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WORKING PAPER 36

The contribution of the microfinance model to Bosnia's post-war reconstruction and development: how to destroy an economy and society without really trying

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List of Abbreviations

AMFI	Association of Microfinance Institutions in Bosnia
CEOs	Chief Executive Officer
CGAP	Consultative Group to Assist the Poor
CIPE	Centre for International Private Enterprise
EBRD	European Bank for Reconstruction and Development
EFSE	European Fund for Southeast Europe
EMD	Executive Manager for Development
EPRU	Economic Policy Research Unit
ESI	European Stability Initiative
EU	European Union
GM	General Manager
HIID	Harvard Institute for International Development
ICO	Instituto de Crédito Oficial
IDB	Inter-American Development Bank
IDPs	Internally Displaced Persons
IFC	International Finance Corporation
ILO	International Labour Organization
IMF	International Monetary Fund
IPO	Initial Public Offering
LIP	Local Initiatives Project
MFIs	microfinance institutions
MIVs	microfinance investment vehicles
NGOs	Non-Governmental Organisations
RS	Republic of Serbia
S&L	Savings and Loans institution
SME	small and medium sized enterprises
UN	United Nations
UNDP	United Nations Development Programme

Abstract

Academic analyses and impact evaluation studies produced by the international development community almost all conclude that the microfinance model has made an important net contribution to the economic and social recovery of post-war Bosnia and Herzegovina (hereafter Bosnia). However, as we now are finding is also the case in many other countries, these far-reaching claims are almost entirely based upon often deliberately flawed impact evaluation methodologies and inappropriate success criteria. This article provides an alternative assessment of the available evidence accumulated to date which, in our opinion, actually shows that the microfinance model has made a distinctly negative contribution to Bosnia's reconstruction and development effort. We argue, centrally, that the microfinance model has assisted the Bosnian economy to move to an unsustainable institutional development trajectory marked by the deindustrialisation, informalisation and infantilisation of the enterprise sector. More widely, we argue that the microfinance model in Bosnia has led to a sub-prime-style episode in Bosnia's post-war history, one that has materially benefitted a tiny elite working within and around the microfinance sector whilst simultaneously destroying many of the most important pillars of the Bosnian economy and society. We find that the best possible explanatory framework for what has transpired in post-war Bosnia is contained in the 'control fraud' concept developed by William Black.

Key Words:
microfinance, neoliberalism, Bosnia, deindustrialization, informal sector, control fraud

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1. Introduction

The concept of microfinance (more accurately, *microcredit*[1]) is the provision of tiny loans (microloans) to the poor that enable them to establish or expand a microenterprise, thereby to plot a private self-help escape route out of poverty. Using material obtained from key informant interviews undertaken between mid-2010 and late 2011,[2] as well as a wide variety of secondary data, including audited reports, this paper explores the impact of the microfinance model in the small western Balkan nation of Bosnia. The microfinance model came to Bosnia shortly after the Yugoslav civil war ended in late 1995, and it grew very rapidly. By the late-2000s, astonishingly, Bosnia was second only to Bangladesh in terms of microfinance 'saturation'. The international development community and microfinance advocates were soon claiming real success was being achieved (for example, Goronja 1999; Berryman/Pytkowska 2005). The then President of Women's World Banking, Nancy Barry, went even further, boldly claiming that, 'Any war-torn country should look to Bosnia as a role model' (quoted in Dolan 2005). Even after the microfinance sector came close to collapse in 2010 on account of massive over-lending, and against a backdrop of persistent mass unemployment,[3] the international development community still remains convinced that microfinance has made a seriously positive contribution to poverty reduction, job creation and growth in Bosnia (for example, World Bank 2012).

We find this long-standing uplifting narrative to be an almost entirely, and wilfully, false construction. In this article we argue instead that the microfinance model as it has emerged in Bosnia since the mid-1990s has actually helped to quite dramatically *undermine* the post-war recovery and development process. Centrally, the microfinance model has impelled the Bosnian economy upon an unsustainable institutional development trajectory, one that is reflected in the deindustrialisation, informalisation and infantilisation of the enterprise sector. In fact, the microfinance model is best described as Bosnia's own destructive sub-prime financial episode, an episode that, very much as per the original US-based version (Dymski 2009), has materially benefitted a tiny elite working within and around the microfinance sector whilst simultaneously destroying many of the most important pillars of the local economy and society. Seeking an appropriate explanatory model that might account for the origin of these negative outcomes, we conclude that many of the important insights, dynamics and perverse incentive structures that constitute the 'control fraud' model developed by William Black (2005) are directly applicable to what has transpired in post-war Bosnia.

1 The term 'microfinance' is the most commonly used term today, so we use this term. Technically speaking, the term microfinance is now the generic term covering all varieties of micro-financial interventions, such as microcredit, micro-savings, micro-insurance, micro-franchising, micro-leasing, and so on.

2 During the course of this research, we interviewed five persons currently or previously employed in the main microfinance institutions (MFIs). For a number of obvious future employment and other reasons, these individuals were all concerned to maintain their anonymity. It was therefore decided not to disclose their names or even the key dates when they were interviewed face-to-face in Bosnia. It should be noted, however, that their key contribution was to point to various issues which were then all confirmed using other publicly available data sources, such as annual audited accounts.

3 For 2011, Bosnian government statistics put the unemployment rate at 43.3%. Measures that take into account employment in the informal economy, such as those produced by the ILO, come in at 27.6%.

2. Background to microfinance

As is well known, the microfinance model started out in 1970s Bangladesh as a small village-based anti-poverty program managed by Muhammad Yunus, the Bangladeshi economist who went on to be co-recipient of the 2006 Nobel Peace Prize along with the iconic Grameen Bank that he founded in 1983. Yunus right away began to make grand claims for the power of microfinance, boldly settling upon a famous assertion that microfinance would 'eradicate poverty in a generation' and that the next generation would have to go to what he called a 'poverty museum' to see what all the fuss was about (Yunus 2006). In very much the same vein, Peruvian economist Hernando de Soto (1989) also began to claim that microfinance, and specifically the informal microenterprises that it supports, would help to bring about a similar historic episode of poverty reduction and development in Latin America.

By explicitly celebrating self-help and individual entrepreneurship, and implicitly delegitimizing all forms of collective effort and capability, represented by institutions such as trade unions, social movements, cooperatives, public spending, a pro-poor "developmental state" and – most of all – policies to equitably redistribute wealth and power, neoliberal policy-makers everywhere quickly fell in love with microfinance. With decisive support from the US government through its USAID aid assistance arm, and a little later on substantial technical and financial support from the World Bank too, Grameen Bank-style microfinance institutions were soon getting a firm foothold in many other developing countries. Supposed confirmation of the hugely positive impact of microfinance was duly forthcoming from Yunus, who quickly took to claiming (quite wrongly as it turned out[4]) that 5% of Grameen Bank borrowers were escaping poverty every year.

There was still one problem to resolve, however, which was the microfinance sector's reliance upon subsidies from the international donor community and from governments in the countries concerned. With the neoliberal policy-making establishment then in thrall to the 'full cost recovery' mantra (for example, World Bank 2002a), this was an obvious anomaly that had to be put right. The answer was found in the microfinance model's commercialisation and conversion into a for-profit private sector-driven business model, a model that ditched the subsidy element in favour of market-based interest rates and the introduction of Wall Street-style incentive structures, self-regulation and managerial practises (Wall Street being seen at the time as the epitome of financial sector efficiency). The microfinance sector was thus deliberately placed on an entirely new institutional trajectory. From the late 1980s onwards, the international development community made it perfectly clear that it would henceforth recognise and support only microfinance institutions (hereafter MFIs) of the for-profit variety. By the same token, existing not-for-profit MFIs were strongly encouraged to convert into for-profit status or, a step further, into a fully-fledged private microfinance bank with deposit-taking capability. Even the iconic Grameen Bank felt it had no other option but to agree to convert over to commercialised respectability, which it did in 2002 through the so-called 'Grameen II' project. Finally, adding huge momentum to the commercialisation changes getting underway was the realisation that microfinance, almost exactly as in the United States with regard to the sub-prime mortgage market, represented an amazing opportunity for financial elites to make massive profits lending high-priced money to the very poor. Accordingly, from the late 1990s onwards a flood of private investors, investment funds, foreign commercial banks and, inevitably, special purpose microfinance investment vehicles (MIVs) began to enter the microfinance sector *en masse* (Leleux/Constantinou 2007).

4 The 5% claim originated in a study by then World Bank economists Shahidur Khandker and Mark Pitt (Pitt/Khandker 1998). However, Pitt and Khandker's conclusions were pretty comprehensively rebutted in later papers by Roodman and Morduch (2009, 2011) and by Duvendack and Palmer-Jones (2011). Notably, in Roodman and Morduch's later paper (2011), it is shown that Pitt and Khandker made a critical mistake in not eliminating a tiny number of outliers from their large data set. By excluding just 16 outlier rich families from the 5,218 families surveyed by Pitt and Khandker, Roodman and Morduch were able to show that all the supposed positive gains from microfinance completely disappear.

With the supply of funding to the microfinance sector rapidly increasing, influential proponents of the commercialised microfinance model began to develop an argument that a 'new world' of massive poverty reduction success was just around the corner. Perhaps the most high-profile of these dedicated microfinance proponents were Maria Otero and Elizabeth Rhyne (Otero/Rhyne 1994; see also Drake/Rhyne 2002) both then at the high-profile US-based microfinance advocacy body *ACCION*,[5] and Marguerite Robinson (Robinson 2001) then at Harvard University's Harvard Institute for International Development (HIID). Helping these dedicated advocates to pump-up the microfinance sector even more was a growing band of celebrity supporters drafted in to offer their personal endorsement and support for Muhammad Yunus, and for the microfinance concept in general. Support for microfinance thus began to come from Hollywood stars, European and Middle Eastern royalty, sportspeople, entrepreneurs, high-profile politicians (notably Bill and Hilary Clinton), rock musicians and others. Moreover, such was the success of the carefully cultivated 'feel-good' profile of microfinance that it was often viewed by both those on the right *and* on the left of the political spectrum to be the long-awaited answer to poverty, unemployment and exclusion. The UN thus had unanimous support when it declared 2005 to be the International Year of Microcredit. Apotheosis was reached in 2006 when Muhammad Yunus and the Grameen Bank became the joint recipients of the Nobel Peace Prize. Not surprisingly, microfinance began to be described as the one international development policy that the average person in the street had heard of and, moreover, might actually wish to individually support.[6] By the mid-2000s, the microfinance industry was at the peak of its power and influence. And then it all went spectacularly wrong.

It is widely accepted that the initial catalyst that began the global downfall of the microfinance model was the 2007 Initial Public Offering (IPO) of Banco Compartamos, the largest microfinance bank in Mexico. This was an event – a scandal – that revealed spectacular profiteering by senior managers, as well as by outside advisors,[7] but no evidence whatsoever of any real progress in terms of poverty reduction among its poor clients (Bateman 2010: 142-52,). The 'Compartamos scandal' precipitated a wave of bad news that began to engulf the microfinance industry with breathtaking speed. It soon became clear that the unethical behaviour uncovered in the Banco Compartamos example was not a rarity at all, as some microfinance supporters claimed, but actually more like the industry norm (Bateman 2010; Klas 2011; Sinclair 2012). At the same time, a growing number of economists began to argue an even more serious charge: that even if managed correctly and ethically, the microfinance model still represented an 'anti-developmental' policy intervention (Bateman 2003, 2010, 2011; Chang 2011; Bateman/Chang 2012). This 'anti-developmental' contention was then backed up by a number of high-profile independent systematic reviews looking at the accumulated evidence of microfinance impact. These reviews found that there was actually *no* solid empirical evidence to confirm that microfinance had had a net positive impact on poverty in the previous thirty years or so (Duvendack et al. 2011; Stewart et al. 2011). Even confirmed microfinance supporters were finally forced to concede this awkward fact (for example, Dichter/Harper 2007; Roodman/Morduch 2009; Roodman 2012). Finally, starting with Bolivia in 1999, and then Nicaragua, Pakistan, Morocco, and Andhra Pradesh state in India (Schicks/Rosenberg, 2011), and also Bosnia as we show below, the microfinance sector right across the globe became inextricably linked to hugely destructive sub-prime-style 'boom-to-bust' episodes.

5 In August 2009 Maria Otero left *ACCION* to take up the position of Under-Secretary of State for Democracy and Global Affairs in the Administration of US President Barrack Obama.

