USAID BUSINESS ENABLING PROJECT

TITLE: RECOMMENDATIONS FOR A LEGAL AND REGULATORY FRAMEWORK FOR MICROFINANCE IN SERBIA

AUTHOR: JENNIFER CHIEN

DATE: November 2013

Contents

Executive Summary

1. Small and medium enterprises (SMEs) are a critical pillar in the Serbian economy, and SMEs can help to increase employment and economic growth in the country. However, the majority of SMEs have limited access to finance.

2. Existing banks are not meeting the financing needs of SMEs, particularly microenterprises, and the current regulatory framework prevents any "real" microfinance from filling this critical gap. The few existing microcredit providers operate in a legal grey zone and are forced to provide microcredit through banks, leading to higher operational costs, artificially higher interest rates, and greatly limited outreach.

3. An enabling legal and regulatory framework can unlock the real potential for a non-bank financial institution (NBFI) sector in Serbia that provides products and services better suited to the needs of SMEs using a market-based, commercially sustainable method. The total potential portfolio size for microcredit in Serbia is estimated to be EUR 267M, and only 2-7% of this demand is currently being met. A microcredit company (MCC) law would allow for growth of both new and existing MCCs, for which international investors have already expressed their strong support.

4. In the near-term, a MCC law should be developed that strikes an appropriate balance between providing minimum requirements for topics such as licensing and registration, permissible activities, ownership and governance, supervision, and reporting, while not overburdening these non-deposit-taking institutions with unnecessary or excessive regulation that increases compliance costs and decreases access to finance.

5. The existing legal framework will also need to be harmonized for MCCs, particularly with respect to laws and regulations on financial consumer protection, tax, accounting, and payments.

6. The risk of overindebtedness can be mitigated through the use of tools such as credit bureaus and assessments of creditworthiness, disclosure and transparency rules, financial literacy and education, and market monitoring. Existing rules regarding financial crimes should also be adapted for MCCs.

7. A new legal framework for MCCs should be accompanied by well-targeted, complementary policy initiatives to further encourage the growth of microfinance.

8. A long-term vision and strategy should be developed for improving financial inclusion in Serbia, of which a MCC law is merely the first step. A broader range of financial products and provider types will ultimately be needed to successfully serve unmet financial needs. For example, adjustments to the prudential framework can be made that, while still protecting financial stability, remove disincentives for banks to serve lower-income clients.

1. Introduction

1.1 Purpose and scope of this report

The Serbia Business Enabling Project ("BEP") is a USAID-funded project operated by Cardno Emerging Markets USA, Ltd. to assist the Government of Serbia in strengthening the business environment, fiscal and macroeconomic management, financial market development, and business education throughout the country. With respect to financial market development, BEP helps to increase the availability, competitiveness, and affordability of financial services through the drafting of new legislation, strengthening of institutional capacity, and shaping of policy.

A primary objective of this work is expanding access to finance for micro, small, and medium enterprises (MSMEs), a sector that has long faced difficulties in obtaining the necessary finance for growth, yet is critical to economic development and increased employment in the country. Non-bank financial institutions (NBFIs) could fill this financing gap by operating in under-served areas and by providing credit products and utilizing a lending methodology more appropriate for the MSME sector. However, the existing legal and regulatory framework poses a major obstacle to the development of NBFIs in Serbia.

This report provides concrete recommendations to the Ministry of Finance and Economy (MoFE), the National Bank of Serbia (NBS), and other policymakers on the development of an enabling legal and regulatory framework for commercially-oriented microfinance in Serbia. The scope of this report is on non-deposit-taking microcredit[1] companies (MCCs).[2] The primary focus is on providing international best practices and regional examples with respect to the key components of a new legal framework for MCCs that are applicable to the Serbian context and adapted to policymakers' priorities and concerns. Given the fact that a legal framework is only one component of increasing access to finance for MSMEs, the report will also briefly discuss broader topics such as estimating market impact and introducing complementary policy initiatives.

1.2 Lack of access to finance constraining potential of MSME sector

Small and medium-sized enterprises (SMEs) accounted for 66.7% of employment, 67.8% of total turnover, and 57.4% of gross added value of the non-financial sector of the Serbian economy in 2009.[3] Given that Serbia continues to suffer from high unemployment and low economic growth, fostering healthy growth of the SME sector is strategically important for increasing employment and income levels and strengthening competitiveness. However, more than two-thirds of SMEs report problems getting credit in Serbia, compared to about one-third of SMEs in middle income countries.[4] The sector as a whole is under-leveraged, with SMEs forced to seek financing from internal or informal sources.

SMEs face numerous hurdles in accessing finance. Bank loan products focus on traditional, larger corporate clients; about 60% of SMEs believe that the duration of loans, repayment terms, and collateral requirements are poorly or not at all suited to their needs.[5] The size of loans poses a particular constraint to start-up enterprises and MSMEs. The Serbian Chamber of Commerce reports that these enterprises are

[1] The European Commission defines microcredit as the extension of very small loans (microloans) to entrepreneurs, social economy enterprises, employees who wish to become self-employed, people working in the informal economy, and the unemployed and others living in poverty who are not considered bankable.

[2] This report uses the term "microcredit companies" to more clearly differentiate from microfinance institutions, i.e. institutions which may engage in savings as well as lending.

[3] "Preliminary Research on MFIs – the Experience Among Balkan Countries." USAID-Business Enabling Project, 2011.

[4] "Financing the Growth of Small and Medium Sized Enterprises: A White Paper for the Government of Serbia." USAID-Business Enabling Project, 2012.

[5] Ibid.

most in need of EUR 5,000-10,000 loans, whereas banks often do not provide loans below EUR 10,000. Lack of physical accessibility is also an issue, as many SMEs operate in localities outside of urban centers where traditional bank branch outreach is limited. As a result of these hurdles, poor access to finance is consistently ranked by Serbian businesses as one of the most significant constraints to growth and job creation and a problem that is getting worse, not better.

1.3 Obstacles to microcredit in current legal and regulatory framework

Microfinance provides a market-based solution to addressing the problem of mobilizing finance for MSMEs, utilizing a microlending methodology that, while differing substantially from the traditional methodology of banks, has proven successful across the globe. MCCs can provide an alternative source of finance, with loan products and services better tailored to the needs of MSMEs. Microcredit clients in Serbia report utilizing microcredit providers because they best meet their needs in terms of loan currency (dinars) and size and accessibility of loan officers. Research by the International Labor Organization indicates that if the obstacles to microcredit in Serbia are removed, it would be possible to create from 130,000 to 260,000 new jobs cumulatively over 5 years.[6] Rather than encouraging the grey economy, microfinance could actually provide the means for informal and semi-formal start-ups and MSMEs to expand operations and enter the formal sector.

