# SME ACCESS TO FINANCE IN BOSNIA & HERZEGOVINA

## A POST-CRISIS INQUIRY OF FINANCIAL INSTITUTIONS AND COMPANIES

**July 2014**

This document was produced for review by the United States Agency for International Development and the Swedish International Development Cooperation Agency. It was prepared by:

**David T. King**, Ph.D., Technical Director, Economic Growth

**Cardno Emerging Markets USA, Ltd.**, implementer of

**FIRMA Project** USAID-Sida Bosnia & Herzegovina

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## Acronyms and Abbreviations

| Item | Meaning |
|---|---|
| A2F | Access to Finance |
| BiH | Bosnia & Herzegovina |
| BLSE | Banja Luka Stock Exchange |
| EBRD | European Bank for Reconstruction and Development |
| ECB | European Central Bank |
| EFSE | European Fund for Southeast Europe |
| EIF | European investment Fund |
| Ex-YU | The set of countries that formerly made up Yugoslavia |
| FBiH | Federation of Bosnia & Herzegovina |
| FIRMA | Fostering Interventions for Rapid Market Advancement project |
| FSD | Financial Sector Development |
| IFC | International Finance Corporation |
| IRBRS | Investment-Development Bank of Republika Srpska |
| ME | Medium-sized Enterprise |
| MFO | Microfinance Organization |
| NBFC | Nonbank Finance Company |
| NPL | Nonperforming Loan |
| RS | Republika Srpska |
| SASE | Sarajevo Stock Exchange |
| SBA | Small Business Administration (USA) |
| SE | Small Enterprise |
| Sida | Swedish International Development Cooperation |
| SMEs | Small and Medium Enterprises |
| WB | World Bank |

## Acknowledgements

The author gratefully acknowledges the outstanding research and organizational assistance and expert advice of **Amar Brkan**, without whom the preparation of this report would not have been possible. He also expresses his appreciation for the friendly cooperation of the many individuals, institutions, and companies interviewed, whose open and frank expression of their observations and expert opinions as to its subject matter provided the factual foundation of this document.

# 1. Executive Summary

**Justification for the Report**

USAID-Sida FIRMA, a 5-year project which began in August 2009, was tasked with upgrading the competitiveness of BiH's wood, metal, and tourism sectors. Access to finance – along with product and productivity upgrading, connection to markets, workforce development, and business environment improvement – was one of its key focus areas. Top-line objectives included a significant increase in business finance for its beneficiaries over the life of the project. FIRMA undertook several activities to improve SME access to finance (A2F), and these had a positive impact; the business finance growth objective was achieved. Nevertheless, it was apparent that A2F would remain a significant issue for competitiveness for companies in BiH beyond the term of the project. FIRMA therefore commissioned this comprehensive assessment of A2F in BiH in its final year.

There have been A2F and related assessments for BiH previously (see reference list), and their findings are recognized in the present report. However, for a number of reasons, an update is needed:

- The global financial crisis of 2008-9 has had a significant effect on bank credit policies, which are markedly more conservative than they were in the years leading up to 2008, when loan growth reached 20-30% per year.
- The inconsistent recovery since 2009[1], which continues, has had a negative impact on the businesses in BiH in general, making many of them less attractive / more risky to lenders and investors.
- The well-known and ongoing political stasis in BiH, and its stagnant business enabling environment (by far the lowest ranked in Southeast Europe[2]), has heightened country risk and reduced investment attractiveness, for both foreign and domestic providers of finance.

This report concentrates on access to finance for small and medium-sized enterprises (SMEs) – that is, companies that are in between "micro" and "large". In order to provide a complete picture as to SME A2F, however, it is necessary to evaluate financial sector development (FSD) in BiH in general, since any advance, while it may not provide a direct source of SME finance, certainly supports it indirectly. For example, in a well-developed capital market, while most open for direct fundraising to large firms, it is common to see securitized funds dedicated to certain types of finance (mortgages, vehicles) or target borrowers (agriculture, exporters) that benefit many SMEs. A capital market also enables fundraising by nonbank finance institutions – finance companies, leasing companies, factors – that provide some of the most convenient sources of finance to SMEs.

This assessment is organized according to the three fundamental aspects of A2F: (1) the supply side, or the availability of finance and how it is channeled through financial institutions to SMEs, (2) the demand side, or the "bankability" of BiH enterprises, and (3) the supporting infrastructure and services for the financial sector, including regulation and judicial enforcement, professional

[1] Over the past five years, the average BiH real GDP growth rate has been 0.9% per annum.

[2] In the 2014 World Bank Doing Business report, BiH is ranked 131 out of 189 countries. The next closest in SEE in Serbia (93), followed by Albania (90), Croatia (89), Kosovo (86), Romania (73), Bulgaria (58), Montenegro (44), Slovenia (33), and Macedonia (25).

consulting services, and risk-management resources such as credit information, collection, and liquidation services.[3]

The report seeks to answer the critical question of whether, in fact, there is an access to finance gap in BiH. That is, can viable businesses in fact find the finance they need, or are there many fundamentally bankable projects or businesses in BiH that cannot find adequate finance? If they cannot, why not, and what can be done about it?

Our approach to answering these questions was to **directly interview** a wide range of participants on both sides of the market for finance and representatives of its supporting services – face-to-face, one-on-one, at their premises. We did not send out a survey for remote response or interview over the telephone, nor did we collect financial statements, and we assured interviewees that their replies would be confidential. Instead of statistics, we sought their frank opinions and observations as experienced, on-the-ground operators. We interviewed 27 financial and support institutions and 36 companies throughout BiH, compiling some 300 pages of notes. All of the findings that we report are drawn from these key informant interviews. The interview guides for financial institutions and companies are provided in the annex to this report

**Condition of the Financial Sector in BiH**

As is well known, the BiH financial sector is dominated by commercial banking, which holds over 85% of all outstanding financial assets, a number that would be close to 90% if the stagnant holdings of privatization investment funds were not counted, or if microfinance institutions are grouped with commercial banks. Nonbank finance companies (leasing, factoring, equipment finance) are very minor players. The capital markets are entirely insignificant as sources of finance. Consequently, and in stark contrast to well-developed financial sectors, where SMEs have ready access to nonbank finance, in BiH they are almost entirely dependent on the commercial banking system.

However, that system suffered severely during the crisis and its aftermath, which caused enormous increases in the banks' nonperforming loans (NPLs); these rose from an average of 5-6% of total loans in 2007 to 14-16% by 2010. Meanwhile, the global scale of the financial crisis triggered rapid adjustments of international standards for capital adequacy and loan classification. As parent banks were subject to greatly heightened scrutiny by headquarters country regulators, their credit lines to BiH subsidiaries were frozen or even reduced. And at the same time, BiH bank regulators – the Federation Banking Agency (FBA) and the Banking Agency of Republika Srpska (BARS) – already in the process of adopting Basel and EU banking standards, themselves became much stricter in their oversight.

The result of these developments was a complete reversal of the credit policies of commercial banks in BiH, from a drive for growth in the *quantity* of loans to an obsession with loan *quality*. BiH bank credit expansion collapsed overnight, from over BAM 2.5 billion per year in 2007-08, to an actual contraction in 2009, and an annual average of about BAM 600 million since then. As a result, the country's credit/GDP ratio – the principal measure of financial sector depth – which rose from only 25% in 2000 to approximately 60% at the outset of the crisis, has largely stagnated since then.

Nevertheless, all banks declare their interest in SME lending, and some banks have fared better than others. The BiH banking system consists of three major categories of banks: the very large subsidiaries of major international banks, the foreign and domestic-owned medium-sized banks, and

[3] This report does not include an in-depth assessment of the legal infrastructure of the BiH financial system, which is generally well-developed. Where particular legal, regulatory, or supervisory issues directly affecting access to finance were raised by multiple interviewees, these are described. A recent comprehensive review of the financial sector legal system is contained in the USAID PARE project's document, *Model BiH Financial Development Report* (March 2013).

the smaller domestic banks.[4] While the large international banks became much more conservative in their lending, and still have no wish to significantly expand their loan portfolios (especially to business) the medium-sized banks, some of which have undergone recent ownership changes, have become significantly more aggressive, even if to a significant extent they are simply taking over SME clients shed by the large banks, rather than banking new SMEs. Many of the smaller domestic banks, meanwhile, though certainly focused on SME lending, have severe liquidity constraints: they are under pressure to increase capital because of high NPLs, and have difficulty competing for retail deposits with the larger banks that are perceived as safer.

The underdeveloped status of the financial sector in BiH has broad similarities to what is seen in developing countries worldwide. Even in Latin America, which has several quite large economies and many more years of integration in global capital markets than the countries of Southeast Europe, a recent analysis (World Bank 2014) finds that bond markets are typically dominated by government, with few private corporation issues, and equity markets remain "small, illiquid, and highly concentrated in large firms". However, at least there are trends in the LAC markets toward greater capitalization of bond and stock markets, while in BiH they are stagnant.

**Major Findings**

Against this background, the general findings of this assessment, in brief, are as follows:

- Lenders in BiH are extremely risk-averse, largely with reason. Bankers (as well as lessors and factors) say that they are open to lending to SMEs, that they will provide credit to any "bankable" SME, and that the constraint to expanding their lending is the lack of bankable SME projects. While we find that this is true on its surface, the big question is how "bankability" is assessed. Even though the macroeconomic growth outlook was significantly more positive prior to the crisis, it is hard to believe that businesses were four or five times (based on actual loan growth) more bankable then than they are now. As banks were over-optimistic then as to business viability, they are probably over-conservative now, in BiH and globally. This is the nature of the business cycle.

  However, there are other reasons to be conservative about bankability. In particular, in BiH, the "second way out" for a lender is severely compromised. This is due to (i) well-known judicial inefficiencies that, while generally regarded to be improving, frustrate and delay seizure of loan collateral, (ii) lack of supporting services for collection of overdue payments and consulting to assist turnaround, workout, and recovery, and (iii) lack of liquidation markets for collateral once it is in the lender's possession.

  In advanced financial sectors, legal recourse and enforcement are clear, supporting services are plentiful, and collateral liquidation markets are deep. Therefore, even though in all cases lenders rely first on fundamental business success (cash flow) in evaluating a loan, they do have reliable ways of recovering value in the event of default. For lenders in developed financial markets, risk is measurable and to some extent manageable. In BiH this is far from the case: the "second way out" is highly uncertain, and therefore greatly discounted, and consulting services to help companies get out of default are extremely limited. The result is that lenders must depend overwhelmingly on the basic business projection – they have no "safety net". For two SMEs with exactly the same degree of confidence in their basic business and cash flow outlooks, a loan to the one in BiH carries substantially more risk than to the one in, say, Germany. In many cases, then, the BiH SME does not get a loan, its competitiveness compared to the German company is reduced, and overall economic growth is repressed.

[4] We do not focus on microfinance institutions in this assessment, since our target beneficiary group is SMEs – companies between "micro" and "large".

At bottom, "bankability" simply means that loan risk is acceptable. But loan risk is weighed on *two* bases: cash flow risk (how likely the business will be able to service the loan out of its profitability) *and* **recovery risk** (how likely the bank can recover the funds it has advanced in the case that the business cannot service the loan out of cash flow). In BiH, because the second area of risk is substantially higher than it is in advanced markets, cash flow risk must be lower to compensate. This means that only larger, stronger companies with highly reliable cash flow are "bankable" in BiH. In a financial sector that properly facilitates the second way out, and readily provides consulting services to companies, many more SMEs become bankable.

- Lenders struggle cover their operating and risk costs in interest margins, but interest rates are too high for many SMEs to afford. Other than the smaller domestic banks, BiH banks are generally liquid, and competition is strong for the loan business of companies considered bankable. Larger and stronger SMEs can shop their loan business to multiple banks and obtain attractive commercial interest rates, as low as 5% per annum. For smaller SMEs interest rates can reach 12-13%, but banks say that this still does not adequately cover operating and loss risk. Meanwhile, smaller SMEs facing such interest rates complain that they are unaffordable, and therefore avoid borrowing. And they are right: because its currency is tied to the Euro, BiH has a low inflation rate (the GDP deflator was actually slightly negative in 2013) so that in real terms, such interest rates are indeed extremely high.

  How can interest margins not be high enough to cover loss risk, but real interest rates be too high? Again, part of the answer gets back to the uncertainty of recovery of loan value through turnaround or collateral seizure and liquidation. Another reason is the relatively high operating costs that banks face in pursuing and administering SME lending. Given the conservatism of banks in expanding their lending especially to smaller SMEs, combined with the unwillingness of smaller SMEs to borrow at interest rates that are unaffordable, operating and risk costs are spread across a narrow range of borrowers, elevating required interest margins further, in a vicious circle.

- SMEs face severe working capital constraints, and lack financing alternatives. The number one problem for SMEs in access to finance is working capital. The main reason for this is that banks in BiH – as in many developing countries – simply do not finance business' principal working capital assets: receivables and inventories. In developed capital markets, these are routinely financed through self-liquidating asset-based lending mechanisms, so companies find that that they can readily access working capital. Working capital in BiH is provided in the form of overdraft lines – which must be "cleaned up" on their anniversary dates, potentially creating extreme financial stress – and through short-term loans, often secured by real estate. Neither of these credit structures is at all appropriate for real working capital finance.

  Why don't banks in BiH finance receivables and inventory? Because, for receivables, there is no objective company credit rating service to "qualify" a company's receivables as worthy collateral, leaving the lender in the position, if it were to accept them as loan security, of evaluating not only the creditworthiness of the borrower, but that of its customers. Meanwhile, for inventory, there are two problems. The first is the inability quickly to seize inventory collateral in case of loan default, which is essential, because it will very probably have been dissipated for cash by the time a court judgment is reached. The second problem is the inability easily to liquidate inventory at a reasonable value if and when it can be seized.

  Unable to borrow against receivables and inventory, the only way that BiH firms can preserve liquidity for working capital is to stretch out their own payables. In general BiH firms have large receivables, offset by large payables (someone else's receivables). The result is an economy trying to get by on far to little actual liquidity. This is a recipe for survival, not growth.

- BiH SMEs, particularly smaller ones, also lack access to growth finance. In addition to more working capital to acquire raw materials and build finished goods inventory, growth requires

investment in new product development and plant expansion. It is like project financing, in that time is required before the growth initiative pays off in increased sales. Even if they are willing to grant a grace period (which they resist), banks cannot be expected to entirely underwrite such projects. It is normal that they need a cushion of risk capital below their loans that would absorb unexpected losses and limit their exposure to the venture. However, smaller SMEs often do not have the resources to provide a cost share of 1/3 or more that banks would like to see, and neither private nor development credit-supported risk capital funds exist in BiH. Therefore, many good concepts for business expansion by SMEs go unfinanced and unrealized, including some specific examples that we observed in our site visits and interviews with companies.

Even though the ratio of private credit to GDP in BiH did rise rapidly from a very low level over the mid-00s, it now sits in a range far lower than in economies with well-developed financial sectors, because of the lack of asset-based working capital finance, and the scarcity of growth capital.

