LEGAL FRAMEWORK FOR NON-BANK FINANCIAL INSTITUTIONS IN SERBIA

Review of Outstanding Issues as Discussed on Meetings with National Bank of Serbia's Working Group Tasked with Developing Improvements to the Statutory Framework Governing Financial Services, 2 – 3 June, 2016

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I. INTRODUCTION

This report has been prepared by Maria Doiciu, Consultant for the USAID Business Enabling Project, pursuant to a request made by the Working Group tasked with developing the legal framework for non-deposit taking financial institutions (NDTFIs) / non-bank financial institutions (NBFIs) set up by the National Bank of Serbia (WG-NBS).
The purpose of this report is to provide additional information related to the legal framework for NBFIs for use by policymakers of the WG-NBS so as to inform their decisions on the institutional structure and overall framework for regulation of the non-bank sector in Serbia.

The main elements of the analysis are:

- **A pros vs. cons assessment to aid in making the decision of whether to draft a new law to govern NBFIs or introduce amendments to existing banking regulations to allow NBFIs to lend/provide financial services directly to clients (i.e. the Bulgarian vs. the Romanian model).**
- **A pros vs. cons assessment to aid in making the decision of whether to develop separate legislation for NBFIs that extend only one financial service (leasing, micro-credit, factoring, or consumer credit) as opposed to umbrella legislation covering all types of financial services that may be delivered simultaneously by NBFIs licensed and supervised by the NBS.**
- **Information on specific/separate provisions in the umbrella NBFI legislation on minimum capital requirements for registration/licensing, limitation of geographical reach, interest on consumer credit, credit provisioning, etc. depending on the activity the NBFI engages in, such as factoring, leasing, micro-finance, and consumer credit.**
- **Regulation specific to different categories of NBFIs, e.g. closer regulation of large NBFIs with regard to their risk management structures, reporting requirements, performance indicators, and interest caps for consumer lending.**
- **Portfolio quality of NBFIs vs. that of banks in Romania and Bulgaria.**

The study is organized into two sections: an assessment on the issues listed above, with examples, and more detailed information on microfinance sectors in the countries covered by USAID Business Enabling Project's study *Comparative Analysis of Statutory Frameworks Governing Non-Deposit-Taking Financial Institutions in France, Romania and Bulgaria*, followed by a section that provides conclusions and recommendations.

II. ANALYSIS OF KEY ELEMENTS OF THE REGULATORY FRAMEWORK FOR NON-BANK FINANCIAL INSTITUTIONS IN THE BALKANS AND SOUTH-EASTERN EUROPE

The following summary tables provide an overview of regulation and supervision arrangements applicable to NBFIs and the specific characteristics of the industry, as well as the impact the legal framework has had on the development of the sector.

1. **Pros vs. cons assessment of whether to draft a new law to govern NBFIs or introduce amendments to existing banking regulations to allow NBFIs to lend/provide financial services directly to clients (i.e. the Bulgarian vs. the Romanian model).**
2. **Pros vs. cons assessment of whether to develop separate legislation for NBFIs that extend only one financial service (leasing, micro-credit, factoring, or consumer credit) as opposed to umbrella legislation covering all types of financial services that may be delivered simultaneously by NBFIs licensed and supervised by the NBS.**
3. **Information on specific/separate provisions of umbrella NBFI legislation on minimum capital requirements for registration/licensing, limitation of geographical reach, interest on consumer credit, credit provisioning, etc. depending on the activity the NBFI engages in, such as factoring, leasing, micro-finance, and consumer credit.**
4. **Regulation specific to different types of NBFIs, e.g. closer regulation of large NBFIs with regard to their risk management structures, reporting requirements, performance indicators, and interest caps for consumer lending.**
5. **Portfolio quality of NBFIs vs. that of banks in Romania and Bulgaria**

1. Pros vs. cons assessment of whether to draft a new law to govern NBFIs or introduce amendments to existing banking regulations to allow NBFIs to lend/provide financial services directly to clients (i.e. the Bulgarian vs. the Romanian model)

