

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

Mark Berryman and Justyna Pytkowska

This case study highlights developments in the dynamic Bosnian sector since the *MicroBanking Bulletin* first documented the sector's emergence in 2000.³ It focuses on data from six institutions: EKI-World Vision, Mi-Bospo, Mikrofin, Partner, Prizma and Sunrise; all of which are participating in this edition of the *Bulletin*. Hereafter, the term "Bosnian MFIs" refers to these six MFIs unless otherwise noted. The case⁴ will provide a brief background of the sector, describe issues facing Bosnian MFIs, illustrate the MFIs' responses to the operating environment of Bosnia and Herzegovina (BiH), and highlight the growth and financial performance of the respective institutions.

Figure 1: Federation of Bosnia and Herzegovina



Source: CIA World Factbook, www.cia.gov.

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 away 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 with the Dayton Peace Agreement in 1995, unemployment had skyrocketed to 85 percent, as most factories had been

destroyed during three years of war. In such an atmosphere, many people became self-employed entrepreneurs for survival.⁵

A microentrepreneur 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 rubble.⁶ In addition, BiH had many internally displaced persons (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 conflict).⁷

Although most of today's institutions began operating in 1997, the idea of microcredit 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.⁸ The success of microfinance from the beginning and its continual growth has proven it to be an important factor in the post-war economic transition of Bosnia and a key driver of economic growth.

BiH's 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.⁹ By 2003, the Bosnian MFIs studied in this case alone had reached up to 40,000 active borrowers, 61 percent of whom were women, a segment of the population severely affected by the war. At that time, their total active borrowers represented 62 percent of the clients served by the 40 largest MFIs operating in Bosnia.¹⁰

Originally risk-averse and predominantly serving higher-income clients, Bosnian MFIs have recently

³ Isabelle Barrès, "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

⁴ This case study originally appeared in May 2004 as a publication of the Microfinance Centre for its annual conference.

⁵ Nataša Goronja, "The Evolution of Microfinance in a Successful Post-Conflict Transition: The Case Study for Bosnia-Herzegovina," ILO/UNHCR Workshop, "Microfinance in Post Conflict Countries," Geneva, Switzerland, 1999.

⁶ Goronja, "The Evolution of Microfinance."

⁷ "Guiding Principles on Internal Displacement," E/CN.4/1998/53/Add.2, United Nations, New York, 1998.

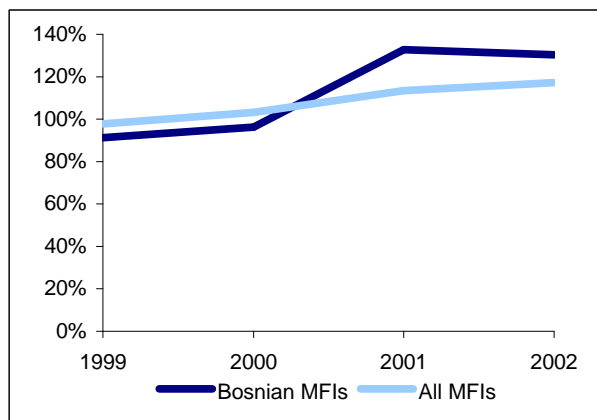
⁸ K. Kuehnast, "Innovative Approaches to Microfinance in Post Conflict Situations: Bosnia Local Initiatives Project," World Bank, Washington, DC, March 2001.

⁹ *Ibid.*

¹⁰ Forty MFIs are estimated to be operating in BiH. The Microfinance Centre for CEE/NIS (MFC) tracks the 17 MFIs that follow international best practices.

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 among Bosnian MFIs since 2000. The average loan balance as a percentage of per capita income at the end of 1999 was 86 percent, compared to 90 percent at the end of 2002.

Figure 2: Growth in Bosnian self-sufficiency



Source: *MicroBanking Bulletin* no. 10 data.

Even at a young age, the Bosnian MFIs as a group posted impressive results. Each of the MFIs in this case study became 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 percent financially self-sufficient (well above the 117 percent average for all MFIs reporting to the *Bulletin*). In addition to becoming increasingly profitable, the Bosnian MFIs have grown significantly in scale. Average total assets and gross loan portfolio have both increased threefold since the end of 1999, with an almost commensurate increase in the number of active borrowers.

Compared to average ECA MFIs¹¹ over the same period, the Bosnian MFIs showed a greater percentage increase in number of borrowers served, notwithstanding their significantly smaller percentage increase in total assets.

Figure 3: Average indicators of Bosnian MFIs

Scale & Outreach	1999	2002	% ?
Avg. # of 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%

Source: *MicroBanking Bulletin* no. 10 data.

¹¹ The non-Bosnian ECA group includes NOA (Croatia), Constanta (Georgia), FINCA (Kyrgyzstan), and XacBank (Mongolia).