- Financial sector supporting services in BiH have major gaps, especially in collection, collateral liquidation, and consulting. Consulting services shortages include those needed by banks to help turnaround of defaulting borrowers for loan recovery, and services needed by SMEs in facilitating relationships with lenders and applying for loans.
- Both development finance and development policy in BiH fail SMEs. Particularly in times of recession or slow growth, government leadership is needed, for example in launching major infrastructure projects. However, in BiH, we are still awaiting a full-scale implementation of the long-awaited corridor 5C highway project, which would create many SME business and lending opportunities. Meanwhile, government development credit programs that are critical to partnering with the private sector to reduce credit risk and stimulate loans to SMEs are inadequate to the need.

The crisis has affected attitudes toward credit on both sides of the financial market. Lenders have become more conservative both because their nonperforming loans rose dramatically, and because bank regulation has become much stricter both internationally and in BiH. On the demand side, companies that faced financial pressures once the recession set in, especially if they had over-borrowed when credit was easy to get previously, have become less willing to take it on even when they can. Companies want to be sure of income before they borrow, but this means they may not take on debt that would in fact enable those sales. Solutions are needed to reduce risk for both sides.

**Recommendations**

The overarching problem in access to finance in BiH is on the supply side: **the inability of lenders to manage and reduce loan risk**. A major secondary problem, on the demand side, is **lack of support for SMEs in accessing credit**, as well as **inadequate government leadership in development policy** that would spur real economic activity and attract finance to SMEs. Our recommendations, summarized in broad terms here and with greater detail in the concluding section of this report, address these issues.

- Strengthening the "second way out". The legal-regulatory framework for preventing defaulters from opening new accounts and transferring assets has improved, as has the adjudication process for collateral claims. Lenders say that court-based claims procedures that used to take up to 5 years are now resolved in 18-24 months. This is still considerably too long, and more resources need to be devoted to court administrative management to improve efficiency.

  Legal inconsistencies that allow those simply in possession of an asset to prevent their repossession by the asset's owner in the event of default need to be eliminated. This would remove a severe constraint to the emergence of leasing in particular as a ready source of finance to SMEs. Additional legal shortcomings affecting execution against collateral identified in a

recent report[5] include: (i) strengthening the ability of a lender to execute immediately against a borrower owner's promissory note (personal bond, or *mjenica*) and (ii) amending the Law on Enforcement to speed execution against collateral, and to require all claimants in an execution proceeding against a borrower to inform all others of their claims.

It is helpful that large international collection services companies are beginning to enter the BiH market. A law that clarifies the powers and behavior standards of private collections agents is needed. Project support to recruit and train these agents would speed deployment.

Dedicated effort is needed to expand liquidation services and deepen liquidation markets, probably including support for establishing regional auction / liquidation centers. Improving the professional capacities of bankruptcy trustees could be Included in this support.[6]

Finally, substantial expansion of the cadre of qualified business consultants is needed, as a service for banks in workout, to help turn around companies in default and resume their ability to service loans.

- Development credit programs are required to share / reduce risk and lower interest rates. In various ways – such as through partial loan guarantees and first-loss provisions – government and donor development finance programs can significantly reduce principal risk and encourage banks to lend. Development credit enhancement can also stimulate the emergence of new financial products. These include special-purpose vehicles that would fund themselves through securities issues on BiH capital markets, helping those markets become a useful channel of finance to SMEs while providing investment instruments for banks and insurance companies in BiH with excess liquidity. Programs can also encourage the establishment of nonbank finance companies, such as those that would factor the receivables of BiH public institutions – notorious for overdue payment (but not nonpayment) – and provide critical liquidity both to SMEs selling to government and to the economy in general.

  Such programs are normal in advanced economies, where development credit is a permanent element of overall economic and industrial development policy. BiH must establish these programs, and donor support in this area would be highly productive.

- Greater access to qualified business consulting services is essential. It is also the case that advanced economies provide major assistance to their SMEs in the form of ready access to consulting services, especially for the purpose of accessing development credit programs. Publicly-funded small business assistance centers are common. It is understood that many entrepreneurs, focused on their business operations, do not have the capacities in financial projection easily to develop required loan application materials, nor are they well-enough informed about credit sources in any case. Accessing finance is a specialty area that is best provided by outside financial advisors, and for this reason their availability to SMEs is subsidized. Similar support is needed in BiH, so that viable SMEs are not prevented by excessive cost from getting professional assistance in accessing finance.

- Government must much more actively implement major infrastructure programs that would stimulate economic growth and SME credit. Research has demonstrated that infrastructure spending in times of economic slack has large employment and income multipliers. Meanwhile, BiH has a number of major infrastructure projects that have already been defined and are critical to growth – not only the highway, but in renewable energy and agriculture. Government must lead in getting these long-delayed projects off the ground. Money is not the issue: not only have

[5] USAID FIRMA project, *Analysis of Legal Obstacles to Collection of Claims in FBiH* (December 2013)

[6] The need for a law authorizing private collections agents, improving the expertise of bankruptcy trustees, and broadening and deepening markets for auction sales of collateral assets were also key conclusions of the FIRMA collections report (USAID FIRMA December 2013).

IFIs already committed funds, domestic banks with excess liquidity report that they are ready to co-invest in them, and they also see them as a way of generating numerous opportunities for lending to SMEs that would supply the projects with materials and services. These projects would also stimulate financial products development, such as infrastructure bonds issued on BiH capital markets.

- Finally, we echo recommendations made in previous assessments of A2F in BiH to encourage the emergence of institutional investors. This means (i) stimulating the voluntary purchase of life insurance via tax incentives, and (ii) reforming the pension system to introduce mandatory, defined-contribution (Pillar 2) retirement savings. These reforms are essential for capital markets development by providing a constant inflow of funds to accommodate expanded issuance of securities by companies and investment funds. Their fundamental purpose, however, is to provide income security for families and retirees, which is in any case critically needed in BiH.

# 2. The Supply Side

## 2.1 Overview of Credit Supply

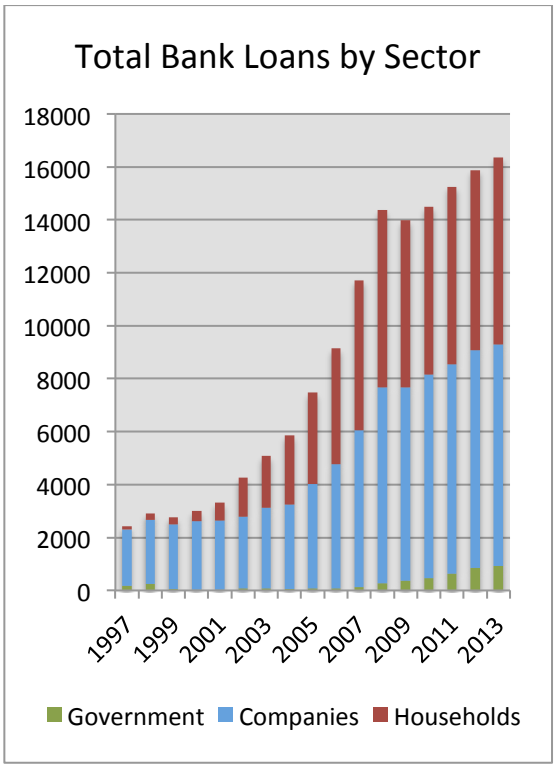
Financial institutions in BiH consist of commercial banks, leasing companies, microcredit organizations (MFOs), factoring companies, insurance companies, and investment funds. However, in the supply of credit, commercial banks by far dominate, as seen in the following table.

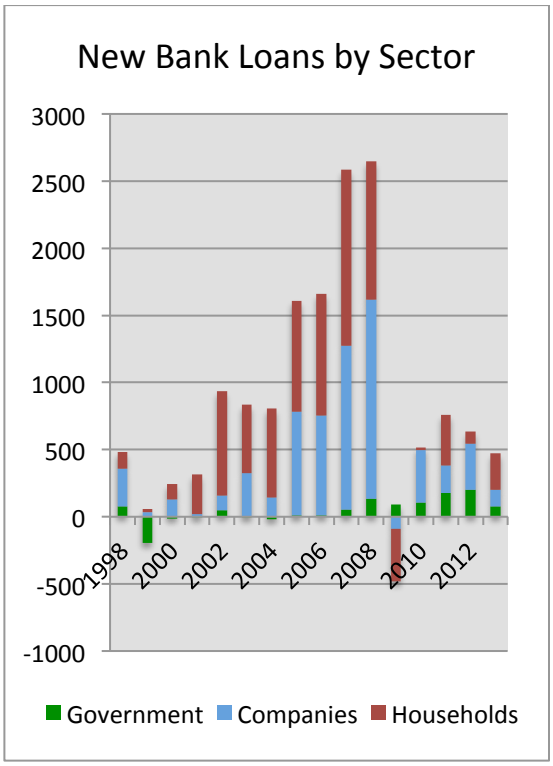
| *Table 1:* **Holdings of Financial Assets in BiH** | | |
|---|---|---|
| **Financial Institution** | **KM MM** | **%** |
| Commercial Banks | 20,923 | 86.1% |
| Insurance Companies | 1,054 | 4.3% |
| Investment Funds | 810 | 3.3% |
| Leasing Companies | 767 | 3.2% |
| Microcredit Organizations | 752 | 3.1% |
| Total | 24,306 | 100.00% |

Source: USAID PARE (2013). Data are end-2011

Commercial banks are shown here to account for over 86% of all credit outstanding in BiH, but this is probably an underestimate, because (i) all of the leasing companies are owned and financed by the commercial banks, and (ii) a significant share of the financial assets of insurance companies are in fact deposits in commercial banks. In other words, there is a degree of double-counting in the table, and the actual share of BiH financial assets held by commercial banks very likely exceeds 90%.

Consequently, looking at the lending of BiH commercial banks tells most of the story of total credit supply in BiH over time, as in the following tables. The data are in BAM millions.



The left-hand chart shows the dramatic rise in total bank credit over the mid-00s, which took the credit-to-GDP ratio from only 25% in 2000 (typical of the less developed economies) to approximately 60%. During this time, BiH GDP per person rose from approximately €1600 to €3500, illustrating the close correlation between credit and economic growth. However, the crisis brought credit expansion to an abrupt halt in 2009-10, with much lower loan growth since then.

The right-hand chart shows the change in outstanding bank loans over the period – that is, the *flow* of credit from year to year. Banks made over BAM 2.5 billion in new loans in both 2007 and 2008, giving way in 2009 by an actual contraction of credit – the first time that had happened in the decade – and new lending has been much reduced since then. The contrast between BAM 1.5 billion in lending to companies in 2008, versus just BAM 125 million in all of 2013, is striking.

Looking at the composition of lending by sector in these charts, the expansion of lending to households stands out. In the late 90s, less than 10% of total bank lending was to consumers, and almost 90% to companies. Beginning in the early 00s, however, the red bars in the charts start to sprout, and by 2013 the companies share was barely over 50%, with households at almost 45%. Several banks in our interviews expressed a conscious shift toward household lending and away from business lending, because the former is less concentrated; it is easier to garnish individual wages; and household assets, especially in the form of urban apartments, are considered the most liquid form of collateral. One large bank reported moving its outstanding loan portfolio from 60% business loans and 40% consumer loans at the end of 2008 to the exactly the opposite shares by end-2013, which could only have happened by halting or even reducing loan growth to companies, while expanding loans to households. Loans to SMEs would be most negatively affected by this.

## 2.2 Commercial Banking

### *2.2.1 Bank Credit Policies Toward SMEs*

Banks in BiH generally divide business clients into two major categories, each with two subcategories. These are (i) corporations, with the very large corporations broken out from the rest, and (ii) SMEs, which consist of (a) medium-sized enterprises (MEs), and (b) small enterprises (SEs). Broadly speaking, their interest in lending declines with size. The most underserved are the SEs.

***General attitudes toward SME risk.*** Most banks in BiH, regardless of size or ownership, have stated credit policies that affirmatively favor SMEs. However, bank credit officers generally view the risk profile of SME clients in general as not improving, and some say still worsening, mainly due to general economic conditions in the country. This attitude is surely aggravated by the elevated NPL levels that most banks have on their books in the wake of the crisis. As a result, in a significant number of cases a loan to an SME would be placed in a higher risk category by a bank from the beginning, requiring immediate reserve expense.

Conceptually, banks making loans to SMEs can compensate for this by (i) raising the amount of own funds/equity that a company is required to contribute to a project for which it seeks financing, and/or (ii) raising the interest rate. However, neither is easy. SMEs often lack the resources to provide enough equity to a new project that would make banks truly comfortable – for example limiting their loan-to-equity to a desirable ratio of 2:1. As for interest rates, they are markedly higher for SMEs than for large companies, but limited by competitive pressures in the BiH banking system. Therefore, banks are not able to fully cover their operating costs and risk premia in interest spreads. The result is gravitation toward larger, safer clients, reduced willingness to take on risk, and less lending to SMEs, especially smaller ones.

***Credit rating models and sector preferences.*** Banks generally use credit rating models with an extended scoring matrix to qualify credits. These models are quite rigid, and contain a wide range of variables and ratios that are meant to indicate the strength of the client's business, cash flow, and collateral. Credit policies toward specific economic sectors are also reflected in the rating model, and some industries such as trade and energy, with reliable cash flows, are preferred.

Sector preferences are also affected by the ease of liquidating collateral. This is one reason why banks generally report less enthusiasm about lending to manufacturing businesses than to companies in trade. For example, during the boom years prior to the crisis, construction machinery was widely financed and had a good secondary market. That market disappeared with the crisis, so now loans and leases for construction equipment are avoided. This would come back if major government-financed infrastructure projects were initiated, such as the 5C highway. Real estate financing has gone through similar cycles, based mainly on the perceived value and marketability of housing collateral. In tourism, hotel financing continues, but only because its cash flow is considered reliable.

***Outreach and marketing to SMEs.*** As noted, all banks say that they have positive policies toward SME lending. The three largest (Raiffeisen, UniCredit, and Intessa), however, are still conservative in pursuing this market, due to their lingering post-crisis elevated NPLs and the extended period of slow growth in the real economy that has followed. The mid-sized foreign-owned banks (Sparkasse, Sberbank, and Nova Banka) are considerably more aggressive, and their SME loan portfolios are growing. These banks have active outreach efforts to SMEs through their regional branches. However, it is often reported that to a significant extent their growth has come from taking over clients that were previously at the bigger banks, rather than through developing new clients.

***Competition.*** All banks report that the market is highly competitive, but this extends to SME lending only to a limited extent. It mainly ends up forcing interest margins down on loans to the safer / more valued clients. The banking industry in BiH is in somewhat of a state of flux, with some major changes of ownership in the recent past. Some speculate that at least one of the larger banks will exit the BiH market due to excessive competition and consequent inability to earn a satisfactory return on assets.

### *2.2.2 Categories of Commercial Banks in BiH*

We can separate BiH banks into three groups – (i) large international banks, (ii) smaller international and domestic banks, and (iii) smaller domestic banks. They display significant differences in their business models.

**Large International Banks**

The large foreign owned banks – Raiffeisen, UniCredit, Intessa (and formerly, Hypo) – very rapidly expanded their credit portfolios in the five years up to 2008, with credit policies that were undoubtedly too liberal. Subsequently, the global financial crisis led to a dramatic worsening in the quality of their loan portfolios. Capital adequacy deteriorated sharply, especially at the group level, and these banks became much more conservative in their lending practices and radically slowed loan growth. Effectively overnight, they changed their priority from loan *volume* to loan *quality*, and this still prevails.

