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A Review of the Bosnian Microfinance Sector: Move to Financial Self-Sufficiency

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This case study highlights developments in the dynamic Bosnian sector since the *MicroBanking Bulletin* (MBB) first documented the sector's emergence in 2000.[1] It focuses on data from six institutions: EKI-World Vision, Mi-Bospo, Mikrofin, Partner, Prizma, and Sunrise; all of which are participating in the upcoming 10th edition of the MBB and have provided over four years of financial and institutional data.[2] Hereafter, the term Bosnian MFIs refers to these six MFIs unless otherwise noted. The case will provide a brief background of the sector, describe issues facing Bosnian MFIs, illustrate the MFIs' responses to the Bosnian operating environment, and highlight the growth and financial performance of the respective institutions.

Background

All MFIs in Bosnia confronted significant challenges when they began providing their first loans. Even before the war broke out in 1992, Bosnia's economy was struggling in its transformation from a socialist system. Large industry dominated the economic environment in most towns. Although massive factories provided employment and a stable salary, they were poorly run and never market driven. By the time the war ended in 1995 with the Dayton Peace Agreement, unemployment had skyrocketed to 85%, as most of the factories were destroyed during the three years of war.[3] In such an atmosphere, many people turn to self-employment through entrepreneurship for survival.[4]

Internally displaced individuals are persons or groups who have been forced or obliged to flee or to leave their homes or places of habitual residence, in particular as a result of or in order to avoid the effects of armed

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[1] Barrès, Isabelle. "Bosnian MFIs: Performance and Productivity," *MicroBanking Bulletin*, no. 6, Washington, DC, 2000. The case focused on eight MFIs: AMK, Mi-Bospo, LOK, MEB, Partner, Mikrofin, Sunrise, and EKI-World Vision

[2] The *MicroBanking Bulletin* (MBB) has become the premier benchmarking source for the microfinance industry. Originally an output of the MicroBanking Standards Project, the MBB is now one of the principal products offered by the MIX (Microfinance Information eXchange). MBB 10 will be disseminated in summer 2004. It is a trends analysis focusing on MFIs that have been contributing to the MBB for more than 4 years.

[3] Goronja, Nataša. "The Evolution of Microfinance in a Successful Post-Conflict Transition: The Case Study for Bosnia-Herzegovina." Geneva, 1999. *ILO/UNHCR Workshop: Microfinance in Post Conflict Countries.*

[4] Ibid.

conflict.[5] A micro-entrepreneur in Bosnia is likely to be a war returnee or demobilized soldier who previously was a factory worker or ran a sophisticated private business and returned home to find it in rubbles.[6]

Although most of today's institutions began operating in 1997, the idea of micro-credit was introduced within months of the Dayton Peace Agreement. In a post conflict situation, loans are typically earmarked for larger governmental reconstruction projects and rarely for grassroots, private micro-credit.[7] The success it had from the beginning and its continual growth has today proven to be an important factor in the post-war economic transition for Bosnia and key driver for economic growth.

BiH's investment in, and commitment to, microfinance has proved to be a worthwhile investment. It has rapidly created jobs and improved the country's financial infrastructure, especially for smaller borrowers.[8] By 2003, the Bosnian MFIs studied in this case alone had reached up to 40,000 active borrowers, 61% of whom were women, a segment of the population severely affected by the war. The number of active borrowers represents 62% of the clients served by the 40 largest MFIs operating in Bosnia.[9]

[5] UN Guiding Principles (1998).

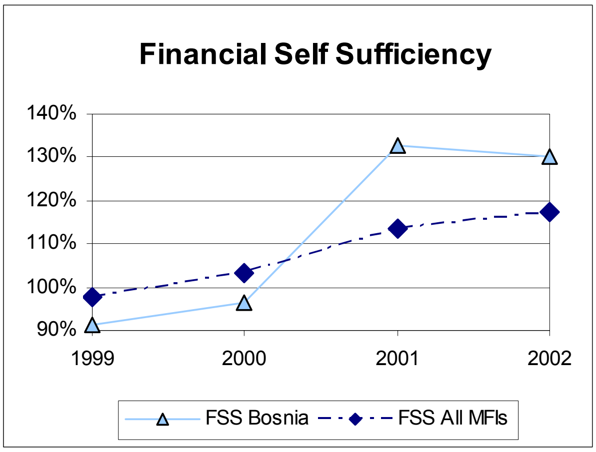
[6] Goronja, Nataša. "The Evolution of Microfinance in a Successful Post-Conflict Transition: The Case Study for Bosnia-Herzegovina." Geneva, 1999. *ILO/UNHCR Workshop: Microfinance in Post Conflict Countries.*

[7] *Innovative Approaches to Microfinance in Post Conflict Situations: Bosnia Local Initiatives Project*, Social Development Notes, Note No. 50, March 2001.