However, the legal and regulatory framework in Serbia prevents the existence of a "real" microfinance industry. The current supply of microfinance is very limited. The two microcredit institutions that do exist, AgroInvest and Micro Development,[7] operate in a grey zone without clear legal standing and are forced to provide microcredit through banks due to the prohibition on direct lending by non-banks. These complicated arrangements lead to higher operational costs and lower margins, limiting outreach and the ability to become commercially sustainable. These increased costs result in artificially higher interest rates being charged to consumers already more vulnerable. The lack of a formal legal framework recognizing NBFIs also serves as a serious disincentive to donors and investors.

1.4 Real potential for microcredit in Serbia with regulatory reform

An enabling legal and regulatory framework would help foster the growth of a healthy and sustainable NBFI sector. The introduction of a regulatory framework for non-bank, non-deposit-taking credit institutions is a critical first step. Focusing on non-deposit-taking institutions addresses potential concerns by financial regulators regarding systemic risks and fits more easily within the existing legal and regulatory framework, while still providing formal legal recognition and permission to lend that would greatly aid existing microcredit providers, encourage the entry of new MCCs, and attract investors. The fact that two microcredit providers have managed to maintain operations in an inhospitable regulatory environment, with higher repayment rates and lower numbers of non-performing loans than found in the banking sector, is itself indicative of the demand for and the commercial viability of microcredit in Serbia.

A regulatory framework for MCCs would have an immediate beneficial impact on microcredit providers. Research reports in 2010 (during the prior effort to draft a MCC law)[8] estimated that the total potential portfolio size for microcredit in Serbia is EUR 267M. The current microcredit portfolio reaches only 2% to 7% of this demand. These figures represent significant room for growth and increased penetration by

[6] Serbia Microcredit Gap-Assessment, ILO Social Finance Programme, October 2008.
[7] It is unclear to what extent MicroFinS, a third microcredit institution, is still fully operational. Note that two microfinance banks also exist (Opportunity Bank and ProCredit), though both operate as fully prudentially regulated banks.
[8] During this effort, a draft "Law on Micro-Financial Companies" ("Draft MFC Law") was completed but did not reach the formal adoption stage.

both new and existing MCCs. Current providers have suggested that their loan portfolios could expand by 50% or more if they were allowed to lend directly.

Microcredit providers in Serbia report an average microloan size of EUR 960-1,600. This average does not meet the full needs of start-up entrepreneurs and MSMEs. Regulatory reform that allows for the expansion of current microcredit portfolios and encourages new, commercially-oriented entrants would help broaden the range of microfinance clients served and loan sizes offered, reaching this key missing "middle" between existing microcredit and commercial lending. An expanded number of commercially viable MCCs would also impose competitive pressure on industry pricing, helping to decrease the price of microloans (beyond the operational cost savings provided by being able to lend directly).

In addition to permitting new and expanded microcredit institutions, greater legal certainty would attract critical investment from international donors and investors. Numerous investors have indicated that the main problem they see in the Serbian environment is the lack of a regulatory framework for microfinance. There is strong interest in investing in the country, as microfinance investment vehicles (MIVs) and other investors are actively looking for investment opportunities and other microfinance markets in the region are saturated. Investors such as Blue Orchard, CoopEst, Deutsche Bank, Developing World Markets, European Bank for Reconstruction and Development, MicroVest Investments, OikoCredit, ResponsAbility, and VisionFund International have already expressed interest in investing in microfinance in Serbia. Existing microcredit providers report that investors have indicated financing commitments estimated at a total of EUR 40M if a new MCC law is passed. It is also expected that several new MCCs would enter the market, bringing in additional start-up investment. The strong interest displayed by a large number of investors further bolsters the significant growth potential of a NBFI sector in Serbia.

2. Key components of legal framework for microcredit companies

Section 1 of this report clearly lays out the need for increased access to finance for MSMEs, the legal and regulatory obstacles faced by microcredit providers, and the real potential for growth of a NBFI sector in Serbia. This section briefly discusses the strategies and approaches to consider with respect to a legal and regulatory framework for microfinance, followed by detailed recommendations on the key components to include in a law on MCCs.

A long-term vision and strategy is required in order to develop a healthy, sustainable NBFI sector in Serbia. Ideally, the NBFI sector would include a range of different types of NBFIs providing a variety of financial products (including savings products) and serving a broad range of clients. Both NBFIs and banks should operate within a harmonized legal and regulatory framework with respect to overlapping activities. A comprehensive strategy to increase financial inclusion from multiple angles would include scaling up microcredit operations of NBFIs while also encouraging commercial banks to move down market (to be addressed in Section 6). While these issues are beyond the immediate scope of this report, it is important for policymakers to begin considering how they ultimately envision a dynamic NBFI sector beyond microcredit providers, and how this vision can be achieved over the long-term.

Given that developing a long-term strategy for NBFIs is still in its initial stages in Serbia, focusing on non-deposit-taking institutions is a logical first step. Policymakers could consider two options: a broader non-deposit-taking NBFI framework or a more narrow MCC-specific law.[9] For practical purposes, a MCC-specific law may be the most expedient approach. As there are no other NBFIs currently operational, a more narrow MCC law is a suitable option that would allow policymakers to expand microcredit in a controlled fashion and monitor how the microcredit market develops over the next few years, at which point the legal framework could be revisited and expanded upon (similar to the experience in Romania, which began with a MCC law that was later replaced by a NBFI law).[10]

There are numerous policy considerations to weigh in developing a MCC legal framework. A well-crafted framework should strike an appropriate balance between providing minimum requirements regarding topics such as licensing, governance, and reporting while not overburdening these non-deposit-taking institutions with unnecessary prudential requirements or other excessive regulation. EU policy, such as the European Commission Communication on a European initiative for the development of micro-credit in support of growth and employment of 2007 ("EC Communication on Micro-credit Initiative"), recommends that any regulation and supervision be proportionate to its costs and the risks that MCCs pose, as higher compliance costs ultimately result in limiting access to finance. Non-prudential regulation of microfinance typically focuses on consumer protection, market conduct, and anti-money laundering/combatting the financing of terrorism (AML-CFT) issues. Weighing the supervisory needs of MCCs against the capacity and priorities of existing supervisory bodies is also an important consideration.

At the same time, it is worth noting that the two larger existing microcredit providers, AgroInvest and Micro Development, already comply with a variety of financial and social performance standards, auditing and reporting requirements, and consumer protection standards either imposed by donors and investors or taken on voluntarily. In addition, it is envisioned that the emerging MCC industry in Serbia would ideally be comprised of a limited set of commercially operated, sustainable, and professionally run

[9] Both of these options assume that policymakers do not wish to amend the existing Law on Banks to allow for MCCs, which is another legal approach in theory, though one that appears to be less politically feasible.