> **Former large bank credit risk director**: "A few years ago, December was the best time to go for a loan, because banks were trying to achieve their annual loan volume growth targets. Now it is the *worst* time to go, because they are cosmetically cleaning up their balance sheets to reduce NPLs, increase liquid assets, and report better end-of-year loan quality."

Each of the larger banks has its own special situation, but to some extent they are all still in "survival mode" in the wake of the crisis. They have limited their aggressiveness in seeking new clients. Target credit portfolio growth is moderate or even negative, while shifting from business to retail.

SME lending is seen by large banks as difficult for profitability, because of (i) the high operating costs (personnel, branch premises, outreach) involved in originating, evaluating, and administering SME loans, and (ii) high risk costs due to default probabilities based on actual experience. These costs eat up most of large banks' interest margins, even though SME interest rates are elevated. Furthermore, for smaller SMEs – those taking loans of less than BAM 2 million (which the large banks call "micro") – both of these costs are even higher. For example, one major bank indicated average risk costs for consumer loans of 0.5% per annum, for

larger SMEs of 2% per annum, and for smaller SMEs of 6% per annum. Adding this to the cost of funds, plus operating costs, yields a loan interest rate that offers little room for profit to the bank, even while driving away SME borrowers because it is very high in real terms.

To a significant extent, the large banks view the SME sector as too costly and too risky. Nevertheless, they feel obligated to serve SMEs, in order to preserve their market image as "universal banks". They say that their SME account managers do understand the SME market, thanks to extensive training, but that they tend to be more junior and with little or no credit approval authority, which prolongs the process from loan origination to disbursement. While not significantly reducing the approximately 15% share of SME loans in their portfolios, they also have not grown their SME lending for five years now, and do not intend to. They say that the overarching problem with SME lending is the BiH economy itself: the low average income level, and the lack of clear and ambitious economic development policy.

> **Large international bank credit risk manager**: "We have struggled to expand SME lending for many years, but we have not succeeded. SME is the hardest lending segment to grow."

**Medium-Sized Banks**

The second group of banks are medium-sized and are newer on the BiH market. Three are subsidiaries of international bank groups (Sberbank, Sparkasse, and ProCredit) and one is majority locally-owned (Nova Banka). In general, these are banks that were less affected by the crisis, are generally well-funded, and are seeking to grow and gain market share. They may currently hold about 20% of total BiH bank loans, and this share is rising.

The second group is most ambitious about expanding SME lending, and actively taking customers from the big banks as they trim their portfolios. Therefore, to a significant extent this is refinancing, rather than new finance. Some have experienced quite rapid growth over the past couple of years, as the bigger banks have constrained their lending, but in general their annual credit growth targets are in the 5-10% range. Credit management is more conservative than it was prior to the crisis. Loan officers and branch managers have less and sometimes no approval authority – all tickets must be approved by a central underwriting team. Loan application and credit rating procedures are highly standardized and controlled, with little room for exception. The international banks are also subject to strict approval limits, beyond which loans must be referred back to the parent bank for underwriting.

In some cases the mid-sized international banks have moved in the opposite direction from the larger banks, increasing the ratio of their business-to-retail lending. Nevertheless, they say they are in a position to be "very picky" in financing SMEs, because the larger banks are reducing SME clients.

These banks also seem to be more flexible in approaching both sectors and SMEs. One, for example, highlighted satisfactory lending experience in the wood products sector, with clients serving Western European customers. They speak of long-term partnerships with SME clients gained from larger banks – even though interest rates are higher – and of working closely with them to structure loans properly.

**Smaller Domestic Banks**

The third group is made up of smaller domestically-owned banks, including Union Bank, Privredna Bank, BOR Bank, Moja Banka, MF Banka, and others. These banks have constraints in funding themselves and are saddled in some cases with old bad loans. They are small, and in some cases overly exposed to individual clients. They account for less than 5% of the market, but are generally seeking to grow especially in SME and consumer lending. In most cases they have privatized, and in several cases have installed capable new management teams.

The domestic banks tout their ability to design credit policies exclusively for the BiH market – to "make their own rules" they say – whereas credit policies for the large international banks are viewed as driven by their global constraints, regardless of whether those issues are relevant to BiH.

In contrast to the international banks, who generally find themselves with excess liquidity, a principal constraint for the domestic banks is their difficulty in attracting funding. International banks are considered safer by the depositing public, so the domestic banks must offer higher deposit interest rates, and even then they have trouble attracting depositors. Their higher financing costs mean that they cannot compete for business from the larger companies (including larger SMEs) that can obtain lower interest rates. They depend on owner equity or subordinated debt, and manage their funding availability and cost by drawing on SME-dedicated lines from the World Bank, KfW, the EBRD, the EFSE (European Fund for Southeast Europe), the European Investment Fund (EIF), and others.

While some of the domestic banks have multiple branches, others have limited outreach potential, with only a single headquarters location.

**Microfinance**

Microenterprises are fairly well-served by microcredit organizations (MFOs), including EKI, Mikra, Sunrise, and others. BiH has one of the highest penetration rates for microfinance in the world; the sector was a donor priority in the wake of the 1990s war. Like the smaller domestic banks, MFOs are limited by their access to funding, and microfinance accounts for only some 3% of business lending in BiH. They do report increased demand in recent years, due to the increased conservatism of the large banks, and some MFOs are moving into the SE space. However, microfinance is generally outside the focus of the present assessment, because its terms – small loan size (up to BAM 10,000) and elevated interest rates (18-20%) – are generally not suitable for the goods and services-producing SMEs between "micro" and "large" size that have the greatest potential to drive aggregate economic growth.

### *2.2.3 Bank Loan Products and Collateral Practices*

The great majority of commercial bank lending in BiH is channeled through three basic loan products:

- *Overdraft credit lines*, which have terms of up to 12 months, and must be "cleaned up" on the anniversary date of the loan, after which they are normally extended for another 12 months. These lines serve as the main source for working capital finance for many companies, and can be quite large. They are generally secured only by the personal promissory note of the owner.
- *Working capital installment loans*, generally of up to three years, which are meant to serve non-plant-and-equipment financing needs. They are secured by mortgages on real estate and equipment, cash deposits, personal promissory notes, sometimes personal assets of the owner(s), and sometimes third party guarantees.
- *Equipment term loans*, generally with 5-7 year terms, to finance the purchase of equipment. They are secured by the purchased equipment itself, as well as other assets of the company and the owner's personal guarantee note.

Banks very rarely take receivables and almost never inventory as primary collateral, in stark contrast with practices in advanced economies, where these assets are the principal resource for flexible working capital lines that typically grow with a business. Three banks in BiH have experimented with receivables financing, but, similar to the high degree of conservatism displayed by the principal factoring company in BiH (see below), they restricted the receivables qualified for finance to a short list (approximately 30) of large retailers. The product did not prove popular because it did not offer

the wholesalers and distributors who would have access to it anything that they could not more easily get from a standard overdraft or working capital term loan, and was dropped.

The quote in the box illustrates the real problem that banks have in developing normal working capital revolvers that are formulaically tied to an SME's aggregate pool of receivables – the standard loan structure seen in advanced financial sectors. The solution in advanced economies is not for the bank to have to rate each and every one of the borrower's customers, but for an independent company credit rating agency to do so (Dun & Bradstreet, Coface, etc.). The bank can then designate a minimum credit rating from one of these agencies that a company's customer must have in order to be included in the receivables collateral pool against which money may be borrowed. Furthermore, the bank can require that any receivable that is more than, say, 30 days overdue must be dropped from the collateralized receivables pool, and any funds advanced against that receivable returned.

> **Mid-size international bank credit risk director**: "To collateralize receivables, we would have to assess not only the business, but all of its customers."

High collateral value-to-loan ratios are often cited as a hindrance in SME access to finance. However, we do not find that this in itself is a primary problem – nor is it unique to SMEs in developing countries. The basic issue, as noted elsewhere in this report, is that banks want to do everything they can to avoid ever having to pursue this "second way out" – regardless of the ratio – because of (i) the procedural difficulties of actually seizing the collateral and (ii) the difficulty of liquidating seized collateral at its appraised value. These tasks are time-consuming and expensive. They drive banks away from loans that are relatively more risky – as most SME loans are. Because these problems fundamentally undercut the ability to recover loan value from any pledged assets other than cash deposits and, perhaps, third party guarantees, *there is essentially no amount of collateral that can compensate for the higher risk in SME lending*. This means that bank lending is focused primarily on proven SME businesses with reliable cash flow.

The narrow range of loan products means that finance often cannot be structured to meet the actual needs of business. Growing businesses need growing working capital lines, and the overdraft and term loan structures are not well-suited to this requirement. Nor are standard term loans for plant and equipment well-suited for installing a production line for a newly-developed product, especially if grace periods are nonexistent or not long enough, because it takes time to get up and running.

By far the banks' most preferred collateral assets are apartments in urban centers. These are generally expected to hold their value and have a fairly liquid market. The result of this preference, and of all of the other problems that the banks see in SME lending, is a general trend on the part of commercial banks to shift their growth focus from companies to retail.

#### *2.2.4 Liquidity and Funding*

The large banks in BiH report adequate if not excess liquidity, even though their parent banks are if anything reducing credit lines to their subsidiaries. These banks are highly trusted for the safety and security, so they easily attract retail deposits even though paying very low interest rates on them. Combined with their highly conservative loan growth policies, the banks end up with excess liquidity. However, the average tenor of deposits is short, which inhibits longer-term lending because of funding maturity gap risk. There is essentially no domestic funding source for longer than three years.

Financial institutions that depend on foreign supranational organizations to raise loanable funds, such as MCOs, report that their funding costs have risen as much as a full percentage point, to 6.5% per annum over EURIBOR, over the past year or so, because of heightened BiH country risk.

The smaller domestic banks face particular obstacles in funding, because depositors feel that their money is more secure in the larger international banks. Domestic banks must offer interest rates 1-2

percentage points higher to attract deposits, and even then it is difficult. In addition, deposit terms are quite short. Expansion of domestic bank loan portfolios therefore depends on their ability to tap owner equity and attract funds from international financial institutions, and these sources are limited and inconsistent or impermanent.

Furthermore, some of the domestic banks are in heightened supervision due to high levels of legacy NPLs, and are not allowed either to advertise for deposits or to pay more than market rates for them. Liquidity constraints also affect some domestic banks' ability to make somewhat larger loans, because of bank supervision regulations that limit a single loan to no more than 2.5% of a bank's equity. For some domestic banks, this would make a loan of say BAM 1 million a problem, forcing a borrower to go to multiple banks for finance.

There is little or no interbank money market in BiH to provide short-term liquidity. The CBBiH does not supply liquidity to the market, even in overnight funds. While the large international banks can provide finance to their subsidiaries, European Banking Authority (EBA) regulatory rules prohibit them from funding them at a preferential rate. Therefore when the cost of funds in European money markets in general goes up, there is further pressure on bank interest margins in BiH.

#### *2.2.5 Bank Regulation and Credit Expansion*

There is no doubt that BiH bank supervisory requirements have exerted conservative pressure on bank business finance since the beginning of the global financial crisis. There were weaknesses in loan classification practices pre-crisis (partly because even Basel I standards were not yet implemented), and bank credit quality during the boom deteriorated. As a result, nonperforming loans (NPLs) were understated, which magnified pressures on supervisors later. NPLs continued to grow well after the crisis, similar to the situation in other SEE economies. Over the past year or two NPL/total asset ratios have started to improve.

With the major adjustments in international bank supervision standards since the crisis, pressure for more disciplined loan risk evaluation and classification will continue. The two entity BSAs are still in the process of fully implementing the Basel II standards, at the same time they are moving toward Basel III. There are also EU directives relevant to bank supervision: the EBA series of Basel-consistent capital requirements directives (CRDs), as well as a common reporting framework (COREP) for standardized reporting of credit, operational, and market risk, and the calculation of capital adequacy ratios. These all feed through the BSAs into demands for additional capital, stricter risk assessment, and heightened reporting requirements for all of the banks, limiting their ability and willingness to pursue higher risk loans. Banks complain that the regulators (especially the FBA) are too rigid, citing for example the requirement for additional reserves against loan loss when a grace period is offered.

The international subsidiary banks are also constrained by the supervision of banking agencies in their parents' headquarters countries, such as the Austrian Financial Market Authority (FMA), which has implemented Basel III and EU standards.

In sum, as banks install the required new regulatory procedures both at the group level and in BiH, risk assessment is becoming increasingly standardized, with less and less room for modification based on particular situations in BiH. Loan officers report little flexibility allowed by their credit risk managers, due to regulatory strictures, for exceptional situations or for financial product innovation. They complain that regulators are too simplistic, focus too much on capital adequacy, and fail to look at the quality of risk management or of nonperforming loans. These conditions are unlikely to change in the foreseeable future.

## 2.3 Nonbank Finance Companies

Nonbank finance can be analyzed through two major categories of credit suppliers: nonbank finance companies (NBFCs), and institutional investors. NBFCs consist of leasing companies, factoring

companies, purchase order finance companies, export finance facilities, inventory finance companies, and equipment finance companies. All of these are very active in well-developed financial sectors. While relatively little used by larger corporations, they offer a wide range of extremely useful financing options to SMEs, because of the highly focused nature of the collateral that secures their credits. In BiH, the only NBFCs are leasing companies (all owned by banks), one factoring company, and limited government export finance funds (which we do not cover here). There is no dedicated purchase order finance, nor are there equipment finance companies.

Institutional investors, meanwhile, are those that in advanced economies invest the majority of their funds in securities markets – insurance companies, pension funds, and investment funds. All of these exist in BiH to a limited extent, but because there is no private sector issuance of bonds or equity on local capital markets, as well as the fact that the pay-as-you-go ("pillar 1") pension fund simply disburses everything that it takes in, their contribution to business credit is minimal.

### *2.3.1 Leasing*

In developed financial sectors, equipment leasing is one of the most frequently-used options for SME access to finance. Ownership entitles the leasing company easily to repossess the equipment in the event that lease payments go into default. Therefore lease deals are compartmentalized, and their viability evaluated strictly on the basis of the company's ability to make monthly lease payments out of cash flow. SMEs are able to finance equipment without burdening their balance sheets. Even though implied interest rates in lease finance are somewhat higher than standard bank financing – since leasing companies fund themselves in commercial paper markets and have higher average funding costs than banks – this is a particularly useful A2F channel for growing SMEs that have already committed their available assets to securing other bank debt.

Leasing companies in BiH are subsidiaries or even simply departments of large banks, so leasing is essentially an extension of banking. Prior to the crisis, banks had moved a significant share of their volume-driven real estate project financing and production equipment financing into their leasing subsidiaries. Many of these deals failed during the crisis. Subsequently real estate leasing has virtually disappeared, and equipment leasing is limited to larger and safer clients.

***Indirect legal obstacles in leasing:*** Even though the title to leased equipment does remain with the lessor, in BiH this turns out to be a highly compromised advantage to leasing companies. Despite the fact that the lessor owns, for example, a leased car, has a signed agreement acknowledging this with the lessee, and has a duplicate set of keys, it is prohibited by other law from going and picking the car up when a lessee defaults – even if it knows exactly where the car is parked, and on a public lot. Even though the law on leasing allows such repossession, other heritage law equates *possession* with ownership, putting the lessee on an equal standing as regards rights to the leased asset, so that he/she can sue the leasing company for taking it without consent. Therefore, unless the lessee formally signs off to return the asset voluntarily, the lessor must go through the lengthy process of obtaining a court order to recover it, no different from what a bank must do to seize assets that secure a standard bank loan.