6 As indeed many individuals did when the person-to-person (P2P) organization Kiva was launched in 2005.

7 As Head of ACCION, Maria Otero was central to the entire Compartamos investment and for her efforts was eventually awarded a $1 million dollar bonus in 2008 and in 2009, prior to joining the Obama administration, a further $550,000 bonus (Sinclair 2012: 75).

Not least because of the massive public and private resources that have gone into establishing and maintaining the framework for the microfinance model since the 1980s (for example, Balkenhol 2007: 213), and thus resources *not* made available for other potentially more powerful local interventions (i.e., the opportunity cost), the microfinance model now effectively stands accused of being one of the most serious development policy blunders of all time.[8]

3. Development of the microfinance model in post-war Bosnia

The microfinance model was effectively pioneered in Bangladesh and Bolivia, two countries with endemically high levels of poverty, exclusion, inequality and under-development. Very soon, those supporting the microfinance model began to see a very useful application for microfinance specifically with regard to post-conflict countries and regions (for example, Haughton 1998). Perhaps nowhere has the microfinance model been more exalted as a post-conflict reconstruction and development policy as in Bosnia, the small multi-ethnic state that emerged from the Yugoslav civil war that ended in late 1995. The new state of Bosnia was immediately faced with a major reconstruction and development challenge. With a large population of refugees and Internally Displaced Persons (IDPs), an exhausted social welfare system, massive unemployment, endemic poverty and an almost collapsed industrial and agricultural sector, it was clear that Bosnia was in very desperate straits. Above all, the country urgently required new jobs and income streams.

Bosnia's first wave of post-war politicians elected into office immediately began to lobby for a major Marshall Plan-style program of state investment, large-scale public works programs and extensive program support for a reinvigorated small and medium sized enterprises (SME) sector, all to be underwritten by financial resources generously granted to Bosnia by the international development community.[9] Similar measures had, after all, played a very considerable role in the successful reconstruction of Western Europe after 1945 (Eichengreen 1995). This was especially the case with regard to the SME-driven recovery that took place in northern Italy and in the former West Germany, two of the most devastated countries to emerge from World War Two (for example, Pyke et al. 1990; Pyke 1992; Pyke/Sengenberger 1992). Bateman (1996) also pointed to the northern Italian region of Emilia-Romagna that had famously recovered by using much of its pre-war military-industrial complex as the foundation upon which it was able to build a flourishing SME sector (Weiss 1988; Capecchi 1990), which suggested very important policy lessons for the central and southern parts of Bosnia also in possession of a substantial military-industrial complex.

However, right from the outset any form of overtly interventionist policy for Bosnia was explicitly rejected by the international development community. The reason for this was largely related to politics. Specifically, and essentially no different to what had transpired in the rest of Eastern Europe after 1990 (Andor/Summers 1998), the neoliberal policymakers in the World Bank, IMF, USAID and other western government institutions demanded that the reconstruction of Bosnia had to follow the same radical free market neoliberal principles that were very much in vogue in the developed economies.

8 The major international development agencies have reacted to these latest revelations by dropping all their earlier references to microfinance leading to poverty reduction. The central claim now is that microfinance is (still) a critical policy intervention because it will bring about what is termed 'universal financial inclusion'. It remains to be seen if independent analysts will be convinced by this supremely cynical shifting of the goal posts. See Milford Bateman. 'Let's not kid ourselves that financial inclusion will help the poor', *The Guardian*, Poverty Matters Blog, 8th May 2012. : http://www.guardian.co.uk/global-development/poverty-matters/2012/may/08/financial-inclusion-poor-microfinance (26.11.2012).

9 In per capita financial terms foreign aid to Bosnia was programmed to exceed the level of Marshall Plan funding that helped reconstruct Western Europe (CFER 2000).

In terms of stimulating activity at the local level in Bosnia, the microfinance model fitted the bill perfectly. Here was a market-driven, unsubsidised and private-sector-friendly way of helping Bosnia's new poor to find their own solutions to poverty and unemployment. In many respects, in fact, Bosnia was deliberately positioned to be the international donor community's 'test-bed' for post-conflict microfinance. With large infusions of international donor funding, especially from the World Bank through its Local Initiatives Project (LIP), a network of NGO-structured MFIs was very quickly established. Also thanks to significant international donor agency assistance, the globally active Pro-Credit microfinance banking network soon had its own branch network in Bosnia. Those of Bosnia's commercial banks that survived the war were soon 'down-scaling' out of lending to large state and private companies and SMEs, and moving into highly profitable and less risky microfinance applications. A little later on, after Bosnia's commercial banks were more or less all bought up by the large western banking chains, the 'downscaling' movement began to accelerate considerably. Significant cross-border capital began to flow into the Bosnian subsidiaries, the bulk of which went into fuelling the further expansion of microfinance in Bosnia rather than more risky SME financing (see below). Foreign-owned banks were also better able to mobilise large amounts of local savings thanks to savvy marketing campaigns and increased reputational capital. The result was that highly profitable household microloans used for consumption spending purposes effectively became the profit mainstay of the commercial banking sector in Bosnia. As Chen and Chivakul (2008: 3) report, 'the average real growth of credit to households between 2001 and 2006 was about 50%, while the real growth rate of credit to enterprises was only 13.5%'.

Once the microfinance model had been fully accepted and institutionally embedded within the post-war Bosnian economy and society, from the mid-2000s onwards attention shifted towards its further commercialisation. Headed up by the World Bank, moves began to change Bosnian law to allow for MFIs, almost all of which were initially structured as non-governmental organisations (NGOs), to convert into fully-commercial undertakings, though they were to remain as non-deposit-taking institutions. These moves eventually resulted in 2006 in the Law on Microcredit. This law required an MFI to convert either to non-profit foundation status, or else into a for-profit company. Although the 2006 Law has only been fully implemented in one of the two entities in Bosnia, the Republic of Serbia entity (see below), it nevertheless set in motion a real momentum for growth throughout Bosnia's microfinance sector. After 2006, an MFI's board members and senior managers realised that they could become rich as private individuals if they could, first, 'go private' and personally take a significant stake in their own MFI, and, second, grow their own MFI as rapidly as possible to the point where a Compartamos-style initial public offering (IPO) became feasible. This drive for personal enrichment, as opposed to poverty reduction, was very early on recognised by the microfinance advocacy bodies, microfinance ratings agencies and, most of all, by the main international development agencies working in Bosnia. But it was accepted at the time as a perfectly normal market-driven development, and so given every possible encouragement.[10]

By 2007-2008, however, things began to go very wrong. First, it was now perfectly clear that the increasing supply of microfinance in Bosnia was not responding to genuine demand on the part of the poor, so much as to the personal enrichment-driven desire on the part of managers and board members in the main MFIs to grow as large as possible and as quickly as possible. Bosnia's poor were being sucked into far too much personal debt as a direct result. By 2006-7 multiple lending began to emerge, along with the first isolated cases of individual over-indebtedness. Warnings of a potentially serious over-indebtedness problem

[10] For example, without any real appreciation of, or possibly genuine interest in, the negative results of deregulation, commercialisation and privatisation as evidenced from recent economic history in Eastern Europe and elsewhere (for example, Bateman 2000; European Commission 2000; for the negative US experience, see Black 2005), the EBRD nevertheless continues to take every opportunity to push deregulation and the idea that MFIs should be commercialised and privatised into the hands of its own senior staff and outside investors.

began to be sounded by some local media outlets, but these warnings were completely ignored. Bosnia's MFIs *individually* refused to take any action to head off what was clearly a problem looming on the horizon (e.g., restrict their own growth), though, of course, they were not averse to *other* MFIs taking the appropriate action. After having given the senior managers and board members of the main MFIs in Bosnia almost every possible incentive and encouragement to expand their MFI, the international development community found it hard to then curtail the expansionary tendencies of the MFIs at a later date. Moreover, the long-standing board members and senior managers of almost all of Bosnia's main MFIs were by then intimately involved in promotional work on behalf of the international development community, with the same few individuals routinely wheeled out at the most prestigious conferences whenever the call went up for someone to recount how microfinance had magnificently transformed Bosnia into a flourishing economy.

Second, given that most MFIs in Bosnia actually saw their fastest period of expansion *after* 2006 thanks to foreign loans, while many commercial banks found their funds flow from head-offices abroad being cut off, the diversion of Bosnia's available financial resources into unsustainable microfinance applications and away from potentially more sustainable SME lending became even *more* pronounced over the period 2006-2010. The World Bank reports, for instance, that SMEs began to face enormous difficulties obtaining financial support from the banking system, and that 'The lack of access to term capital at competitive interest rates was seen as one of the chief constraints to growth in (Bosnia's) enterprise sector'.[11] One result was that from 2008-9 onwards, the World Bank, and other institutions, such as the European Bank for Reconstruction and Development (EBRD), increasingly had to get much more involved in establishing and financing SME credit programs in order to fill the growing SME 'funding gap'. Pointedly, these new programs began to take place at the very same time as the main MFIs were desperately struggling to find new clients who might wish to access a microloan.

Third, just as the first real evidence began to come in that the over-indebtedness situation in Bosnia was beginning to get out of hand (i.e., around 2006-7), the external pressure on Bosnia's MFIs to expand their lending activity actually began to be ratcheted up very considerably. A new generation of international for-profit MIVs had been established in the early 2000s, and many of these MIVs felt that an enormous profit-making opportunity existed in Bosnia. Without any serious enquiry or real concern, a number of self-declared 'socially-oriented' MIVs began to descend upon all the main Bosnian MFIs offering unlimited quantities of capital for on-lending. The result was an astounding rate of growth of MIV loans to Bosnia's MFIs. For example, with just 72KM million (around €36 million) in loans by MIVs in 2006, by the end of 2007 the figure was 275KM million (around €140 million), a staggering rise of 280% in just over one year (AMFI/MIX 2009). By all accounts, the most aggressive of these MIVs were the European Fund for Southeast Europe (EFSE) based in Luxembourg, with around €121 million invested in Bosnia at the end of 2011,[12] and Blue Orchard based in Switzerland.[13] A good part of the motivation for engaging in such lending was clearly the prospect of earning interest rates of between 7.5% and 10.5%, a very healthy return indeed in today's capital markets. Adding further fuel to the fire were two state-led development-focused institutions working in Bosnia: the EBRD,[14] and the Spanish state-owned development bank, Instituto de Crédito Oficial (ICO), based in Madrid.[15]

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11 See 'Bosnia and Herzegovina: Making Finance Accessible for Small and Medium Enterprises', http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/0,,contentMDK:23143342~menuPK:3949141~pagePK:146736~piPK:226340~theSitePK:258599,00.html (26.11.2012).

12 EFSE Annual Report 2012: 28

13 As of end 2008, Blue Orchard had over $57 million loaned out to Bosnia's top five MFIs. Drezgić et al. 2011: 186. In recent years, however, it has been reducing its exposure to Bosnia.

14 Between 2006 and mid-2012, the EBRD provided nearly €70 million to MFIs in Bosnia for on-lending. Email correspondence with the EBRD, August, 17th, 2012.

15 As of end 2008, ICO had $34 million loaned out to Bosnia's top five MFIs. Drezgić et al. 2011: 186

A further indication of the astonishing level of debt eventually racked up by Bosnia's MFIs was that by the end of 2008 their total volume of liabilities to international and, to a much lesser extent,[16] local institutions and investors was $621 million, which was 39% of the total volume of debt of *all* non-bank MFIs in the 27 countries of Eastern Europe and Central Asia (Pytkowska et al. 2009). By 2008 there were nearly 400,000 active microloans amounting to around $770 million in a country with a population of only 3.8 million (Cain 2010). By any meaningful definition of the term, 'microfinance saturation' was thus attained: every single Bosnian individual who wished to access a microloan could very easily do so – in fact, was being *implored* to do so. By 2009, as Table 1 shows, Bosnia was the world's second most microfinance 'saturated' country,[17] topped only by the iconic home of microfinance, Bangladesh (and also by the spectacularly over-blown and soon to collapse – in 2010 – microfinance sector in the Indian state of Andhra Pradesh).