Figure 4: Average indicators of ECA MFIs (without Bosnia)

Scale & Outreach	1999	2002	% ?
Avg. # of 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%

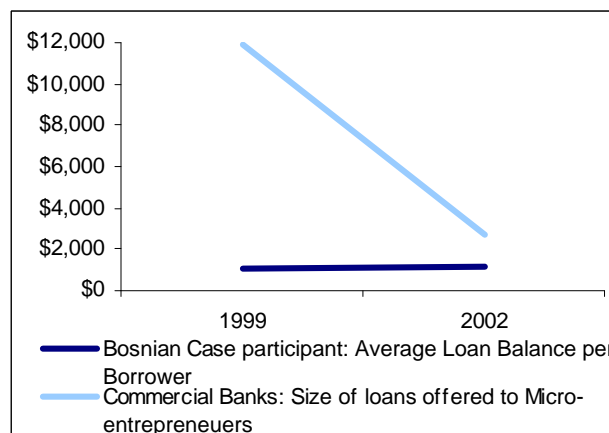
Source: *MicroBanking Bulletin* no. 10 data.

Landscape of Bosnian Microfinance

Competition

Competition continues to play a serious role in MFI operations 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 obtain credit from the traditional financial sector. In many locations, clients have more than one institution from which to choose, so MFIs often compete over the same client.

Figure 5: The closing loan size gap



Source: *MicroBanking Bulletin* no. 10 data and *MicroBanking Bulletin* no. 6 data

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 start to feel the pressure, as the gap in loan sizes offered by MFIs and 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 in which seven participating commercial banks offer loans starting at 5,000 KM¹²

¹² The Convertible Mark, or KM, is the currency of the state of Bosnia and Herzegovina. Convertible Mark banknotes were issued for the first time on 22 June 1998.

(USD 2,673).¹³ As seen in the preceding graph, the loan gap was much wider in 2000, when commercial banks were offering small and medium enterprise (SME) loans starting at 25,000 KM (USD 11,904). To put the comparison in perspective, the average loan balance per borrower for the Bosnian MFIs was then USD 1,146.

Client retention

Many Bosnian microfinance clients, known as “the new poor,” are highly educated individuals who have become unemployed as a result of war and the economy. 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 fact that Bosnian MFIs do not “force” clients to take loans in sequence. Individuals can leave a program and re-enter at some other time or borrow from 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 continue to 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, which has yet to be amended, forbids MFIs from offering additional financial products, including savings, insurance and leasing. However, donor initiatives are underway to amend the BiH microfinance law.¹⁴

MFIs 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 addi-

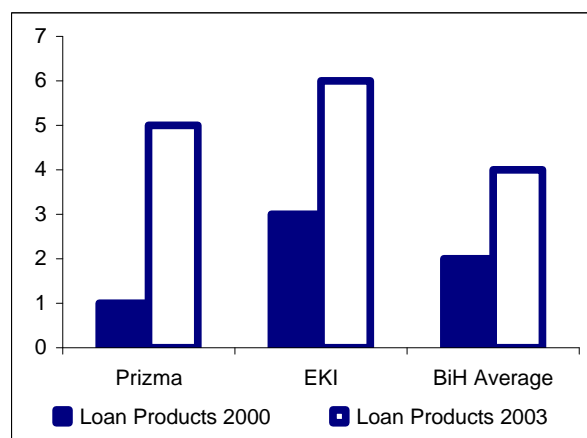
tional branches and sub-branches in new, often distant locations in both the Federation of BiH and the Republic Srpska. EKI, Mikrofin, Partner, Prizma, and Sunrise have all followed this strategy. The average number of offices of an MFI in 2000 was 8; by 2003 the average Bosnian MFI had 19 offices. Sunrise expanded from 4 to 17 offices from 2000 to 2003, while Prizma expanded from 10 to 26 offices.

Geographic expansion encouraged many of the MFIs to re-organize their institutional structure. For example, both Prizma and Partner recently developed and implemented intranets— Internet-based communication systems for employee communication—that has helped assure the institutional integrity of a decentralized system and reduced costs. All MFIs in this study are now highly decentralized. Head offices 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 as operational costs fall. The decentralization strategy has contributed to a decrease in the average total expense ratio from 32 percent of average total assets in 1999 to 20 percent 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 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.

Figure 6: Growing loan product diversity



Source: *MicroBanking Bulletin* no. 10 data.

¹³ The European Fund for Bosnia and Herzegovina projects consists of three lending programs: the Housing Loan Programme, Small and Medium Enterprise Loan Programme, and Rural Loan Programme.

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

Learning from clients has become a routine activity for Bosnian MFIs when developing new loan products. The process has paid off: clients now have a variety of products from which to choose. In 2000, the average Bosnian MFI offered two products. By 2003 the same group offered, on average, four different products.