> **Leasing company director**: "Only the best companies get leases. If you are not a very strong SME, interested in standardized equipment, you will not qualify for an equipment lease. If they could not get a bank loan anyway, we would not lease to them."

Thus in BiH the principal attraction of leasing to the creditor – its ownership of the leased item, supposedly enabling immediate recovery of it in the event of payment default – is undermined by BiH law. Leasing companies report that this can lead to absurd cases in which bank regulators require them to establish higher reserves against a lease than would be the case for a similar loan: if a lessor has not recovered a leased asset after payments have gone six months overdue, it must reserve 100% of the outstanding value.

***Tax regulations*** also inhibit the development of a wider leasing industry, because they discriminate against financial leases, which would be appropriate or even required by accounting standards in a many cases (for example, when the lessor plans to keep the equipment at the end of the lease). For a financial lease, BiH taxation treats the transaction as a sale (even though it is not), and requires VAT to be paid up front, at the beginning of the lease, on *both* the value of the subject asset *and* the value of the "service" – the implied interest rate. This heavily biases leasing in BiH toward operating leases only, for which VAT payments are month-by-month. Meanwhile, however, leasing companies can find operating leases unprofitable because they must take the equipment back at the end of the lease, and incur costs or losses on recovering residual value from it.

The recording of a lease as a financial lease under IAS is simply meant to provide more accurate reporting of a firm's actual financial obligations. The lease is still a lease (the lessor still owns the asset until the end of the lease), and should be treated as a such for tax purposes. The fact that implied interest on a financial lease faces VAT, while the interest on a standard loan does not, makes financial leasing even more expensive / less attractive. The BSAs have not encouraged a change in tax treatment, despite being requested to do so by the BiH Leasing Association. The effect of the BiH tax and regulatory treatment is to repress the development of the leasing industry and deny lease options to companies.

These legal and tax obstacles repress the leasing industry in BiH, as demonstrated by comparison to neighboring countries. In Croatia, outstanding leases grew by approximately €100 million in 2013, a 35% increase, to nearly €400 million outstanding. In BiH, leasing actually fell by 15% in the same period, by about €14 million equivalent, to under €100 million total. The sector is in something of a vicious cycle downward, almost entirely due to poor regulation.

Leasing in BiH is dominated by vehicles – broadly 70% of all leases – and most of that is commercial. Leasing companies report that prior to the crisis, they had partnerships with distributors of a variety of types of equipment; now, it is only for vehicles. Leasing companies report little or no product innovation since the crisis, and more conservatism in providing finance. Leasing company staff report little flexibility in credit extension. Leasing of equipment is difficult, and for used equipment much more difficult, because lessors do not want to have to repossess (even aside from the judicial inefficiencies) and try to sell it into a weak and illiquid secondary market. Leasing company interviewees state that the capacity of the leasing houses in BiH is far below the potential need.

The upshot is that leasing in BiH is less and less distinguishable from bank lending, and indeed the larger banks are moving toward simply merging in their leasing businesses, so that they are not even subsidiaries any more, but simply departments offering a specialized loan product. The desired customers for leasing deals are the larger, safer ones – the same ones targeted for standard loan products. Indeed, even in vehicle leasing, the great majority (80%, according to one major leasing company) is to corporate clients, rather than SMEs.

In sum, leasing in BiH is far from the flexible, accessible alternative to bank credit for SME finance that it needs to be, and the leasing sector is actually shrinking. An SME that cannot obtain a bank loan in BiH is just as likely not to be able to access leasing.

### *2.3.2 Factoring*

Factoring is present in BiH on an extremely limited basis. There is one nonbank finance company dedicated to it fully (Prvi Faktor), which is foreign-owned (Slovenia) and regionally active in most of ex-YU. The company targets corporate clients only, and purchases receivables only on condition of recourse – that is, in the event that a client does not pay, the receivable can be put back to its original owner, requiring repayment of funds advanced against it. In well-developed financial sectors, factors offer both recourse and non-recourse factoring (at higher discount rates for the latter). Prvi Faktor also has a quite limited list of companies whose receivables it will buy – the

major distributors or retailers – and puts fixed limits on its exposure to each of them. The effective interest rate, including fees, comes to 12-15 ppa.

Some banks have sporadically pursued the product, but mostly not as true factoring (i.e., they have not bought receivables), but as a loan product secured by receivables from companies on a list that they have previously approved. One bank in the RS (Nova Banka) has been more aggressive, offering relatively low discounts for buying receivables, and doing so on a non-recourse basis.

While factoring should be a ready source of finance to SMEs, as it is in economies with well-developed financial sectors, in BiH it faces the same issues that limit banks' interest in taking receivables as primary collateral for working capital loans. These are (i) the scarcity of objective information on companies' trade creditworthiness, provided in advanced markets by company credit rating services, and (ii) the difficulty of collecting and enforcing payment of trade receivables (more on this below). Consequently, only the receivables of larger, more clearly creditworthy customers are factored, and credit provided by factors ends up looking much like normal bank lending. Again, in sharp contrast to its useful role to SMEs in developed financial systems, factoring essentially does not serve them in BiH.

## 2.4 Capital Markets and Institutional Investors

Though BiH has a reasonably well-developed legal, administrative, and supervisory environment for the operation of capital markets (thanks to prior donor assistance projects), they are insignificant sources of finance to the business sector, lacking both issuers and investors.

There are two securities exchanges in the country – the Sarajevo stock exchange (SASE) and the Banja Luka stock exchange (BLSE). In ***equities***, the great majority of trading on these markets is in the shares of large companies that went through the process of privatization in the late 1990s. There have been very few initial public offerings (IPOs) of equity by companies in the entire history of both of these exchanges, and only very occasional issues to raise additional equity capital by companies already traded. In other words, even though open to any company and their procedures for issuing equity are clear, these securities markets have been negligible channels for access to finance not only for SMEs but for businesses of any size.

Through ***bonds***, the securities markets have channeled new finance, but almost entirely to government issuers – the entities and a handful of municipalities, the latter only in small amounts. Only one corporate bond has been issued on the SASE, and that was by a bank. Furthermore, the principal purchasers of the government and municipal bond issues have been the banks. Trading in bonds is confined mainly to those that were issued to individuals in compensation for war damages and frozen prewar foreign currency accounts, which does not create any new business finance. Newly-issued government and municipal bonds are generally held by the initial buyers (mostly banks) to maturity.

Market principals and fund managers point to several reasons for the underdevelopment of securities markets, despite the accommodative legal and regulatory environment. They cite a lack of general knowledge about what securities are and what it means to be a shareholder. They note the dominance of the commercial banking system, which more or less monopolizes lending to the larger corporations that would be natural issuers of corporate bonds. That is, companies see no significant advantages, either in cost of funds, loan term, or administrative convenience, in switching from bank borrowing to bond issuance.

Smaller companies can issue on the securities markets by going through a brokerage house. The procedures are clear. However, few are aware of the opportunity or how to go about it, and the potential loss of ownership control is said to be a major deterrent.

**Stock exchange manager**: "Domestic investors suffered big losses on BiH stock markets when the crisis hit. They still have not recovered from that severe loss of confidence. It is very hard to bring them back."

In addition to a lack of issuers, there are limitations on the ***demand side*** of the capital markets. As discussed below, neither insurance companies nor pension funds in BiH have sizeable investible balances – a huge contrast to advanced economies, where they hold half or more of all financial assets. From the point of view of individuals and the investment funds, there was significant interest up to the global crisis, but when it caused foreign investors to rapidly pull out, the prices of BiH equities fell sharply, and many people lost money. There is now a severe lack of confidence on the part of domestic individual investors in financial market institutions and their regulators – whether deserved or not.

Even though the framework of securities law and supervisory oversight is clear on paper, the SEC is a state-level institution, and therefore, according to market participants, is affected by the political tensions common to all such bodies in BiH. SEC commissioners have a five-year mandate, but at this writing they are all currently in their sixth year of "technical mandate" – i.e., no new commissioners have been formally named since 2009.

Market participants look to prospects for regional integration of securities markets – something anticipated for at least 15 years – as a way of improving liquidity and expanding usage. Efforts are underway for the SASE, BLSE, and Montenegro stock exchanges to share a common trading platform with the Istanbul stock exchange, and the SASEX 10 index already trades there.

Market participants believe that there are opportunities to stimulate issuance on capital markets. Echoing anticipation by others of the corridor 5C project, they propose that government issues a bond to finance its share of the construction cost, which would attract investors. The large international banks, who have excess liquidity, also seek higher-return opportunities, for which bonds issued on capital markets for large infrastructure projects would be highly suitable. They complain that IFI loan financing of these deals denies them an investment opportunity they would readily seek, as well as sidetracking a potential stimulus for capital markets development.

### *2.4.1 Investment Funds*

Investment funds hold only a little over 3% of total financial assets in BiH, but even this overstates their importance in the financial sector. The great majority of their assets are equity shares obtained in the process of privatization of state-owned companies that took place in the late 1990s. The owners of these closed-end funds are individuals that obtained their original participations through privatization vouchers distributed to citizens, and other domestic and foreign investors who subsequently bought those participations from the original owners. While the investment funds have gone through periods of significant activity in buying and selling shares, they have supplied essentially no new capital to the financial sector throughout their existence. They have periodically been urged to become more involved in corporate governance through their ownership positions, but this has never really materialized.

There is one relatively new open-ended investment fund managed by one of the large international banks. It seeks to attract its customers to shift from bank deposits and earn a higher return. Its investments are entirely in government treasury securities – both RS and FBiH, as well as Serbian and other foreign government securities. It also reports some success in attracting Bosnian diaspora investors, which is an encouraging sign.

### *2.4.2 Insurance Companies*

The insurance sector in BiH is dominated first by auto and then by property insurance, with private life insurance only about one-fifth of the total. As a result, the BiH insurance sector supplies limited funding to the financial sector, since it is "whole life", really a form of saving, that generates an investible surplus. The auto and property insurance business has a short-term horizon, with the bulk of premiums cycled back into payouts against claims. Annual increases in the sector's holdings of financial assets – *i.e.*, the flow of funds they provide to the financial sector – are quite limited. For

example, in 2013 the total capital of BiH insurance companies increased by only BAM 11 million – versus total bank credit expansion of BAM 470 million.

Representatives of institutions in the BiH insurance sector describe it as "wild west", with excessive competition from too many insurers leading to unrealistically low prices in both vehicle and property insurance, combined with aggressive attitudes toward claimants to reduce payouts against legitimate claims. One insurer failed, which will have a substantial impact on the insurance companies' mutual fund. Two companies are under surveillance, but are said to be still issuing policies.

**Insurance company general director**: "In insurance, law is imperfect, but even the law that exists is not being followed. No one knows who's in charge."

The breakdown of written insurance in BiH is approximately as follows:

*Table 2:* **Insurance Premiums**

| **Type** | **Share** |
|---|---|
| Third party auto liability (mandatory) | 48% |
| Auto damage and theft (CASCO) | 11% |
| Property | 11% |
| Life insurance | 19% |
| Employee accident & health | 8% |
| Other | 3% |
| Total | 100% |

Source: BiH Agency for Insurance, 2013 data

Other than for auto – three-fifths of the entire market – insurance penetration in BiH is very low. Voluntary purchase of insurance by individuals is quite limited. The majority of property and life insurance is written as a condition of bank loans – for home mortgages or as key person insurance. This is a growing segment for insurance companies, as banks increasingly insist on protection of their collateral and limitation of business risk, so offers some prospect for increased credit supply.

For an insurance sector to supply a substantial flow of funds to credit markets, life insurance must be a major product. As noted above, in Western markets, where the individual demand for life insurance is virtually universal, the insurance sector is a huge supplier of funds to money and capital markets. In the U.S., for example, insurance company assets are over 25% of GDP, and in Germany nearly 60%. The low level of demand for life insurance in BiH – as in most other transitional developing countries – deprives the financial system of one of its most important potential sources of long-term funds.

Furthermore, insurance companies report that they are unsatisfied with the options for investment in BiH of the cash balances that they do have. BiH insurance industry regulation rightfully restricts the types of assets that insurance companies may invest in to those of very high quality, in order to protect policyholders. However, because capital market issuance is so limited in BiH, this means that insurance companies generally must simply hold their balances in low-yield bank deposits.

### *2.4.3 Pensions*

BiH has only a pay-as-you-go (Pillar 1) pension system, with the two entities operating their own funds. It has zero investible surplus, and indeed struggles to make its monthly payments to retirees on time.

It is generally agreed that pension reform would significantly help BiH financial sector development, especially capital markets. The creation of a second pension pillar – mandatory, defined-contribution, individually-owned accounts – has been evaluated and recommended for welfare as

well as financial sector development reasons, but there has been no action, in part because of the well-known "transition cost" of this reform.

While there has been some movement in the RS toward voluntary defined-contribution pension savings, such a "Pillar 3" reform is not likely to successfully address the public welfare problem, given the evident lack of interest on the part of most BiH citizens even to voluntarily purchase life insurance. Therefore, it will also not generate the inflow of long-term savings needed for capital markets development.

## 2.5 Development Credit in BiH

***Domestic programs**:* Each of the entities has a government-owned development bank. The Investment-Development Bank of RS (IDBRS) is generally considered to be run in a more transparent manner than the Federation Development Bank[7]. Nevertheless, both of these banks are known to the market and have over time supplied substantial business finance.

IDBRS does some direct lending, generally to larger companies. Most of its lending is indirect, with its funds channeled through banks in the RS, who are required to lend them out at low interest rates. It actively seeks credit lines from IFIs to supplement its own funding (which originally came from the privatization of RS Telekom in 2008). The bank has a range of credit lines supporting, in addition to SMEs, large subregionally-important companies, housing, credit lines to domestic banks in the RS, startups, and war veteran businesses. It also has a credit guarantee fund with the capacity to support BAM 30 million in loan principal. It acts in many ways like a development agency.

There is also one government-owned bank remaining in the Federation – Union Bank, formerly the BiH subsidiary of Jugobanka, the largest bank in ex-YU – which has received subordinated debt funding from the Federation government. It has proposed itself as a channel for supplying government-supplied development finance to SMEs in line with economic development policy, but the Federation government has not taken this up.

Other domestic government loan or grant programs include those of the two entity ministries of industry, the Federation Ministry of Crafts, and others at the entity and some cantonal levels. There are some domestic credit risk mitigation / guarantee programs, including those of SERDA, Zenica-Doboj canton, and Brčko District, sometimes donor-supported.

Companies widely view the development credit and grant programs of the entities as complex and unwelcoming. Even companies that would easily qualify for credit from the Federation Development Bank report negative experiences. Company interviewees commonly stated that they view government development credit programs as at a minimum requiring connections, so many do not even try to access these programs.

***Donor programs**:* USAID's Development Credit Authority (DCA) program, now co-funded by Sida, has successfully supported $50 million or more in mainly SME loans over the past ten years through facilities with several banks. The participating banks state that the 50% principal guarantee helps them make a positive loan decision in borderline cases. It reduces the risk cost in the event of a default.

Other donor programs include a €20MM European Investment Fund 50% credit guarantee program for SMEs through ProCredit Bank. As noted above, several IFIs supply credit lines to BiH banks aimed at SMEs or certain sectors, such as agriculture or exports. Aggregated across all programs, donor facilities supply a significant amount of finance to SMEs.