[10] However, note that a drawback of this approach is limited flexibility under the MCC law in the future, as the law would be structured around a single type of financial institution and not a range of possible NBFIs. Though this report focuses on a MCC law, a NBFI law would include many of the same provisions.

institutions (as opposed to a larger number of smaller, less commercially oriented entities), an objective which the MCC law should both reflect and reinforce.

The following sections highlight the key topics to include in a MCC law, discussing the pros and cons of various regulatory approaches and drawing from international best practices and relevant examples from Romania and the Kyrgyz Republic, two good case studies of legal frameworks specifically for microcredit.

2.1 Definition of "microcredit"

A definition of microcredit can be included in the MCC law in order to maintain the intended focus of policymakers on individuals and enterprises with limited access to finance. In some countries, definitions of microcredit include restrictions on the types of clients that can be served and the purposes of microloans (e.g. "productive" uses as opposed to consumer lending). These types of restrictions can help prevent the likelihood of regulatory arbitrage by institutions with different objectives, such as payday lenders. However, restrictions of this nature can be problematic for multiple reasons. MCCs need the flexibility to serve a range of clients in order to operate on a sustainable basis. It is also difficult to determine where to draw the line for such restrictions and how to enforce them in practice.

A practical approach as this stage may be to include the ability for policymakers to issue more detailed bylaws on the "purpose" of microcredit at a later stage, depending on need as the MCC industry develops and evolves. If provisions are included in a definition of microcredit at this time, the language used could be kept relatively general to broadly convey policy intentions without unduly restricting MCCs. For example, the Law on Microfinance Organizations in the Kyrgyz Republic states that the "goal" of a micro-finance organization is "to provide accessible micro finance services to alleviate poverty, increase employment, assist in the development of entrepreneurship and social mobilization of [the] population in the Kyrgyz Republic."

Including limitations on loan size in the definition of microcredit is a more concrete method of maintaining the focus on microfinance. In order to provide flexibility to MCCs, a two-pronged approach could be used, consisting of: (1) a higher single loan size limit, combined with (2) a lower average outstanding loan balance. This approach provides MCCs with the ability to serve some clients that may have graduated to larger loans, while requiring that the majority of their clientele remain focused on lower-income clients. When determining the amounts at which to set these limits, policymakers should look to current operations of microcredit providers as beginning reference points and consider how portfolio composition may evolve as a result of the MCC law. The limit of EUR 25,000 stated in the Draft MFC Law appears appropriate for the current Serbian context, although if the two-pronged approach is taken, it may be prudent to raise the maximum single loan size limit a small degree (combined with a much lower average outstanding loan balance). Regardless of the chosen approach, it is preferable to set actual monetary amounts in bylaws as opposed to in the MCC law itself, so that the amounts are easier to adjust as needed.

2.2 Registration of MCCs

The MCC law should include basic provisions on the registration of MCCs. These provisions should be clear and straightforward regarding the standards and requirements to be complied with in order to become a registered MCC, such as permissible legal forms. As policymakers have indicated a desire to focus on the growth of commercially-oriented MCCs, which is fitting given the stage of development of the financial sector in Serbia and the decreasing presence of donor funding, it may be appropriate to require that MCCs be joint stock companies or limited liability companies.

As non-depository MCCs do not pose a systemic risk, a risk-based approach towards registration should be taken. Requirements should not be as extensive as licensing requirements for banks. Registrants may be required to submit the following:

- Organizational establishment documents
- Information on ownership structure
- Information on directors and management
- Evidence of initial minimum capital duly paid
- Initial operating plans

Any registration requirements should be linked to confirming compliance with specific regulatory objectives, such as rules on ownership and governance. The procedures for registration and associated timeframes should also be clearly laid out, as well as what body is in charge of registering MCCs (to be discussed further in Section 2.6 Supervision).

For example, in the Kyrgyz Republic, registration procedures for microcredit agencies (MCAs) and microcredit companies (MCCs) are more simple and straightforward than the licensing procedures for deposit-taking microfinance companies (MFCs). MCAs and MCCs require a certificate from the National Bank of the Kyrgyz Republic, as opposed to MFCs which require both a certificate and a license. To obtain a certificate of registration, MCAs and MCCs submit an application, notarized copies of establishment documents, their state registration certificate as a legal entity, a list of members of the management body, and confirmation of funds as charter capital. An additional feasibility study and business plan must only be submitted by MFCs. In both the Kyrgyz Republic and Romania, MCCs and NBFIs are registered by the national bank.

The initial minimum capital requirement should be specified in the MCC law. When determining the amount of initial minimum capital required, policymakers should strike a balance between an amount that is low enough to allow for the entry of new MCCs while high enough to provide a barrier of entry to unprofessional, poorly-operated institutions (though note that ownership and governance requirements are also an effective tool for this purpose). As a comparison, the minimum capital requirement for NBFIs in Romania is EUR 200,000. The NBFI law in Romania also empowers the National Bank of Romania to issue higher minimum capital requirements at a later point in time according to the types of activities of NBFIs, which may be useful if it is anticipated that the range of permissible activities of MCCs in Serbia will expand over time.

Policymakers may also wish to consider including a provision in the MCC law on the use of the term "microcredit company" (or the equivalent title used to name this new type of financial institution), in order to create a clearly defined class of formal lending institution. Such provisions should require that these new institutions use the term "microcredit company" in their name (and not the term "bank"), while also prohibiting institutions not registered as MCCs from using such term. Similar provisions are included in the laws on NBFIs and MFIs in Romania and the Kyrgyz Republic, respectively.

2.3 Ownership and governance

Ownership requirements should be crafted that are appropriate for the types of MCCs anticipated in Serbia. For example, overly strict restrictions on the participation of foreign equity holders (as well as borrowing from foreign sources or the employment of foreigners in management or technical positions) may hinder the development of MCCs in Serbia. Due to the fact that it may be some time before new and existing MCCs are considered attractive enough to domestic Serbian commercial investors, foreign investors will likely be necessary to bring in new capital and technical expertise for both existing and greenfield MCCs. In the Kyrgyz Republic, founders of MCCs or MCAs may be legal or physical entities irrespective of place of registration and residence or citizenship (as applicable). Ownership diversification requirements may also make it more difficult for MCCs to maintain their social mission, and are more appropriate for prudentially regulated institutions.

"Fit and proper" requirements should apply to owners, board members, and senior managers of MCCs. These requirements serve as a means to keep out owners with bad records (a concern noted by Serbian policymakers) and maintain the professional standards of MCCs. Again, such requirements should be adapted for MCCs. "Fit and proper" requirements may include prior professional experience in finance, but should provide some flexibility and not be limited to banks or depository institutions. Experience in existing microcredit providers or MFIs should be considered valid professional experience. In Romania, larger NBFIs are required to have managers, directors, and supervisory board members with "a good reputation and experience adequate to the nature, extent and complexity of the non-banking financial institution's activities and to the responsibilities incumbent upon them".[11]

Other corporate governance requirements should generally be limited, not overly prescriptive, and allow for flexibility in operations, i.e. appropriate to the limited systemic risks associated with non-depository, microlending institutions. In the Kyrgyz Republic, the only corporate governance provisions with respect to MCCs or MCAs relate to basic auditing requirements.

