

Microcrediting in Bosnia and Herzegovina: What went wrong?

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Introduction

After the end of the war until present, micro-credit sector, together with banking sector, in international and domestic public, was often perceived as an example of positive business development experience in the financial sector. It wasn't rare case that micro-credit organizations (MCOs) from Bosnia and Herzegovina win the world awards, and a prominent business magazine Forbes among one hundred of the most successful microfinance institutions around the world in 2007. included five organizations¹ from Bosnia and Herzegovina. However, until recently local media started to put micro-credit organizations in a negative context. Therefore, the logical question poses itself: What led to a complete shift in public perception regarding the operations and activities of credit organizations?

To answer this question, it is best to start from the very beginning of microcredit activities in Bosnia and Herzegovina.

Beginning of microcrediting

Beginning of microcrediting in Bosnia and Herzegovina is linked to the Local Initiatives Project (LIP), established in 1996 as a part of the assistance of the World Bank provided for the postwar recovery and economic reconstruction of Bosnia and Herzegovina. The main development goals of the LIP project were²:

- (1) Provide access to credit for the microentrepreneurs who were affected by the consequences of the war and had no access to credit from commercial banking sector, and
- (2) Assistance in the development of independent, financially viable microfinance institutions that will provide loans to entrepreneurs with low incomes on permanent basis.

Since 1996 microcredit sector has recorded steady growth. The most microcredit organizations was supported by a large number of international organizations which have significantly influenced the fact that the most MCO in a short time period become self-sustaining and very profitable. Number of active clients and loan portfolio consistently grew at annual rates that often exceeded 40 percent, while at the same time the quality of loan portfolio was exceptional with portfolio at risk over 30 days less than 1

¹ FORBES-On the list of top 50 MFIs are: 14EKI 18 PARTNER, 24 MIKROFIN, 32 MI-BOSPO and 39 SUNRISE. From http://www.forbes.com/2007/12/20/microfinance-philanthropy-credit-biz-cz_ms_1220microfinance_table.html

² E. Dunn and J. Tvrčković, clients of microcredit organizations in Bosnia and Herzegovina, Report on the initial research - Component Impact Assessment, the Local Initiatives Project LIP II, April 2003.

percent. All this was aided with abundant financial resources, mainly by international lenders, who incited the growth and development of the microcredit sector.

Fall of micro-credit activities

After the end of 2008 when the loan portfolio reached level of one billion, and the number of active loans rose to 400,000 there was „incredible upheaval“. Until then praised and highly profitable sector began to deal with the first „real problems“ from their inception. Portfolio quality began to decline rapidly, more and more customers began to deal with problems in repayment of their loans. Comparing to 2008, in 2009 loan portfolio declined by 22 percent or for 200 million BAM³, and the number of active clients has declined by 14 percent, or for 55,000. At the same time costs of provisions for credit losses⁴ have increased by 255 percent or from 32 million to over 112 million convertible marks⁵, soaring operating costs of the business to, until then, „unimagined heights“.

What went wrong?

In the beginning, the reasons for this state were attributed to current financial crisis which affecting the whole world, but is it really that way?

No one could seriously argue that the global financial crisis had no impact on clients of microcredit organizations, and therefore on the micro-credit organizations, when we are daily "bombed" by information from the Bosnian media about the growing number of laid off workers and firms (in all sectors) that "sob" in insolvent economy. However, the actual cause of the problem of micro-credit organizations is looking much deeper⁶:

- First of all, in recent years some banks entered into the market of micro-credit organizations additionally sharpening already sharp competition in the sector. Loans of different banks and MCOs have become "more accessible" almost to everyone who has applied for credit. Information about the clients available to MCOs and banks were inadequate until the mid 2008, although the Central Credit Registry (CRK) at the Central Bank was established a year earlier. Banks were the first who have given their client databases to Central Registry but significant number of MCOs has not delivered this information. Therefore, users of CRK database did not have a complete picture of the indebtedness of their clients, and due to lack of adequate information they continue with credit activities without the real insight into the borrowing of their customers. As a result, customers were able to choose in which MCO to take the loan or use a few loans in two or more MCOs and banks simultaneously. In addition, they could be late with payments in one

³ Bosnian Konvertible Mark – it is pledged to EURO in ratio 1 EURO=1.95 BAM.

⁴ Provision for loan losses include the costs of reserve for late loans and costs of write-off loans.

⁵ AMFI Indicators as of 31.12.2008 and 31.12.2009.

⁶ Mujković Alem, the impact of microfinance institutions and credit-guarantee funds to micro and small enterprises in BiH, 2010.

MCO, while in the second they could raise the new loan (of course due to an incomplete picture about their credit history).