However, they cannot substitute for a properly-funded domestic government development credit policy. In addition to the need for a sizeable loan guarantee program, financial institution

[7] The Federation Development Bank failed to respond to our multiple requests for an interview over an extended period in preparation of this report.

representatives say that government – through the entity development banks – should take the lead in organizing syndication of financings for major infrastructure projects in strategic sectors, which they say would attract in their financings.

## 2.6 Summary of Findings – the Supply Side

### *2.6.1 Summary: Lenders' Issues in SME Credit*

To summarize the supply side discussion, we review here the range of constraints that interviewed credit institutions – banks and nonbank finance companies – expressed in providing business finance in BiH. As could be expected, in their view most of the problems are with the "bankability" of SMEs, exacerbated by collateral and collection issues.

- *Weak business management:* Especially in moving down the size scale, banks cite a lack of management knowledge as a key reason for not lending. They note the inability of managers to articulate a clear business model, their lack of understanding of the kind of information and security they need to provide to get a loan, and loan requests for entirely new business ideas that are unrelated to their existing businesses. They also note a general decline in technical expertise in BiH compared to Yugoslav days, when there were numerous factories producing products requiring elevated engineering skills, from airplane parts to high-tech optics. Even in those industries that have capability, such as wood processing, lenders say many of them produce too little added value.
- *Lack of equity:* Often SME owners seeking finance for new product development or a new project often have very little of their own cash to put into it, requiring the banks to provide finance on an unrealistically leveraged basis.
- *Bank staff capacity constraints:* The cost-reduction policies that the larger banks adopted in the wake of the crisis are ongoing. Generally they are experiencing rising accounts per loan officer, which reduces the time that professional staff can devote to new clients. These staff constraints amplify conservativeness, because it is less time-consuming to approve a loan for a larger, existing and trusted client than a new one. Several bank loan officers interviewed expressed frustration, overwork, and job dissatisfaction: "Only 20% of my time is spent on my proper job. The rest is paperwork . . . It is easiest just to say no."
- *Lack of collateral:* Since banks limit they types of collateral they will accept, companies may not have enough to secure a loan. In most cases, however, banks say that collateral itself is never the issue in turning down an SME client. Rather it is cash flow, and trust / confidence in the capabilities of the owner-manager.
- *Underreporting of financial results:* It is well-known that companies, especially smaller ones, massage their financial statements (hide information) in order to avoid BiH employer and profit taxes. While in the past bank loan officers were able to use so-called "soft facts" in making loan decisions – their sense/knowledge that *actual* cash flow was substantially greater than reported – post-crisis internal bank credit rating systems force loan officers to be guided strictly on reported financial statements. "The smaller the company, the less reliable are their financial records", said one loan officer. Another said, "We could do more lending more easily if we could see true financial statements".

  Nevertheless, some informants considered that this common problem is improving, mainly through the impact of the VAT system. Whereas in the past income was under-reported by 20-30%, now they say it is more like 10%.

> **Mid-size international bank credit risk director**: "Today I had to reject a loan to an SME – a hotel. I am quite sure that their income is much better than they show in their books, and that they could service the loan. However, we are no longer allowed to rely on unreported cash income. Taxes, especially on employee wages, keep many companies at least partly in the gray economy. "

- *Poor business and investment climate:* Representatives of financial institutions in general regard BiH economic prospects as poor. When asked for their outlook over the coming 1-3 years, they expect minimal growth – certainly no substantial recovery. They also cite a poor investment climate, particularly in comparison to other countries in the region, and corruption. These concerns simply heighten their conservatism and reduce their interest in lending to SMEs, which are considered more vulnerable to weak growth. Banks cite substantial economic uncertainty in general, which makes it hard to rely on loan applicants' business projections, and keeps them from relaxing their conservative credit policies. One large bank reported that 70% of its clients' businesses still have not recovered to the level of sales they had in 2008.
- *Lack of major project financing opportunities:* Many financial institutions await leadership in development policy from government, especially noting the lack of progress by BiH governments in advancing major needed infrastructure programs. Implementing these programs would provide a range of financing opportunities that banks would welcome, from large syndicated loans (or bond investments) to governments procuring the projects, to the many SMEs who would provide their construction-related supplies and services.
- *Transfer / disappearance of collateral:* It is commonly noted that when a loan goes into default and a bank (or leasing company) initiates recovery proceedings, including blocking bank accounts and pursuing seizure of collateral assets, business owners often simply set up new companies with new bank accounts and transfer assets to them. While this should be a criminal offense under existing BiH law, there is often little consequence.
- *Collection, collateral enforcement, and liquidation obstacles:* Overburdened loan officers lack sufficient outside services to assist in collection, though these are starting to expand. BiH lacks clear regulation of private collection agencies. Procedures for seizure of collateral from a defaulting borrower, or especially a lessee, are cumbersome and time-consuming, even though this too is starting to improve. Liquidation of seized collateral remains a losing proposition for lenders, other than perhaps vehicles and urban apartments.

These issues combine to push banks toward conservatism in lending. While most pronounced in the larger banks, all are most comfortable simply funding existing clients, or proven clients who they can lure away from other banks. New clients face a considerably more difficult path to finance, and smaller SMEs particularly.

#### *2.6.2 Summary: Lack of Nonbank and Development Finance*

Nonbank financial companies, which should be one of the best sources of finance to SMEs, provide them hardly any additional options in BiH. Both leasing companies and factors face the same set of risks and lack of supporting services that banks do in credit evaluation, collection, and enforcement. Leasing is further inhibited by inconsistencies in law that restrict their ability to recover equipment that they own and lease, and by tax disadvantages.

Capital markets are small and illiquid and are not used for private sector fundraising even by larger companies. They provide nothing to SMEs. Nevertheless, banks and institutional investors with excess liquidity would put funds into private sector instruments if they were available.

Given the limitations in private sector supply of finance to SMEs, well-designed, well-funded, and sustained domestic development finance policy is needed. The domestic development credit programs, supplemented by donor programs, are helpful, but are far from sufficient to address the elevated risk perceptions and conservatism of commercial lenders.

# 3. The Demand Side

The "demand side" of the access to finance equation is essentially the question of so-called "bankability": are there viable businesses seeking finance but unable to find it? Viable or bankable businesses are those with valid needs for plant and equipment, working capital, product development, or expansion financing, and that have reasonable prospects for servicing and repaying it out of the growing cash flow that such financing would enable. If there are many such companies unable to access finance with reasonable effort and on reasonable terms, then overall economic growth and employment are directly and irrecoverably damaged.

To assess this question, we formally interviewed companies in face-to-face site visits. We constructed a three-by-three sample of companies from FIRMA's database of over 400 stakeholders. We selected companies according to sector, size, and locality in BiH. The following table provides the breakdown of the 36 companies that were interviewed.

| Sector | Region[8] | | | | | Size[9] | | | | Total Cos | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | SA | MO | TZ | BL | ZD | S | MS | ML | L | # | % |
| Metal | 1 | 3 | 3 | 3 | 2 | 4 | 2 | 5 | 1 | **12** | 33% |
| Wood | 3 | 1 | 2 | 5 | 4 | 4 | 4 | 7 | 0 | **15** | 42% |
| Tourism | 2 | 3 | | | 1 | 3 | 3 | | | **6** | 17% |
| Other Mfg | 2 | | | | 1 | 0 | 2 | | 1 | **3** | 8% |
| **TOTAL** | **8** | **7** | **5** | **8** | **8** | **11** | **11** | **12** | **2** | **36** | 100% |
| % | 22% | 19% | 14% | 22% | 22% | 31% | 31% | 33% | 6% | | 100% |

The interview guide for companies is provided in the Annex. All were extremely forthcoming and informative in their responses.

## 3.1 SMEs and Finance

### *3.1.1 Financial Needs and Use*

In taking account of company opinions about access to business finance and their attitudes toward borrowing, it is important to understand that they are responding largely to what they are offered. That is, most BiH companies, especially SMEs, do not even realize how much broader the financial options for SMEs are in advanced economies. For example, none of our interviewees mentioned capital markets as even a theoretical source of finance. Very few saw receivables finance as a realistic option, and none imagined that revolving inventory could be financed. Several had done production equipment leasing, but most, especially smaller companies, viewed leasing only as an option for vehicles. In sum, company judgments on access to finance are limited by the state of financial sector development itself.

The majority of companies that we interviewed felt that they can access finance from banks, at least to some extent. All are registered with bank accounts; most (but not all) know who their account manager is. However, most companies are quite conservative in taking on bank finance – they see it as expensive and risky. They employ finance considerably less readily than SMEs typically do in advanced economies. If there were better-targeted loan products, with less collateral risk, it is likely that they would be less conservative.

It is useful to break SMEs into two groups – larger (some MS and all ML and L in the above table) and smaller (S and some MS) – in evaluating their access to finance.

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[8] Sarajevo, Mostar, Tuzla, Banja Luka, Zenica-Doboj

[9] S=<250K; MS = 250K-2MM; ML=2MM-25MM; L=>25MM BAM/yr sales

**Larger SMEs**

For *larger, growing companies* in BiH. access to finance is not a major obstacle. This is a point of agreement between both banks and businesses. Our interviewees in this category validated the statement repeatedly made by financial institutions that successful SMEs could get finance. In fact, we found that such companies often found the banks competing against each other to get loan business.

> **Example**: An rapidly growing manufacturer of lighted commercial exterior signage, located in central BiH with approximately BAM 2 million in annual revenues and 40 employees, wished to build a new production facility. It put its financing need out for bids to a range of banks, received site visits and competitive offers from almost all of them, and in the end obtained a 10-year term loan at under 6 percent per annum.

While larger SMEs find it easier to access credit, they are more conservative than before the global crisis in doing so. This is especially true for larger companies that over-borrowed and over-expanded and faced severe financial pressures when business fell off. Many interviewees reported willingness to borrow only when they are very sure of business.

Most larger SMEs have both bank overdrafts and short-term loans, usually using them only for working capital needs. For plant and equipment, many have longer-term loans, and have also used leasing, more or less like a term loan but with a somewhat easier security agreement. These loans are collateralized primarily by real estate (the company's and sometimes the owner's), equipment, the personal promissory note (*mjenica*) of the owner, and occasionally a third party guarantee.

One of the characteristics of so-called "revolving" overdraft facilities is that the must be "cleaned up" – reduced to zero – on their annual anniversaries before they are renewed for another year, presumably so that they are still classified as true short-term overdrafts and avoid reserve provisioning. However, this can create severe problems in some cases. In general, a growing company has working capital assets and requirements that even if seasonal are steadily expanding. For this reason, a "true" working capital revolver that is formulaically tied to these assets may never be fully paid down – its outstanding balance can be expected every year to be larger than the last. For a growing company to have to reduce its working capital finance to zero can be extremely difficult. Companies in BiH, forced to use overdraft facilities as their primary working capital lines, commonly report that when the time comes to clean up their overdraft at one bank on its anniversary date, they simply borrow that amount through their overdraft facility at another bank, pay down the first one, and the next day reverse the transaction. This displays how artificial and unsuited an overdraft line is for working capital finance.

In the case of one larger company interviewed, this requirement touched off a chain reaction that resulted in near-bankruptcy. The company had admittedly over-expanded prior to 2008, and though managing its problems, was financially stressed. When the anniversary date arrived, it was not able to access any other financial source, so failed to clean up its large overdraft. This default resulted in the blockage of its accounts, further financial pressure, and the closing of a production facility with consequent major loss of jobs. Based on its working capital assets, the credit should have been simply continued. This case shows how this simplistic form of the financial product, and the lack of appropriate working capital products, can have a profoundly negative real economic effect.

Many larger SMEs have successfully accessed development credit resources, including the entity development banks, IFI-backed commercial bank credit lines, loan guarantee programs provided by BiH government agencies and donors, and various grant facilities.

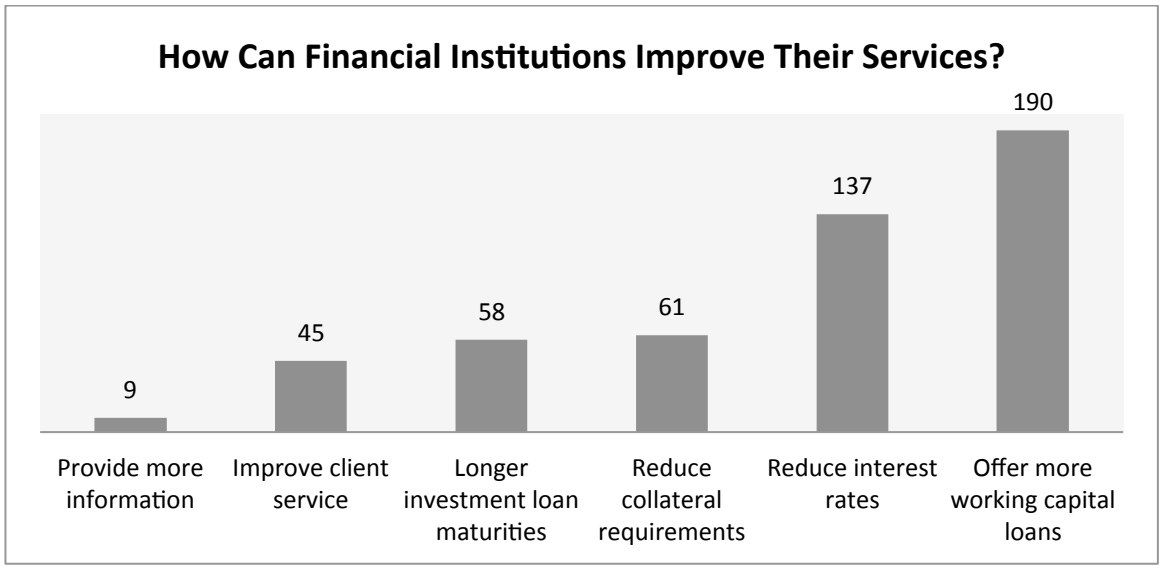
Interest rates for larger SMEs are competitive, generally in the 5-8% range (unsubsidized).

Some larger companies reported the availability of equipment finance from manufacturers in foreign countries, but that it was expensive and they had not used it. No interviewees reported accessing funds through the capital markets.

**Smaller SMEs**

SMEs that are smaller – less than approximately BAM 1.5 million per year in revenues – have a harder time obtaining finance. They rely primarily on owner capital. They have particular difficulties with financing expansion or startup projects. Among numerous examples from companies interviewed for this report were (i) a small tour operator seeing an opportunity in building a bed-and-breakfast hotel near a rural tourist attraction, and (ii) a wood industry technical consultant wishing to domestically manufacture tooling for cutting and shaping equipment to replace imports. These entrepreneurs had clear knowledge of the market for their projects, and the industry knowledge and professional/technical expertise to manage them. However, as smaller service-oriented SMEs, needing funds with grace periods for the time required to develop the project, with little physical collateral, and with limited resources for an equity contribution, obtaining finance was difficult to impossible. The amounts needed in these kinds of cases are well in excess of what donor or domestic ministry grant programs would typically offer. What is needed is some kind of development credit support: financing from an equity / risk capital fund, complemented by a partial loan guarantee.