2.4 Permissible activities

The MCC law should clearly state the permissible activities of MCCs. Obviously, lending is the key activity that should be explicitly authorized. With respect to other permissible activities, policymakers should consider what types of financial products and services are needed by under-served clients[12] and are appropriate for MCCs to provide. In Romania, NBFIs are allowed to engage in the following credit-related activities:

- Granting of credits, including but not limited to: consumer credits, mortgage credits, real estate credits, microcredits, financing commercial transactions, factoring, discounting, and forfeiting operations;
- Financial leasing;
- Issuance of guarantees;
- Granting of credits with receipt of goods as pledge or pawning through pawnshops;
- Granting of credits to members of non-profit associations organized based on the free consent of employees/pensioners, organized under the form of mutual aid funds, supporting their members by financial loans;
- Other forms of a financial credit nature; and
- Issuance of credit cards.

In the Kyrgyz Republic, MCCs are also allowed to conduct factoring and leasing with the approval of the National Bank of the Kyrgyz Republic. Other activities that could be considered in Serbia include providing insurance (as an intermediary) and payment and transfer services. Some of the aforementioned activities could be included as permissible activities in the current MCC law, while others should be considered for the longer-term. Regardless of the types of permissible activities allowed in the current MCC law, the law should build in the flexibility to both expand the list of permissible activities in the future and issue bylaws regulating these activities as needed.

The law should also allow for secondary and related activities, such as consulting and training. For example, in Romania, the earlier Law on Microfinancing Commercial Companies of 2005 provided that

---

[11] Article 31, Law No 93 of 2009 on Non-Banking Financial Institutions.
[12] For example, existing microcredit providers in Serbia have noted high client demand for insurance products.

MFIs could offer services for the economic development of microcredit beneficiaries as a secondary activity, including "consulting services, information, education and specialized training."

The MCC law can explicitly ban certain activities, namely deposit-taking. In Romania, NBFIs are forbidden from receiving deposits, issuing bonds, and operations with tangible and intangible assets, except for those related to crediting activity or necessary for the institution's adequate functioning.

However, it may be helpful for the sake of clarity to specify that cash collateral or compulsory savings do not constitute deposit-taking. Requiring cash collateral or mandatory savings from microcredit clients in lieu of traditional collateral is a common characteristic of microlending methodology. If there are concerns regarding risks posed by cash collateral, the MCC law can specify that cash collateral not be intermediated and require that such funds be held in a licensed bank, low-risk securities, or in an escrow account. In the Law on Microfinancing Commercial Companies in Romania, MFCs were allowed to accept as collateral deposits established by the beneficiaries of microcredits, on the condition that such amounts representing the guarantee were deposited in a credit institution authorized by the National Bank of Romania.

2.5 Prudential regulation, loan loss provisioning, and risk management

In general, prudential regulation is not warranted for MCCs as they do not pose a systemic risk to the financial sector and do not put public savings at risk. Prudential regulation imposes unnecessarily high compliance costs on MCCs and supervisors alike. In the event that standards or guidelines (as opposed to regulation) are contemplated for certain topics such as client documentation or leverage ratios, they should adapted for microlending. Guidelines should be relatively simple, allow room for innovation, and require low compliance costs. Extensive loan documentation should not be required as it is not practical for typical microcredit clients, which are often informal or semi-formal microenterprises lacking formal financial statements. A simple leverage ratio intended to ensure that MCCs do not become over-indebted should be high enough to permit healthy market growth.

MCCs do need the ability to create loan loss reserves and write-off such reserves for tax purposes. If guidelines are issued on loan classification (though again, note that such guidelines are not necessary from a prudential supervision perspective), they should take into account the fact that the general provision requirement should not be higher for microcredit than for traditional bank loans simply due to the fact that microloans are not "conventionally" collateralized, as they are not inherently riskier than traditional bank loans. However, provisioning schedules for delinquent microloans should be more aggressive given the more frequent repayment installments of microloans and the fact that microloan portfolios can deteriorate more quickly than a typical loan portfolio. The central banks in both Romania and the Kyrgyz Republic issue regulations on loan classification and provisioning requirements for NBFIs and MFIs, respectively. These regulations include general rules on classifying loans and related loan loss provisioning by category of classification.

Similar to above, any provisions on risk management included in the MCC law should be relatively simple, allow room for innovation, and impose appropriate compliance costs. Again, provisions should match the actual risks posed by MCCs to the public (and not necessarily to the business itself or its shareholders). Such provisions should not be overly rigid or prescriptive, and should focus on the policy objective as opposed to how exactly such objectives are achieved operationally within MCCs.

Regulation 20 of 2009 issued by the National Bank of Romania requires that NBFIs establish risk management committee and audit committee responsibilities and an internal control system. The regulation includes rules on the roles and responsibilities of the Board of Directors and management, monitoring activities and correcting deficiencies, and identifying and evaluating significant risks. Credit risk procedures must be established to ensure the maintenance of sound lending standards, the monitoring and controlling of credit risk, and the identification and management of non-performing loans.

Policymakers in Serbia may wish to formulate simpler rules (or guidelines) than these on risk management. Recent regulations issued by the National Bank of the Kyrgyz Republic in 2013 establish minimum requirements for credit risk management by MFIs, including rules on what provisions should be reflected in MFIs internal credit policies.

2.6 Supervision

A critical question yet to be determined in Serbia is how MCCs will be supervised and by whom. "Supervision" of MCCs does not entail the type of onsite and offsite monitoring applicable to deposit-taking institutions.[13] The responsibilities of a supervising entity should include maintaining a public register of MCCs approved to engage in lending and serving as a repository of periodic reports required of registered MCCs. The supervising entity could also develop and promote compliance with sound financial performance standards, promote transparency and a code of conduct among MCCs, and collect and publish social performance indicators.[14]

As MCCs are non-deposit-taking financial institutions, direct supervision by the NBS is not justified. Direct supervision by the MoFE may also not be justified nor feasible given limited capacity within the MoFE. Therefore, two alternative options are: (1) self-regulation by an industry association, or (2) delegated supervision to an industry association.

Self-regulation means supervision by a body that is controlled by the supervised entities (e.g. an industry association). Historically, self-regulation by industry associations has achieved mixed results with respect to prudential regulation and preserving the financial soundness of deposit-taking entities. However, self-regulation with respect to non-prudential topics such as consumer protection (as would be the case in Serbia) may still provide some benefits. A MCC industry association could perform the functions listed above, registering new MCCs, collecting periodic reports submitted by MCCs, and articulating standards of good practice for the industry with respect to financial performance and consumer protection.