Table 1: Microfinance penetration by country (and region) in 2009

Global ranking	Country	Borrower accounts/Population
1	Bangladesh	25%
–	(Andhra Pradesh, India)	17%
2	Bosnia and Herzegovina	15%
3	Mongolia	15%
4	Cambodia	15%
5	Nicaragua	11%
6	Sri Lanka	10%
7	Montenegro	10%
8	Vietnam	10%
9	Peru	10%
10	Armenia	9%
11	Bolivia	9%
12	Thailand	8%
13	India	7%
14	Paraguay	6%
15	El Salvador	6%

Source: Bateman 2011: 4

The year 2009 saw a double digit increase in the number of non-performing microloans. By the end of 2010, the once mighty microfinance sector in Bosnia was on the verge of collapse. The client base of Bosnia's MFIs had fallen back to 2006 levels, dramatically raising unit costs. Defaults rose to new heights, and an almost double digit portfolio at risk (over 30 days) was reached by early 2010. Loan provisioning had to rise by more than 250% in just one year. Finally, the entire microfinance sector plunged into a dramatic loss.[18] Moreover, in terms of the social mission, things were looking equally bad. Around 28% of all MFI clients in 2010 were found to be 'seriously indebted or over-indebted', of which around three-fifths of

[16] 90% of external funding was sourced from international financial institutions, with only 10% from local sources, mainly commercial banks. Pytkowska et al. 2009, 61

[17] Even when using other ways of calculating over-indebtedness, and also correcting for certain issues, such as multiple borrowing (for example, see Krauss et al. 2012) Bosnia still comes out as one of the most microfinance saturated countries in the world.

[18] Compared to positive results in 2008, in 2009 the microfinance sector racked up a total loss of KM 37 million (about $US24 million) – see AMFI 2010.

these unfortunate clients were in a situation where the monthly repayment *exceeded* their total household disposable income, with the remaining two-fifths operating just under that threshold (Maurer/Pytkowska 2011: 4). Perhaps not surprisingly, the very poorest were found to be most in debt, with the incomes of those over-indebted found to be more than *half* that of those not over-indebted (ibid: 4). Moreover, not only an MFI's clients were ending up in real difficulty; non-clients, too, ended up suffering if they were one of the estimated 100,000 individuals in Bosnia that had agreed to guarantee one or more microloans for family and friends. In the Republic of Serbia entity, for instance, in 2011 guarantors were forced to hand over nearly KM5 million (around $US3 million) to repay more than 4,000 microloans (nearly 8% of the total microloans outstanding) that were in default – a figure almost double the amount guarantors had to hand over in 2010 to cover 2,650 microloans in default.[19]

With the microfinance sector in deep crisis in 2010, international donor support arrived to try to prop it up. An urgent process of recapitalisation, merger, consolidation, debt rescheduling, and further commercialisation got underway, including the use of additional international community funds (i.e., bail-outs) to save the sector (EBRD 2010). Nonetheless, in spite of the obvious 'saturation' and clear need for individual household deleveraging, the same institutions that gave rise to the unsustainable boom continued to channel significant funds to the microfinance sector for further on-lending.[20]

4. The key problems of the microfinance model in Bosnia

Notwithstanding the huge problems that have emerged, there still remains remarkably little genuine debate as to the long-term consequences of Bosnia's post-war association with the microfinance model. As is the norm in many developing countries,[21] the Bosnian microfinance industry and its supporters have instead wilfully assisted in the preparation of a sizeable number of methodologically questionable evaluations and research studies, the aim of which was to convince the world that everything was pretty much going according to plan. In this section we show why the presumed positive outcome of the microfinance model in Bosnia, a viewpoint that is largely based upon these flawed outputs, is almost entirely wrong.

The initial post-war promise in Bosnia was for poverty alleviation to be quickly secured through large numbers of sustainable jobs in microenterprises, additional income generated in the community, empowered women, an accelerated accumulation of social capital, growing numbers of conversions of informal microenterprises into more productive formal SMEs, and generally a sustainable 'bottom-up' local economic development trajectory established thanks to microfinance (for example, World Bank 1997; Matul/Tsilikounas 2004; Dunn 2005). However, in spite of a raft of well-publicised positive statistics concerning outreach and MFI sustainability (Berryman/Pytkowska 2005), a growing number of independent researchers began to point to the serious downsides to the microfinance model in Bosnia. Microfinance was, in many respects, structurally *undermining* the post-war recovery and development effort in Bosnia (see Bateman 2003, 2006, 2007, 2011; Drezgić et al. 2007, 2011; Mujković 2010).

19 Banking Agency for the Republic of Serbia 2012: 54

20 Notably, as a glance at recent press releases makes quite clear, both the EBRD and EFSE remain major funders of Bosnia's MFIs. In the first half of 2012, for example, the EBRD has provided €8 million to Partner and EFSE has provided $US 5 million to EKI and $US 6.6 million to Partner.

21 In the UK government-funded systematic review of the evidence of the impact of microfinance on the poor, the survey team found a very large number of wilfully biased, distorted, non-randomised selection of clients and locations, and simply unusable impact-evaluations, such that out of a total of 2,643 impact-evaluation publications only 58 were considered to have reached a quality threshold in terms of research design and methods of analysis (see Duvendack et al. 2011). A very good many of the impact-evaluations surveyed were undertaken by MFIs themselves and/or their close supporters in the main international development institutions, with the obvious possibility that the results were deliberately manipulated upwards in order to maintain or increase the chances of financial support for an MFI's activities and continued support for the microfinance model per se. There are many obvious parallels here to the behaviour of the three major global credit ratings agencies, all of which wilfully provided incorrect ratings of certain investment instruments in order to secure lucrative consulting contracts with the same client.

Our argument in this paper is not just that the microfinance model has failed to fulfil its initial promise, but that it has actually made a significant net *negative* impact upon the Bosnian economy and society. This negative impact occurs thanks to several pivotal adverse institutional developments and trajectories, which we outline now.

4.1. Primitivisation, deindustrialisation and informalisation

It is well known from entrepreneurship theory and studies in institutional economics that it is new, creative, technically innovative ideas and institutions that are the key engine in economic development (Schumpeter 1987([1942]; North 1990; Baumol et al. 2007). An important role is played by innovative, growth-oriented, export-driven, new technology-based and (so) productivity-raising SMEs (Bateman 2000). This dynamic is especially important in developing and transition countries, which need to master key technologies, better understand 'state of the art' industrial products and processes, develop at least some innovative capabilities in domestic microenterprises and SMEs, and establish a tissue of pro-active development-focused institutions and organizations (see UNCTAD 2003; Amsden 2007; Chang 2007). Crucially, to establish these higher productivity-generating trajectories requires a financial system that is willing and able to channel a significant volume of financial resources (savings, remittances, government investment, donor funds, etc.) in the appropriate direction, as opposed to financing other less productive and largely unsustainable applications, such as informal microenterprises and self-employment ventures.

However, this industrial upgrading scenario is precisely *not* what has been happening around the globe in recent years under the influence of neoliberal policy-makers and the microfinance industry (for example, Reinert 2007). Instead, since the 1980s scarce financial resources have increasingly been intermediated through commercial banks and MFIs into the very lowest productivity-raising, but highest short-term profit/lowest risk, applications. Under such an 'adverse selection' scenario, the establishment of a sustainable development trajectory becomes a distinctly remote possibility. Nowhere more so than in Eastern Europe, including with regard to Bosnia, has this adverse scenario been played out with such damaging consequences (for example, Andor/Summers 1998).[22] More widely, Chang (2011) points out that the chances of developing countries ever escaping endemic poverty and underdevelopment have been receding in recent years, thanks largely to the combination of market-driven microfinance, on the one hand, and the de-legitimisation and phasing out of industrial policy and associated financial institutions (e.g., development banks), on the other. Notably with regard to Africa, Chang finds that the popularity and high profitability of market-driven microfinance has helped to divert funding away from high risk/low profit support activities for key enterprises (mainly SMEs), enterprises that might achieve minimum efficient scale, deploy some state-of-the-art technologies, develop some innovative capacity, productively link with other enterprises vertically (sub-contracting) and horizontally (clustering), and that might have some potential to exploit non-local markets. Amsden (2001), on the other hand, brilliantly shows how East Asia's late industrialising countries avoided such 'adverse selection' problems and became hugely successful.

[22] This was in spite of the fact that a good many development economists predicted at the beginning of the transition process in Eastern Europe that neoliberal transition policy would inevitably, and quite unnecessarily, destroy a very large part of the industrial sector and technological base (Amsden 1994; Taylor 1994). As Amsden et al. (1994) correctly stressed, the imperative in Eastern Europe was for state mediation and an industrial policy that could help the best-placed enterprises (irrespective of ownership, sector or size) to restructure and survive in the new market economy. This advice was ignored. Many Eastern European countries were only able to 'recover' from their communist era policies thanks to a massive build-up of consumer debt underpinned by a growing inflow of foreign loans and commercial bank transfers of cash from their Western European home-base to Eastern European branches for on-lending. When in 2008 this unsustainable dynamic quite predictably went into reverse, almost all the Eastern European economies affected had to be bailed out by the international development community – see de Haas et al. 2012.

Pointedly, even the main multilateral banks are now coming around to accepting that the 'adverse selection' mechanism just outlined is responsible for holding back sustainable growth and development in developing countries. Astonishingly, the still broadly neoliberal-oriented Inter-American Development Bank (IDB) now argues that the above mechanism is actually the *central* factor in accounting for the endemic poverty and underdevelopment that has – at least until recently – been the experience of Latin America. In its 2010 flagship publication (IDB 2010), the conclusion reached is a denunciation of purely market-driven financial intermediation processes. Going further, the IDB also provides a quite dramatic refutation of the microfinance model, noting that, '(U)nlike other regions of the world, the overwhelming presence of small companies and self-employed workers (in Latin America) is a sign of *failure*, not of *success*' (IDB 2011: 6; our italics). It is also no coincidence that several of the countries identified by the IDB as *most* affected by this capital misallocation dynamic – Mexico, Peru and Bolivia – are also the very same countries that were globally celebrated for the quite spectacular growth of their respective microfinance sectors from the 1990s onwards (Berger et al. 2006). Moreover, in the case of the one Latin American country – Bolivia – that, along with Bangladesh, gave huge legitimacy to microfinance as a local development policy, the microfinance model now appears to be rapidly losing support. The feeling within the current government,[23] and in other important non-governmental circles too,[24] is that the microfinance experiment has been a serious setback for this poor country, notably in that it effectively over-turned many of the important gains made in the 1950s and 1960s in promoting a more innovative, industry-based, and higher productivity SME sector.

We would argue that Bosnia is one of the very best country examples of the destructive capital misallocation process just outlined. The lack of a productive SME sector in Bosnia combined with a massive expansion of very low productivity informal microenterprises and forms of self-employment, are the two obvious reflections of this 'adverse selection' process at work. At least three negative trajectories are involved here. First, mainstream banking analysts predicted that the nascent SME sector would benefit from the inflow of foreign banks (for example, de Haas/Naaborg 2006). In fact, the SME sector was largely ignored by the commercial banks, most of which found microfinance applications to be far more profitable and less risky in the near term. In addition, *ex post* evaluations of many well-publicised international donor-driven programmes ostensibly designed to support SMEs showed that most programs actually permitted – if not encouraged – the easier microenterprise option, and so largely ended up supporting microenterprises instead (Chapman et al. 2008: 44). The overarching result of this massive increase in microcredit lending activity in the late 1990s and early 2000s was a growing raft of microenterprises the vast majority of which largely did/do not operate at, or near to, minimum efficient scale. That is, right from the offset a vastly *unproductive* enterprise sector was constructed in post-conflict Bosnia. As of mid-2012, nearly 23% of those employed in Bosnia were self-employed, and mainly working in very simple buying and selling activities. But even for registered micro and small enterprises (75.5% of enterprises in Bosnia are registered as micro [0-9 employees] and 17.8% as small [10-49]) the dominant activity in both size categories is 'wholesale and retail trade, and repair of motor vehicle and motorcycles'. In fact, nearly 33% of ALL enterprises are mainly involved in this one activity category (ASBH 2012). The nature of this negative structural development was specifically highlighted in the SME strategy document for Bosnia (Ministry of Foreign Trade and International Relations 2009: 18) which noted that "Given the size of population and cities, there are more cafes and

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23 The Bolivian government under leftist President Evo Morales is now coming out strongly against the very powerful microfinance sector, claiming that in thirty years or so it has created nothing more than a giant bazaar economy, rather than a flourishing and growth-oriented enterprise sector. Bateman interview with Martin Bazurco, Minister for Micro and Small Enterprises, La Paz, Bolivia, May 9th, 2012.