Smaller SMEs we interviewed often cited the difficulty of obtaining adequate **working capital finance** as their principal constraint to growth. Without it, they struggle to build inventory to be able to respond quickly to orders, as well as to cover needs in advance of seasonal shipments, even when future sales are highly reliable. Because of working capital constraints, most smaller companies cannot respond to a large increase in orders. As noted above, banks do not offer true working capital revolvers that are secured by future orders, receivables, or inventory. Businesses report that they are offered short-term installment loans for working capital on which payment must begin immediately, or cash-collateralized overdraft facilities. Either product defeats the purpose of the credit. The following graphic summarizes responses from a sample of approximately 120 firms to a survey that the FIRMA project conducted in 2011, and highlights the working capital constraint:




Smaller SMEs in particular complain that bankers look at them only formulaically, giving them little "quality time" and making no attempt to really understand their businesses. Loan terms are rigid, grace periods are lacking, and interest rates are high – in the 9-13% range for smaller companies.

Meanwhile, bankers report substantial credit demand simply for liquidity (working capital), but they are not interested in supplying such loans in current conditions.

Smaller company owners, who are rarely personally wealthy, are often unwilling to provide the personal guarantees and mortgages on their family homes that banks demand in order to extend credit. With other kinds of SME credit products – leases, factoring, true revolvers, or purchase order finance, which are secured by the assets they cover and self-liquidating – this would not be an issue.

Smaller SMEs also complain about the difficulty of accessing the grant facilities that do exist. They see a few large companies getting large grants, with many SMEs getting very small grants that are less than requested and insufficient for their projects, especially from the domestic ministry programs. Meanwhile, application and documentation are complex, and they view the award process as influenced strongly by political or personal connections.

### *3.1.2 SME Access to Other Financial and Supporting Services*

There are other financial services needed by SMEs that are unavailable in BiH. One example is third party liability insurance. This is a form of insurance that is standard for many types of businesses in advanced economies, protecting them against loss in the event of the injury of a customer using their product or service. BiH companies must go out of the country to get such coverage. In some cases companies are required to obtain such insurance by BiH law, but there is no corresponding insurance regulation requiring the industry to provide it.

Bank-provided financial guarantees can be difficult and expensive, especially for smaller SMEs. For example, in order to bid for an offer of business premises by a local municipality, an SME needed a guarantee from its bank that it could cover the rental cost for a year if successful. The bank's fee for the guarantee worked out to 1 ½ months of rent for a 1-year guarantee – clearly exorbitant. The company eventually managed to come up with the cash on its own and paid the municipality 12 months in advance.

### *3.1.3 Trade Credit Constraints*

Many SMEs report that among their top problems with finance is getting paid by customers. This leads to cash flow difficulties that may put pressure on a company's ability to service other obligations including bank debt, which could even lead to the blocking of its accounts. Larger SMEs that import materials are at a further disadvantage when receivables from domestic customers are stretched – for example, an electronics equipment manufacturer that imports components selling to a BiH power station – because they generally must pay in advance or on delivery from foreign suppliers. Companies that must pay cash for raw materials, such as furniture companies purchasing sawlogs or lumber, but must offer trade terms to their retailer customers, are in a similar bind.

The issue of general illiquidity caused by problems in collecting trade receivables is often traced to BiH government and public institutions – hospitals, utilities, state-owned companies – which are notorious for not paying their bills on time, stretching out payments to suppliers far beyond invoice dates. Nevertheless, companies still seek government business, because they are confident that in the end they will in fact be paid. In pursuing government procurements, bidders report that demands for 120 day terms are typical, and that offers from bidders of even longer payment terms score higher in tenders. Payment from government is a constant negotiation – companies report that if they seriously need cash, they can usually successfully beg the government institution to make at least a partial payment on their overdue receivables. However, though the outstanding balance is reduced, it is not unusual for full payment to be more than a year late, and as much as 2-3 years before the full balance is finally cleaned up.

Similarly, it is reported that the larger corporations put pressure on their suppliers to accept very long payment terms and payment delays – partly because of their own debt servicing requirements to banks – creating a significant liquidity problem especially for SMEs.

At the same time, the issue of receivables-based finance, and of trade credit and collection in general, is not confined to government and large companies. Many companies face collection problems, whether or not they have business with government. Therefore to unlock trade credit and working capital finance tied to receivables, a broader approach is necessary – one that addresses needs for objective company credit rating, and for efficiency of collections and greater certainty and speed of enforcement (USAID FIRMA December 2013). These initiatives would also encourage banks to more readily provide working capital lines formulaically tied to receivables.

## 3.2 Industry Development Policy and Support

The lack of economic development policy in general is cited by virtually all – both financial institutions and companies – as a significant issue in access to finance. Clear and active development support policies would give banks more confidence in lending to manufacturers. Several banks noted how long they had been awaiting and looking forward to major construction of the Corridor 5C highway, which will engage many businesses and provide numerous high-quality loan opportunities.

There are other long-unaddressed problems in law and regulation that inhibit credit. A good example is in renewable energy, which can offer highly viable loan and investment opportunities under an appropriate regulatory regime. However, in BiH, there is still no feed-in tariff established for solar energy, so neither project finance in this area, nor indeed projects themselves, can safely go forward. Due to confusion in law, the Elektroprivedas will not sign long-term purchase agreements at defined prices per KwH with prospective suppliers of energy from these sources.

SMEs, especially smaller ones, are also critical of chambers of commerce, local economic development agencies, business associations, and cluster organizations, which they see as uninterested in them and favoring larger firms.

SMEs have generally positive attitudes toward donor programs to build SME competitiveness, but understand that they are impermanent.

## 3.3 Summary of Findings – the Demand Side

To summarize the above, we review the range of constraints that interviewed companies expressed in accessing finance in BiH. As could be expected, in the view of companies, most of the problems are with the suppliers of finance.

- *Interest rates are too high:* It is common for businesses to rank the level of interest rates as one of their principal obstacles in access to finance, and sometimes this is viewed with skepticism, equivalent to complaints about taxes. In the case of BiH, however, they are right: with the BAM tied to the Euro, inflation in BiH tracks inflation in Europe, which is very low – indeed currently below the ECB's presumed target of 2% per annum. This means that the 9-13% interest rates that are required by banks for smaller SMEs are indeed very high in real terms, and to many unaffordable.
- *Banks do not understand my business:* SME managers complain that they are not able to get the needed time from their account managers, and that account managers do not understand their needs well enough to structure appropriate loan products. "Banks just see the tip of the iceberg – the don't see our day-to-day problems", said one. SMEs also face a heavy monthly reporting burden to banks once they get loans.
- *The process of getting a loan is difficult:* SMEs report that the so-called "time to yes" between applying for and receiving a loan is extremely long, because of extended back-and-forth between bank loan officers, credit committees, and credit risk managers. They say that the loan ultimately offered, on a "take-it-or-leave-it" basis, can end up structured considerably differently and with different terms from what was agreed in the original term sheet.

- *Range of loan products is limited, inflexible:* SMEs cite the inability to obtain working capital finance based on their current assets and do not see factoring as available to them. Some note their difficulties in having to annually clean up the overdraft lines that are their only source of working capital finance. They complain that leasing companies will not lease to them the kinds of production equipment that they need.
- *No interest / support from government policy and development agencies:* Many businesses recognize and greatly appreciate that donor projects have helped companies become more competitive, and have supported some small-scale infrastructure supporting certain sectors. However, they see that donor support projects are naturally periodic, and regard the lack of consistent and properly-budgeted BiH government economic development policy as a critical problem. They believe that proper economic development policy would strengthen their business prospects and encourage banks to lend. This view exactly mirrors that of interviewees on the finance supply side.

> **Tourism sector business owner**: "In 17 years, government has ever really come up with a tourism marketing strategy necessary for growth."

- *Development credit application and grant processes are difficult:* Especially the entity development banks and ministry programs were cited as complex, sometimes unresponsive, requiring connections, and sometimes providing loan amounts so small that they do not justify the cost of applying for them. Donor grant programs are considered easier to pursue, but not large enough.
- *The collateral that SMEs do have does not help them get loans:* Receivables and inventory are not financed, for reasons described above, so a substantial share of SME assets is essentially wasted as a resource for securing working capital finance. Weak or nonexistent secondary liquidation markets mean that banks demand very high collateral-to-loan-value ratios for equipment finance. Finally, even for real estate, if the SME's property is located in a smaller city or outlying or rural area, it is undesirable as collateral to lenders, who ideally prefer urban residential properties with reliable markets.
- *Lack of collateral inhibits startup and expansion financing:* Smaller, service-oriented entrepreneurs often see opportunities for expansion of their SMEs by launching related production or other services – but these require construction and/or equipment, and time to develop. Such businesses by their nature rarely have collateral adequate to secure loans – either in the business or personal – nor do they have sufficient equity to put into a project that would substantially reduce the lender's risk and collateral requirement. As is well-recognized in advanced economies, these situations require some form of development credit enhancement.

# 4. Financial Sector Supporting Services

## 4.1 Credit Information Services

There are both public and private credit information services in BiH. AFIP in the Federation, and APIF in the RS, collect company financial reports twice a year. Companies are required by regulation to report, but not all do. The agencies charge a fee to release information on companies. Some users complain of delays in receiving the information. Almost all financial institutions use their reports regularly, but wider use by firms for trade credit decisions is rare.

These agencies allow a bank to see a company's current indebtedness, but they do not provide any information on credit history, nor do they rate companies' creditworthiness. The CBBiH maintains a registry of bank loans and leases that does keep historical data. A bank requires the client's approval to access this data, but since this is a requirement for a loan, this does not present a problem.

There are issues in centralizing company information, with several different points where it is collected, including initial business registrations at the commercial courts, the AFIP and APIF-filed financial reports, the CBBiH, and the bank supervision agencies' records on blocked accounts. The lack of centralization enables business owners in default to more easily set up multiple companies, open new accounts, and shift assets.

In the private sector, LRC Credit Bureau serves most financial institutions in both entities. LRC produces industry analyses, and it maintains a database of company financial information over time, populated by the AFIP/APIF reports. It also offers debt collection services on a success fee basis. While LRC provides credit analyses for individual companies, it does not rate the creditworthiness of companies in general in any organized way. This needed service does not exist in BiH.

## 4.2 Collection and Collateral System

Even though in all cases the lender or lessor looks first and foremost to a company's business and cash flow in making a loan decision, its "second way out" in the event of a problem loan depends on a streamlined and efficient process for pursuing collection, collateral seizure, and collateral liquidation. When there are obstacles here, the "second way out" is something financial institutions simply want to avoid ever having to pursue. As a result, they do not make loans to companies whose cash flow is considered more risky – something true of almost all SMEs – or they elevate the risk premium in interest rates to levels that make borrowing unaffordable. They conservatively gravitate toward large and well-established clients with highly reliable cash flow. The view expressed in the box at right is somewhat extreme, but does reflect the antipathy that all banks have toward the collateral recovery process.

> **General director of a domestic bank**: "Collateral is *never* a way out."

### *4.2.1 Collection*

Some larger European collection companies are entering BiH (such as German-headquartered EOS). Several banks mentioned having used its services in pursuing collection of overdue loans. EOS purchases receivables from the banks at a discount, then pursues collection for its own account. Some banks that had in-house collection units with call centers and site visitations have found this option economic. As mentioned above, LRC Credit Bureau, a private BiH company, provides collection services, with a focus on large companies' trade receivables, but does not purchase them.

BiH does not have a law that clearly defines the powers and limitations of private collections agencies. Such laws have been passed within the past year in Serbia and Kosovo and are already having positive effects.

The general problem of delay in collection of trade receivables is cited by banks as a risk element in lending to SMEs, because it compromises their cash flow. This problem also reflects the absence of adequate working capital finance – for receivables, inventory, and purchase orders – from the financial system, which would provide companies with routine liquidity to service their payables. For trade receivables, outside collection services are rarely used, certainly not by SMEs.

On the other hand, the recently adopted **Law or Guarantors** is widely considered by lenders a regressive step, to the extent that it has inhibited their ability to pursue a guarantee – whether by a third party or through the owner's own "bill of exchange": the personal guarantee required from non-corporate business owners for virtually all loans and leases. The law requires that lenders first exhaust their remedies against the primary borrower before going after the guarantor. This means at a minimum that recovery against a problem loan would be delayed, which could impose higher costs in reserving against the loan. The effect of this is again to increase loan risk and add to the interest rate risk premium.

### *4.2.2 Collateral Enforcement and Recovery*

While bank and leasing company credit risk officers still complain about the difficulties and delays in pursuing collateral recovery through the court system (some more than others) there is a general view that things have gotten better, thanks mainly to legal improvements. One large bank credit risk officer said that the average execution process through the courts is now 18 months, less than half of what it was four years ago. However, creditors still cite managerial inefficiencies in the courts. Judges themselves are said to be too occupied with court operational details – courts should have dedicated administrative managers – and the location of the court is said to matter greatly for speed and fairness.

> **Credit risk manager, large commercial bank**: "In sum, we are still not getting the full benefits from improvements in the legal environment for collateral recovery, because of a lack of court management, and unskilled liquidation managers ."

Eventually, the bank will obtain a decree that allows it to receive the collateral in exchange for the loan value, essentially through a court auction. By then, bankers frequently state that the collateral is greatly depreciated. Furthermore, they point to pervasive fraud in the collateral appraisal process in the first place. Narrow auction markets are also a problem (see below).

Lenders also note the ease with which borrowers in default can shift assets that have been pledged against loans to other legal entities – by loan, lease, or transfer – putting them further out of the reach of creditors. While better data management is making it more difficult for an owner to transfer assets to another company he/she owns, it is still possible to do so to a related party.

### *4.2.3 Bankruptcy and Liquidation*

Even if collateral recovery was relatively quick and free of obstacles, the viability of the "second way out" would still depend crucially on the existence of secondary markets for liquidation of seized real estate / plant, equipment, and inventory assets. Real estate and premises are generally considered the most reliable collateral, but even here lenders highly prefer urban residential properties. Especially in smaller communities, where everyone knows each other, they report substantial re-market risk in finding buyers for a repossessed home or building.

For equipment, especially in conditions of relatively stagnant economic growth, the problem is finding a secondary buyer. For as long as the lender must hold the piece of equipment prior to finding a buyer, it incurs storage and maintenance costs, and meanwhile the value of the equipment depreciates with age. Some lenders reported cases where even after obtaining court orders to seize equipment collateral, they did not do so because the cost of storing and maintaining it would exceed any liquidation value. Again, the effect of weak or absent liquidation markets means that lenders strenuously want to avoid ever having to seize equipment collateral. Even for real estate, banks report extended periods to sell it because of generally weak markets.

One large bank estimated that it recovered only 25% of loan value from liquidation of collateral assets. SMEs report occasions when banks simply refused their equipment assets as collateral, because they did not think they could sell them at all. With these conditions, it is little wonder why banks require high collateral-to-loan value ratios when extending credit.

The lack of liquidation markets, combined with the inability to quickly seize collateral in case of default, means that BiH banks essentially never accept inventory as primary collateral. The only exception would be a commodity stored in a bonded warehouse.

Large and well-developed financial systems have wide and deep liquidation markets. Even these may of course go through cycles that degrade the value of collateral and force banks to take writeoffs – as has periodically been the case for real estate. In normal times, however, lenders in advanced economies can be reasonably confident of relatively quickly recovering significant value in the sale / auction of property, equipment, and even all kinds of inventory collateral. As a result they are readily willing to lend against these assets.