In the case of delegated supervision, an outside body (most likely the industry association, though another entity could be authorized) serves as an agent of the MoFE or the NBS. This arrangement implies that the MoFE or NBS maintains a greater degree of legal authority and responsibility for MCCs than in the case of self-regulation. Unlike self-regulation, a formal link is established between the financial regulator and the industry association, allowing the MoFE or NBS to monitor and supervise the association's work. Delegated responsibilities could include collecting registration information[15], collecting data and reports, and recommending sanctions (the regulator would be responsible for any direct intervention in problem institutions). In addition, the association would again play a general oversight role over industry members with respect to sound financial performance and consumer protection (further discussed in Section 3).

There are pros and cons to either approach. The self-regulation approach is typically taken for practical purposes because it is more cost-effective as government supervisors are not involved. Delegated supervision allows for a greater degree of quality control over the association's activities, with the

---

[13] One could consider either "oversight" (more hands-off monitoring) or "lite supervision" (in between oversight and full supervision) of MCCs.

[14] Policymakers may also wish to consider requiring that MCCs obtain ratings from a third-party rating agency specializing in MFIs (e.g. MicroRate, Planet Rating, M-CRIL), which can cover both financial and social performance. Such ratings would be another cost-effective means (from the regulator's perspective) of monitoring MCC performance on a hands-off basis.

[15] Note that the MCC law should clearly specify which body issues official licenses to MCCs permitting them to be initially established and obtain permission to lend. Presumably, either the MoFE or NBS would issue these licenses, though this authority could potentially be delegated to an industry association. In the case of delegated supervision, while the industry association could collect registration information, the MoFE or NBS would actually issue the official license.

attendant resources required of the MoFE or NBS to ensure that such an arrangement works as promised. It will also be necessary to clearly define the relationship between the MoFE or NBS and the agent, including assigned responsibilities and processes. For example, the MCC law will need to specify the party responsible for enforcement and penalties for non-compliance.

Regardless of the chosen approach, the MCC industry association will likely play a key role in registering, monitoring, and overseeing the industry, whether formally or informally. The MCC law should therefore specify that membership in the association be mandatory and indicate the general responsibilities of the association. The law itself should not be overly prescriptive regarding the organization, operations, or fees of the future association, in order to allow flexibility for the association to be structured and developed as needed. Given that there are only two fully functioning microcredit providers in Serbia at the moment, the capacity of a future industry association and potential conflicts of interest will need to be carefully considered. The creation, build up, and training of an industry association and its staff will require both time and resources.

It is worth noting that in Romania and the Kyrgyz Republic, NBFIs and MFIs are currently registered and overseen by the respective national banks. The prior Law on Microfinancing Commercial Companies in Romania stated that the MFI industry association had the obligation to monitor the performance of microfinance companies and to calculate and publish performance indicators on at least an annual basis.

2.7 Reporting and auditing requirements

Any reporting and auditing requirements included in the MCC law or bylaws should be lighter than prudential reporting requirements for deposit-taking institutions, as detailed technical reports impose unwarranted compliance costs on MCCs. The content and frequency of reports should be tailored to specific (non-prudential) policy objectives, such as monitoring the microcredit market, promoting consumer protection, preventing financial crimes, and tracking performance and outreach of MCCs. Requirements could include periodic reports on operations such as financial statements and statistics on portfolio quality and information on the types of products being offered. In Romania, NBFIs report their financial statements, the structure of their credit portfolio, and any additional data or statistics required to the National Bank of Romania on a quarterly basis. In the Kyrgyz Republic, MCCs report quarterly and annually on their directors and management, financial condition, and loan portfolio using a form prescribed by regulation.

In Romania, NBFIs must be internally and externally audited, whereas external audits are voluntary for MCCs in the Kyrgyz Republic. Regulations include instructions on what must be included in internal and external audits.

2.8 Other topics to consider

There are a few other topics which policymakers should consider addressing in the MCC law. One is the transformation of existing microcredit providers into MCCs. The law should provide sufficient time for existing microcredit providers to fully transition to registered MCCs in full compliance with all provisions of the MCC law. This transition will necessitate, among other items, building up internal infrastructure to provide loans to clients directly and transitioning microcredit clients currently served through banks to become the MCC's own clients. Policymakers should consider whether there are other implications that arise from the transfer of microcredit clients that will require special rules or bylaws.

General data privacy and client confidentiality rules should be applied to MCCs similar to requirements for banks. These rules should not impede the ability of MCCs to report data to the credit bureau of the Association of Serbia Banks. Rules on bankruptcy and insolvency for MCCs should be similar to those for Serbian companies in general. The MCC law should also include provisions on branching, any limitations or allowances on raising capital, and regulatory sanctions and penalties.

3. Harmonization with existing legal framework

The above Section 2 covers some of the key topics that should be addressed in a MCC law. Creating a legal and regulatory framework for MCCs also requires considering what existing laws and regulations will need to be harmonized to apply to MCCs and microcredit clients. One such area is consumer protection. AML/CFT rules will be addressed in Section 4.

3.1 Consumer protection

It is critical to ensure that financial consumer protection rules apply to MCCs and microcredit clients. Typical microfinance clients have lower levels of literacy and numeracy than normal banking clients, and may not have experience with the formal financial sector. Consumer protection rules are therefore doubly important for this more vulnerable segment of the population. Such rules are also an important means to help decrease the risks of overindebtedness. The three main topics that should be covered by consumer protection rules are:

(1) Adequate and transparent information: Ensuring that clients receive accurate and comprehensible information on the pricing and terms of financial products.
(2) Fair treatment: Avoiding abusive lending and collection practices and other unethical treatment of clients.
(3) Recourse: Providing clients with effective mechanisms for addressing complaints and resolving errors or disputes.

As a general principle, all providers of a given financial service (e.g. banks, MCCs, etc.) should be held to the same consumer protection standards, in order to provide both a level playing field for providers and comprehensive protection to consumers. Consumers need the same protection from misleading loan information whether they are borrowing from a bank or a MCC. Similarly, there should not be an artificial divide between users of credit or microcredit, such as between an individual microentrepreneur and a small microenterprise. Particularly in the case of microcredit, both natural persons and legal persons will face the same consumer protection-related concerns.