- However, it is not true that MCOs did not know "absolutely nothing" about the borrowing of its clients. Competition between micro-credit organizations and banks led to the erosion of standards in borrowing thanks to the lenders fight for market share. MCOs didn't take enough account of the creditworthiness of their clients and their ability to repay the loan, but the decision on approving loan was based mainly on previous credit history of the particular client in a given MCO⁷, not taking sufficient account about whether the loan is used for investment in business activities or to coverage obligation on loans to banks or other MCO.

- Finally, clients of MCOs mainly belong to the poor social classes, usually not knowledgeable enough for rational management with loan funds. These customers are usually without previous experience in the use of loans (before the loan in MCO) and usually are not aware of the obligation which comes with the loan. Typical customer of MCOs runs a very small business or even working in a company in which has a small and irregular incomes. Therefore, the MCO clients are much more sensitive to market disruptions, than customers of other financial institutions.

All this resulted that "significant" number of clients overestimate their possibilities for loan repayment (due to use of more than one loan at once), and these same customers „fall into the trap of indebtedness“. And not only that. In the same trap they indent guarantors of these loans.

All this leads to the conclusion that the number of 400,000 MCO's clients in the country that has less than 4 million residents was not objective, and that the actual number of beneficiaries of microcredit is much smaller.

According to research conducted by MFC⁸ in Bosnia durring September 2008 on a sample of one hundred MCO clients, at least every fourth borrower has problems with repayment, and there is indication that this number will grow.⁹ Second round of research, which was also conducted by MFC during 2009¹⁰, confirmed the results of the first round of research. Judging by this research, at least 25 percent of the total number of MCO clients using two or more loans at the same time in different MCO. This tells us that the real number of active clients of MCOs is overestimated by at least 25 percent. This assumption "holds water" only in the most optimistic case - that is, if we assume that each of these (overindebted) clients use only two loans. However, the actual number of loans used at the same time is usually much higher. Results of second research showed that customers who have problems with repayment using five, six or ten loans at the same time. These same microcredit users (in most cases) are

⁷ Access of Low Income Housholds to Financial Services in Bosnia and Herzegovina, Study Findings, Microfinance Center, 2008.

⁸ Microfinance Center for South East Europe and New Independent States.

⁹ Access of Low Income Housholds to Financial Services in Bosnia and Herzegovina, Study Findings, Microfinance Center, 2008.

¹⁰ The second round of research included analysis of the credit history of 887 clients in the Central Register of Credits, and conducted interviews with 239 clients.

also guarantors for other loans in the same or other MCO or bank. From the total number of interviewed clients 11 percent of them are also guarantors on loans that are not paying off regularly.¹¹

As a result of this is „a growing bubble of debt“ of microcredit clients, either by their own or others loans. Therefore it is clear that the „bubble“ that grew all these years, finally had to burst, as happened in 2009.

Then where is the problem?

Based on this with we can ask the question whether the microcredit organizations in Bosnia and Herzegovina make more damage than benefits to their clients?

It seems that the problem is in the mission of MCOs. As we previously stated, the main goal (and it is mentioned in the mission of all MCO in Bosnia and Herzegovina) of micro-credit organizations is to enable access to credit for small entrepreneurs who were affected by the consequences of the war, and who had no access to credit from commercial banks. However, as things look today, all or at least most of the MCOs has not kept their own mission, and profit goals overcome the social ones.

From experience we know that the microfinance all over the world (not just in Bosnia and Herzegovina) is associated with high interest rates - sometimes more than 30 percent annually - and a high rate of loan repayment, which opens up possibilities for achieving potentially large profits. Thus, for example, micro-credit sector in 2008 achieved adjusted return on average assets of 3.1 percent, while return on average equity was 16.1 percent.¹²

In striving for higher profitability, and with these associated desire for a bigger market share, it seems that MCOs „turned back“ from their original mission without taking much care who is their target clientele. An increasing number of clients could get consumer loans in addition to loans for business activities. The results of the first round of MFC's research showed that even 49 percent of MCO clients in Bosnia invested loans in consumption.

The erosion of standards in borrowing has resulted with that „almost everyone“ who has applied for a loan could get the loan. It was not rare case that people without any source of income, to whom the social support is much more appropriate, could raise a loan (with high interest rates from 25 to 35 percent annually) without any serious assessment about their ability for repayment of the loan. Therefore, MCOs expose themselves knowingly to the „significant“ credit risk. What is even worse, the MCOs, consciously or perhaps unconsciously, indent these people in so-called „debt bondage“. As Margerite Robinson notice in her book *the Microfinance Revolution: Sustainable Finance for the Poor* from 2001, „it is often forgotten that another word for the loan is a debt. When loans are given to

¹¹ Study of Overindebtedness of Microcredit Clients in Bosnia and Herzegovina, Microfinance Center, 2008, December 8, 2009.