24 For example, the former President of the Chamber of Small Industries in Bolivia, Enrique Velasco, published an article in May 2012 in a major La Paz newspaper effectively denouncing the microfinance sector for impoverishing Bolivia with its support for the informal petty traders, and not for growth-oriented industry-focused SMEs. http://www.paginasiete.bo/Suplementos/Ideas/2012-06-10/Destacados/04ideas-001-0610.aspx (26.11.2012).

small grocery stores than in most other places in the world. These industries are facing strong competition and low profit margins, so that they are barely surviving, sometimes for several months only. From the sector perspective, the trade sector (either wholesale or retail) dominates.'

Second, after an initial wish to do otherwise,[25] the microfinance sector is almost entirely engaged in funding informal business activities. One of the traditional benefits of formalisation – better access to credit – simply has no meaning in Bosnia because microfinance is available to any individual or organisation regardless of operating methodology or legal structure. The result was that the informal sector in post-war Bosnia soon began to expand as a percentage of total employment; for example, going from an already high 37% in 2001 to just over 42% in 2004 (Tiongson/Yemtsov 2008: 4). The rapid rise in the informal economy was seen as a negative development (Bateman, 2006), even by the Head of the World Bank in Bosnia.[26]

Third, because of high interest rates (up to 40% in some MFIs) and short repayment periods, the idea of funding a(ny) business that might want to work on the basis of some technology or innovation is completely fanciful. Almost all microenterprises supported are no/low technology units, principally quick-turnover petty trade-based operations (e.g., fixed retail outlets, street stalls, shuttle traders, fast food outlets).

The Bosnian economy and enterprise sector since 1996 has thus been subject to a debilitating financial structure that has manifestly underpinned the combined infantilisation, informalisation and deindustrialisation trajectories. At the same time as most developing countries have been desperately trying to move up the technology and industrial ladder, the previously quite highly industrialised, technically sophisticated, R&D-driven, and internationally-connected Bosnian industrial structure was effectively allowed to collapse. This was at least partly thanks to the emphasis upon funding market-driven microfinance programs rather than a comprehensive program of industrial policy support directed at existing industrial enterprises.

It is also important to recount that today's deep-seated problems were actually first identified and highlighted as early as 1999. This was when the EU/Bosnia-Herzegovina Consultative Task Force, a policy co-ordinating body established in June 1998 by the Council of the European Union, convened a working group to develop an urgent industrial policy response to the worsening economic situation in Bosnia. This new body was particularly worried about the rapid decline of the industrial sector and its associated institutional fabric, as well as the almost complete lack of new private formal sector industrial SMEs. An urgent policy response was called for, but virtually nothing happened other than the establishment of a few minor SME credit lines which were mainly taken up by companies importing capital and consumer goods into Bosnia.

At the start of the new millennium, real fears began to be expressed that the Bosnian economy was manifestly 'Africanising' (*Africanizacija*), which is described as an economy's descent into a situation where the enterprise sector is overwhelmingly composed of enterprises that are informal, micro, largely petty trade-based, temporary and isolated (Bateman 2010: vii). In its annual human development survey of Bosnia, for example, UNDP (2002) reported on the very bleak chances of a sustainable 'bottom-up' recovery now taking

[25] The microfinance sector actually commenced in Bosnia with a commitment to support only registered microenterprises, based on an understanding that an officially sanctioned expansion of the informal sector would be a negative development for the country, and so had to be avoided. But when it became clear to the MFIs that the overwhelming majority of their potential clients were already, or planning, to operate informally, financial self-sufficiency imperatives dictated that this requirement had to be quietly dropped (see Goronja 1999).

[26] In early 2006, the then Head of the World Bank in Bosnia, Dirk Reinermann, publicly expressed his deep concern over the size of the 'large and growing informal sector' and that it represented one of the 'key challenges in Bosnia and Herzegovina' (see Press Release, World Bank, Sarajevo, March 2nd, 2006). As perhaps the main driving force behind the rise of the informal sector, thanks to its support for microfinance, one might perhaps interpret this as a *mea culpa* on behalf of the World Bank.

place in Bosnia, thanks to the domination of the informal microenterprise and self-employment sector in the emerging economic structure. The conclusion reached was a chilling one: Bosnia's population had effectively been, 'condemned to reliance on a grey, trade-based, unsustainable economy rather than a production-based one' (UNDP 2002: 38). A little later the independent European Stability Initiative (ESI 2004) issued an even more alarming report focused on the growing number of bad local economic development indicators, all of which were suggesting to them that the Bosnian economy was actually not developing from the 'bottom-up', but going backwards. The US government financed and generally neoliberal-oriented Centre for International Private Enterprise (CIPE) was forced to concur with the ESI's proposition that economic policy in Bosnia had effectively undermined development, arguing in its own words (CIPE 2004: 2) that,

> 'Bosnia (is) going through a process of de-industrialisation on a devastating scale. The new private sector is dominated by microenterprises in trade and basic services, generating very little employment. Bosnia seems to be developing backwards: where once it manufactured jet aircraft, it now exports aluminium; where once it exported furniture and finished wood products, it now sells only raw timber. Outside of the larger cities, many Bosnians are abandoning the towns and returning to the land their families left a generation ago. Forced out of the formal economy, they scrape together a living through some combination of casual labour, informal trade and subsistence agriculture.'

These and other similarly alarming reports that were to emerge in the following years were all ignored. The reason for this was perfectly clear: the resulting policy advice would inevitably threaten the pivotal role accorded to microfinance in the global effort to reconstruct and develop the Bosnian economy after 1996.

4.2. Consumption spending as the main use of microloans

A second trajectory in Bosnia underlines just how little of Bosnia's scarce financial resource base has actually gone into *any* form of enterprise development. It turns out that a very large part of the microfinance sector in Bosnia does not even deal with sub-optimal lending to low productivity informal microenterprises, but overwhelmingly it works with simple consumption lending. As elsewhere in the world,[27] the microfinance movement in Bosnia was founded upon the vision of a poor individual establishing a tiny microenterprise and escaping poverty, but the truth is somewhat different: microfinance has virtually supported mainly consumption spending that could not be financed out of current income.

This situation emerged in Bosnia thanks to a number of factors, all of which are related to the profitability and lower risk of simple household microloans (thanks to high interest rates and the personal guarantee system ensuring a high repayment rate) compared to any form of enterprise loan.[28] In particular, Bosnia's MFIs very early on discovered household microloans to be a highly profitable business area and (at least until 2009) the lowest risk business area too. Initially, it was very widely assumed that most Bosnians in poverty and without a job were heroically using a microloan to escape their predicament through self-employment (for example, Goronja 1999). However, data collected in the first major post-war household survey showed something else; that Bosnians actually used microloans mainly to support consumption spending and other non-business related needs.

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[27] As Beck and Ogden summarized in the *Harvard Business Review*, 'Many heads of microfinance programs now privately acknowledge what John Hatch, the founder of FINCA International (one of the largest microfinance institutions), has said publicly: 90% of microloans are used to finance current consumption rather than to fuel enterprise.' See Beck/Ogden 2007.

[28] More accurately, household microloans were sometimes used for enterprise development purposes, but by the same token, many individuals receiving enterprise loans used them for simple consumption spending needs.

Table 2: Main Reason for obtaining a loan in 2001 (in percent).

Main reason for obtaining a loan	2001
Buy inputs/working capital	2.5
Investment in equipment/lands/building/animals	5.4
Consumption needs	73.4
Consumer durables	1.7
Purchase dwelling	1.3
Reconstruction of dwelling	13.1
Other reason	2.7

Source: Chen/Chivakul 2008: 13

With its innovative system that each microloan required nothing more than some minor paperwork and the signatures of two guarantors, the MFIs soon began to pile into household micro-lending with virtually no concern whatsoever for their original mission to fund enterprise development, or what might be the eventual economic or social impact of such a micro-lending trajectory. The commercial banks helped considerably as well. Once privatised and sold off in the early 2000s to the main western European banking chains, Bosnia's private commercial banks became increasingly focused on maximising profits. One of the main ways to do this was to stay out of, or get out of, risky and low profit margin SME lending, and instead expand the offer of high profit-low risk household microloans.[29] For example, the global Pro-Credit banking network initially built up a significant part of its business in its Bosnian network based upon the provision of household microloans.[30] Many of the other MFIs claim to only be providing microloans for 'income-generating activities' as per the accepted microfinance model, but it is well known that this requirement was widely overlooked. In fact, as the decade went on it became even easier to access a microloan without paperwork or even a guarantor. An even higher volume of household microloans was therefore pumped out. After 2007 many MFIs moved to formally provide microloans to salaried workers and pensioners for consumption purposes. Very soon up to 33% of all clients were openly admitting to repaying the microloan from a salaried job or pension, rather than from a business supported by the microloan (Maurer/Pytkowska 2011). The figures show that between 2001 and 2006 real yearly total growth of credit to households in Bosnia was 50%, compared to a 13% growth rate for credit to enterprises, including micro-enterprises (Chen/Chivakul 2008). Moreover, in the immediate run-up to the 'microfinance meltdown' (2006-2008), an even *larger* volume of microcredit was pushed out and mainly used to purchase imported consumer goods (IMF 2010), but also, and an obvious indication that the dénouement was fast approaching, increasingly used to repay old microloans.

The importance of this diversion of microfinance into household micro-lending is that it adds considerable weight to the overall capital misallocation argument outlined in the previous section. If scarce financial resources in Bosnia were not even going to informal microenterprises, of which a tiny few would at least stand a chance of registering some positive development benefits, then the extent of the 'adverse selection' problem is magnified considerably. A poor country is effectively using its financial resources simply to underpin a one-off and unsustainable consumption-driven trajectory. Moreover, the specific focus upon lending for consumption purposes has two further serious downsides to it. First, with so many poor individuals in Bosnia forced to access an expensive microloan to underpin consumption spending, and so gradually diverting a growing part of their minimal incomes into regular

[29] It also did not help Bosnia's development chances that in the early years after the war, Bosnia's private commercial banks simply deposited their funds in western European banks offering good interest rates and zero risk (see Čaušević 2002).

[30] Due to extremely high losses in 2009 (KM13.3 million, around $US8.5 million), however, Pro-Credit Bosnia's household microloan offer was soon dropped almost completely.

interest repayments, there can be no doubt that the further impoverishment of the poor is underway. While interest rates are less onerous in Bosnia compared to many other countries, the prevailing rates of around 23-40% still represent an important, and growing, cost item in the budget of any poor family attempting to survive through regular use of microcredit. Second, the large part of Bosnia's financial resources that were channelled into high profit household microloans and which were in turn mainly used to purchase imported consumer goods, has inevitably exacerbated the already weak foreign trade position of Bosnia.

4.3. Client failure and displacement

As we have noted already, and it is still the case today in the context of the global financial crisis, neoliberal policymakers and many others working in the international development community continue to believe that the answer to unemployment and poverty lies in (more) microenterprise development (for example, Smith/Thurman 2007). Furthermore, the key binding constraint in poor communities is very often presumed to be a financial constraint which, once removed, will allow the poor to open a microenterprise and so quickly escape poverty on their own (Hartarska/Nadolnyak 2008; World Bank 2008). A final twist is that a greater supply of microfinance is automatically assumed to be imparting a positive impact in the community if it leads to a rise in the rate of new entry of informal microenterprises (Banerjee et al. 2010).[31] At least in the context of Bosnia, we argue, all of these viewpoints are fundamentally mistaken.

As Amsden (2010) and also Galbraith (2008: especially 151-163) have emphasised, the main problem affecting small enterprises around the globe is not so much a financial constraint as a *demand* constraint. It is almost the definition of a poor and distressed local economy that there are serious local demand constraints, which means that the typical local economy simply does not possess the elastic ability to absorb an unlimited supply of simple items and services produced by an expanded local microenterprise sector. In other words, there is no Says Law that exists – 'supply creates its own demand' – which might allow for the unending expansion of local informal microenterprises based upon an unending increase in local demand for the simple items and services that they might supply. The reality is, other things being equal, that new and expanded microfinance-induced microenterprises do not raise the *total* volume of business/demand so much as redistribute or subdivide amongst market participants the prevailing volume of business/demand (on this, Davis 2006). This point is, of course, the 'fallacy of composition' and it has quite serious implications for the presumed efficacy of microfinance. It is a fallacy that was most vividly and tragically misunderstood by none other than Muhammad Yunus himself (1989: 156), who very early on said that "[a] Grameen-type credit program opens up the door for limitless self-employment, and it can effectively do it in a pocket of poverty amidst prosperity, or in a massive poverty situation". Even today, under conditions of global financial crisis, neoliberal economists and neoliberal policy-making bodies continue to misunderstand the nature of this supply-demand issue (Bateman 2012).

