. Also, Ministry of Finance personnel in the RS insisted on certain other features not included in the version that had been adopted in the Federation. In particular, the version adopted in the RS reserved for the Ministry of Finance unspecified supervisory jurisdiction over MCOs operating in that Entity, as well as the power to adopt regulations further defining such important concepts as loan size maximums.

Despite these differences, the two MCO laws jointly accomplished something pioneering for the country at the time: a system of reciprocity that made it possible for a legal entity formed in one Entity to be registered also to carry out business in the other Entity. (This milestone was only finally reached for banks with the imposition of a new banking law in RS by OHR, when the RS parliament refused to adopt a law granting clear reciprocity to Federation-licensed banks.)

Shortcomings with the MCO laws

Although the reciprocity provisions of the MCO laws made possible the development of a truly national microcredit sector (an important symbolic occurrence in the overall development of Bosnia as a workable "single economic space"), the lack of harmony between the two regulatory regimes caused problems for nationally active MCOs in practice. In the Federation, the Ministry of Social Affairs failed to exercise any form of regulation over the fast-developing sector (permitting, for example, numerous phantom MCOs that had fulfilled the minimal

prerequisites for registration to remain on the registration books, even though they never became operational). The sector in the Federation therefore depended exclusively on monitoring and reporting by the Local Initiatives Project as the only source of publicly available benchmarking data (and these data were inadequate, as they did not include several sizeable Federation-registered MCOs that did not participate in Local Initiatives Project funding and therefore did not report to the Federation apex). In the RS, the Ministry of Finance involved itself more in the monitoring of MCOs than the MCOs felt appropriate – including in some cases on-site inspections that were not contemplated at the time of the MCO law's passage in RS. Meanwhile, the Ministry of Finance itself complained that its supervisory responsibilities were too vaguely defined (indeed they were not defined at all), that the Ministry lacked the personnel to carry out any meaningful form of supervision, and that the law failed to give them appropriate enforcement powers with respect to problems they did find (such as the phantom MCOs that also existed on the registration rolls in RS).

Developments in the Broader Financial System (2002 – 2003)

Development of strong Banking Agencies and cleanup of banking sector; privatization of the payment system

The two Banking Agencies developed as strong and independent bodies, with increasingly capable and professional supervisory staff. This development was instrumental in the cleanup of the Bosnian banking sector. It also helped the banks to have entrusted to them the main retail role in the privatization of the payment system, which took place with dismantling of the former government-controlled sole-source payment services provider in each Entity.

Entry of foreign banks and rapid increase in savings mobilization and liquidity

Along with the strengthening of the banking sector came the first significant wave of new foreign banks receiving licenses to operate in Bosnia. Although formed as domestic Bosnian joint stock companies (in one Entity or the other), as required by the Entity-level banking laws, strong foreign financial services 'brands' such as Raiffeisen and Hypo-Alpe-Adria seemed to inspire greater confidence among potential savers than the old Bosnia names that many people still associated with the loss of their savings during the war years. This new confidence led to a sharp upsurge in liquidity in the banking sector as a whole.

Emergence of a credit information services industry

Another development of significance during this period was the launching of a private credit bureau, LRC. Patterned on the U.S. model, where an extremely broad range of data is collected (including not just defaults in payments on bank loans but also positive data such as on-time utility payment and mobile

telephone bills), the credit reports offered by LRC have a significant likelihood of being useful to MCOs and their potential clients alike. Although growth in participation by MCOs was slow at first, the system nonetheless offered a potentially workable mechanism to combat serious cross-borrowing and over-indebtedness problems as competition in the microcredit sector became more acute.

Effects of these developments on microfinance

Some strong banks, led by Raiffeisen, began lending to MCOs for onlending[6] – something permitted under the MCO law in both Entities – rather than compete with MCOs for the retail small loan market. (Despite this new source of lending capital, many MCOs also had access to as good or better deals from foreign social investment sources, an illustration of how donor funding can crowd out commercial capital.) Other banks looked with interest at the successful track records of the MCOs with small retail lending and began to use their newfound liquidity to offer competing products. As the retail market became more competitive, MCOs began increasingly to see their bank partners (upon whom they depend for access to the privatized payment system) as competitors, and began to resent the absence of any meaningful protection against client poaching by their own banks. (Some would of course argue that this competition is a sign of the success of the microcredit sector, although others might counter that banks' use of their MCO customers' confidential information gives them an unfair competitive advantage.)

6. Many MCOs, including all of the participants in the Local Initiatives Project, had received sizable equity grants from their sponsors, putting them in a strong balance sheet position as potential borrowers.

However, still no Bosnian bank was successfully focusing on savings services for the poor, although a USAID-sponsored study projected strong demand. Legally prohibited from savings mobilization, some MCOs began to see this restriction – along with lack of legal capacity to participate directly in the payment system – as a significant disadvantage to their legal status.

Maturing of the Market and Consolidation of Financial System Legislation and Regulation at the State Level – Prognosis for the Future (2004 into the Future)

Transformation of MCOs?