[8] Ibid.

[9] 40 MFIs are estimated to be operating in BiH and the Microfinance Centre for CEE/NIS (MFC) tracks the 17 MFIs, which follow international best practices.

Originally risk averse and predominantly serving higher-income clients, the Bosnian MFIs have recently attempted to broaden their client base and serve rural clients engaged in agricultural activities. Still, the average loan size relative to GNP per capita is rather high and has on average increased slightly for the Bosnian MFI's since 2000. The average loan balance as a percentage of per capita income at the end of 1999 was 86% compared to 90% by the end of 2002.



Even at a young age, these Bosnian MFIs as a group have posted impressive results. Each of the Bosnian MFIs in this case has become financially self-sufficient in less than six years. At the end of 1999, the average Bosnian MFI had yet to achieve self-sufficiency; however, by the end of 2002, it had become 130% financially self sufficient, well above the 117% average for all MFIs reporting to the MBB. In addition to becoming increasing profitable, the Bosnian MFIs have significantly grown in scale; their average total assets and gross loan portfolio have increased three fold since the end of 1999, with an almost commensurate increase in the number of active borrowers.

[11] The following MFIs are included in the non-Bosnian ECA peer group: NOA - Croatia, Constanta - Georgia, FINCA -Kyrgyzstan, and XAC Bank - Mongolia.

Avg. Bosnian MFIs

Scale & Outreach	12/31/1999	12/31/2002	% ∆
Avg. # of Active Borrowers	2,311	6,657	188%
Avg. Gross Loan Portfolio	2,239,568	7,508,883	235%
Avg. Total Assets	2,737,683	8,416,768	207%

Avg. ECA MFIs (Without Bosnia)

Scale & Outreach	12/31/1999	12/31/2002	% ∆
Avg. # of Active Borrowers	5,237	12,038	130%
Avg. Gross Loan Portfolio	1,013,816	3,769,012	272%
Avg. Total Assets	1,324,546	5,705,747	331%

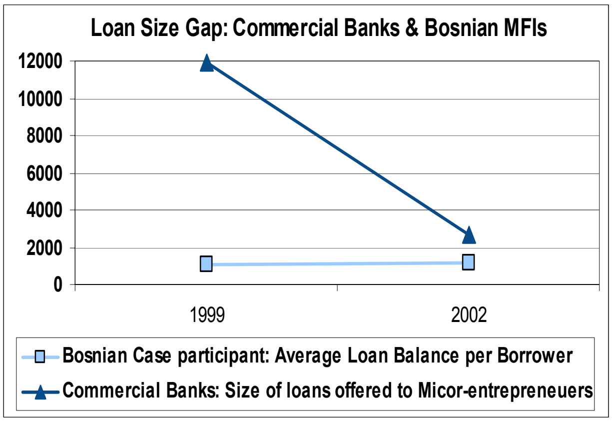
Compared to the average ECA MFIs[11], over the same period, the Bosnian MFIs showed a greater percentage increase in number of borrowers served notwithstanding their receiving a significantly smaller percentage increase in total assets.

Landscape of Bosnian Microfinance

Competition -

Competition continues to play a serious role for MFIs operating in Bosnia. Competition has prompted the Bosnian MFIs to significantly grow their portfolios, expand operations into new areas and develop new products. Although these institutions actively seek new clients, clear client segmentation has yet to occur in the industry. MFIs generally target clients who are unable to attain credit from the traditional financial sector. In many locations, clients have more than one institution to choose from for financial services and products, and MFIs often compete over the same client.

Although competition from commercial banks was expected to add to the competitive landscape, it has yet to become a serious factor. However, MFIs will assuredly increasingly feel the pressure as the gap in loan sizes offered by MFIs and those offered by commercial banks has narrowed dramatically in the last four years. Contributing to this narrowing is the fact that Kreditanstalt für Wiederaufbau (KFW) is currently managing an EU project whereby seven participating commercial banks offer loans starting at 5,000 KM[12] ($2,673).[13] As seen in the following graph, the loan gap was much wider in 2000 when commercial banks were offering SME loans starting at only 25,000 KM ($11,904). To put this in perspective, the average loan balance per borrower for the Bosnian MFIs was $1,146.



Client Demands and Retention -

Many of the clients, known as "the new poor," are highly educated individuals who have become unemployed as a result of the economy and war. These clients, however, are becoming more sophisticated in their demands and no longer desire the "one size fits all" loan product. In an increasingly competitive environment, they are able to shop around for a more favorable product.

Client retention is further complicated by the Bosnian sector's loose method of retaining clients. MFIs do not "force" clients to take

[12] Convertible Mark or KM is the currency of state of Bosnia and Herzegovina. The Convertible Mark banknotes were issued for the first time on 22 June 1998
[13] The European Fund for Bosnia and Herzegovina projects consists of three lending programs: Housing Loan Programme, Small and Medium Enterprise Loan Program, and Rural Loan Programme.

loans in sequence. Individuals can leave the program and re-enter at some other time or with another institution at no additional cost. In addition, clients are neither required to participate in meetings nor to maintain savings as a condition for receiving a loan.