As for bankruptcy, it is said to be "a never-ending process", because the market is uneducated about it, and bankruptcy and liquidation managers are seen by banks as inadequately trained and not given clear performance targets. There are only a few cases of successful bankruptcy in BiH.

## 4.3 Consulting Services

The highly structured loan application and credit rating and approval processes that are typical of almost all banks, combined with the high caseload of most bank loan officers, create a significant need in SMEs for outside assistance in accessing finance. The procedures are complex and require accurate full financial statements and cash flow projections, in addition to a clearly-written business plan. Banks complain that SMEs often are not capable of preparing quality business plans, and indeed it is unrealistic to expect most SME managers anywhere to be able to prepare these materials. Furthermore, neither companies nor bankers may have enough understanding to propose a loan structure that is appropriate for the financing need. Therefore, the ability to readily obtain supporting consulting services is one of the keys to accessing business finance.

Bankers note the need for particular technical consulting expertise, such as in energy and agriculture, that would increase their confidence in making a loan.

Provision of consulting support, either directly or through cost subsidies, is on of the most typical ways that governments in advanced economies promote the growth of their SMEs. This is a specifically SME-targeted policy, because SME owners are more often technical experts in their product areas rather than professional managers. In the USA, for example, the federal government's Small Business Administration (SBA) supports over 900 Small Business Development Centers across the country, often in partnership with state and local governments, business-focused NGOs, universities, and private sector institutions. The range of consulting services provided is very broad, and services are either free or greatly discounted. Such services are much less available in BiH, where they are even more needed.

In BiH the bulk of such support has been delivered through donor projects, that have also trained and provided hands-on experience to many local consultants, a number of whom now operate independently.

There are other important professional services to which SMEs need access, especially (i) accounting and auditing, and (ii) legal services. These are services which have developed substantially in BiH over the past 15 years, and are in general adequately supplied to SMEs by the private sector.

## 4.4 Summary of Findings – Financial Sector Support Services

The following are the key findings from our interviews as to the most supporting services most important to increased A2F in BiH.

- *Company credit rating services* do not exist in BiH, but are needed for facilitating trade credit and receivables finance.
- *Collections:* While some providers are starting to emerge, outside collections services in BiH are in very short supply. No law specifically authorizing and regulating private collections agents has been passed. This industry needs to develop.
- *Collateral recovery and liquidation:* There has been some improvement in the process of pursuing collateral recovery through the courts. However, due to weaknesses in law that limit the ability of lenders to execute readily against collateral, it still takes considerably too long (average 18 months), during which time collateral depreciates or disappears. Once recovered, liquidation is difficult in the small BiH market; other than urban real estate, collateral often fetches no more than 25% of its appraised value. Consequently, because they wish greatly to avoid ever having to pursue collateral recovery and liquidation, banks do not make loans to companies whose cash flow is considered at all risky – characteristic of

almost all SMEs to some extent – or they elevate the risk premium in interest rates to levels that make borrowing unaffordable.

- *Consulting services* in BiH are inadequate to the needs of SMEs in preparing themselves and applying for loans, and to the support that banks need in turning around companies in default. While it is common to hear lenders say that there is a "lack of good projects" in BiH, at the same time they say that there is a lack of know-how in presenting projects. In other words, there are good projects that are hidden because they are not presented with a clear business plan and properly analyzed cash flow. And, because consulting services supporting turnaround of borrowing companies are so limited, loan risk to SMEs is again elevated, reducing the willingness of lenders to provide credit.

# 5. Issues, Needs, and Recommendations

In this section, based on the findings reported above, we present our major recommendations for expanding access to finance for SMEs in BiH. In general, all of these recommendations would be contained in BiH development policy focused on SME access to finance, and would form suitable tasks and objectives within the scope of work of one or more development initiatives focused on implementing the policy. There are three broad areas of need.

## 5.1 Financial Sector Supporting Services: Credit Information, Collection, Consulting, and Collateral-based Recovery

- Trade credit, factoring, and bank receivables finance are all constrained in BiH because there is no objective reference for determining company creditworthiness. Consequently these forms of working capital finance are limited to large companies or established or personal business relationships. The introduction of **company credit rating services** is needed in BiH. Credit rating stimulates greater financial discipline in SMEs while providing objective information to trade and financial creditors. To accomplish this, a development project can (i) work with and support LRC Credit Bureau to expand and formalize its company credit assessment services, and (ii) facilitate the entry into BiH of a large international company credit rating provider, such as Dun & Bradstreet or Coface.
- While improvements have been made to the **legal-judicial system** supporting collateral recovery, further needed advances to support collections, speed court-authorized collateral seizure, and increase recovery value when selling collateral, are:
    - Amending law to allow an asset's owner (such as a lessor) to repossess it immediately and without a court order in the event of default
    - Strengthening the ability of a lender to execute immediately against a borrower owner's promissory note (mjenica)
    - Amending the law on enforcement and bankruptcy law in various ways to speed execution against collateral
    - Adoption of a law on collections agents, and training and deploying them
    - Appointment and training of commercial court chief administrative officers, to relieve judges of these routine duties so that they can focus on speeding adjudication
    - Training of bankruptcy trustees and liquidators
    - Organizing the widening and deepening of asset liquidation markets, possibly regionally.

- The availability of **business consulting services** to serve lenders by intervening in companies whose loans go into default, to turn them around and restore their ability to service their loan obligations, is an essential element of risk reduction and management. Meanwhile, of course, this can enable a company to survive rather than go into bankruptcy, protecting employment. A number of development projects have trained consultants in the past, but further efforts are needed to build out this cadre and demand for it, focusing on turnaround consultants and encouraging their engagement in companies.

## 5.2 Financial Products Development

For SMEs and growing companies in BiH, there are two major needs that are not being adequately supplied by the financial sector in its current state of development: (i) working capital finance, and (ii) growth capital. Furthermore, these two are related, because if all of a company's cash flow must be devoted to working capital needs – the first thing that must be taken care of for the business simply to continue to operate – then it has nothing left to invest for growth, including what a lender would require as the owner's share of new project financing.

Improvement over time in the collection and collateral recovery system should encourage banks in BiH to expand their offer of working capital revolving loans tied to receivables and inventory, as well as their growth finance to SMEs in general. However, the following recommendations for financial products development are focused on addressing these two A2F gaps by encouraging a substantial expansion of **nonbank finance** in BiH – through nonbank finance companies (NBFCs) and capital markets. In several cases, the emergence of these products would be greatly advanced by coupling them in some manner with development finance facilities, as will be further discussed in the following section.

- **Leasing** needs to become one of the most flexible and accessible financing sources for SMEs in BiH, as it is in well-developed markets. In the legal-regulatory area, this requires (i) revision of law that conflicts with a lessor's right under leasing law to easily repossess a leased asset in cases of default, and (ii) revision of VAT rules that inhibit financial leasing. It may also require encouragement of the entry into BiH of lessors that are independent of the highly conservative large international banks, or even the startup of stand-alone domestic leasing companies.

- **Factoring** can be expected to benefit generally from advances in company credit rating and collections. In addition, targeted encouragement can be provided to the emergence of a NBFC that would factor **government receivables**, and help to unblock the substantial liquidity denied to the economy because of both the very long trade terms that public institutions require of their suppliers and their chronic delays in meeting even those generous payment terms. Since the issue is one of *delay* in payment, not *nonpayment*, this would seem to provide a business opportunity for an NBFC. This could be assisted by a partial guarantee on the liabilities of a vehicle dedicated to this product.

- While SMEs technically can tap BiH **capital markets**, it is unrealistic to expect them to do so. In advanced markets the main methodology for channeling savings in capital markets to SMEs is through *intermediary funds*, which may often include credit enhancement by government. A good example is the U.S. SBA's Certified Development Company (CDC) program. CDCs are private nonprofit companies licensed by the SBA located across the country that make loans to businesses, generally in 50/50 co-funding with banks. The CDCs' funding comes from SBA-guaranteed bonds sold on capital markets. The program is targeted on long-term fixed-rate financing to SMEs for major productive assets such as plant and equipment. SMEs consequently are able to *indirectly* access capital markets without themselves having to go through the procedures and costs to enter them.

In BiH, such **special-purpose securitized funds** should be encouraged. They can channel funds to SMEs while stimulating the development of capital markets. Especially with even a partial principal guarantee on their liabilities, they would offer securities that could be of significant interest to the few institutional investors in BiH, to foreign portfolio investors and diaspora, and to domestic banks with excess liquidity looking for alternatives to government bonds Such funds would help banks fulfill their desires to increase lending to SMEs while simultaneously allowing them to efficiently diversify and reduce credit portfolio risk.

Of course, the effectiveness of this initiative will depend on the capability of fund management. This is something that can be developed through a support program charged with catalyzing the formation of such funds, and subsequently self-sustained by local professionals.

- Capital markets can also be stimulated by BiH governments, by taking the lead in issuing **infrastructure bonds** connected to major infrastructure projects that are urgently needed for economic development, as further discussed below.
- As for institutional investors, there are two clear recommendations that repeat those made in earlier assessments of A2F in BiH: (i) the voluntary purchase by individuals of **life insurance** needs to be encouraged through tax incentives, such as a deduction against taxable income in the amount of the premium, and (ii) **pension reform**, long advocated, is required, especially in the form of a mandatory defined-contribution (Pillar 2) system for wage earners. Both of these substantially stimulate access to finance and financial sector development, but their primary importance is in protecting the livelihoods of families and retired individuals, who cannot be adequately served by BiH's chronically underfunded pension and social welfare systems.

## 5.3 Development Finance and Policy

Aside from legal and regulatory changes, or simply waiting for gradual economic recovery, any significant expansion of access to finance for SMEs in BiH over the foreseeable future requires government and donor support. Again, it must be emphasized that such support is large, widespread, and permanent in the economic development policies of advanced countries. Developing economies cannot expect to successfully compete if they cannot also provide such support, because their firms will remain unable to adopt new technologies, achieve world-class quality standards, penetrate markets, and reach their potential for growth.

### *5.3.1 Development Finance*

Our major finding is that A2F is constrained by the inability of lenders to reduce risk of recovery in the event that loan goes into default, because of the systemic problems we have reviewed, so that they have to rely almost exclusively on cash flow projections in making a loan. This biases them toward only larger, established companies in low-risk businesses. Therefore, for lenders, the number one priority for expanded SME finance is for **risk participation** through development credit programs. To a lender seeking a partner in the risk of a loan, participation means one or both of two things: (i) increasing the amount of equity – or more broadly "risk capital" – underneath the senior loan to help fund the project, and (ii) guaranteeing to share, to some extent, in any loss of principal that may happen.

> **Bank corporate lending manager**: "We know that banks are extending the recession because we must be so conservative in granting credit. But we cannot move on our own to restart the economy – we need others to lead and share risk with us."

In addition to the possibilities for risk-sharing through BiH government and donor assistance mentioned in the previous section for financial products development, recommended mechanisms include:

- Expanding **partial principal guarantee** funds, like the USAID DCA facilities and similar BiH government and donor programs. Again it is worth

referencing the US Small Business Administration, a dedicated, permanent institution with very broad outreach, which guarantees up to 90% of principal loss in its standard loan guarantee programs.

- **First loss buy down**, in which a government guarantee fund absorbs 100% of loan losses up to an agreed maximum amount.
- **Public-private risk capital funds** to add equity or subordinated debt to SME projects, below the banks, encouraging them to provide senior credit. As noted above, banks are too often asked to essentially underwrite projects, because SMEs do not have enough capital to contribute to them. More equity reduces risk not only because it is a cushion against default, but because it allows a company to absorb loss and stay in business. Such funds could be directly financed by government and private partners (such as rapidly expanding social investors), or could issue government or donor-guaranteed securities on capital markets.
- **Project loan syndication**: Financial institution representatives suggest that the entity development banks could take a much more active role in leading project financings in strategic industries (transport, energy, utilities, agriculture) and organizing syndications with private banks and IFIs.

### *5.3.2 Development Policy*

It is virtually unanimous among private sector representatives both on the supply and demand sides of the financial market that the economic outlook for BiH is weak, but that BiH is not realizing its potential for growth, due in part to ineffective development policy and support. Financial institutions cited political stasis in economic polity design and leadership. Most businesses that we interviewed reported never having been visited by anyone from their local municipality or any government development agency.

Key recommendations for economic development policy and intervention that would support SME access to finance are:

- Launch **public infrastructure projects**. Banks repeatedly stated their interest in lending or investing in major infrastructure and agriculture projects, on a co-financing basis with IFIs and BiH government, if government would show leadership in getting the projects off the ground. Examples that were mentioned – in addition to the oft-cited, long-awaited corridor 5C highway – included the city sewer system renovations; large-scale plantations for sunflower seeds, grapes, or tobacco for domestic processors that must now import these raw materials; wind farms in Herzegovina; and mid-sized hydropower projects. In addition to providing banks with instruments for investment of their excess liquidity in the project financings themselves, all of these projects generate attractive loan opportunities to SMEs that would gain the business of supplying their many material and service inputs.

  It is also worth emphasizing that research shows that infrastructure spending by government in general and highway spending in particular has significantly larger multiplier effects on overall economic growth during periods of economic slack than it does during expansions (Federal Reserve Bank of San Francisco 2012). The delay in starting these needed projects in BiH has extended the recession. They remain an urgent priority for growth.

> **Private investment fund manager**: "Bosnia is a small economy – any big project would move it ."
>
> **Mid-size international bank credit manager**: "There is nothing happening in the BiH economy that would generate new projects."
>
> **Small manufacturer**: "No one has ever knocked on the door to see what I do or need."

- Supply **financial consulting to SMEs**. Above we recommended support for the training and deployment of turnaround consultants to help banks reduce loan risk by improving the chances that firms in default can recover loan repayment capacities. In addition to these resources serving banks, SMEs need much more ready access to consultants to facilitate identification of and introduction to suitable sources of finance, and that can help them prepare and submit loan or investment applications. As in advanced economies, it is *not* realistic to expect these services to be supplied on a strictly private, profit-making basis on the scale needed – as too often seems to be the end goal of development projects. These are services that should permanently be made available to SMEs in BiH on at least a partially-subsidized basis. While donor programs can help get the ball rolling (and have), it is essential that BiH governments strategize and budget ongoing programs to provide normal, ready access to SMEs for consulting services.

  General support for **SME competitiveness**, which supports access to finance by making SMEs more fundamentally "bankable", also needs to remain a permanent element of BiH government development strategy, and deserves further donor assistance.

To conclude this study, it is worthwhile to remind ourselves of the circular, "chicken-and-egg" issues in financial sector development that are apparent in BiH. For example, conservatism by banks in lending to SMEs reduces portfolio size which raises operating costs per client, which pushes up interest rates, which reduces SME loan demand, which further aggravates the problem. Lack of bank working capital finance secured by receivables means that SMEs lack liquidity, which makes it harder for them to service their payables, further aggravating general illiquidity and making SMEs less attractive to bank finance. Institutional investors have some investible money, but capital markets do not supply them instruments, while borrowers don't issue on capital markets because there are insufficient institutional investors. To move forward in financial sector development for the benefit of SMEs, across the board interventions are needed – in supply, demand, and supporting services.