The crucial importance of this 'fallacy of composition' point is that it inevitably gives rise to two important, but hitherto largely ignored, downsides to the microfinance model: displacement and client failure. Displacement is the situation where new microenterprises

[31] For example, Banerjee et al. (2010: 30), make the important claim that, 'While microcredit "succeeds" in affecting household expenditure and creating and expanding businesses…..'. The use of the word 'succeeds', even if in inverted commas, clearly implies the authors consider that entry is by itself always a good thing. However, no evidence is presented in the article, or discussion of failure rates is entered into (higher entry is usually correlated to higher exit and so many more possibilities of adverse results for the individual involved), that might support this understanding: it is simply assumed to be true. Of course, within neoclassical theory, new entry *is* indeed seen as a very good thing, if not the central driving force behind economic development, so perhaps it is felt that no evidence is needed here. Given the all too often negative impact on those failing in a microenterprise, as we found in Bosnia (see also Bateman/Sinković 2011, for some evidence of similar problems emerging in Croatia), we disagree.

can only survive by eating into the local demand that up to then was supporting incumbent and already struggling microenterprises, meaning that the net employment and income impact of any microfinance program is reduced to a greater or lesser extent. Client failure is the situation where a few years, sometimes just months, into any microenterprise project the business fails. This event leaves a microloan to repay but with no income flow with which to do so, or else a messy default on the microloan to contend with. Thanks to both factors, microfinance programs all too often result in promoting nothing more than an unproductive process of local "job churn", with lots of entry and exit but no real net employment, income or productivity improvements registered.

Client failure and displacement have turned out to be important downside impact issues in Bosnia. Consider the client failure issue first. One problem in Bosnia's poorest communities is that demand has virtually always been weak, suggesting that there would clearly be real difficulty in supporting the massive programmed expansion of the microenterprise sector. This was pretty much the case right after the conflict ended, as Matul and Tsilikounas (2004: 458) reported,

> "Markets (in Bosnia) were flooded with goods after the war, many people were producing bread, growing cows or chickens but did not know where to sell their goods given the large level of available supply and market saturation. Many refugees were selling clothes that had been imported from Hungary and had to sell them for very small margins due to high competition."

As the macro-economy recovered it was natural that some additional local spending power would trickle down to the local level to be used to support the purchase of the simple items produced by local microenterprises. Some new microenterprises were also getting started with the help of microfinance. Moreover, as noted above, since so many microloans were being used to underpin consumer spending, this created a form of temporary demand that allowed many microenterprises in the shuttle trade and import fields to get established. However, Bosnia's recovery through till around 2008 was always fragile and patchy at best. Competition for local markets was never anything other than what we could describe as fierce, and getting even fiercer in the run-up to the global financial crisis in 2008. There are only so many street stalls, second-hand clothes shops, fast food outlets, informal taxis, and so on, that a locality can support before the margins on such activities are reduced to zero. Moreover, the artificial demand created by microloans used for consumption spending inevitably began to decline, and it pretty much collapsed from mid-2008 onwards.

Persistent low demand in Bosnia, growing competition from new entrants, and then a sudden collapse in demand from mid-2008 onwards, are all key factors in the extremely high level of microenterprise exit found in Bosnia from the early 2000s onwards. Using Labour Force Survey data Demirgüç-Kunt et al. (2007) reported, for example, that nearly 50% of new microenterprises generally do not survive beyond one year. This very important failure issue did not, however, elicit any further discussion from the same authors as to the consequences on the poverty status of those individuals having failed.

Our findings on this issue help to fill this important data gap. It seems that in a number of ways, and largely overlooked in the literature to date, microenterprise failure is very often a seriously negative outcome for the average individual client of an MFI in Bosnia. First, any family savings are run-down right away in order to repay a microloan. Second, there is ample evidence to show that those failing in a microenterprise, but who chose (or were effectively forced) to continue to repay their microloan, often end up drawing down important physical assets, such as family land, housing, private vehicles, machinery, and so on. As many local media outlets report, Bosnia's steadily emerging markets in land and housing are at least partly being expanded by the growing need of the poor to repay a microloan through a forced asset sale. This suggests that the typical developing country crawling wealth transfer process

– wealth going from poor to rich via forced assets sales to repay a loan (India is a typical example, Roth 1983) – has begun to emerge in Bosnia too.

Third, many in Bosnia have been forced to divert other important family income flows into microloan repayment. Very much like Bangladesh, Bosnia has one of the largest remittance income flows in the world, and much of this cash is routinely used to repay microloans, most of which are taken out for consumption spending.[32] Pensions and other transfers are increasingly routinely used to repay microloans too (Maurer/Pytkowska 2011). Naturally, diverting such valuable income flows into microloan repayment, in the event of a micro-enterprise failing, is unlikely to raise the living standards of those involved.

Fourth, even those quite unconnected to a failing microenterprise, such as those who guaranteed a microloan for friends and family, as is the common procedure in Bosnia, have ended up severely disadvantaged by being forced to repay a microloan on someone else's behalf. As many as 100,000 individual guarantors in Bosnia are now being chased for the full or part repayment of a microloan that has been defaulted upon by friends or family.[33] When the original recipients began to default in 2009, the guarantors quickly came into the spotlight and were thereafter chased for repayment, adding considerably to the overall chaos brought on by the collapse of the microfinance model. The worse case scenario turned out to be the situation where an over-indebted individual has also individually guaranteed someone else's microloan – more than one third of borrowers are guarantors for others (ibid: 6).

Turning to the issue of displacement, we also found abundant evidence that high levels of job and income displacement exist in Bosnia but, as with the case of client failure, are largely ignored. This is particularly unfortunate since displacement has been repeatedly flagged up as a critical factor as far back as the early 2000s. For example, in a major UK government-funded survey of three Bosnian cities (Birks Sinclair Associates 2002), an important conclusion arrived at was that the overarching constraint upon the new and expanded operation of local micro- and small enterprises was stagnant local demand. In the three Bosnian cities in question – Travnik, Trebinje and Zenica – the survey found that local demand in Trebinje accounted for 89% of business outputs, in Zenica 75% of business outputs and in Travnik 65% of outputs. If most existing microenterprises have their fate tied up with generally stagnating local demand, then establishing *new* competitors to this existing raft of struggling producers 'as a way to resolve unemployment' will mainly result in displacement effects, and so no *net* improvement. Other indirect evidence to support the contention that displacement is a major issue comes from surveys of the informal sector that report 'informal sector competition' as one the most important barriers to business operation and expansion (for example, World Bank 2002b).

It is noteworthy that in all of the major impact evaluations undertaken in Bosnia to date (at least those we have been able to locate), the evaluation teams involved in these studies made the far-reaching decision to ignore the crucial downside impacts registered thanks to client failure and displacement (notably Dunn, 2005 and Augsburg et al. 2012). We venture to suggest that this is a reflection of the deliberate bias built into almost all impact evaluations undertaken by microfinance advocates and funding institutions, extensively reported on by Duvendack et al. (2011), the unstated aim of which is to somehow arrive at a broadly positive impact evaluation no matter what the reality on the ground.[34]

[32] As is common elsewhere, Demirgüç-Kunt et al. (2007) also found that families enjoying large remittance flows are much less likely to indulge in micro-business activities.

[33] See 'Balkan loan guarantors struggle to pay others' debts' *Reuters RPT-FEATURE*, August 17th, 2009.

[34] Even though the impact evaluation of the World Bank's two main microfinance programs undertaken by Dunn (2005) has little real credibility because it did not factor in either of these crucial (downside) impact issues, the World Bank nevertheless continues right up to the present day to (wrongly) claim, using the Dunn study as its main supporting evidence, that its two main microfinance programs 'created or supported' as many as 200,000 jobs (World Bank 2012: 10).

4.4. Over-indebtedness of clients and non-clients

Client over-indebtedness is perhaps the single most important reason behind the wave of hugely destructive repayment crises and 'microfinance meltdowns' in previously supposedly well-performing microfinance sectors, notably in Bolivia in 1999-2000, Nicaragua, Pakistan and Morocco starting in 2008 and, most recently and spectacularly, in Andhra Pradesh state in India in 2010 (Arunachalam 2011).

Bosnia has not escaped this destructive over-indebtedness trend. From around the early 2000s onwards, the main MFIs in Bosnia all began to adopt a 'growth at any cost' strategy. Even though 'saturation' was manifestly evident by mid-2005/6 (Bateman 2006), even *more* rapid growth of MFIs was proclaimed as important in order to satisfy supposedly 'unmet demand' for microloans. Rapidly growing numbers of multiple microloan holders also became evident, with clients holding several microloans across several MFIs. In fact, very many individuals in Bosnia got hooked into taking out multiple microloans, mainly using each new microloan to repay existing microloans, but in the process building up a mountain of personal debt that at some future point needs to be repaid. The psychology behind such seemingly perverse behaviour is well known, and not too far away from the reasons why gamblers often end up in big trouble – the vain hope of one big final payout that will clear all previous debts incurred. Another possible reason very specific to Bosnia is to access a new microloan in order to repay the guarantor in the event that he/she is called upon by one's MFI to repay an earlier microloan moving into default. As one respondent in a focus group interjected, "When they call your guarantor you always need another loan to repay that loan." (Lindh de Montoya/Selimic 2010: 57).

Predictably, multiple borrowing soon became one of the most serious client problems in Bosnia: a major survey of MFI clients by Maurer and Pytkowska (2011) found that nearly 60% of borrowers had more than one microcredit outstanding, with a full 9% having more than 5 microcredit contracts outstanding, as Table 3 shows.

Table 3: Multiple Borrowings in Bosnia

Number of microcredit contracts	1	2	3	4	5+
% age of clients	42%	26%	15%	8%	9%

Source: Maurer/Pytkowska 2011: 2

Another point to note is that it is often argued that this multiple microloan scenario can be quite easily averted in the presence of a credit registry, so that MFIs can check potential clients to see if they are already in debt to some other MFI. This is an almost wholly mistaken belief. In Bosnia a private credit registry was established as early as 2002 (the Long-Range Company Credit Bureau), and then in 2006 a national credit registry was established involving both legal entities (the Central Registry of Credits of Legal Entities) and physical persons (Central Registry of Credits of Physical Persons). But with little take-up in the first two years or so, from September 2009 reporting to the Central Registry had to be made mandatory. When the incentive structure governing the behaviour of both senior managers and loan officers is such that the core objective becomes the need to churn out as many microloans as possible, which is exactly what happened in Bosnia, we should not be surprised to find that recourse to any credit registry is generally considered a waste of time and financial resources, which is also what happened in Bosnia.

Finally, we should note the international donor community's belated response to the huge over-indebtedness problem it created – the establishment of a network of debt counselling agencies across Bosnia. The Centre for Financial and Credit Counselling was established in 2009 with financial support from the UK government's aid arm, DFID, and the World Bank's IFC arm, plus some financial and/or simply moral support from the key local MFIs that were responsible for leading the poor into such high levels of debt. It was established with the aim of helping the most indebted in Bosnia to manage their way toward a sensible debt repayment strategy. Renamed 'Plus' in 2012 to avoid the stigma of indebtedness falling upon those using its services, it has benefitted from the advice of a number of institutions skilled in working with the over-indebted poor, such as the Bristol Debt Advice Centre in the UK. A wider, but unstated, aim is to encourage the poor in Bosnia to essentially *avoid* any further engagement with microfinance if at all possible.

4.5. Destruction of local community solidarity

Everywhere around the globe we find that the rapidly growing and microfinance-induced informalisation of the typical local economy is an important factor in undermining the accumulation of social capital and solidarity. This is because of the microenterprise sector's well documented association with illegality, tax avoidance and pitifully low wages. These familiar negative outcomes are repeated right across Bosnia (Tiongson/Yemtsov 2008) Perhaps worst of all, a recent EBRD-funded study (Augsburg et al. 2012: 2) found that participation in microfinance programs in Bosnia meant that, "Children aged 16 to 19 started to work significantly more (..). At the same time, school attendance decreased significantly for these young adults". There is probably no better way of destroying trust, neighbourliness, social solidarity in the local community and development potential than denying young adults a full education.