	Pros	Cons
New law to govern NBFIs	**Single legal framework applicable to the NBFIs sector will allow the sector to develop coherently, and will enable specific regulation and supervision.** More easily understood by potential local/international investors into the sector. More easily amended when the evolution of the NBF sector requires corrections or measures to enable growth. Easier to implement specific regulations related to the NBF sector, e.g. prudential regulations for large NBFIs. Creates an enabling environment for development of the NBF sector and improves access to finance for SMEs and individual clients. *Detailed information on the Romanian legal framework for the NBF sector is provided in the Comparative Assessment section.*	At the beginning, the more time needed to draft, promote, and enact a new legal framework regulating the NBF sector and new financial institutions (NBFIs) as opposed to amending existing banking regulations. The NBS should create a separate licensing and supervisory department for the NBF sector.

	Pros	Cons
Amendments to existing banking regulations to allow NBFIs to lend/provide financial services directly to clients	**Initial amendments could be enacted in an easier and less time consuming process.**	Difficulty in understanding the new amendments will make investors hesitant to invest into NBFIs: less investment in the sector expected until the separate legal framework for the NBF sector is enacted. Based on practice (Bulgaria) continuous amendments[1] to the banking law will be needed due to the ongoing evolution of the non-bank sector. Thus, at the end, this process requires significant time and resources. Less effective supervision and control of the NBF sector due to lower specialization of supervisors tasked with controlling/supervising both banks and NBFIs[2]. *Detailed information on the Bulgarian legal framework for the NBF sector is provided in the Comparative Assessment section.*

[1] The Credit Institutions Law was adopted by the Bulgarian National assembly in July 2006. As of December 2015, this law had been amended 28 times. In 2009 the Bulgarian National Bank issued its Ordinance 26 aimed at clarifying registration, reporting, and oversight of NBFIs.

[2] The Supervision and Control Department of the National Bank of Romania includes a specialized NBFI Control and Inspection Division. The Department for Regulation and Authorization includes a division specialized in the regulation and registration of NBFIs. Staff of these departments is specialized in dealing with the NBFI sector.

2. *Pros vs. cons assessment of whether to develop separate legislation for NBFIs that extend only one financial service (e.g. leasing, micro-credit, factoring, consumer credit, etc.) as opposed to umbrella legislation covering all types of financial services that may be delivered simultaneously by NBFIs licensed and supervised by the NBS*

Separate legislation for NBFIs that extend only one financial service (e.g. leasing law, micro-credit law, factoring law, consumer credit law, mortgage law, etc.)	**Pros**	**Cons**
	Legal framework specific to each type of financial service provider, e.g. minimum capital requirement, provisioning policy, registration requirements, reporting requirements, etc. Note: In Romania, mortgage lenders were included in Law 93/2009 on NBFIs, which led to an increase in and diversification of financial resources available to investors in the housing/construction sector. For mortgage lending, the recommendation is to enact a separate law or to specifically regulate the minimum capital requirement under the umbrella law. This is due to the specifics of mortgage lending, such as long repayment periods, large amounts, FX risk, legal framework on real estate collateral, etc.	Regulations governing only a single type of financial service provider will lead to specialization of NBFIs. In this case, without cross-selling, they will need greater initial capital to achieve sustainability and a wider network of agencies. NBFIs will therefore need more time to achieve financial and operational sustainability as they will be unable to cross-sell different products to the same clients and it will be more expensive to reach specific types of clients. These issues may reduce the number of Serbian-funded NBFIs.
		It will take longer to draft, promote, and enact separate laws due to the nature of the lawmaking process itself. Each of these individual laws would first have to undergo a consultation process with key stakeholders in each area and the appropriate Ministry / Government Agency. Each law governing a particular financial service will have a specific target group that will lobby for its

		individual interests. For instance, road transporters' associations will be active in lobbying for leasing regulations (as they use leasing to acquire their vehicles).
		More difficult, expensive, and time-consuming access to financial services for beneficiaries (SMEs, consumers), since SMEs would have to identify and negotiate with each NBFI individually.
	Pros	**Cons**
Umbrella legislation covering all types of financial services that may be delivered simultaneously by NBFIs licensed and supervised by the NBS	**Faster promotion and enactment of one law.** The draft umbrella law will be discussed with all stakeholders once, endorsed once by the relevant Ministries, and be reviewed and approved once by Parliamentary committees.	More complex in that it requires more consultation at the drafting stage of the process with various key stakeholders such as SME associations, consumer associations, construction companies, car retailers, Ministries, foreign aid agencies, donors/ investors, etc.