¹² AMFI indicators as of 31.12.2008.

extremely poor, these borrowers are unable to use them effectively due to lack of opportunity for profitable selfemployment. Therefore, indenting in to a debt those who are too poor to effectively use the loan does not help either borrowers or lenders. The poorest of the poor should not be the responsibility of the financial sector but ministries of health, labor, social policy, donor agencies and private charitable organizations.¹³

According to Robinson, the loan is a powerful tool when it is available to economically active poor (loan capable), which at least partly participate in the economy. While other tools are necessary for the very poor who have more needs for food, shelter, medicines and employment.

This is the main problem of MCOs. If clients are not able to achieve high returns on invested funds, which will cover the cost of interest on microcredit with 20 percent or more, then they will be in situation which is even worse then before the loan.

Then what can be expected from customers who use the loans for non-business purposes? After each loan they will be more in-debt, and it might be expect that at some point they take a new loan only to repay matured annuities of the existing loans, which ultimately leads to the fact that the loan becomes „purpose to itself“. In other words, client raise a new loan, not to put it in business acitivity or consumption, but to pay installments of the current loans, and thus in the following months, had to take even higher amount of the loan to pay annuities, not only for loans raised earlier, but also the loan that was raised last time, so going in a vicious circle of „debt bondage“. And not only that MCO clients use loans for the repayment of other loans, but these loans in the last years have longer and longer repayment period. Long repayment period from 3 or 5 years, combined with high interest rate, is often brought up to that the amount paid for interest is more then a half of the amount of the loan or nearly equal to the amount of the loan. So with every new loan debt of the client was nearly doubled.

All of this was hidden behind the previously „praised“ results of the microcredit sector. All these years, MCOs have tried to snatch an increasing share of Bosnian market, without taking much care to whom they disburse the loans, and in what purpose the loan will be invested. Due to specific nature of operations and rapid growth MCOs have failed to develop institutional capacities to be able to assess and effectively monitor loan disbursement.

Because of that deterioration of business results during the 2009 is not surprise. Almost all MCOs had negative results for the first time since inception, and last year's positive net result in the total amount of 50 million, was replaced with this year's loss of 37 million KM.

¹³ Robinson, Marguerite S. The Microfinance Revolution: Sustainable Finance for the Poor, Washington: The World Bank and New York: Open Society Institute, 2001.

To be even worse, so far built a positive image of MCOs, as institutions that support entrepreneurs without access to commercial loans, began to collapse. Now MCOs are increasingly perceived as „exploiters who are charging exorbitant interest rates on loans to poor population“¹⁴.

Certainly some of the blame for situation in the sector bearing an international lenders attracted by high profitability of the Bosnian microcredit sector. All this time they offered the loans to MCOs „as on a platter“. After they "collected a cream" in the form of high profits during these years, now, when everything has gone wrong, suddenly they want to withdraw from Bosnia and Herzegovina.

Is everything so bad?

Although the current situation does not look bright for the microcredit sector in B&H, MCOs had same positive influence. MCO had significant impact on overcoming the problems of lack of adequate collateral, and thus they provide the opportunity to micro and small enterprises to build a credit history that would facilitate their subsequent borrowing.¹⁵ When no one wanted to lend the money to small entrepreneurs because of (with them related) high risk perception, MCOs have proved that it is possible. Not only that, there are plenty examples of positive impact of MCOs on business in terms of increasing the volume of business activities, profitability and business formalization.¹⁶

In a recently published article Richard Rosenberg¹⁷ referred to the perennial diaries of the poor from India, Bangladesh and South Africa, whose results were published in book *Portfolios of the Poor: How the World's Poor Live on \$ 2 a Day* (Collins, Morduch, Rutherford, and Ruthven 2009), which partly confirms the positive experiences in Bosnia. The poor believe that microfinance and microcredit affect positively on their lives in terms of smoothing of cash flows in their household because, for them „is more valuable to have an access to credit at time they need to be able to cope with potential shocks, than it is a price they pay for its use“¹⁸.

As pointed out by Richard Rosenberg, The truth is that „people do not always borrow wisely. It is also true that there will always be a certain number of people who will inevitably over-indebt themselves and what will as a result lead them to even worse situation than before the loan. However, until the number of these clients is relatively small, it is better to live with over-indebttness then deny the loans to the great majority who are helped by the borrowing.“¹⁹

¹⁴ Mujković Alem, The Impact of Microfinance Institutions and Credit-guarantee Schemes on Micro and Small Enterprises in Bosnia and Herzegovina, 2010.

¹⁵ Ibid., Study was conducted on a sample of 53 MCO clients in 29 municipalities of the Sarajevo municipality Macroregion.

¹⁶ For more information see: Mujković Alem, The Impact of Microfinance Institutions and Credit-guarantee Schemes on Micro and Small Enterprises in Bosnia and Herzegovina, 2010. and Dunn, Elizabeth. Impact of Microcredit on Clients in Bosnia and Herzegovina: Final Report, Sarajevo: Local Initiatives Project LIP II, May 2005.

