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The Impact of Micro Finance Institutions on Micro and Small Enterprises – a Necessity of Adequate Legal Framework

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Abstract

The new world concept of overcoming poverty through an active engagement developed micro crediting. The author defines microcredit, microfinance and microfinance institutions and their relation to micro and small enterprises. Micro crediting through methods of Muhammad Yunus has become an inspiration and model for developing countries for self-employment of vulnerable groups. Many non-governmental and other organizations funded the poor through microcredit and transformed into microfinance institutions. Because of their activities, especially in developed countries, the question of their integration into the legal and financial system arises. Special attention in the paper is devoted to the regulation of microfinance institutions in the EU because there are no specific regulations related to them. The author analyses the advantages and dangers of this form of financing and presents an overview of their work. The necessity of establishing adequate legal regulation of microfinance institutions has been pointed out, so it will be able to control and direct their work and provide positive socio-economic resulting effects.

Key words: *micro-credit, micro-finance institutions, financial and legal framework*

1. INTRODUCTORY REMARKS

One of the ways of applying modern concept of fighting poverty is developing entrepreneurship through the assistance of organizations with social mission. With the collapse of the "welfare state", a large room has opened up for the operation of various non-profit organizations and civil associations.[1] Through this concept, social innovators began to offer financial assistance to poor workers who lack access to bank credits, mainly due to the shortage of security. The newly established model of funding (through micro credits) immediately showed that the poor are able to transform their lives.[2]

2. MICROCREDITS, MICROFINANCING AND MICROCREDIT INSTITUTIONS

2.1. Historical development

Micro credits became perfect solution for fighting poverty. The actual beginning of the development of micro-credits was an attempt to enable the poor to initiate simple activities that generate income in order to find the way out of poverty by lending them tiny, micro amounts of money. The idea was conceived and later turned it into a concept by Dr. Muhammad Yunus, a Bangladeshi economist (educated in the United States) who later received the Nobel Peace Prize. By realizing his idea of micro crediting, Yunus was able to attract significant resources from international community. In that way, he could realize his idea of creating a "bank for the poor." He created the most famous social enterprise, the Grameen Group. The Grameen Group has operated as a network consisting of 30 sister companies linked to the Bangladesh Grameen Bank, the initiator of the idea of micro crediting, which has approved loans in the amount of over € 7.5 million to the poor, of which 97% were women. Yunus claimed that in this way poverty will be eradicated in one generation.[3] Yunus's model of micro crediting and the claim that through self-assistance and individual entrepreneurship people can overcome poverty has prompted many international organizations to support his ideas financially. By the year 2000, this model of micro crediting and encouraging social entrepreneurship by micro credits was generously funded by the international community.

2.2. **The term of micro crediting, micro financing and micro financing institutions**

In literature, the terms of micro credits and micro financing are often used as synonyms, but it is important to emphasize the difference between them, since both terms are often used and can cause confusion. Professor Sinhra states that "micro crediting refers to small loans, while micro financing is a more appropriate term for NGOs (non-governmental organizations) and microfinance institutions, in addition to offering micro credits, supplement their operation with other financial services (savings, insurance, etc.).[4] Therefore, it can be concluded that micro credits are integral parts of micro financing, but micro financing also includes additional non-credit financial services such as savings, insurance, pensions and payment services.[5] Micro financing involves providing financial services for the poor layers of society that lack access to formal banking services. Microfinance services are designed specifically for the poor because they provide access for people who have previously been excluded and classified as inadequate to the financial system (*unbankable*), and not only in terms of crediting, but other services as well, such as micro-savings accounts, money transfer, micro-insurance policies, and the like.[6]

As a result of the lack of necessary capital to meet the high demand of loans and avoiding to rely on donor funds and commercial bank loans, non-profit organizations appeared in the arena of social entrepreneurship. Those who were involved in micro financing of social entrepreneurs were transformed into official microfinance institutions or obtained a banking license.[7] Microfinance (non-depository) organizations/institutions became an important and indispensable factor in the field of work and encouraging the economic development of the most vulnerable social groups. Their significance has been expressed through the ability to bridge the gap between banks and micro and small enterprises that have no access to the traditional way of crediting.