Going further, it is manifestly clear that the often stunning Wall Street-style salaries, bonuses, share options and other rewards that senior managers of MFIs and outside investors deem they deserve, and make sure they attain, have become one of the most grotesque social capital-destroying features of the global microfinance industry (Sinclair 2012). Notable examples of Wall Street-style excess have arisen in India and Mexico, where the original employees of both SKS and Compartamos manoeuvred their way into ownership of the MFI and then personal fortunes (Bateman 2010; Arunachalam 2011). Even Muhammad Yunus has spoken out strongly against the egregious profiteering and subsequent damaging impact upon social solidarity that is now contemporary microfinance practise.[35]

Bosnia has not been spared of such negative inequality/greed-driven dynamics. First, Bosnia's statistical services have reported for some time that the senior managers working in the country's microfinance industry are routinely among the highest paid individuals in the country. Adverse media comment is rising fast, forcing most MFIs into undertaking more PR events and lobbying in order to maintain their popular and, more importantly, political support. But citizen and government disenchantment with the microfinance industry continues to rise. Mujković (2010: 6) reported that MFIs in Bosnia were increasingly seen to be "exploiters who are charging exorbitant interest rates on loans to poor populations". Any remaining trust in the microfinance sector then largely evaporated in 2011 when the Bosnian statistical service announced in one of its regular bulletins that the highest paid individual in Bosnia was the Executive Director of Mikrofin, an individual who in July 2010 received a taxable monthly income (salary plus bonus payment) of 220,249 KM (around $US 150,000).[36] Even long-time microfinance supporters were deeply embarrassed at this latest

[35] See 'Sacrificing Microcredit for Megaprofits' *New York Times*, January 14th 2011.
[36] See 'Najveća mjesečna plata u RS' (Highest monthly salaries in the RS) *Večernje Novosti*, July 7th 2011.

Wall Street-style turn of events.[37] After long claiming that microfinance was all about 'assisting Bosnia's poor to escape their poverty', and after very significant grant funding from the international development community actually provided the initial capitalisation for virtually every MFI (Agencija za Bankarstvo Federacija BiH 2011: 25), based on the idea that the MFIs would then use these resources to directly and exclusively improve the lives of the poorest, many ordinary Bosnian people now feel that they have effectively been abused by the microfinance industry, not assisted to better their lives. Bravely, some at the very heart of the microfinance sector have publicly lamented the way things have turned out. As one Director of an MFI in Bosnia, Selma Čizmić of LIDER, candidly admitted in 2010, "I hope microfinance lenders will get back to the original purpose of microfinance and will stop being too much into it for profit." (Cain 2010)

Second, with so many of the poor and unemployed in Bosnia forced into informal microenterprise operations, the continuing microfinance support provided to new entrants is increasingly perceived as a way to make the already poor pay to resolve the poverty of others equally poor. As already noted, thanks to displacement effects the average returns enjoyed in many informal occupations/microenterprises in Bosnia are not only minimal, but subject to serious downward pressure due to the continued inflow of 'poverty-push' microfinance-assisted entrants. The inequity of this 'poverty management' process - the abject poor forced to endure even *lower* financial rewards in order to help out others also in abject poverty – has long been recognised as destroying important solidarity links within the local community (World Bank 2002b).

Third, a notable negative impact here has been on the social capital of individual borrowers, which is undermined whenever a guarantor gets a call to repay a loan he/she guaranteed. As one international donor-sponsored study concluded, "(R)elationships with guarantors are highly valued – they are an economic asset, of sorts, for those with irregular employment, and are sabotaged when (MFIs) call guarantors to inform them that they will need to step in and pay."[38] Solidarity links with the extended family, friends and neighbours, links that were unwisely overlaid with guarantor responsibilities, have thus all too often been blown apart.

Fourth, a peculiarity of the Bosnian legal system that was designed to minimise corruption, has instead turned out to erode the confidence in local institutions and in wider society. Defaulting individuals in Bosnia are required to go to court to officially sign off on their microloan, and thus are widely advertised as bankrupt. It was hoped this adverse publicity aspect would dissuade corrupt bank managers from quietly granting loans to family and friends with the intention all along for these loans to be defaulted upon. But with so many defaults now taking place among the poor, especially among those who took out a microloan for consumption purposes or a tiny 'business' that was never likely to make a decent return, the process has turned out to be supremely alienating and humiliating. When one MFI working exclusively with women in Bosnia, *Žene za Žene* (Women for Women), was forced to drag more than four thousand of its failed women clients through the court system in this way, it was widely agreed in Bosnia that this was hardly the best global advertisement for 'gender empowerment' (Goronja 2011).[39]

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[37] The authors contacted Mikrofin on several occasions by telephone and with follow-up emails with a view to confirming this point as well as to obtain data on other important issues raised in this article. However, after the Mikrofin spokesperson contacted by telephone initially seemed helpful, saying 'we will be back in touch very soon', the research team received no reply to all subsequent correspondence. This lack of cooperation is in spite of the fact that Mikrofin has endorsed the principles of the 'Smart Campaign', an initiative of the US-based microfinance advocacy group ACCION which is designed, among other things, to encourage transparency, honesty and accountability in the microfinance sector. See http://www.smartcampaign.org/about-the-campaign/campaign-endorsers (26.11.2012).

[38] Lindh de Montoya/Selimić 2010: 20.

[39] Due to its large and growing number of defaulting clients, and consequently a seriously deteriorating financial position, in mid-October 2012 the Federation Banking Agency pushed *Žene za Žene* to close down. Its remaining loan book was taken over by the Sarajevo-based MFI *Lok*. http://www.profitiraj.ba/20110926272/mikrokreditne-organizacije.php (26.11.2012).

5. Bosnia as a case of Blackian control fraud

In assessing the reasons behind the negative contribution of the microfinance model in Bosnia, and particularly the 'microfinance meltdown' that took place in 2010, the prevailing narrative put forward by the Bosnian microfinance industry and its international supporters is seriously inadequate. Explanations emerging from within the microfinance industry are generally simplistically premised on the notion that the managers of MFIs were simply 'caught off-guard' or 'over-optimistic', and so massive over-lending and subsequent profiteering by managers are seen as unfortunate but quite unrelated to the 'real' microfinance model. Recommendations based on such a weak grasp of reality are thus seriously flawed, and typically relate to nothing more than the need for 'better marketing' and more research by managers of MFIs to understand 'the extent and dynamics of over-indebtedness.'[40]

We actually need to locate a more robust explanatory model for the Bosnian microfinance sector's hugely destructive impact. In what follows we argue that the best possible explanatory framework with regard to the structure, conduct and performance of Bosnia's microfinance sector since 1996, as well as the errant behaviour of the global microfinance industry overall, is contained in the concept of control fraud developed by William Black, probably the world's leading systematic analyst of the relationship between financial crime, financial structures and incentive mechanisms. Black's model of control fraud famously emerged out of his personal experience in the United States as one of the senior regulators at the time of the Savings and Loans institution (S&L) crisis in the 1980s. Prior to the huge bail-out of Wall Street that took place after 2008, the US government described the S&L crisis of the 1980s and early 1990s as the greatest collapse of U.S. financial institutions since the Great Depression. Established from the early 1800s onwards, the S&Ls traditionally provided low cost loans to its medium-to-low-income members to facilitate house building and purchase. The S&L sector grew steadily and by the 1900s was a major part of the financial sector. Following extensive deregulation of the S&Ls in the 1970s under President Carter, accelerated in 1980 after Ronald Reagan became President, however, the S&Ls were gradually taken over by their senior managers. The broadly democratic character and 'community embeddedness' that were the original hallmarks of the S&L movement were ditched, as well as almost all checks and balances on the activities of the senior managers.

Senior managers of S&Ls were thus given the freedom and opportunity to reconstruct the objective function of the S&L into one based on the satisfaction of their own demands for wealth and power, rather than supporting members of the S&L in their reasonable desires to obtain affordable loans. Among other things, this involved senior managers awarding themselves stratospheric salaries and bonuses, awarding themselves and friends interest free loans, as well as putting S&L funds into business projects that not only drained the S&Ls capital but also involved the same senior managers investing privately in the project using interest free loans to do so. This increasingly unstable management structure inevitably led on to control fraud, which is the situation where senior managers can quietly subvert the organisation and engage in legal (at least initially) activities principally to promote their own personal enrichment. Those inevitably losing out are the shareholders, customers, employees and the wider society. Black's overall take on the crux issue that befell the S&Ls in the United States is best summed up by the title of his signature book – '*The best way to rob a bank is to own one*'. (Black 2005)[41]

[40] A fairly typical example of such insouciance would be Schicks/Rosenberg 2011.

According to Black (2012),[42] there are essentially four steps to be taken in order to optimize accounting control fraud:

- Grow extremely rapidly by
- Making bad loans at a premium yield while
- Employing extreme leverage, and
- Providing only grossly inadequate reserves against the inevitable losses

Using variants of this basic ‘recipe’, unethical CEOs of financial institutions, very much including MFIs, can virtually guarantee to make themselves wealthy individuals. Using a combination of deregulation, desupervision and *de facto* decriminalisation, Black shows that the perfect ‘criminogenic environment’ can be created to the benefit of senior management in charge of major financial institutions. Such a ‘criminogenic environment’ both gives rise to the control fraud and it provides the precise mechanisms and tools whereby an institution’s assets can be transferred over to senior managers with the least chance of prosecution. As Akerlof and Romer (1994) famously argued, promoting and benefitting from such a ‘criminogenic environment’ is all too often seen as a ‘sure thing’ by senior managers.

While the Bosnian situation has certain specific features, of course, the evidence nonetheless shows that there are at least seven areas where Bosnia’s microfinance sector experience since 1996 strongly correlates to the general defining characteristics of control fraud and a criminogenic environment as outlined by Black.

5.1. Loan growth is always good

Black’s model of control fraud predicts that senior managers of a financial institution will insist on an unsustainable growth strategy, but will nevertheless be able to convince all external parties (e.g., auditors, regulators, clients, the media) that it is a sound strategy.

After a slow build-up, from 2006 onwards the volume of microloans disbursed in Bosnia began to accelerate at an alarming pace. Between 2006 and 2008 the microfinance sector almost tripled in size. The extent of over-lending was becoming apparent to many, but the microfinance industry continued to claim that nothing was wrong. With an obvious nod to previous global campaigns which falsely purported to locate an ‘absurd gap’ between the global supply of microcredit (too little) and the global demand (unfulfilled),[43] a technique notably deployed in Andhra Pradesh prior to its catastrophic ‘microfinance meltdown’ in 2010,[44] the microfinance industry in Bosnia began to make similar claims. As elsewhere, the argument was couched in terms of the ‘financial inclusion’ proposition – that many parts of Bosnia were supposedly still under-served by the microfinance sector, so no-one should rest until this appalling situation was addressed. Right up until the ‘meltdown’ in 2010, virtually all of the PR outputs of the international development agencies and MFI funders were reflexively structured so as to reflect the ‘fact’ that there remained a major ‘funding gap’ in terms of microfinance, a ‘funding gap’ that they were desperately trying to fill.[45] Some shallow

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[42] See William Black, ‘Microcredit Accounting Control Fraud Deepens Bosnia’s Nightmare’, *New Economic Perspectives*, March 11th 2012. http://neweconomicperspectives.org/2012/03/microcredit-accounting-control-fraud-deepens-bosnias-nightmare.html (26.11.2012).

[43] The Boston-based ACCION microfinance advocacy body is intimately associated with many of these false ‘absurd gap’ claims, which largely originate in order to add weight to its core argument that commercialising microfinance was the preferable structure for the microfinance industry. See the discussion in Bateman 2010: 52-54.

[44] Almost right up until the entire microfinance sector collapsed in Andhra Pradesh thanks to over-lending and massive individual over-indebtedness, the main MFIs, microfinance advocacy bodies and research institutions all held firm to the agreed line that the main problem affecting the poor in Andhra Pradesh was, as ever, the desperate shortage of microfinance. For example, see Ed Bland, ‘An Open Letter to the Editor of the Wall Street Journal’, August 14th, 2009. (http://unituslabs.org/updates/an-open-letter-to-the-wall-street-journal/ (26.11.2012).

[45] For example, see EBRD press release, ‘EBRD supports micro enterprises in BiH’, 18th September, 2006. The same ‘funding gap’ claim cropped up in very many of the EBRD’s press releases around this time.

academic analysis appeared at the time to rather conveniently offer support for the general contention (for example, Hartarska/Nadolnyak 2008). The microfinance sector also established the Association of Microfinance Institutions in Bosnia (AMFI) which played an important role in supposedly confirming the 'value' of microfinance and the never-ending need for yet more. AMFI's lobbying role was especially applied to senior members in the Bosnian government, most of whom had initially been very lukewarm in their support for the concept (Bateman 2003).