	Registration, licensing, and supervision would be common to all NBFIs. However, the specifics of each financial product should be governed by the draft law: e.g. minimum capital requirement for NBFIs that provide multiple financial services (such as micro-credits, leasing and/or consumer credit) should be higher than for NBFIs extending only one financial product.	Specific regulations on risk management, provisioning policies, capital requirements, etc. applicable to large NBFIs must be developed ahead of time so as to be available to NBFIs that become large.
	A beneficiary/SME can approach a single NBFI for multiple financial products, which makes the process easier, faster, more cost-effective, and less time-consuming. Allows long-term partnership for sustainable development between a beneficiary (SME/client) and the NBFI.	
	Allows and encourages graduation of clients to mainstream financial institutions (banks) as clients become bankable and their financial needs can no longer be met by NBFIs.	

3. *Information on specific/separate provisions of umbrella NBFI legislation on minimum capital requirements for registration/licensing, limitation of geographical reach, interest on consumer credit, credit provisioning, etc. depending on the activity the NBFI engages in, such as factoring, leasing, micro-finance, and consumer credit*

<table>
<tr><th>Specific/separate provisions of umbrella NBFI legislation</th><th>Examples from practice in the Balkans and South-Eastern Europe</th></tr>
<tr><td>Minimum capital threshold registration / licensing requirements</td><td> Capital threshold for NBFIs
The minimum capital requirements/capital threshold an NBFI must meet to be licensed to operate should be based on the following criteria:

The NBFI’s ability to break even in the first year of operation considering a debt-to-equity ratio of 1:1 (as practice has shown that investors will not agree to a debt-to-equity ratio greater than one in the first year of an NBFI’s operation) to ensure that the NBFI is sustainable, and
Projected income and expenses, to ensure that the capital threshold does not prevent establishment of new NBFIs.

In Romania, the minimum capital requirement for NBFIs extending multiple financial services is the local currency equivalent of EUR 200,000. However, practice has shown that an excessively low capital threshold is counterproductive due to the difficulties faced by NBFIs in achieving sustainability and fulfilling their social and development-oriented mission. Example from practice: The EUR 200,000 capital threshold applied in Romania proved to be too low, so that some initially licensed NBFIs withdrew from the market after only one year of operation (such as Integra Oradea, an NBFI extending financial and non-financial services mainly to women clients in Bihor County).
A special requirement applies to NBFIs extending mortgages, where the capital threshold is the equivalent of EUR 3,000,000.
In Bulgaria, the capital threshold is BGN 1,000,000 (equivalent to EUR 500,000).
In France, NBFIs/MFIs are registered as NGOs. No capital requirements apply to NGOs, and their portfolios are financed from donations, governmental programs, banks, and, more recently, crowd-funding. </td></tr>
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Limitation of geographical reach	In **Romania**, **credit unions are restricted to the county they are incorporated in**. However, the law does not prevent credit unions incorporated and lending in one county from establishing branches (operating units) in neighboring counties (Romanian Law 376/2002 on Credit Unions). Other NBFIs face no geographical limitations. **There is no geographical limitation on NBFIs in either Bulgaria or France**.
	In **Croatia**, banks provide leasing, factoring, and mortgage finance. Credit cooperatives are the only NBFIs allowed to operate in Croatia, and their operations are restricted to a maximum of two adjacent towns or counties. Consequently, Croatia's NBF sector is limited to a few credit cooperatives established in large towns, with all other NBFIs ending operations or limiting them to their respective geographical areas (e.g. Demos; http://www.demos-skz.hr/area.htm, Trg Josipa Broza 4, 47000 Karlovac; http://www.demos-skz.hr/first.asp). There is no cap on interest on microcredits extended by credit cooperatives. Demos was established as an MFI in the early 2000s by international donors active in Croatia with the aim of contributing to development of entrepreneurship and facilitating access to finance by underserved entrepreneurs and micro-enterprises by extending microcredit directly to target beneficiaries and providing business development support services. In its early years it operated as a pilot project under an agreement between the Croatian Government and donors. At the end of this stage of the project, the microcredit portfolio of the Demos Foundation was transferred to a credit cooperative as this was the sole form of incorporation available. Due to the restrictive legal framework for NBFIs, most of Demos's regional offices have continued to operate, and Demos has concentrated its activities in two counties. Micro-credit funds allocated to Croatia from EU funded Progress and JASMINE programs that remained unused at the end of 2014, as neither Croatian SME banks nor credit cooperatives were able to qualify for EU programs supporting the growth of national MF sectors. Microcredit funds were re-allocated to other EU member states. One of the main criteria the SME banks and credit cooperatives were unable to meet is the minimum number of micro loans extended per year. SME banks did not extend enough micro loans, while the credit cooperatives are faced with the geographical limitation. In short, no entities in Croatia are able to make use of EU MFI funds.