Business Enabling Environment -
The Bosnian economy is not progressing as quickly as was expected. Unemployment is still high and the privatization process remains slow. Legal barriers still create problems for small entrepreneurs, impeding the growth of the country's micro-enterprises.

The regulatory environment also poses problems for MFIs that are interested in offering additional products. The existing law has yet to be amended, which forbids MFIs from offering additional financial products including, savings, insurance, and leasing. However, donor initiatives are underway to amend the BiH microfinance law.[14]

MFI's React to the Bosnian Operating Environment (2000-2003)

Geographic Expansion and Decentralization -
Competition has encouraged Bosnian MFIs to actively seek new clients. With institutions competing for the same clients, many MFIs have opened additional branches and sub-branches in new, often distant locations in both Federation BiH and the Republic Srpska. EKI, Mikrofin, Partner, Prizma, and Sunrise have all done so. The average number of offices of an MFI in 2000 was 8, and by 2003 the average Bosnian MFI had 19 offices. Sunrise expanded from four to 17 offices from 2000 to 2003 and Prizma expanded from 10 to 26 offices over the same period.

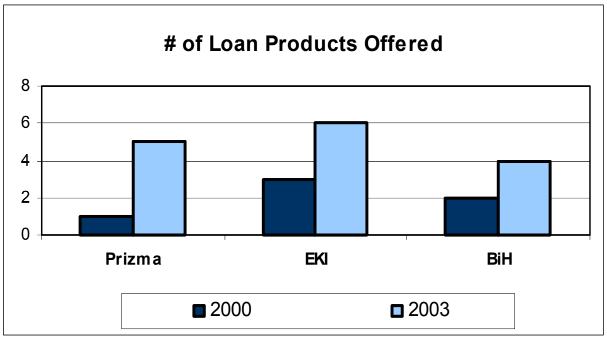
Geographic expansion encouraged many of the MFIs to re-organize their institutional structures. For example, both Prizma and Partner recently developed and implemented an intranet – internet based communication system for employee communication – that has helped build the institutional integrity of the decentralized system and reduced costs. All the MFIs in this study are now highly decentralized. Head offices now primarily fulfill a supervisory role, while branch offices are profit centers and individually monitor their own performance. This has translated into branches becoming more responsive to the needs of their clients while operational costs have fallen. The implementation of a decentralized strategy has contributed to the decrease in the average total expense ratio from 32% of average total assets in 1999, to 20% by the end of 2002.

Product Diversification and Development
Due to increased competition and client demands, five out of six of the participating MFIs have launched new products since the last study. It has become evident that the "one size fits all" product will not work when MFIs compete for the same client. Therefore, all of the MFIs now carry out market research when designing new products. For instance, EKI organizes focus groups with its clients, while Partner and Prizma monitor exiting clients through telephone interviews and exit monitoring forms in order to gauge what products their former clients prefer.

Learning from clients has become a routine activity for all the MFIs when developing new loan products. The process has paid off, and

[14] The World Bank is attempting to have a BiH law amended, which will allow MFIs to invest in a fund or for-profit organization as well as a law that would allow for MFIs to expand their product lines. The International Fund for Agriculture Development (IFAD) is advocating for a new law that will enable the creation of savings and credit associations.

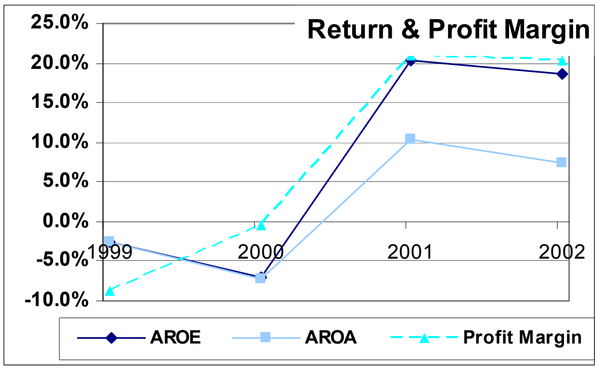
clients now have various products to choose from. In 2000, the average Bosnian MFI offered two products and by 2003, the same group offered on average four different products.



As seen in the preceding graph, Prizma has differentiated its products quite extensively, offering only one type of product in 2000 to offering five in 2003. EKI has added one product per year since the last study and now offers six different products to current and potential clients. EKI offers a fixed asset loan, agriculture loan, solidarity group loan, working capital loan, non-registered business loan and a fixed asset/agriculture loan.