Overall, one might say that a form of 'collective hysteria' appeared to have emerged in Bosnia. All involved in the microfinance industry, and very many outside it who might have known better, were unable to think other than that microfinance was a wonderful invention, that poverty in Bosnia was being reduced very fast, and that – crucially – this could only be done if there was yet *more* microfinance on offer. The mounting evidence to the contrary was automatically dismissed by the main MFIs and their supporters, often very aggressively.[46] Thus was unending growth of the microfinance sector hot-wired into the financial system in Bosnia.

5.2. Asset stripping precipitates bankruptcy

Black's model (see also Akerlof/Romer 1994) predicts that senior managers will often steer an institution into bankruptcy in order to extract as much value for themselves as possible. The institution eventually closes, and society is left to pick up the economic and social pieces, but in the meantime the senior managers walk away with significant value. In some cases, however, this process involves an already ailing institution being looted for whatever remaining value senior managers can extract and convert into their own private assets before the institution eventually goes under.

The Bosnian microfinance sector has now seen its first case of asset stripping followed closely by bankruptcy. The MFI concerned is Sinergija Plus based in Banja Luka in the Republic of Serbia (RS) entity in Bosnia. With the crucial approval of the Banking Agency in the RS (approval not so far given to MFIs in the Federation entity, see below), in 2007 Sinergija Plus, along with its near-neighbour Mikrofin, converted into a private company. Sinergija Plus emerged under the effective control of its two senior Directors – the General Manager (GM) and the Executive Manager for Development (EMD). As everywhere else, the new commercialised Sinegija Plus soon began to ramp up the supply of microcredit. As was also usual, and *especially* in the Bosnian microfinance sector (see below), Sinergija Plus's two Directors very generously rewarded themselves for their work; in 2008, for example, sharing between them a total salary pot of KM463, 000 (around $US300,000).[47] To a growing number of Sinergija Plus's employees, such high financial rewards were just one of the most obvious signs that the MFI had fallen under the total control of the two main Directors, and eventually full ownership would be ceded to them also. However, when a group of Sinergija Plus employees attempted to form a trade union to better defend their own and the local community's interests, the core fifteen of these employees were quickly fired.

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[46] In 2006, one of the co-authors (Bateman) was contracted by a European Commission-funded project to prepare a seminar paper to be delivered in Sarajevo on September 26th under the auspices of the Economic Policy Research Unit (EPRU), an international donor-funded body that was advising the Bosnian government on the formulation of its economic policies. Once the theme of the seminar became widely known – essentially, the failings of microfinance – the EPRU immediately came under pressure from the microfinance sector and some international donor supporters to cancel the event. Failing this, at the very last minute the format for the seminar was changed without any notice and another paper was allowed to be presented during the time allotted for the originally contracted paper. This additional paper, by the Director of one of the major MFIs in Bosnia, confined itself to presenting a variety of financial statistics and ratios that supposedly 'proved' that microfinance was successfully working to develop Bosnia's economy. The final question time session was then effectively dominated by a stream of aggressive questioning coming from several of the senior employees of Bosnia's leading MFIs, thus preventing any real debate as to the problems with microcredit.

[47] MKD Sinergija plus d.o.o. Banja Luka, Financial statements for the year ended 31st December 2009: 29.

The next problem to emerge for Sinergija Plus was the unfolding crisis in Bosnia's microfinance sector beginning in 2008-9, which began to undermine its planned rapid growth model. New clients became far more difficult to find, existing clients began to default and losses were racked up for the first time in its history. In the face of such difficulties, Sinergija Plus's two Directors opted for a hugely risky strategy, or possibly a supremely opportunistic/cynical one fully in line with Akerlof and Romer's 'bankruptcy for profit' conclusions (Akerlof/Romer 1994), that would eventually lead to the bankruptcy of the MFI. The decision was made to begin to siphon off a large chunk of the cash-flow generated within Sinergija Plus in order to underpin a property construction company – Sinergija Invest – that was founded in 2009 and put under the control of the General Director, Mr Damir Miljević, one of the two Directors of Sinergija Plus. Land parcels were purchased to a total value of KM 2.3 million, which were paid over three instalments out of Sinergija Plus's cash-flow. The construction of a number of office buildings and apartments then began on this land, the construction contracts also financed out of Sinergija Plus's cash-flow.[48] Thus, at precisely the time when Sinergija Plus's financial position was at its most vulnerable, and realistically all financial resources were needed to shore up the balance sheet, Sinergija Plus's cash-flow was used instead to fund a raft of extremely speculative property development projects through Sinergija Invest.

When a number of Sinergija Plus's major funding partners failed to receive any repayments on their wholesale loans to Sinergija Plus, in September 2012 Sinergija Plus was finally forced into bankruptcy proceedings. The discussion has now turned to the eventual ownership of property assets accumulated by Sinergija Plus in its very short period of operation. It seems likely to us, as well as to a number of former employees subsequently sacked by the Director, that the original intention of the two Directors was always to float off Sinergija Invest into their own full or partial ownership. This would deliberately strip out much of the value generated in Sinergija Plus and put it into private hands – that is, into the hands of the two Directors of Sinergija Invest. But this hugely risky strategy appears to have failed because the property assets are now tied up in bankruptcy proceedings. We thus see here an *attempted* asset stripping prior to bankruptcy exercise, rather than a successful exercise in asset stripping prior to bankruptcy.

5.3. Regulatory capture

Black's model predicts that senior managers who are control frauds will exhibit a visceral hatred towards, and attempt to change or frustrate, all government regulators and any others who might try to properly regulate or monitor their activities.

It is telling that the single most important regulatory issue concerning Bosnia's microfinance industry relates to the ability of an MFI to convert into a for-profit company. For reasons that will become clear in the sections that follow, nowhere has the constant lobbying by the microfinance sector been focused and more sustained than on this issue of conversion and ownership. Prior to 2006, the microfinance sector remained true to its origins in the non-governmental sector and international donor-funded programs. However, important change finally came in 2006 when a new law on microcredit was finally approved by the central government. This new law did two things. First, it passed responsibility for supervising the MFIs to the Banking Agency operating in each entity. Second, MFIs had to re-register in one of two approved forms; as a foundation dedicated to working in the local community and receiving grants with which to make microloans up to KM10,000 (about $US6,000) or as a for-profit microcredit company that could not receive grants but could make microloans up to KM 10,000 (about $US12,000). Almost all the then existing MFIs in Bosnia very much wanted to convert into for-profit company status.

[48] 'Novac iz Sinergije izvukli za gradnju zgrada' (Sinergia's funds used for real estate development), *Glas Srpske*, 18th July, 2012. http://www.glassrpske.com/novosti/vijesti_dana/Novac-iz-Sinergije-izvukli-za-gradnju-zgrada/lat/85856.html (26.11.2012)

However, the law on microcredit has so far been interpreted rather differently in the two entities. Following an intense lobbying effort in the Republic of Serbia, the 2006 law was interpreted by the relevant regulatory authority rather favourably towards those MFIs wishing to become for-profit businesses. MFIs were right away allowed to convert into for-profit company status, with Mikrofin and Sinergija converting right away. In the Federation, however, the Banking Agency has been much less forthcoming to lobbying. Its central concern, more or less ignored in the Republic of Serbia, was that the eventual ownership of the substantial grant funding that gave life to all of the MFIs operating in Bosnia, as well as retained surplus/profit, would become the private property of the newly converted MFIs.[49] The Banking Agency of the Federation wished that this substantial amount of donated capital remain the property of the local community and not simply become the property of the MFIs, still less the private property of the senior managers of the MFIs. It has therefore to date refused to allow MFIs operating out of Federation territory to convert into for-profit company status until this important ownership issue is resolved.

However, with so much potential personal enrichment at stake, it was probably inevitable that the main MFIs in the Federation territory would launch a lobbying campaign to try to change the regulations in their favour, similar to the one successfully undertaken by their counterparts in the Republic of Serbia. In fact, this lobbying campaign pretty much began right after the 2006 law was passed. It remains an open secret that senior managers in the main MFIs in the Federation entity are desperately keen to enjoy the same private financial rewards as their MFI counterparts in the Republic of Serbia (see below), so there is little doubt about the main motivation behind such lobbying.[50] Nonetheless, there has been no success to date. However, just as in other regions in the Western Balkans,[51] the growing feeling in Bosnia today is that the Banking Agency of the Federation will inevitably have to give way at some stage to the financial muscle and influence of the microfinance industry it oversees.[52]

5.4. Extreme compensation schemes

Black's model predicts that senior managers who are control frauds will make every attempt to privately enrich themselves at the expense of shareholders, customers, regular employees and the wider local society.

As already noted above, senior managers in all of the main MFIs have ensured that they generally receive astonishingly high financial rewards for their services. The microfinance sector's senior managers are among the very highest paid people in Bosnia, and, at certain specific times, the very highest paid employees in the country. Generous bonuses on top of salaries are also the norm.

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49 As examples, EKI was capitalised with around $US5 million of donor funding, Mikrofin received around $US5 million and Prizma received $US3.5 million (data from various audited accounts).

50 Authors' interview with Nizama Kataldo, Sector for Supervision of Microcredit Organizations, Banking Agency of the Federation of Bosnia and Hercegovina, Sarajevo, 29th September, 2011.

51 In the new territory of Kosovo, for example, senior managers in the main MFIs are lobbying the local authorities and the international donor community to allow all initial grant funding to remain the property of the MFI after its conversion into a for-profit institution, and that it not be returned to the local community as per the original agreement with the donors. Retaining this donor funding on an MFI's balance sheet will allow for an MFI's managers to become very rich indeed when it comes time to sell their personal stakes in their MFI. Although some resistance is being offered by valiant defenders of the common good, it seems unlikely that there will be any success: by all accounts, the MFIs in Kosovo are now too powerful, too well-connected and there is simply too much money at stake. See 'Microfinance Law – this is a bank robbery', *Balkan Insight*, 24th May, 2012. http://www.balkaninsight.com/en/blog/microfinance-law-this-is-a-bank-robbery (26.11.2012).

52 Indeed, MFIs in the Federation entity have already been successful in pushing to be allowed to establish insurance operations similar to those established by several MFIs in the Republic of Serbia. Although out of 19 requests to establish a for-profit insurance arm, permission was granted to just six of the largest MFIs, these operations stand to make significant profits for those MFIs that were successful in their application, and thereafter the MFI's senior managers too. AMFI Press release http://www.amfi.ba/en/news/37-agencije-za-bankarstvo-izdale-clanicama-udruzenja-mikrofinansijskih-organizacija-u-bih-osam-dozvola-za-rad- (26.11.2012).

Another less obvious form of compensation is for senior staff to grant themselves access to loans from the MFI on very favourable terms and conditions. Interest rates on these self-awarded loans are often very low and, in some cases, zero. In addition, such employee loans are often granted over a long time period (e.g., ten years), meaning that easy payment is possible out of the income earned on whatever project the loan supports, and inflation will also eat away at the real balance to be paid. Moreover, as highlighted in the next section below, very often such favourable loans are deliberately offered as part of a plan for senior managers to *privately* purchase a share in a venture that the MFI establishes as a *corporate* entity. With the income derived from this asset, which can also be controlled by the same senior managers, repayment is usually not any sort of a burden at all. As we will show, Mikrofin stands out as the one MFI that has extensively used such favourable loans to senior managers as a way to facilitate the gradual transfer of the MFI's value into the hands of these same individuals.[53]

5.5. Privatising an MFI's assets

Black's model predicts that senior managers who are control frauds will eventually seek to convert their employer's assets into their own private assets. Just some of the ways this aspect of control fraud can be realised include: investing the institution's assets into a new venture which includes participation of the senior managers as private individuals; interest free loans to senior management; interest free/low interest loans to family and friends in return for favours; and interest free/low interest loans to family and friends that are deliberately defaulted upon. Most important of all is the process whereby senior managers quietly take over part or full ownership of the financial institution that employs them. This process of unethically, and often illegally, transferring a company's ownership and assets into the private hands of its senior managers is very well known, notably in Eastern Europe after 1990 (Prasnikar/Svejnar 2000).

As even some advisors attached to the major microfinance advocacy bodies obliquely warned would likely happen,[54] the commercialisation of Bosnia's microfinance sector was virtually guaranteed to open the door to control frauds in the shape of asset stripping by an MFI's senior managers. Virtually all of the MFIs in Bosnia operated upon the mutually agreed basis that senior managers would eventually become important, if not majority, owners of their MFI.[55] The most spectacular example of such control frauds to date once again involves the MFI Mikrofin that is headquartered in the Republic of Serbia entity in Bosnia. Mikrofin has been very active in opening important new business ventures that are underwritten with Mikrofin funds and/or collateral, but in which senior managers of Mikrofin have allowed themselves to participate in as *private individuals*. Going even further, participation by Mikrofin's senior managers has been facilitated thanks to self-awarded low or no interest loans. The result is that two obvious cases of control fraud have arisen so far, with one potentially very large case of control fraud looming on the horizon.