In Serbia, several laws and decisions already exist with respect to consumer protection, including the “Law on the Protection of Financial Services Consumers” of 2012, the “Penalty Interest Law” of 2012, the “Decision on Terms and Manner of Handling Customer Complaints by Banks” of 2011, and the “Decision on Terms and Methods of Calculating the Effective Interest Rate and on the Layout and Content of Forms Handed Out to Consumers” of 2011. However, the application of each of these laws and decisions is limited in a manner that is detrimental to the principles described above, resulting in incomplete protection of consumers. For example, the “Law on the Protection of Financial Services Consumers” and the “Decision on Terms and Methods of Calculating the Effective Interest Rate and on the Layout and Content of Forms Handed Out to Consumers” only apply to natural persons and, in the case of the law, only natural persons who are using financial services “for the purposes outside his trade, business or profession.” As a result, a significant gap in coverage exists between natural persons and larger formal businesses, into which microentreprises and MSMEs fall.

Though it is beyond the scope of this report to discuss these laws and decisions in detail, it is strongly recommended that these laws and decisions be re-examined to determine how to appropriately revise their scope given the introduction of MCCs. There are a few options to achieve this goal. Existing laws and decisions could be amended so that they are applicable to both natural persons and legal persons (preferably to all legal persons, but at a minimum to microenterprises and MSMEs), and provisions relevant to microcredit made to apply to MCCs (i.e. not limited to just banks). Alternatively, in the event that there are inherent obstacles to this approach, similar consumer protection rules could be included in the MCC law or bylaws, or incorporated into a code of conduct issued and enforced by the MCC industry association. However, this second approach would create parallel sets of institution-specific rules, which is not best practice. Policymakers should craft an approach that causes the least possibility for confusion and redundancy in the existing legal and regulatory framework, which points to amending existing laws and decisions as the most appropriate option to move forward. If this route is taken, a cross-reference to applicable consumer protection laws and decisions should be included in the MCC law itself.

Policymakers should also consider adapting existing rules with respect to consumer protection to fill certain gaps and better address the needs of microcredit consumers. For example, with respect to disclosure and transparency, "total cost of credit" has been found to be more comprehensible to low-income consumers than effective interest rates and its disclosure should be mandated. The standardized form in the "Decision on Terms and Methods of Calculating the Effective Interest Rate and on the Layout and Content of Forms Handed Out to Consumers" providing a consistent layout to be used for loan offers is helpful. For low-income and low-literacy consumers, it can be particularly beneficial to complement the presentation of these standardized "summary sheets" with the obligation that trained provider staff orally communicate key information and are available to answer questions. Rules on recourse could also be expanded to ensure that microcredit consumers have easily accessible, low-cost avenues to lodge complaints and seek redress (e.g. the industry association could play a mediator role). All of these further efforts could be considered as longer-term objectives.

Finally, an important issue to consider is what body will be responsible for supervising and monitoring compliance with respect to consumer protection laws and regulations that are made applicable to MCCs. The existing rules on financial consumer protection are issued by the NBS. However, it is not currently clear whether the NBS or the MoFE will have oversight over MCCs. This situation raises similar considerations discussed in Section 2.6. Again, two possible options are for the NBS to delegate supervisory responsibilities to the MCC industry association, or for the industry association to self-regulate with respect to consumer protection rules.[16] This question should be discussed among financial regulators and stakeholders to determine what is the most effective and efficient approach.

3.2 Tax, accounting, payments, and other harmonization needs

When drafting the MCC law, policymakers should consider how the tax code will impact MCCs and their operations. As noted previously, the rules regarding tax deductibility of expenses (such as loan loss provisioning) should apply consistently to all types of institutions subject to a profit tax, such as MCCs. If there are other favorable tax treatments applicable to the lending activities of banks, such treatments should be made to apply to the lending of MCCs as well in order to provide a level playing field. Similar efforts were undertaken in Romania and the Kyrgyz Republic to ensure that the tax code did not include inconsistent treatment of microcredit that impeded the development of microcredit providers. Beyond these issues, policymakers may also wish to consider whether additional tax incentives to encourage the growth of MCCs.

Laws and regulations with respect to accounting, auditing, payments, and foreign exchange operations, among others, should also be examined to ensure harmonization with the new MCC law and the intended operations of MCCs. In addition, the Law on Banks and any regulations or bylaws related to lending should be examined for any harmonization needs, either within the MCC law or in such laws or regulation. Finally, if any usury laws or regulations are in place that would negatively impact the operation of MCCs, exemptions should be considered with respect to microcredit provision.

[16] Supervisory arrangements with respect to consumer protection of the financial sector vary greatly across countries. Two approaches used in other countries are: (1) direct supervision by the main financial regulator, either via the prudential supervision department or a separate consumer protection department (e.g. Ireland, Portugal), or (2) setting up a separate financial consumer protection supervisory body (e.g. Australia, Mexico).

4. Addressing potential concerns with microcredit

This Section 4 discusses two potential concerns with microcredit that have been noted by Serbian policymakers: (1) overindebtedness and (2) financial crimes.

4.1 Overindebtedness

Historically, microcredit has enjoyed high repayment rates around the globe. The experience of microfinance has shown that lending methodologies can be successfully adapted so that microfinance is not inherently riskier than traditional bank lending. Still, as with any financial product, there are potential risks. To be clear, overindebtedness is by no means inevitable with respect to microcredit, and appears less likely in the Serbian context given the current behavioral trends of consumers with respect to borrowing. However, multiple factors can lead to an increased risk of overindebtedness, including irresponsible provider behavior on the supply side and poor borrowing decisions by consumers on the demand side. Oversaturation of the microcredit market is also an important factor. In the case of Bosnia, where the MFI industry have been rapidly expanding over a number of years and grew increasingly overheated, repayment crises began in 2008. The crisis has been partly attributed to lending concentration and multiple borrowing by consumers from more than one MFI, overstretched MFI capacity, and a loss of MFI credit discipline.

Many of the topics discussed in Section 2 for inclusion in the MCC law can help to prevent more extreme cases of unscrupulous microcredit providers and loan sharks and diminish the risks of overindebtedness. Examination of the backgrounds of MCC owners, "fit and proper" requirements for directors and managers, proper risk management procedures, and adequate internal controls can all contribute to ensuring that MCCs are professionally operated and well-run institutions, particularly as the microcredit market becomes more competitive (which should take a number of years in Serbia). Promotion of responsible lending by the MCC industry association should also be encouraged.

In addition to these provisions, policymakers can work towards preventing overindebtedness by taking a systemic approach and addressing the issue at multiple levels. Four possible tools at the consumer, provider, and market level include: (1) credit bureaus and assessments of creditworthiness, (2) disclosure and transparency, (3) financial literacy and education, and (4) market monitoring.