Microfinance institutions are often defined as "organizations that provide financial services to the poor." The term will be explained based on their scope of operation. Firstly, these organizations provide microcredit services, and secondly, in addition to providing the aforementioned service, they include in their work special programs for self-employment and other financial services for the above population.[8] Thus, in addition to offering micro credits, these organizations also offer non-financial services to their clients, primarily counselling, education and regular monitoring. Everything started as an idea of linking micro crediting and the concept of social entrepreneurship. Farmers invested in mechanization or cattle fund, tailors in better machines, bakers have bought new furnaces and thus joined the market in the hope that their own engagement would help them overcome their difficult economic position. This financing concept has rapidly found fertile ground in all parts of the world. Modern forms of micro crediting have been created as a result of inability of the poor, but also of the rural population to finance entrepreneurial ideas with borrowed funds, since they do not meet the strict conditions for obtaining banking loans.

3. INTEGRATION OF MICROFINANCE INSTITUTIONS IN THE FINANCIAL SYSTEM

The concept of micro financing has allowed micro credits to develop not only in underdeveloped countries but also in developed market economies, as the problem of poverty is also present in these regions. This has enabled this type of financing to expand throughout the European Union. In the member countries and regions of Europe, these forms of lending have usually been used as a way to encourage the growth of self-employment and the creation and development of micro and medium-sized enterprises. In many cases, this was linked to the efforts to encourage the transition from unemployment to self-employment. In the strategic vision of the European Union, micro credits are of particular importance for rural areas and in most cases they are linked to social entrepreneurship.

In developed countries, the fundamental question that arises is the integration of microfinance institutions in the existing legal framework. The characteristics that distinguish this type of financing obviously exclude it from the banking system, so there is also the issue of controlling their work. In these countries, financial regulations include two aspects of supervision: *prudential supervision* and *structural supervision*.[9] The purpose of the prudential aspect is to control systemic risk in the financial system and protect the depositors.[10] Financial institutions receiving deposits from general public which have prudential control. The regulation requires applying the rules on capital adequacy and the rules of remedying credit losses. A supervisory process is also required in order to ensure financial security. It follows that prudential control refers to the supervision of the financial health of regulated institutions.[11] In order to become regulated microfinance institutions with enabled supervision, they must obtain a license from the central bank. This opened a widespread discussion on the need to regulate microcredit organizations in this way due to the costs and increase in the price of their operation.[12]

More broadly, the operation of microfinance institutions shows great importance due to their basic role, i.e. micro financing (a large number of vulnerable groups in almost every country), as well as for the creation of sustainable economic development of countries. On the other hand, the influence of these financial institutions on the overall economic development, in addition to the financial system, raises the question of a legal framework that can control and direct their work and enable the positive socio-economic effects that result from it.

4. FLEXIBILITY OF THE LEGAL FRAMEWORK FOR THE OPERATION OF MICROFINANCE INSTITUTIONS

Legal regulation of the work and operation of microfinance institutions differs from country to country. Let us start from the regulations adopted by the European Commission which defines micro credits in Europe as a means of meeting the needs of two groups: "micro-enterprises" defined as enterprises with fewer than ten employees (category which includes more than 90% of all companies in Europe) and "disadvantaged people" (unemployed or inactive people, those receiving social assistance, migrants, etc.) who want to find a job but lack access to banking loans. In most EU countries, there are no specific laws related to micro financing.[13] They are mainly regulated within the laws related to the financial sector. Micro crediting is regulated by applying the general laws on financing and crediting.[14] From the general approach of the legislator and the missing legal framework we conclude that the specific nature of this financial activity and its possible effects on the entire community are not recognized.