Interest rate cap	In **Bulgaria**, the rapid evolution of the consumer credit sector, coupled with a lack of financial education, prompted the regulatory body (National Bank of Bulgaria) to amend the banking law limiting the interest rate to 40% per year **for consumer loans only**, with the intention to prevent over-indebtedness of individual customers. The average interest rate for consumer credits in Bulgaria has ranged between 10 and 102 percent per year between 2012 and 2016.[3] **Romania and France** do not cap interest; all financial institutions, banks, and NBFIs are required to fully disclose costs of financial products offered to individual clients. MFIs comply with the EU Code of Good Conduct for Microcredit Provision, which also requires full disclosure of costs for all financial products and mandates financial education. In Macedonia there is a cap on interest on financial inclusion loans extended by foundations to indigent individuals (**social microcredit**) where the capital comes from subsidized loans or grants from **international donors or governmental programs**.
	In practice, interest cap is an extreme measure the regulators take in case particular categories of beneficiaries (e.g. population under the poverty line) need to be protected from abusive / aggressive lending practices, or where financial institutions (usually NGOs/development agencies) are created or mandated to extend subsidized financial products or instruments (loans, guarantees, micro-grants/loans, etc.). According to an European Microcredit Network (EMN) survey, the average interest rate for a personal micro-credit in the EU is 20 percent, while the average interest for business microcredits is 11% percent.
Risk management policies	In **Romania**, at registration, NBFIs are required to submit their risk management policies, including the provisioning policy. Provisioning policies of large NBFIs (with capital/portfolio in excess of EUR 5mn) registered with the Romanian National Bank's special NBFI registry must be approved and monitored by the National Bank's Supervision Department. Supervisory authorities in Bulgaria and France have employed a similar approach. Provisioning policies of other NBFIs registered in the general registry (with capital/portfolio lower than EUR 5mn) are established and amended by the NBFI's board/executives and do not require approval by the National Bank.

[3] Economic Review 1/ 2016 published by the Bulgarian National Bank.

	Chapter 3 (Risk Management) of the EU Code of Good Conduct for Microcredit Provision provides valuable guidance for NBFIs/MFIs in setting frameworks for effective risk management policies and internal control. The European Commission and EIB have been financing a five-year technical assistance program aimed at building the capacity of microfinance providers in EU and EFTA countries; Serbia has since 2016 been one of its potential beneficiaries. Known initially under the acronym JASMINE, and since renamed as EaSI[4] (European programme for Employment and Social Innovation), this programme consists of rating/assessment services provided by a specialized international rating agency and training/ consulting on strategic planning, risk management, Management Information System, etc. to overcome major weaknesses of NBFIs identified during the rating process and in the course of alignment with the EU Code. All costs of the technical assistance programme, including compliance assessment and certification of NBFI compliance with the EU Code, are fully subsidized.