In order to decrease the risks of overindebtedness, providers should be required to analyze the creditworthiness of potential clients. This requirement is already included in the "Law on the Protection of Financial Services Consumers," another reason to ensure that this law is made to clearly apply to MCCs and MSMEs. Adequately analyzing creditworthiness and repayment capacity of potential clients requires a reliable and comprehensive credit bureau. The existing credit bureau operated by the Association of Serbian Banks has been cited to be strong. However, microlenders, banks, and borrowers would all be best served by a credit bureau that provides comprehensive payment data. Creating a separate credit bureau for MCC clients (as suggested by the Draft MFC Law) would be highly counter-productive. A broader, more comprehensive credit bureau that includes data on all types of payments (including utilities and retailers) and all types of clients (including bank, MCC, and agricultural clients), without minimum loan size thresholds for inclusion, would be the most effective in enabling lenders to accurately and inexpensively assess potential clients.

In the near-term, the MCC law should therefore mandate the participation of all MCCs in the credit bureau operated by the Association of Serbia Banks and ensure that there are no legal or operational obstacles to MCC participation, such as data privacy rules. In addition, MCCs should be assured of reasonably easy access to obtaining credit reports and data from the credit bureau. Over the long-term, policymakers should consider how to strategically expand coverage of the credit bureau as discussed above.

Disclosure and transparency are also important tools to ensure that potential microcredit clients fully understand the loan products they are buying. Mandating the full disclosure of the total cost of a loan product in a manner that the average consumer can understand (such as effective interest rate and total cost of credit presented in a simple, standardized format) helps to prevent irresponsible providers from hiding or misrepresenting costs. Such information, along with information on late payment penalties and the ramifications of default, enable consumers to make fully informed borrowing decisions. Financial literacy and education programs can also help in this regard.

Finally, from a market perspective, early warning systems can be put in place to monitor the risk of overindebtedness. Recent research on the incidence of overindebtedness has highlighted leading indicators that can be used to signal the risk of a potential crisis.[17] These indicators include market penetration, growth rate of total loan portfolio, MFI liquidity, average loan balance per borrower, and multiple lending. If policymakers seek to monitor such information, this information should be included in reporting requirements for MCCs.

4.2 Financial crimes

Non-depository microcredit providers have not historically contributed to pyramid schemes or similar abuses any more so than other types of financial providers, even in countries where serious instances of these problems have occurred. As with any other financial provider, MCCs should be subject to existing controls already in place to prevent financial crimes, though rules will need to be adapted for microcredit. Three types of financial crimes relevant to microfinance are: (1) anti-money laundering and combating financing of terrorism (AML/CFT), (2) fraud and related financial crimes (particularly pyramid investment schemes), and (3) identify fraud.

The “Law on the Prevention of Money Laundering and the Financing of Terrorism” should be examined to extend its application to MCCs where applicable and to ensure enforcement of these provisions by an appropriate supervisory body. Adjustments to the provisions in this law will be necessary to account for the differences posed by microcredit. For example, applying the same AML/CFT rules for conventional banking to much smaller microcredit transactions can severely limit access to finance by increasing the operating costs of MCCs when serving poor clients.

The Financial Action Task Force (FATF) recommends taking a risk-based approach, instructing countries to assess money laundering and terrorist financing risks and to put in place AML/CFT measures commensurate with the risks identified. FATF recommendations explicitly permit countries to utilize simplified measures where lower risks are identified. Customer due diligence rules can be adjusted to be more appropriate for the realities of microfinance by relaxing and simplifying rules on formal identification, permitting the electronic storage of records to lower the administrative costs that MCCs incur with large numbers of small transactions, or allowing agents or thirds parties to conduct customer due diligence.

---

[17] See “Over-indebtedness and Microfinance: Constructing an Early Warning Index”, Center for Microfinance – University of Zurich, 2010.

5. Table: Summary of key topics for legal and regulatory framework for microcredit

The following table summarizes some of the key topics for a legal and regulatory framework for microcredit discussed in Sections 2, 3 and 4.

Key topic	Important considerations
Definition of microcredit	• Include limitation on loan size, but use two-pronged approach for flexibility: (1) higher single loan size limit and (2) lower average outstanding loan balance • Set actual monetary amounts in bylaws, not MCC law • Restrictions on type of client and loan purpose can be overly rigid and difficult to enforce; if included, keep language general
Registration of MCCs	• Take risk-based approach towards registration requirements, which should be less extensive compared to banks • Initial minimum capital requirement should be low enough to allow for new entrants while posing a barrier to unprofessional institutions
Ownership and governance	• Adopt ownership requirements appropriate for MCCs with respect foreign ownership and ownership diversification • Apply "fit and proper" requirements for board members and senior managers similar to banks, but allow flexibility for microfinance experience
Permissible activities	• Clearly authorize permission to lend • Consider including other activities such as leasing, guarantees, factoring, payments, and serving as insurance intermediaries • Allow for related secondary activities, i.e. consulting and training
Prudential regulation, loan loss provisioning, and risk management	• Limit prudential regulation, which is not appropriate for non-deposit-taking MCCs • Allow for creation of loan loss reserves and write-off of reserves for tax purposes • Risk management requirements should not be overly prescriptive or rigid and should match actual (limited) risks posed by MCCs
Supervision	• "Supervisory" entity should maintain registry of MCCs, collect reports, and promote compliance with sound financial performance and consumer protection standards • Delegated supervision provides regulators with some degree of control and monitoring over industry association
Reporting and auditing requirements	• Requirements should be lighter than those for prudentially regulated institutions • Tailor requirements for specific non-prudential policy objectives, such as market monitoring and preventing financial crimes
Consumer protection	• Harmonize with existing consumer protection rules, including revision of existing rules to include MCCs and legal persons (such as microenterprises and MSMEs) • Consider supervisory arrangements for consumer protection
Overindebtedness	• Utilize credit bureaus and assessments of creditworthiness (mandate reporting to main credit bureau by MCCs), disclosure and transparency, financial literacy and education, and market monitoring to lower the risk of overindebtedness
Financial crimes	• Apply existing controls against financial crimes to MCCs, adapted for characteristics of microfinance such as simplified customer due diligence

6. Complementary policy initiatives and long-term financial inclusion strategy

The scope of this report focuses on the first step in expanding microfinance in Serbia: the creation of a legal and regulatory framework for MCCs. While a critical initial goal, increasing financial inclusion in Serbia will require complementary policy initiatives and a more comprehensive, long-term strategy that tackles the issue of financial inclusion from multiple angles.

A new legal framework for MCCs should be accompanied by well-targeted, complementary policy initiatives in order to achieve its full potential. Policy initiatives and specific incentives should aim to encourage more investment in microfinance and MCCs using methods not distortive of the market. For example, concrete government programs could include guarantee programs to domestic banks providing wholesale funding to MCCs or for "riskier" sectors such as agriculture. Development funds could also be better targeted and coordinated to benefit MCCs in under-served markets to reach more MSMEs. Tax incentives or exemptions could be used to further incentivize the provision of microcredit, as noted by the EC Communication on Micro-credit Initiative.