¹⁷ For more information see: Rosenberg, Richard.2010th "Does Microcredit Really Help Poor People?" Focus Note 59th Washington, DC: CGAP.

¹⁸ Rosenberg, Richard.2010th "Does Microcredit Really Help Poor People?" Focus Note 59th Washington, DC: CGAP.

¹⁹ Ibid.

Is there a need for microcredit in Bosnia?

Rosenberg's considerations impose the following questions: How many clients in Bosnia and Herzegovina really benefited from microcredit? What is the number of those who will be in situation to over-indebt themselves in future period? And whether the microcredit sector in Bosnia and Herzegovina can be compared with the microfinance sector in other, even poorer countries?

On the first two questions, at this point, probably no one can give an adequate answer. It remains to be seen how the situation will be unfold in the next months or even years. It is certain that economic situation in the country is not great neither for MCOs, neither for their clients. But if the number of clients who have problems with repayment remain at level of 25 percent or more (as indicated by the MFC's research from 2008), we should certainly ask (as soon as possible) whether the other 75 percent of clients benefited from use of microcredit. If this is not the case then microcrediting in any case is not justified.

As regards to third question, poor people in Bosnia and Herzegovina until recently had much better access to credit than it is the case with poor in other underdeveloped countries. Therefore, the previously mentioned argument that customers appreciate in the first place access to the loan, and that the costs are in the second place „does not hold“ in the case of Bosnia and Herzegovina. It seems that facilitated access to credit has done more harm than good to MCO clients. Certain number of clients lost control over their loans and they began to live beyond their capabilities, and spending was funded by additional borrowing. This is best described by words of client from Visegrad. On question why she put herself and her family in situation of overindebteness by raising more credits than she could repay, she replied: „What can I do, I could simply get the loan at any time, whenever I needed in any MCO.“ This is situation when client wants to fulfil her obligations, but she was not able to do that. However, not all MCO clients have intention to repay their loans like this client. Certain number of clients, on the other hand, due to facilitated access to credit, lost his/her motivation and discipline for regular repayment (although they were able to do so) because they could raise a loan in another MCO. These clients have tried to „take advantage of the opportunity“, and they relied on that they will always be able to get a new loan in another MCO, if they are rejected in the first, due to delays in payments.

As a result of problems in repayment, MCO and banks has tightened their credit policies, and thanks to better insight into the credit history of clients throughout the Central Registry of Credit with the Central Bank, increasing number of customers who were previously delayed with repayments in the MCOs or banks, has denied to further access to credit. Situation is more or less the same in case of clients who use more then one or two loans at the same time. They are rejected to further access to loan because of justified fear of MCOs and banks that these clients have high probability for default and that these clients could get very soon into the problems with repayment. Therefore, instead the clients have facilitated access to loan (due to large number of financial institutions), it happened just the opposite.

It is clear that there is a need for loans with classes of society with low income, otherwise there wouldn't be a large number of loans so far, but remains a "dilemma" of whether or not the microcredit organizations are convenient way of providing credit services.

What next?

During 2010 declining trend in lending activities of MCOs in Bosnia and Herzegovina will probably continue as a result of "cleaning" loan portfolios from overindebted customers.

Once the actual situation is determined, the MCO will have to, if they want to survive, return to its original mission, and that is support to small entrepreneurs who do not have access to loans from commercial banks. But this time support must be „true and real“, without providing consumer loans, and with proper monitoring of expenditure of funds. Only in this case there will be hope that borrowers will be able to achieve high returns that will be sufficient to cover high cost of the loan. Only then the MCOs will be able to bring the real benefit to users of microcredit and the economy as a whole. To be effective microcredit must serve as a tool that will enable micro and small entrepreneurs to start their businesses, but with a tendency that these clients with time evolve into a banking clients, where the cost of sources of funds are much smaller, thereby increasing their potential for growth and development. Microcredit can be cost effective for entrepreneurs if it's given on short term, to overcome certain situations when there is a greater need for liquidity. However, with high interest rates, microcredit on long-term simply is not profitable. In case that the MCO does not return to their original mission and continue to operate as they do until now, we can reasonably question justification of their existence in Bosnia and Herzegovina.

Learning from experience

Micro-credit organizations and their clients have learnt some valuable lessons from this unpleasant experience. MCO are now much more careful in selection of clients, and credit activities in 2009 are reduced by 40 percent (from the amount of one billion and 60 million in 2008 to 641 million of loan disbursed in 2009.). On the other hand, people are much more aware of potential risks that are present on the credit market, and much more cautious in decision whether to raise a loan or not, and whether to be guarantors or not on other people's loans.

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