[4] http://ec.europa.eu/social/main.jsp?catId=1081

4. Regulation specific to different types of NBFIs, e.g. closer regulation of large NBFIs with regard to their risk management structures, reporting requirements, performance indicators, and interest caps for consumer lending

In **Romania**, Section 4, Articles 29 to 34 of Law 93/2009 provides for the enactment of a specific regulation by the Romanian National Bank to govern special requirements for large NBFIs. Criteria for registration of large NBFIs in the Special Registry include but are not limited to:

- Turnover;
- Lending volume;
- Indebtedness ratio;
- Total assets;
- Own capital;
- Quality of major shareholders of the NBFI;
- Good reputation of managers, directors, and members of the supervisory board;
- Limits on exposure to debtors/persons, aggregate exposure;
- Organization of the NBFI's internal controls, internal audit, and risk management functions;
- Internal standards related to operations, management, and risk management in compliance with the National Bank's regulation;
- Reporting requirements are similar for all NBFIs regardless of their size.

In **Bulgaria and France** no specific regulation exists with regard to the size of the NBFI, but there is specific regulation related to the financial product extended, e.g. cap on interest for consumer lending in Bulgaria,

The amendment of the banking law in France, made for MFIs registered as NGOs that are providing financial and non-financial services to final beneficiaries, does not prescribe interest rate cap, or specific supervision.

5. Portfolio quality of NBFIs vs. that of banks in Romania and Bulgaria

NBFIs, and especially MFIs, have developed specific risk management policies to mitigate risk, in particular credit risk. These include credit monitoring procedures and provision of non-financial services to beneficiaries (financial education, business and entrepreneurship training and consulting, mentoring, etc.).

The following information has been summarized from data released by the National Bank of Romania and the European Microfinance Network:

Romania: PAR 90 aggregated (Banks and NBFIs): December 2013: 23,1% June 2014: 19.2%; June 2015: 12.8%[5]. The downward trend is due to adequate provisioning measures implemented by banks and NBFIs.

No data about the portfolio quality of the financial sector in Bulgaria are available in English.

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[5] Romanian National Bank's Financial Stability Report, 2015, http://www.bnr.ro/PublicationDocuments.aspx?icid=6711;

According to the EMN Overview of the Microcredit Sector in 2011, 2012, and 2013, the quality of the portfolio of MFIs in Romania and Bulgaria improved significantly between 2011 and 2013:

Romanian MFIs PAR 30: 2011, 9%; 2012, 9.6%; 2013, 9%
Bulgarian MFIs RAR 30: 2011, 11%; 2012, 9%; 2013, 7.7%

The EMN's preliminary report for 2014-2015 does not disclose portfolio quality indicators[6], however the full report will be available in October 2016, and the evolution of portfolio quality indicators will be available for the EU MF sector in general as well as disaggregated by country.

III. CONCLUSIONS AND RECOMMENDATIONS

1. Based on information related to the growth rates of the NBF sectors from the three countries (Romania, Bulgaria and France) covered by this analysis and the recent EMN MF survey, it may be concluded that the non- bank financial sector, and in particular the micro-finance sector, in Serbia stands a good chance to grow and evolve, and so make favorable impact on the country's financial and economic sectors, if properly regulated.

   In addition, since 2016, Serbian NBFIs active in the microfinance market have been eligible for financial and non-financial resources provided by EIB/EIF as part of EaSI programs financed by the European Commission and the European Investment Bank with the aim of increasing access to financial resources, micro-credits, guarantees, and business development support services by underserved entrepreneurs, farmers, and micro-companies, and strengthening MF providers through technical assistance and equity investments.[7]

   Apart from EU funded programs, capital investor funds targeted at newly-established MFIs institutions, and internal funds (re-invested surplus/profit, etc.), micro-lenders can also attract capital from international and national SME development funds, including those extended by ENIF and ENEF, the EBRD, Investors specialized in microfinance: Coopest, OikoCredit, Deutsche Bank, Blueorchard, and many others.