In addition to product development, a few MFIs have implemented other programs to ensure that they retain their current client base. Partner, for example, introduced a Consumer Protection Code of Practice. This Code established ethical principles and rules of business performance for all Partner staff to guarantee that transparency remains one of its core values. The goal of the Code is to protect clients from inappropriate marketing, pricing and distribution of products and services.

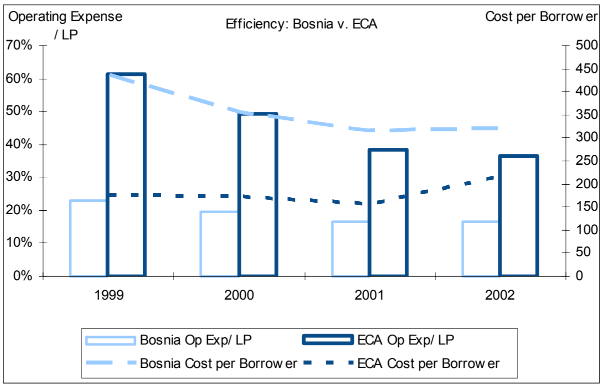
Financial Sustainability and Efficiency - Since the beginning of the microfinance pilot project in Bosnia, the respective MFIs received a clear message from the BIH's Local Initiative Development (LID) project that each institution would need to rapidly become financially self sufficient and seek other long-term funding sources.[15] Five out of six of the MFIs in the study were born out of the LID program, and it is evident that each clearly reacted to the message by the fact that all six of the Bosnian MFIs are now financially self-sufficient. To illustrate this point, in 2000 their average Adjusted Return on Equity (AROE) was -3% and by 2003 had skyrocketed to 21.9%. As seen in the following graph, the same positive trend occurred for the average Adjusted Return on Assets (AROA). In 2000, the AROA was -3.6% and by 2003 had risen to 6.1%. It is worth mentioning that during the same period the average ECA MFIs, without Bosnia, showed a similar positive trend in AROA although AROE was not nearly as positive; the ECA average AROE was -27.2% in 1999 and grew to 9.10% by the end of 2002.



The message to rapidly become financially self-sufficient under the LID program, led many MFIs to closely monitor their financial results. Given a strong demand for cheaper products by their respective clients, institutions focused on greater efficiency and sought to make their operations more

[15] The LID project is a BiH pilot supported by the World Bank, which began with 17 NGOs that knew little about microfinance and now consists of 9 profitable MFIs with an outstanding portfolio of 50 million Euros ($44.1 million). The project is planned to close in 2005.

cost-effective. Many of the MFIs have introduced modern management techniques to improve efficiency. Prizma introduced Activity Based Costing (ABC) to pinpoint inefficiencies and better price its products. The focus on efficiency has obviously paid off as operating expenses relative to the loan portfolio and average cost per borrower have significantly decreased since 2000.



The Operating expense to loan portfolio for the Bosnian MFIs decreased from 26% at the end of 1999 to 19% at year-end 2002 and the cost per borrower dropped from $508 to $372. Interestingly, over the same period, the average cost per borrower for ECA MFIs increased from $175 to $215, despite their posting a strong improvement in operating costs as shown by their reduction of operating expenses as a percentage of loan portfolio of roughly 40%.

To control portfolio costs, the Bosnian MFIs have all gradually given up the "zero tolerance for delinquency" policy due to its high cost, but still closely control portfolio quality.

Integration into the Capital Market -
Although, the development of Bosnia's financial infrastructure remains a challenge for most MFIs, several have embarked on various initiatives to become better integrated into the formal financial sector. For example, both Partner and Mikrofin have recently transferred restricted donations to equity to increase the level of owned equity and improved their attractiveness to international investors and commercial banks. However, this type of strategy has not yet proven successful in attracting new funding.

Several Bosnian MFIs have also been able to increase their access to commercially priced funds from local banks and international investors. In 2000, liabilities priced at market rates funded only 2% of the average loan portfolio, but by 2003 that rate had risen to 12.6%. Several MFIs, like EKI, are considering transitioning into a finance company that will be better positioned to offer a wide range of services and will be able to draw on necessary resources to meet clients' needs. For example, they are considering introducing savings in the next three years. However, in order to do this, the current law on Microcredit Organizations must be amended.

Conclusion -
Dynamic is the best way to describe the Bosnian microfinance sector. A sector that quickly reacts to the operating environment, competition from its peers and changing demands from its clients. Its flexibility and speed have proven successful on almost all fronts; from scale to productivity and even efficiency. However, the most noticeable is the average BiH MFI's improvement in financial performance.

The success in the sector is a model example for other MFIs who begin as a start-up and quickly find themselves in a competitive environment. It is clear that more lessons can be learned from this case for MFIs operating in Central and Eastern Europe and the Newly Independent States (CEE and NIS) as well as for the global industry through further research and analysis.

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