The lack of a unified position on microfinance institutions has imposed the need for considering and analyzing their work thoroughly and collect the necessary knowledge in order to encourage the adoption of an adequate regulatory framework for them. The most important initiative is named *Legal and Regulatory Environment Working Group*. The initiative was founded by the European Union, managed by the European Microfinance Network, and the primary goal is to establish a legal and regulatory framework for micro financing in the EU member states, strengthen the capacity of the network of lobbying at the institutional level, and support knowledge transfer and application of good practice between the micro financing sector in countries of the Union.[15] The undertaken activities have changed the attitude towards the microfinance institutions and micro financing activities. They are being regulated and accepted as proven and profitable mechanism for stimulating economic development.

The *European Initiative for Development of Microcredit in Support of Growth and Employment*[16] is a document that initiates the adoption of national regulations and frameworks of supervision, which should be tailored to the specific needs of microfinance institutions. In addition to this document, the European Code of Good Conduct for Microcredit Provision[17] has also been adopted, which collected, analyzed and proposed the best practices in the work of these organizations based on experiences of microfinance institutions throughout Europe. A document called *Implementation of the European Good Conduct for Microcredit Provision* was also prepared by the European Network of Microfinance Institutions in order to provide better understanding and facilitate the implementation of this practice.[18]

According to EU legislation, non-banking institutions cannot take deposits but conduct lending activities. However, many member states have limited lending only to banks and specific financial institutions by their national laws, while microcredit institutions have the role of intermediaries.[19]

In most EU countries, banks have a monopoly in crediting activities. In the preamble to the First Banking Directive of the EU Council (E-77-780 EEC), it is pointed out that banking or financial institutions whose business is to receive savings or other repayable funds from the public and to grant credits for its own account will be referred to as "credit institutions".[20] According to this Directive, all activities carried out by organizations other than credit institutions, if they do not receive deposits but have a financial activity as their core business established by the annex of this Directive are categorized as "financial institutions".[21]

From the above, it follows that, based on the existing legal framework in the EU, microfinance institutions can not deal with lending directly, but only as intermediaries. Their actions can positively influence the engagement of socially vulnerable groups and the overall economic incentive only if it is regulated and controlled. The absence of specific legislation that precisely defines the field of micro financing can cause problems in some aspects of this type of financing (especially problematic is the issue of accessing the centralized registry of credit history of legal and natural persons, and the like).[22]

5. ADVANTAGES AND NEGATIVE EFFECTS IN THE OPERATION OF MICROFINANCE INSTITUTIONS ON SMALL AND MEDIUM-SIZED ENTERPRISES

The advantages of micro financing should be linked to the idea of social entrepreneurship. This definition contains two elements: social and entrepreneurial. The social element refers to the definition of the meaning of what is considered social. The element of entrepreneurship refers to entrepreneurial activities that contribute to the economic growth and development of general well-being of society. Entrepreneurship means doing something in a different way, rather than doing something better than what is already there.[23] Social entrepreneurs do not have to be motivated altruistically; their motives can be explained by the desire to emancipate.[24] We can say that the essence of social entrepreneurship is in the creation of social benefit, and the revenues generated through social entrepreneurship that contribute to making entrepreneurs less dependent on assistance, donations and subsidies from public sector. The efficiency of social entrepreneurship operates and is expressed locally, although some examples have also shown a global significance (Grameen Bank). Their main task is to provide initial funding for innovative solutions, especially among socially vulnerable groups.

Advantages of micro financing are primarily related to micro and small enterprises. Micro crediting is the only way of suppressing constant lack of financial resources among the marginalized social groups. At the same time, this model opens up new jobs and reduces the rate of unemployment. In addition to its basic role of providing financial services to the poor, micro crediting has become an important leverage of economic development with powerful social and economic effects. In addition to their proven advantages, microfinance institutions have shown a number of negative effects that affected the entire economic system.