As seen in the preceding graph, Prizma has differentiated its products quite extensively. It went from offering only one type of product in 1999 to offering five in 2002. Over the same period, EKI has added one product per year and now offers six different products to current and potential clients: 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 a core value. The goal of the code is to protect clients from inappropriate marketing, pricing and distribution of products and services.

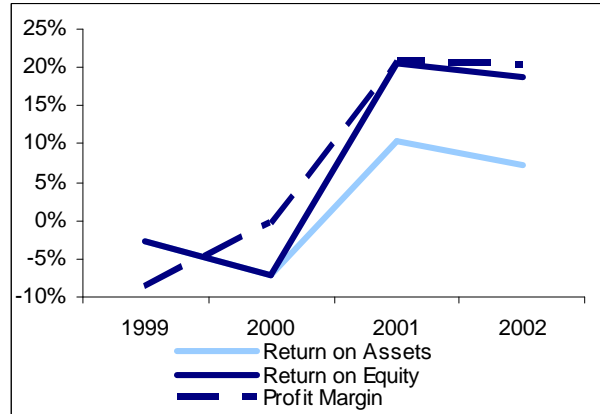
Financial sustainability and efficiency

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 sources of long-term funding.¹⁵ Five out of the six MFIs in this case study were born out of the LID program and it is evident that each clearly heeded the message. All six Bosnian MFIs are now financially self-sufficient. In 1999 their average Adjusted Return on Equity (AROE) was -3 percent, but by the end of 2002 it had skyrocketed to 21.9 percent.

As seen in the following graph, the average Adjusted Return on Assets (AROA) followed the same positive trend. In 1999, AROA was -3.6 percent, but by 2002 it had risen to 6.1 percent. It is worth mentioning that during the same period, 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 percent in 1999 and grew to only 9.1 percent by the end of 2002.

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 a collective outstanding portfolio of 50 million euros (USD 44.1 million). The project is planned to close in 2005.

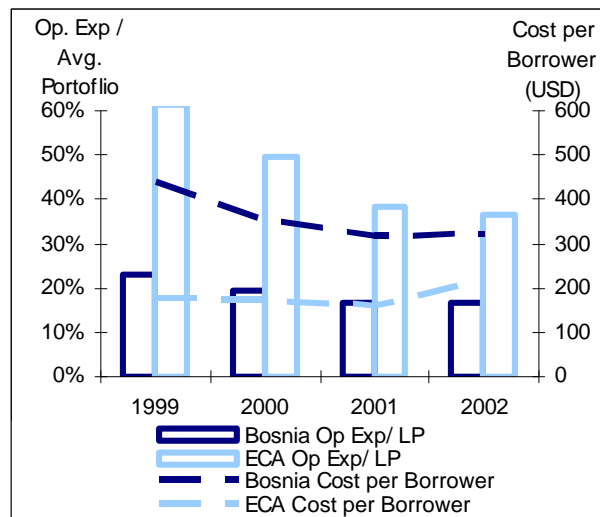
Figure 7: Returns and profit margins in Bosnia



Source: *MicroBanking Bulletin* no. 10 data.

The LID message to rapidly become financially self-sufficient 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 cost effective. Many of the MFIs have introduced modern management techniques to improve efficiency. Prizma, for example, 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 both significantly decreased since 2000.

Figure 8: Gains in efficiency



Source: *MicroBanking Bulletin* no. 10 data.

The operating expense to loan portfolio ratio for the Bosnian MFIs decreased from 26 percent at the end of 1999 to 19 percent at year-end 2002. Cost per borrower also dropped, from USD 508 to USD 372. Interestingly, over the same period, the

average cost per borrower for ECA MFIs increased from USD 175 to USD 215, despite a strong improvement in operating costs, as shown by the roughly 40 percent reduction in operating expenses as a percentage of loan portfolio.

To control portfolio costs, the Bosnian MFIs have all gradually given up a “zero tolerance for delinquency” policy due to 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 thus 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 percent of the average loan portfolio, but by 2003 they had risen to 12.6 percent. Several MFIs, like EKI, are considering transforming into finance companies that would be better positioned to offer a wide range of services and draw on necessary re-

sources to meet client needs. For example, these MFIs are considering introducing savings in the next three years. However, in order to do so, the current law on microcredit organizations must be amended.

Conclusion

Dynamic is the best way to describe the Bosnian microfinance sector. It is 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 to even efficiency. However, the most noticeable achievement of MFIs in BiH is the average improvement in financial performance.

The successful Bosnian MFIs are a model for other MFIs that begin as start-ups 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 the global industry, through further research and analysis.

Mark Berryman (mberryman@ifc.org) served as Analyst for the Microfinance Information eXchange (MIX) from 2003 to 2004. He is currently working with the IFC in Mali.

Justyna Pytkowska (justyna@mfc.org.pl) is a Researcher for the Microfinance Centre for CEE/NIS (MFC).