By 2004, the last full calendar year of the second Local Initiatives Project, most in the Bosnian microcredit sector agreed on the need for there to be a legally feasible means "transforming" the existing nonprofit MCOs into a commercial legal form.[7] However, given the MCOs' growing success in attracting wholesale debt financing to increase their lending (and their strong balance sheet position to do so given the large equity grants most had received), the reasons for wanting a

7. The term "transformation" is used here to refer to a transfer of an MCO's loan portfolio to a commercial legal entity in exchange for shares or other consideration.

"transformation" option were not as pressing as in some countries, where dwindling access to funding or doubts about the legal basis for wholesale borrowing for unlicensed onlending have made the need for such "transformations" truly urgent. Moreover, some Bosnian MCOs questioned vocally the "conventional wisdom" that they would need to take on a commercial legal form to survive and prosper long-term. A strong consensus emerged that the MCO laws should be amended to permit MCOs to form commercial microlending affiliates, but that they should also be given the training to make intelligent choices about whether to undertake such a change.

Savings and credit associations: an old idea reborn?

Besides the demand for a commercial microlending vehicle (one of the legal forms originally proposed under the legal reform component of the first Local Initiatives Project), an IFAD project launched in 2003 focused on rural finance and raised again the idea of a legal vehicle for savings and credit associations (another of the legal forms originally contemplated during the first Local Initiatives Project, and a legal form well-known – if not necessarily widely respected – from the Yugoslav period). However, the IFAD project also apparently underestimated the technical and political challenges of drafting and passing the requisite enabling legislation. Moreover, the response from MCOs (which the IFAD project had contemplated as implementing partners) and the Banking Agencies (who worried about the proliferation of small, difficult-to-supervise depository institutions in the newly cleaned-up financial system) has been skeptical.

Move towards unified and consolidated financial system regulation and supervision

Perhaps the most far-reaching current trend affecting the legal and regulatory treatment of microfinance in Bosnia, however, is not the possibility of new Entity-level legal forms. Rather, it lies in plans to create unified and consolidated mechanisms for oversight of the entire Bosnian financial system under the auspices of the state-level Central Bank, all with the objective of better realizing the goal of uniting the country into a single, workable economic space. To prepare for this evolution, the Banking Agencies have already taken steps to standardize their procedures and coordinate their supervisory activities (particularly with respect to banks operating in both Entities). Ultimately, the plan is to provide some sort of common umbrella over all regulatory aspects of the financial system, including, in addition to banks, insurance and private pensions, leasing companies and the securities market. Given the provisions of the Bosnian Constitution that vest authority for these matters at the Entity level, it is not yet clear exactly how this state-level consolidation of regulatory and supervisory jurisdiction will be implemented. However, the Entities have the power to cede their constitutional authority to the state level, and it might well be that OHR would see fit to encourage them in this direction, if failure to do so impedes Bosnia's continuing development into a unified economic space. However the change is ultimately

accomplished, it is also anticipated that it will be accompanied by a migration of some (and maybe most) of the current Entity-level commercial law (such as the banking law) up to the state level.

The new draft MCO law(s)

A broad consensus has emerged to replace the Entity-level MCO laws of five years ago with a new law that will address the disharmony and other shortcomings of the current laws and permit the current MCOs to "transform" into a commercial legal form or retain their nonprofit form, should they so choose. Owing to legal uncertainty as to whether commercial laws such as the MCO law will have migrated up to the state level, draft Entity-level legislation has been prepared that can be adapted for adoption at the state level if needed. In any event, the contemplation is that the regulatory body for MCOs should be the state-level Central Bank. (The Entity-level Banking Agencies would be the second choice if state-level unification has not progressed, because the Ministries of Finance in both Entities concede freely that they lack the necessary human resources to implement an appropriate transparency-driven monitoring system for MCOs.) The new draft MCO law addresses perceived need for "transformation" options by permitting a class of commercial MCOs, as well as NGO MCOs (relying on the companies laws and foundations laws, respectively, at the Entity level for the creation of the underlying legal entities, as these basic enabling laws are now in relatively good shape in both Entities). The draft also eliminates the various other differences between two current Entity-level MCO laws. Importantly, it is anticipated that any commercial MCO formed as a joint stock company could be licensed as a commercial bank if it can meet the required level of initial minimum capital and other prudential prerequisites for bank licensure. This will permit a smooth legal and regulatory evolution for MCOs from their current nonprofit status ultimately into deposit-taking institutions with power also to offer payment services.

Prognosis for the future

It is likely that some of the larger MCOs will decide to undergo a commercial "transformation," once the legal opportunity to do so is made available. If USAID's consultants are right about unmet demand for savings services among poor Bosnians, eventually one or more will probably also seek to team up with or become a commercial bank. While it is still far from certain whether the IFAD project will succeed in gaining passage of a law on savings and credit associations, it seems likely that all of the other legal options originally envisioned in 1998 for carrying out microfinance in Bosnia will eventually be put in place.