Firstly, as we have mentioned, microfinance institutions are operating as intermediaries in the placement of micro credits. The received funds are transferred to banks, which then deliver micro credits to clients, who are in fact the clients found by the appropriate microfinance institutions through their mission. Mediation makes this financial service expensive, so the interest rates for these micro credits are multiplying compared to the interest rates on banking loans for small and medium-sized enterprises. In this way, the already poor groups are even more burdened and the idea of micro crediting becomes very profitable for those who have the money. Profitability of micro financing has attracted the attention of some major banks.[25] In this situation, the banks have seen the opportunity to expand their activity and client market. In some cases these banks began to offer products to poor layers of population. The high competition and growing number of market participants have led some non-profit microfinance institutions to lose the mission they opted for. In addition to offering access to financial services, the mission of non-profit organizations also includes investing in literacy and empowerment of their clients. Trying to cover the high customer demand, some non-profit organizations narrowed their focus and abandoned these complementary services, which in some cases led to mission drift.[26]

One of the most infamous examples of transformation of a microfinance institution into a traditional banking institution is the *Compartamos Banco* from Mexico. This bank was founded in 1990 as a non-profit organization, and later became a regulated microfinance institution in 2000 and obtained a banking license in 2006 thanks to which in 2010 it had almost two million clients and $ 781 million in active microloans.[27] Although the bank has been criticized for high interest rates and the rejection of social mission, it can be said that a high number of clients proves the fact that the bank provides financial services that are much needed by the community. The development and transformation of the bank did not lead to the discontinuation of relations with clients. In some cases poorer customers were excluded, but the expanded portfolio of loans has allowed clients to meet their needs. This proves that the activity of microcredit institutions should be legally regulated and controlled in order to prevent their basic mission from being disrupted.

Secondly, the negative effects of microfinance organizations on the development of economic system was specifically emphasized and strongly criticized by Milford Bateman in his works.[28] He begins with criticizing the "wrong turn" of microfinance institutions that have departed from their basic mission to help the poor, which we have explained in the previous section. In his viewpoint, this was an "operational problem" which could be corrected, and thus, unlikely represent the basis of his criticism. Much more serious accusation is that the operation of microfinance institutions was essentially "anti-developmental". He thinks that they have unintentionally weakened and destroyed local economic space with their programmes.[29] Micro financing programmes have promoted the increase in supply of simple products, but these programs did not automatically coincide with the increase in their domestic demand. This resulted in market saturation and competition that has caused a high degree of market withdrawal. This again led to job losses and the increase in the unemployment rate. In addition, incorrectly directed development also affects productivity because homogeneous rather than heterogeneous products are offered, and thus, competition in productivity growth disappears.

Thirdly, the model of micro crediting is considered to stimulate weak, mostly short-term, in many cases informal (unregistered) companies rather than small and medium-sized enterprises, which in most economies are an important leverage of development. In the long run, it inevitably leads local economy in the wrong way that will not create an incentive for overall economic development.

Fourthly, the results in the initial stage of development of microcredit model were surprisingly good, given the significant growth in the employment rate. Thus, every village has received a small store, an agricultural pharmacy, and small crafts (hairdresser, tailor, coffeehouse, etc.). It quickly became clear that growth has stopped, and the situation remained unchanged. This creates a serious obstacle to the work of microfinance institutions, because all micro-entrepreneurs expect to keep their status and are not ready neither for making further investment nor for the possible changes in local markets. They are neither ready for their further development nor for the inclusion in the formal business network, that is for being registered.

Finally, although the damage done to the microcredit model is evident, a positive fact is that open discussions on this subject are possible and mistakes are recognized. Both good and bad sides of this model need to be highlighted, so that the necessary changes can be introduced into this model of financing.

6. A BRIEF REVIEW OF MICROFINANCE INSTITUTIONS AND MICROCREDITING IN SERBIA

The previous part of the paper discussed insufficient and inaccurate legal framework for the operation of microfinance institutions. It has caused a variety of good and bad effects of their operation. Consequently, considering the situation in Serbia it can be said that it is unlikely to differ from situation described above.