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## Key Informant Interviews

| Financial Institutions | Type | Location |
|---|---|---|
| MF Banka | Domestic Commercial Bank | Banja Luka |
| Nova Banka | International Comml Bank | Banja Luka |
| Sberbank RS | International Comml Bank | Banja Luka |
| Sberbank FBiH | International Comml Bank | Sarajevo |
| S-Leasing | Leasing Company | Sarajevo |
| BiH Association of Risk Managers | Association | Sarajevo |
| Sunrise Microcredit | MFI | Sarajevo |
| Triglav Insurance | Insurance Company | Sarajevo |
| Raiffeisen Bank | International Comml Bank | Sarajevo |
| Raiffeisen Invest | Institutional Investor | Sarajevo |
| Unicredit Bank | International Comml Bank | Sarajevo |
| Hypo Leasing | Leasing Company | Sarajevo |
| ProCredit Bank | MFI | Sarajevo |
| UniCredit Leasing | Leasing Company | Sarajevo |
| Mikra Microfinance | MFI | Sarajevo |
| EKI Microfinance | MFI | Sarajevo |
| Privredna Banka | Domestic Commercial Bank | Sarajevo |
| Sparkasse Bank | International Comml Bank | Sarajevo |
| Factor One | Factoring Company | Sarajevo |
| Union Bank | Domestic Commercial Bank | Sarajevo |
| Sarajevo Stock Exchange | Stock Exchange | Sarajevo |
| BOR Bank | Domestic Commercial Bank | Sarajevo |
| Nova Banka | International Comml Bank | Sarajevo |
| LRC Credit Bureau | Credit Information Bureau | Sarajevo |
| AFIP | Credit Information Bureau | Sarajevo |
| Intessa Bank | International Comml Bank | Sarajevo |
| Industrial Development Bank of RS | Development Credit Bank | Banja Luka |

| Companies | Sector | Size | Location |
|---|---|---|---|
| DRVO MEHANIKA d.o.o. | Wood | 1-S | Banja Luka |
| METALSKA RADIONICA | Metal | 1-S | Banja Luka |
| MIĆAN DOO | Wood | 1-S | Doboj |
| Opruge Krajnović | Metal | 1-S | Gradačac |
| Metalis d.o.o | Metal | 1-S | Lukavac |
| VIVA Interijeri d.o.o. | Wood | 1-S | Sarajevo |

| Companies | Sector | Size | Location |
|---|---|---|---|
| Neretva Rafting | Tourism | 1-S | Mostar |
| Scorpio doo | Tourism | 1-S | Zenica |
| ZEDEX doo | Wood | 1-S | Zenica |
| ZUPČANIK DOO TEŠANJ | Metal | 1-S | Tešanj |
| Green Visions | Tourism | 1-S | Sarajevo |
| Hotel Sarajevo | Tourism | 2-ML | Sarajevo |
| Nova Marko DI doo Prijedor | Wood | 2-MS | Prijedor |
| Kismet | Textile | 2-MS | E Doboj |
| DOO"HASIĆ-DRVO" | Wood | 2-MS | Gradačac |
| Metplast doo | Metal | 2-MS | Tuzla |
| Edengarden doo | Wood | 2-MS | Sarajevo |
| Hotel Hecco d.o.o | Tourism | 2-MS | Sarajevo |
| Rukotvorine doo | Wood | 2-MS | Konjic |
| Hetmos hoteli d.d | Tourism | 2-MS | Mostar |
| Podrumi Andrija | Tourism | 2-MS | Čitluk |
| Metalac d.o.o | Metal | 2-MS | Široki Brijeg |
| Provis Graphics | Metal | 2-S | Visoko |
| Standard ad | Wood | 3-ML | Prnjavor |
| Drvoprodex doo | Wood | 3-ML | Banja Luka |
| URBAN doo | Wood | 3-ML | Banja Luka |
| METALNA INDUSTRIJA A.D. | Metal | 3-ML | Prijedor |
| Nova Forma doo | Wood | 3-ML | Doboj |
| Izazov | Wood | 3-ML | Tuzla |
| Ećo company doo | Wood | 3-ML | Sarajevo |
| UNIS FAGAS d.o.o. | Metal | 3-ML | Sarajevo |
| SurTec-Eurosjaj d.o.o | Metal | 3-ML | Konjic |
| TT Kabeli | Metal | 3-ML | Široki Brijeg |
| TOM d.d. Tvornica obrade metala | Metal | 3-ML | Gornji Vakuf |
| Artisan doo | Wood | 3-ML | Tešanj |
| Kaldera company d.o.o | Metal | 4-L | Laktaši |
| Tondach | Construction | 4-L | Sarajevo |

## Annex: Face-to-Face Interview Guides

# Financial Institutions – Face-to-Face Interview Guide

*BiH A2F Assessment 2014 – FIRMA Project*

| **Name of Institution:** | |
|---|---|
| Location: | |
| Size: | |
| Interviewee: | |
| Date: | |

**Statement of Purpose:**

I/we represent the USAID-Sida FIRMA project, which has been operating since 2009, with offices in Sarajevo and Banja Luka. FIRMA supports the wood, metal, and tourism sectors in Bosnia & Herzegovina. I/we have been engaged by FIRMA to conduct an assessment of the availability of business finance in BiH, which of course is a key requirement for economic growth. We are trying to determine how easy or difficult it is for businesses to successfully obtain business finance. We want to compare access to business finance in BiH to that in other countries of Southeast and Eastern Europe, and to that in advanced Western countries.

We are doing this through direct interviews of companies, supporting services, and financial institutions like yours. We are much more interested in the observations and opinions of financial professionals like you as to this question than we are in gathering statistics. We are trying to find out from those on the ground what is really going on, what the obstacles are to increasing the flow of business finance to companies, and what needs to be done to improve it.

We guarantee that your comments are completely confidential and will not be quoted identifying either you or your institution without your permission.

**Questions for Discussion:**

1. Main challenges: Broadly speaking, what in your judgment are the main challenges to expanding business finance in BiH?
2. Credit policy: In general, how would you describe your institution's policy toward business lending? Is it conservative, or neutral, or aggressive? How has it changed over time – before, during, and after the global financial crisis of 2008-09? How does your policy toward business lending compare to your policy toward consumer and household lending?
3. Nonperforming loans: It is reported that nonperforming loans at banks in BiH have grown substantially over the past three years and may still be rising. What are the trends at your bank? Has this affected your policy toward business lending?
4. Bankable projects: Some have said that the availability of finance from banks is not a problem in BiH – that banks are liquid, and any deserving company can get a loan if it needs one. To what extent would you agree with that? In other words, is the main question the quality of the companies seeking credit, rather than the willingness of banks to lend?
5. Loan clients: Are there certain industry sectors or categories of companies that your bank is more or less likely to lend to? Could we go through some of them that are of interest to us to get your opinion of them as loan clients, and what makes them either more or less desirable? Does your institution have specialists for certain business sectors?

- Small- to medium-sized enterprises in general (from say KM 100,000 – KM 500,000 / year in revenues)
- Medium-sized companies in general (KM 500,000 to 2,500,000 per year)
- Larger companies in general (greater than KM 2.5 million per year)
- Foreign-owned companies
- Wood products companies (furniture, doors & windows)
- Other light manufacturing companies (metal products, plastic products, food processing)
- Tourism services (tour operators, hotels, restaurants)
- Other services (professional firms, ICT firms, retailers)
- Agriculture
- Government

6. Client services: Does your bank assist potential clients in preparing loan applications? How much time would you say your loan officers spend on average with a company seeking a loan?

7. Loan denial: What percentage of loan applications would you estimate, broadly, are turned down by your bank? When your bank turns down an application, what are the most common reasons for that? (Consider the following list.)

    - Lack of confidence in business model / strategy / prospects
    - Company size
    - Weak management capacity / untrustworthy principals
    - Inadequate loan security: lack of collateral, collateral previously pledged, collateral illiquidity, lack of third party guarantees
    - Lack of supporting financial resources: company capital, owner resources, working capital, access to complementary bank finance
    - Poor credit history
    - Inability to obtain reliable credit history / rating information
    - Existing loan exposure to company
    - Poorly prepared business plan / loan application materials
    - Unreliable accounting / financial statements)

8. Collateral: Many businesses complain about banks' loan collateral requirements. We are very interested in this issue, and have a number of questions about it.

    - What is the most desirable form of loan collateral for your bank?
    - What are all of the types of collateral your bank accepts? (land, buildings, equipment, receivables, inventory, stock in the borrowing company)
    - To what extent are third-party guarantees sought to increase loan security. Do they substitute for collateral?
    - Is there a target ratio for loan-to-collateral value?
    - How does your bank approach valuation of collateral?
    - What are the problems in collateralizing receivables?
    - What are the problems in collateralizing inventory?
    - How difficult is loan recovery through collateral liquidation?

9. Financing products: Could you please run down the business loan products that you offer, and tell us to what extent they are used by your institution. Which of the following do you provide? About what percentage of your loan volume do each of them represent?

    - Long-term loans
    - Mortgages
    - Short-term loans
    - Working capital revolvers

- Inventory finance
    - Warehouse finance
- Purchase order finance
    - Export finance
- Leasing
    - Vehicles
    - Equipment
- Purchase of bonds / debt securities (public, private)
- Equity investment (public, private)

10. Income shares: Approximately what is the split of your institution's income between interest and fees?

11. Development credit: We would like to discuss government or donor subsidized credit to promote economic development. How useful do you find it?

    - Has your bank ever participated in a government- or donor-provided or –subsidized business credit facility of any kind? A credit line, partial guarantee, interest rate subsidy, etc. What has been your experience with these facilities? Are they useful?

    - Have you participated in USAID's Development Credit Authority (DCA) program? Has it caused you to make loans you otherwise would not have made? Has it opened new business channels for you?

12. Regulation: How much do regulatory issues affect your institution's willingness to expand its loan portfolio? Have changes in regulatory guidelines with respect to credit risk assessment, loan classification, and minimum capital standards made your lending more conservative over time? Do you feel that the Federation / RS Banking Supervision Agency policies are holding back business lending unduly?

13. Parent-subsidiary issues: If your institution is a subsidiary of a foreign parent, to what extent is your ability and willingness to provide business finance in BiH influenced by the parent?
    - Is the parent increasing, decreasing or maintaining its level of funding of your subsidiary institution?
    - To what extent is parent approval required to enter new sectors or segments, add financing products, or make new loans?
    - Does parent bank exposure to transnational companies affect your ability to lend to them?

14. Competition: How intensive do you find competition for loan business in BiH from other banks? From other nonbank finance sources (leasing, factoring, securities markets)

15. Trends: Overall, do you think that conditions are improving in access to finance, staying the same, or getting worse? Please comment as to both the supply side or the demand side.

# Companies – Face-to-Face Interview Guide

*BiH A2F Assessment 2014 – FIRMA Project*

| **Name of Company:** | |
|---|---|
| Location: | |
| Size: | |
| Product Line: | |
| Interviewee: | |
| Date: | |

**Statement of Purpose:**

I/we represent the USAID-Sida FIRMA project, which has been operating in BiH since 2009, with offices in Sarajevo and Banja Luka. FIRMA supports the wood, metal, and tourism sectors in Bosnia & Herzegovina. I/we have been engaged by FIRMA to conduct an assessment of the availability of business finance in BiH, which of course is a key requirement for economic growth. We are trying to determine how easy or difficult it is for businesses to successfully obtain business finance. We want to compare access to business finance in BiH to that in other countries of Southeast and Eastern Europe, and to that in advanced Western countries.

We are doing this through direct interviews of financial institutions, supporting services, and a range of companies like yours. We are much more interested in the observations and opinions of business experts like you as to this question than we are in gathering statistics. We do not need or want to see your financial statements. We are trying to find out from those on the ground what is really going on, what the obstacles are to increasing the flow of business finance to companies, and what needs to be done to improve it.

We guarantee that your comments are completely confidential and will not be quoted identifying either you or your institution without your permission.

**Questions for Discussion:**

16. Main challenges: Broadly speaking, what in your judgment are the main challenges to expanding business finance in BiH?
17. Need for finance: Could we discuss your company's need for business finance.
    - Without considering the issue of where or whether you might find finance, what are the things right now for which you need or want credit or investment? Working capital? Equipment? Expansion?
    - Approximately how much additional finance – equity or debt – would you now seek if it were available. Are you trying to find finance right now?
    - Is difficulty in finding finance holding back your ability to grow?
18. Actual use of finance: Can we discuss in general terms your past and current actual use of finance. Have you used finance in any form to start and / or grow your business? If so, can

you please tell us in general about these sources? What are the most important / useful / available to you? We will talk about some of the details in a minute.

19. Types of finance used: Can we learn more about the characteristics of your use of finance. Which of the following sources have you made use of:

    - *Individual sources:* Startup and subsequent finance contributed by owner(s) and / or raised personally from family and friends or other individuals. To what extent was/is this equity or debt? If debt, what were its terms?
    - *Bank credit* – what type(s)? In each case, could you please generally describe the terms.
        - Long-term loans for business premises construction / real estate
        - Long- or short-term loans for equipment
        - Short-term working capital or revolving loans
        - Overdraft lines
        - Any other type of bank credit
    - *Nonbank finance*
        - Leasing – vehicles, equipment
        - Other equipment finance
        - Receivables factoring
        - Purchase order finance
        - Export credit
    - *Development credit*. Has your company ever taken advantage of credit that was in any way backed by local government or donors, such as a credit line, guarantee, interest rate cap or subsidy, and so on. Have you had access to:
        - Federation or RS Development Bank
        - BiH government ministry credit line, subsidy, or guarantee
        - USAID DCA facility
        - Credit line or guarantee supported by EU, EBRD, IFC, World Bank, other donor
    - *Securities*
        - Equity or debt securities / bonds in any form, privately placed or issued on public markets

20. Collateral: Loan collateral requirements are often cited by businesses as an obstacle to obtaining credit. We are very interested in this issue, and have a number of questions about it.

    - Have any assets of your business been pledged as collateral for a loan? If so, which? (land, buildings, equipment, receivables, inventory, stock in your company)
    - Have you / other owners personally guaranteed loans to your company? Have you had to obtain other third-party guarantees?
    - If you have taken out secured loans, approximately what has been the required collateral-to-loan value ratio?
    - Do you think bank valuation of your collateral has been competent and fair?

- Does your company have assets available to pledge as loan security – assets that have not yet been pledged?
- Is lack of adequate collateral preventing your company from accessing finance?

21. Banking relationship: Do you have a good business relationship with your banker? Do you think that your banker understands your business? Do you feel that your bank is interested in your credit business?

22. Loan denial: Have you sought credit and been denied? If so, what was or were the reasons? (Consider the following list.)

    - Lack of confidence in business model / strategy / cash flow prospects, and therefore ability to repay
    - Size of your company
    - Lack of desire to lend to your company's industry sector
    - Perceived management weaknesses
    - Inadequate loan security: lack of collateral, collateral previously pledged, collateral illiquidity, lack of third party guarantees
    - Lack of supporting financial resources: company capital, owner resources, working capital, access to complementary bank finance
    - Poor credit history
    - Inability to obtain reliable credit history / rating information
    - Existing loan exposure to company
    - Poorly prepared business plan / loan application materials
    - Unreliable accounting / financial statements)

23. Obstacles to obtaining finance: Summarizing, what are the main obstacles for your company in accessing finance?