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53 For several years, the audited accounts for Mikrofin show that the category 'Head Office – loans to employees' is indeed a very considerable amount. In 2009, for instance, the value of loans to head office employees amounted to KM 560,000 (around $US330,000), which represents a figure comparable to just under 10% of the total lending of one of the smaller branches of Mikrofin (e.g., Mostar or Trebinje). See page 18, "Microcredit Company 'MIKROFIN D.O.O., BANJA LUKA' Unconsolidated Financial Statements for the Year Ended December 31, 2010 and Independent Auditors' Report".

54 For example, in 2008 lawyer and policy advisory consultant to the World Bank's Consultative Group to Assist the Poor (CGAP) arm, Kate Lauer, expressed her concern that asset stripping might be one of the results of MFI conversion in Bosnia. She noted that, 'In some countries (e.g., Bosnia, where the concern has been expressed not only by regulators but also by bilateral aid agencies), there is heightened concern that transformed institutions will be effectively stripped of their assets by management or others controlling the institution' (Lauer 2008: 18). However, virtually nothing was said or done by the World Bank, or any other major institution supporting microfinance, to try to prevent or publicise such asset stripping. It is surely no coincidence, therefore, that virtually *every* major MFI transforming into a commercial for-profit institution did exactly as Lauer warned that they might do (see Sinclair 2012), and *especially* in the case of Bosnia, as this article demonstrates.

55 A typical comment relating to the MFI Sunrise is the following: 'The Foundation will become a shareholder in the Company, but other shareholders including top management are also expected to subscribe to its capital'. See '*Planet Rating – Sunrise MCI: Bosnia and Herzegovina'*, May 2007.

The first case involves Mikrofin's senior managers establishing a new insurance company 'Mikrofin Osiguranje a.d.' This new venture was founded with 30,000 shares, of which 15,650 of these shares (i.e., a 52% ownership stake) were allotted to the parent company Mikrofin in return for its cash investment of KM 1,565,000 (around $US 900,000). In turn, this cash investment was financed by a loan from the local branch of Hypo-Alpe Adria Bank using Mikrofin's assets as collateral. The remaining 48% of the shares in Mikrofin Osiguranje a.d were allotted to senior managers within Mikrofin acting in a *private* capacity, as well as six other private individuals outside of the company. Importantly, in order to purchase their private shareholding in Mikrofin Osiguranje a.d., Mikrofin's senior managers were awarded a ten year loan of between KM 25,000 and KM 50,000 at a 5% interest rate (that is, somewhat below the regular interest rate charged to Mikrofin clients which is around 20-30%).[56]

The second case of control fraud begins in 2008 when an investment company – Mikrofin Invest – was established using a capital injection of 400,000KM (around $230,000). KM140,000 of the cash investment directly came from Mikrofin's financial resources, while the remainder (KM260,000) was supplied by four of its senior management team in a private capacity, but once more using internal loans as the source of this cash.[57] However, Mikrofin holds only 40% of the equity in this new venture, because the two senior Directors of Mikrofin awarded themselves a 17.5% personal share of the new company, with the other Directors of Mikrofin given a 5% or 10% personal shareholding. Overall, Mikrofin Invest is majority (60%) owned and controlled by the Directors of Mikrofin acting as *private* individuals, not as officers of Mikrofin.[58] Moreover, the primary investment undertaken so far by Mikrofin Invest is an investment of KM 400,000 to take a 0.77% share in MF Bank (see next point). In addition, Mikrofin has taken an equity stake (37.5%) in one of the funds managed by Mikrofin Invest – Open Investment Fund Mikrofin Plus – which as of the end of 2011 was worth KM 843,000.[59] This initial investment greatly assisted the investment fund to achieve sufficient interest and initial scale, which acted to the benefit of the majority owners of Mikrofin Invest, who are, as noted above, the senior managers of Mikrofin acting in a personal capacity.

There is also, thirdly, the case of IEFK Bank which in 2010 Mikrofin elected to purchase for just under KM 13 million (around $8US million), renaming it MF Bank. MF Bank is almost 99.23% owned by Mikrofin and with several of its main officers doubling up their role as senior managers in Mikrofin with well-paid positions in MF Bank. As of mid-2012, MF Bank was reporting assets of around $US40 million and was extending its operations through a program of loans from the major international development institutions. It is clearly on the road towards becoming a major bank in Bosnia. So, as in the two previous cases, are the senior managers in Mikrofin planning to be major beneficiaries of this new arrangement?

Consider that MF Bank is 99.2% owned by Mikrofin, which in turn is owned by the 'Citizens Association Mikrofin' that was set up by CARE, one of the most high-profile international donors. As an NGO, the 'Citizens Association Mikrofin' has no shareholders and it pays out no dividend. On its foundation in 1999, the 'Citizens Association Mikrofin' was governed by a group of five individuals chosen to represent the local community and, we must presume, keen to do whatever might be best for that community.[60] As Planet Rating carefully reported in 2005, however, it seemed that the most important issue the then Board of Directors was grappling with was the issue of how best to convert the NGO Mikrofin into a for-profit private company.[61] Inevitably, virtually all of those who actually made this decision then went on to

56 See 'MKD Mikrofin d.o.o. Banja Luka. Financial statements for the year ended 31 December 2007 prepared in accordance with International financial reporting standards and Independent Auditors Report'.

57 One anonymous interviewee with apparent knowledge of the arrangement suggested that these particular staff loans were interest free, unlike previous loans offered to senior staff at a 5% interest rate. This specific issue was one of a number of clarifications unsuccessfully sought from Mikrofin. See footnote 38.

58 For example, see 'Prospectus – Open Investment Fund 'Mikrofin Plus''. 20th August 2008.

59 See page 22, "Microcredit Company 'MIKROFIN D.O.O., BANJA LUKA' Unconsolidated Financial Statements for the Year Ended December 31, 2010 and Independent Auditors' Report".

60 For the original Board of Directors of the 'Citizen's Association Mikrofin', see *Planet Rating – Mikrofin*, (August 2006).

61 *Planet Rating –Mikrofin – Bosnia and Herzegovina* (April 2005: 3).

become well-paid Directors and/or senior managers in the newly transformed for-profit company that emerged. As noted in the sections above, this group of senior managers has already taken steps to convert Mikrofin's assets into private assets, so there is no reason to expect other than that the ownership and value contained within MF Banka will also slowly bleed into the hands of Mikrofin's senior managers. As the example of Banco Compartamos has vividly shown in Mexico (Waterfield 2008), as well as the example of SKS in Andhra Pradesh state in India (Arunachalam 2011), a weak to non-existent regulatory structure coupled with seriously flawed governance structures and opportunistic individuals creates an environment that is virtually tailor-made for control frauds of this specific nature.

5.6. The inevitable losses are covered by other parties

Black's model predicts that managers of financial institutions growing at a breakneck pace will exhibit very little concern for the inevitable end result of such a risky strategy – losses – because other parties, usually the government, will eventually be forced to come in and bail them out.

Such a strategy appears to have played a role in Bosnia. First, one might speculate that Bosnia's MFIs all pursued rapid growth with little real concern for the final consequences because they already had within the MFI a pot of money that would cover the losses. This was the accumulated reserves formed out of initial grant funding plus retained surpluses, and which were meant to be legally locked away within each MFI. However, it was always known that a fairly straightforward financial transaction would be enough to ensure that these reserves could be used to cover any losses incurred by the MFI. And this is exactly what happened in many cases. Analysis of the audited accounts of most of the MFIs reveals that management salaries continued to gradually rise and that the MFIs' losses were overwhelmingly covered out of accumulated reserves. That is, generous salaries and bonuses awarded as a result of meeting an MFI's growth, market share and profitability targets were not, even just partly, clawed back out of reduced (management) labour costs when the situation went into reverse. For example, previously rapidly growing EKI managed to rack up very serious financial losses in 2009 and 2010, but it was easily able to cover these losses by tapping into its reserves (accumulated surplus over income) which therefore dropped from just over KM 37 million in January 2009 to just under KM 25 million by 31st December 2010. However, senior managers appear to have refused to take any action themselves to make amends for the problems caused by their actions: during this period of horrendous performance the total salary pot of the 24 senior managers in EKI still increased, going up from KM 1,280,000 in 2009 to KM 1,350,000 in 2010, amounting to a 5.5% increase during a period of massive losses.[62]

Second, the extent of over-lending that took place in Bosnia does not seem to have seriously deterred the key funding institutions, most of which continue to offer discounted funds to Bosnia's MFIs to 'help them get back on their feet'. In addition, almost all of Bosnia's MFIs were allowed to extend the repayment terms of the loans they had taken out, further helping them to recover from the catastrophe caused by their own senior managements. Note also that there is also no evidence of any change in senior management personnel at any of the MFIs in Bosnia during this tumultuous period. In many other industries, external help that enables an institution to survive particularly bad management decisions is very often conditional upon major changes being made to the senior management structure. But in the case of Bosnia's MFIs, we find that the very same individuals who created the microfinance industry's huge problems all very much remained in charge after the massive clean-up effort was over.

[62] Microcredit Foundation EKI Sarajevo, Financial statements for the year ended 31 December 2010: 41.

5.7. Seeking kudos

Black's model predicts that senior managers who are control frauds will seek the psychological rewards associated with being the most profitable business, as well as adulation from elite opinion makers.

From the late 1990s onwards, the profitability of Bosnia's microfinance sector was widely promoted as proof that it was doing what it was supposed to be doing: reducing poverty and promoting 'bottom-up' economic and social development. Thanks to its sterling financial performance, Bosnia's MFis began to gain international recognition and also to rack up an impressive set of awards, such as in 2007 when Forbes magazine placed five of Bosnia's MFIs in the global top fifty MFIs.[63] Partly as a result, senior managers of several of the major MFIs in Bosnia became regular 'expert advisor' fixtures in the work and programs of virtually all of the international development agencies, advocacy bodies and main funding bodies. Some of the more high-profile managers even gravitated into advising other developing countries on how to organise a microfinance sector and how best to reduce poverty. Senior figures from the major MFIs made regular appearance on local TV and radio, and were very regular features in local printed media. Even after the entire microfinance sector went into meltdown in 2010, and seemingly oblivious to the damage they had very clearly inflicted upon their own country, the senior managers of Bosnia's MFIs remained virtually as popular as ever within the international development community.[64]

6. Conclusion

This article has outlined a broad picture of the key developments and trajectories in Bosnia's microfinance sector since 1996. We believe that a careful analysis of the available evidence supports the view that the microfinance model has been a first-order calamity for the country. Rather than establishing a firm foundation for sustainable post-conflict reconstruction and development, the primitivising and sub-prime-style dynamics that were unleashed upon Bosnia have contributed to a growing number of deleterious outcomes. Entirely predictably, the Bosnian enterprise structure today is largely petty-trade based, informal, and almost all enterprises operate at a level of operations that precludes any scale economies and any serious engagement with new technologies and innovations. Meanwhile, the mass over-indebtedness of the poorest in Bosnia has inflicted very serious pain on those individuals and households least in a position to cope or progress in the new aggressive market-oriented economic environment of post-war Bosnia. Any positive impact arising from the well publicised, but tiny number, of successful microenterprises is effectively swamped by these negative inter-related trajectories. Finally, we found that the control fraud concept offers the best possible explanatory framework for understanding the recent adverse developments in Bosnia's microfinance sector. As in many other Eastern European countries, weak regulations, inappropriate incentive structures and opportunistic individuals have combined to create a wave of control fraud in Bosnia. All told, given the negative results exposed, the international development community really does need to genuinely reflect – finally – upon the precise role of the microfinance model in development and poverty reduction, not just with regard to post-conflict Bosnia but with regard to all developing countries.

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63 See 'The Fifty top microfinance institutions', *Forbes*, 20th December, 2007. http://www.forbes.com/2007/12/20/microfinance-philanthropy-credit-biz-cz_ms_1220microfinance_table.html/ (26.11.2012)

64 For instance, in 2011 the President of the Management Board of Mikrofin, Mr Aleksandar Kremenović, was one of the high-profile invited guests at the EBRD's prestigious Annual Meeting held in Astana, Kazakhstan. http://www.ebrd.com/downloads/AM11-IB-Web-English-Spreads1.pdf (26.11.2012).

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