Policymakers can also play a promotional role by widely broadcasting access to finance as a high priority in Serbia. Given that donor funding is slowly moving out of Serbia, policymakers should work to build communication lines with domestic and international stakeholders, in particular potential international investors, and provide assurances that an enabling legal and regulatory framework will soon be in place for microfinance. Several internationally-funded credit lines currently exist for SMEs; these funds are channeled to commercial banks due to the lack of other options, resulting in large average loan sizes. These funds should be encouraged to support the growth of new and existing MCCs to better meet the needs of MSMEs.

Over the longer term, policymakers should consider if and when MCCs will be allowed to transition to deposit-taking MFIs, and what adjustments to the prudential framework may be required to make microfinance a more viable option for existing banks. A MCC law by itself will likely not be sufficient to "solve" the problem of access to finance for MSMEs. MCCs will need to be able to access deposits for long-term sustainability, and banks will need to be encouraged to move down market (while existing microfinance banks need the ability to expand outreach).

By definition, borrowers of microcredit are typically self-employed or informally employed (i.e. not salaried by a formal employer), and microloans often have either no collateral or unconventional collateral (which is frequently insufficient to cover a lender's loss in the case of default). The current prudential framework makes it nearly impossible to serve these types of microcredit borrowers due to these inherent characteristics. Uncollateralized lending and lending to unregistered businesses and individuals without a registered salary requires prohibitive reserve requirements of up to 100%. Many start-up enterprises, microenterprises, and MSMEs fall into this group. Opportunity Bank, one of the two microfinance banks currently operating in Serbia, has noted that the current prudential regulatory framework has limited its growth and constrained outreach to low-income clients. However, microfinance banks such as Opportunity Bank and ProCredit have high potential to address the missing "middle" in SME lending, as their loan sizes range from EUR 3,000 to EUR 10,000.

Microcredit lending methodologies developed and utilized around the world have proven that there are effective, alternative means to assess the creditworthiness of less formal clients. The report on "Microfinance Activities and the Core Principles for Effective Banking Supervision" issued by the Basel Committee on Banking Supervision lays out how core principles of prudential regulation can be tailored for depository microfinance. Prudential regulations could therefore be strategically revised to provide the flexibility for financial institutions to serve these types of clients on a commercially sustainable basis, while still requiring appropriate risk analysis and protecting financial stability. For example, recent reports on access to finance and financial institutions in Serbia have suggested the following modifications:

- Revise loan loss provisioning to match estimated losses;
- Reduce overcollateralization and expand types of acceptable collateral;
- Remove disincentives to lending to start-ups;
- Relax tax compliance monitoring requirements; and
- Revise credit file documentation requirements for SMEs.

7. Next steps

There is much to be done to create a legal and regulatory framework for microfinance in Serbia. Many uncertainties exist regarding how the NBFI market may develop given that there is limited existing data from which to draw. Further research and analysis is needed to better ascertain the current state of the microcredit market and the potential future, in order to formulate an appropriate legal and regulatory framework. The following items should be considered as next steps:

- Assess the potential impact of microcredit in Serbia. An analysis should be performed on (1) the current unmet need for microcredit in Serbia,[18] (2) to what extent the introduction of a law on MCCs would increase the availability of microcredit to address this need, and (3) the direct and indirect impact of increased access to finance. Preliminary data exists on these topics, including the NBFI study funded by the EBRD during the drafting of the Draft MFC Law, an analysis prepared on the effects of the Draft MFC Law, and the Serbia Microcredit Gap-Assessment prepared by the ILO. This data should be updated, utilizing current reports and statistics and interviews with stakeholders, to estimate the current demand for microcredit by creditworthy borrowers. Estimates for the potential growth in availability of microcredit can be formulated by analyzing data and projections from existing microcredit providers as well as analyzing the growth trends of microcredit providers in countries such as Romania and the Kyrgyz Republic following the introduction of enabling legal frameworks. In addition to growth trends, the analysis should assess the potential for new MCCs to enter Serbia and target a broader range of clients with loan sizes within the "missing" middle. Analyzing the impact of increased access to finance should include projections on economic growth and increased employment, preferably on a regional and local basis. These projections could be developed from a combination of market statistics, interviews with providers and existing and potential MSME clients, and comparisons with other country experiences. Such analyses could be performed by a local Serbian think tank or an international consultant or consulting company that has undertaken similar assessments in other regional markets.

- Assess the potential for investment in microcredit in Serbia. A rapid assessment of potential investment should be performed. Such an assessment could draw from multiple sources of information, including commitments already voiced by investors to existing microcredit providers and interviews with additional potential donors and investors that have expressed interest in the country and region (both in investing in existing microcredit providers or providing start-up funding to new MCCs targeting a broader microcredit clientele). As there is broad range of global investors and investment vehicles for microfinance with differing objectives and investment mechanisms, a mapping exercise could be undertaken to determine the landscape of potential investors best-suited for the vision of the commercially-oriented MCC sector in Serbia. This outreach should include investors who currently fund SME lending through commercial banks and may wish to move towards MSME lending via other channels if available. Comparisons could also be made with case studies such as Romania and the Kyrgyz Republic, examining the extent of investment flows following a change in law.

- Convene stakeholders and form an official working group. As this effort involves a number of different components and interests, multiple agencies, and a variety of market players, a broad range of stakeholders should be convened. These stakeholders should include donors and investors, relevant government agencies (including both financial regulators as well as policymakers working on economic growth and poverty alleviation), existing microcredit providers, and other interested parties. An official working group should be formed from the

[18] Research efforts on this topic could also be coordinated with the Social Inclusion and Poverty Reduction Unit, which is conducting a broader assessment on financial exclusion in Serbia in the fall of 2013.

group of relevant stakeholders that is tasked with formulating and implementing a concrete strategy to move this effort forward. It will also be necessary to find a "champion" among policymakers who can own this initiative and maintain strong, vocal, and consistent leadership throughout what will inevitably be a multi-stage, multi-year, and multi-stakeholder process.

- Begin process of drafting MCC law. Once the working group is formulated, the priorities and objectives regarding a MCC law should be discussed, roles and responsibilities delegated, and a clear and realistic timeframe developed. The drafting of a MCC law should follow an inclusive, transparent process, both to ensure that concerns from all parties are addressed as well as to generate broad necessary buy-in. This report touches on several key topics, but many more will need to be considered and discussed in greater detail, as will bylaws and necessary amendments to other laws and regulations, by a subgroup tasked with the actual drafting of the MCC law. Throughout this process, drafters should keep in mind the basic principles laid out in the beginning of Section 2: a strategic, risk-based approach should be maintained so as to not unnecessarily over-regulate and overburden MCCs. Drafting of the MCC law should draw from lessons learned from similar experiences in Romania and the Kyrgyz Republic.