The legal framework for the existence and operation of microfinance institutions in Serbia has been insufficiently developed. By 2003, there was an approval issued by the National Bank of Serbia for approving loans from donations, firstly from UNHCR, and then other investors as well. Afterwards, cooperation with commercial banks began which were giving loans on their behalf, but from the funds of microfinance institutions. The 2005 Banking Act prohibited such activity and the banks had a monopoly in the allocation of loans as in the EU, which continued under the new law from 2011. At present, the system works in a way that microfinance organizations make deposits in banks based on which these allocate loans.

This position of microfinance institutions is characterized by a number of shortcomings. Business costs are inevitably increasing, making the cost of loans higher for several reasons: on one hand, due to the operational costs of intermediary role of these organizations, on the other hand, because micro credits in banking practice are categorized as "cash loans" or "consumer loans" which means that according to the current financial regulations, they are required to be secured with up to 122% of capital, or more than double. The available capital is charged, which proportionally reduces the scope of placement. In addition, any change in the relationship between microfinance institution and bank opens up a new negotiating process and establishes new loan conditions. This sometimes leads to obstruction of the work of these institutions which significantly slows down the procedure necessary for their payment. In the case of successful lending, microfinance institutions continue to track and control the use of funds. The most famous microfinance institutions in Serbia are MickoFins-DBS Ltd.. Belgrade, Agroinvest Holding, branch Vision Find International, Mikro razvoj Ltd. Belgrade.

Serbia is a developing country with problems considering economic growth and lack of resources. Therefore, the issue of micro-crediting should be included in consideration as an important lever of the overall economic development of the country. Numerous reasons speak in favour of this fact. First, the Serbian economy primarily consists of micro and small enterprises, then there is a constant lack of funds, new jobs are very difficult to open, and micro and small enterprises depend on banks that fail to provide adequate services to this sector. Alternative sources of funding (microfinance institutions) are limited in the volume of placements and consequently there is a high demand for micro credits.[30] At this moment, the largest amount of support to micro and small enterprises is provided through national support programs run by the Government of the Republic of Serbia. From the aspect of stable and continuous model of supporting this sector it cannot be regarded as sufficient and completely acceptable. The achievement of the above goals and overcoming obvious difficulties indicate the need for establishing a new legal framework for the establishment and operation of microfinance institutions.

The analysis presented in this paper about the effects of microfinance institutions operation indicates that the work of these institutions in some economies was very negative and prevented economic growth. Thus, the world is still missing an ideal solution which would be generally applicable. These types of non-banking institutions are obviously necessary, but their work is only possible with an adequate legal framework. Whatever, it depends on a number of factors: economic, social, cultural and the like.

7. CONCLUSION

With a proper regulation of work of non-banking, financial / non-deposit institutions, bearing in mind the effects that they can produce, would be resulting in positive effects for Serbian economy. *Firstly*, the institutional basis for granting micro credits would be extended, which would significantly encourage more competitive and more efficient market for these loans. *Secondly*, the increasing volume and number of micro credits would also affect the operation of banks by increasing the number of clients who, after having experiences with microfinance institutions, can become bank customers. *Thirdly*, the application of regulatory framework facilitates the inclusion of these users into formal economics and their formal registration, which increases tax payments and control of structural development. Since, in our opinion, micro crediting is linked to social entrepreneurship, significant social goals will be achieved necessary for the development of the country. Currently, one of the dangers in our market is the uncontrolled inflow of funds through various non-governmental organizations that were or can be transformed into microcredit institutions. With a new legal framework, this would be considerably mitigated, especially by institutional controlling. This would strengthen the role of the credit bureau, which could track the inflow and prevent over-indebtedness. As a result, the access to credits would be increased to those individuals in Serbia who lack access to bank loans today, presenting a negligible threat to the stability of the overall economic and financial sector.[31]

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