2. The legal framework should aim at enabling the establishment and development of the Serbian NBF sector, where institutions funded by local investors would be able to compete on equal terms with competitors from EU countries, allowed to operate in Serbia after joining EU, in the benefit of the customers.
3. The National Bank of Serbia should assume the role of regulatory authority for NBFIs (similar to the Romanian and Bulgarian practice) incorporated as commercial or for-profit entities. Where an NBFI is an NGO or other non-profit entity, a supervisory authority connected with the central bank (similar to the French system) should exercise supervision.
4. In Romania, an umbrella law for NBFIs extending multiple financial (credit) and non-financial services directly to targeted beneficiaries has had a positive impact on the

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[6] http://www.european-microfinance.org/docs/emn_publications/emn_overview/Overview2012-2013_Oct2014.pdf

[7] EIB (European Investment Bank) / EIF (European Investment Fund) have been implementing the EaSI (Employment and Social Innovation) Program. More information is available at www.ec.europa.eu/social/microfinace and www.fi-compass.ru.

country's NBF sector. Therefore, in view of the similarities of the economic and financial context in Serbia and Romania, this approach is recommended for Serbia as well.

5. Restriction is not recommended. The regulatory authority would have full control on the sector, and would be able to intervene quickly if the NBF sector were to engage in unethical lending practices, especially due to the lack of financial sophistication among beneficiaries (such as the Bulgarian example of the interest rate cap on consumer credit). Therefore, restrictions on geographical area (as in Croatia) or cap on the interest rates are not recommended from the outset, and neither are unrealistic registration requirements that will discourage investors from establishing and operating NBFIs.

   Restrictive legislation for NBFIs will impede investment and development of the sector, thereby limiting the growth potential of existing NBFIs and the establishment of new ones. As Serbia will join EU in the near future, an underdeveloped non-bank financial sector will not be able to compete with NBFIs based in the EU that will expand their operations in Serbia, and the regulatory authority will not be in a position to restrict the operations of EU NBFIs or protect the domestic market, due to clauses on the free movement of capital included in Serbia's future accession treaty with the European Union.

6. Consumer Protection.

   a) The statutory framework for NDMFIs should stipulate specific client protection requirements for these institutions that are in line with best industry practice, i.e. Chapter I of the European Code of Good Conduct for Microcredit Provision and Serbian legislation extending protection to clients of financial institutions from abusive practices.

      The minimum conditions should relate to:

      - Confidentiality in dealings with clients (see e.g. Romanian Law No. 93/2009, Chapter 4; and European Code, Chapter I, Articles 1.1.21-25);
      - Sufficient information about the cost of credit to be provided to the client in pre-contractual information and annual loan statement (European Code, Chapter I, Customer Relations);
      - The right of the client to withdraw from any credit agreement or repay within 14 days, repay any loan early, have their credit history reported to the credit bureau, and be able to complain for abusive clauses in the credit contract, abusive and inappropriate debt collection practices, misleading publicity, etc.

   b) Full transparency of credit contracts and disclosure of all costs and commissions, as well as financial education and business development support services associated with financial services, are some of the best practices from the EU NBF sector that have contributed to the avoidance of over-indebtedness of clients and sound NBFI portfolios.

   c) The legal framework should allow the NBFIs to perform activities aimed at improving financial and business education of targeted beneficiaries/clients.

      Improving targeted beneficiaries' financial literacy and financial education is needed for financial and social inclusion of NBMFI clients.

      In practice, specialized financial education departments with NBFIs can engage in financial education, or it can be provided in partnership with business development support services (BDSs) providers, including consulting and training firms, regional development agencies, SME development agencies, and the like. Basic training in financing would comprise (pre-application) financial literacy training, assistance with developing business plans during the credit application process, and support services for the loan period.

According to preliminary findings of the EMN's 2014-2015 Survey, MFIs in Europe provide a large range of non-financial services to their clients, from debt counselling/financial literacy to E-leaning, mentoring businesses and entrepreneurship development, etc.

The cost of training and consulting is usually met from public funds (see e.g. Romanian Law No. 93/2009, Chapter 4, Article 14.6), but these funds can also be secured from SME development initiatives funded by international donors or EU technical assistance programs (such as JASMINE/ EaSI TA) and EU micro-finance networks (such as MFC and EMN).

7. Partnerships between NDTFI/NBFI and the banking sector (as in Romania and France) have proven beneficial for both sectors as well as for clients, as seen in the sectors growth rates, increased number of beneficiaries and improved portfolio quality.