SME ACCESS TO FINANCE IN CROATIA:

IS THERE A PROBLEM?

July 2003

ABSTRACT

A complaint often heard throughout Croatia is that SMEs have difficulties accessing finance for growth. At the same time, others state that the Croatian banking sector is the most advanced in the economy, that it is largely foreign-owned, and that it is highly liquid. Moreover, the government of Croatia and the donor community has contributed to benefit SMEs directly at the firm level and by removing financial access barriers. So then, what is the answer—is there a problem? This paper sets the background for understanding the Croatian financial marketplace, it describes the progress that has been made to benefit SMEs, and it discusses some of the obstacles that still threaten development of sector.

All views, opinions and otherwise are expressly those of the author and not USAID.
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EXECUTIVE SUMMARY

Croatia is characterized by a large and growing SME sector. SMEs employ over 60 percent of the workforce. The government of Croatia has taken note of these facts, among others, and it has emphasized support of the sector at the policy level, through special financing programs, and by means of direct firm-level technical assistance. In doing so, the GOC has created the Ministry of Crafts and SMEs, in addition to a development bank modeled after the European Bank of Reconstruction and Development, and a loan guarantee agency. Bolstering GOC efforts, donors have made significant contributions to SME development.

The commercial banking sector is cited as the most advanced in the Croatian economy. More than 90 percent of bank assets are foreign owned. With foreign ownership, new techniques, practices and products have been added to the marketplace, benefiting consumers and businesses alike. As a whole, lending has increased year after year, so much so that the National Bank has placed a temporary cap on lending growth.

Still, SMEs state that financing is difficult to obtain.

Certain structural inadequacies—policy and otherwise—acerbate the problem of access to finance by making risk more difficult to quantify and therefore price. The most serious barrier to capital access for an otherwise viable and growing small enterprise sector, in any economy, is the absence of financial intermediaries between suppliers and consumers, both of which are capable of pricing, pooling and spreading risk. In Croatia, lending decisions are heavily geared toward valuing collateral, which ultimately stifles innovation, product diversification, and competition.

Changes to correct these inadequacies are underway which should spur innovation and competition. Furthermore, new products are gradually entering the marketplace in spite of a less than perfect legal and regulatory environment. Opportunities are being created for SMEs; still, however, much work must be done.

SMEs IN CROATIA

Overview

The Croatian economy is characterized by a large SME sector. Approximately 150,000 SMEs are registered—95,000 as crafts and 55,000 as limited liability companies. Over 60 percent of labor force is concentrated in the SME sector. Employment in the SME sector is on the rise; however, total unemployment continues to grow. Steady and increasing gains in the SME sector are not enough to counter overall employment loses in the economy.

Impediments to SME Growth

Universally, four obstacles are cited that limit SME development. They are:

1. **The Policy and Regulatory Environment.** Even though the business environment is often referred to as satisfactory and in harmony with European Union legislation, the fact is practical implementation falls short. In some areas, systems have not yet been developed that offer the potential to greatly benefit the SME, such as adequate property protection mechanisms and a workable system that guarantees secured transactions all of kinds.

2. **Enterprise Development Services.** High quality business services are available at the enterprise level, but due to the cost of such expert advice, most firm level assistance is out of reach to the average consumer. In addition, most SMEs do not recognize an internal need for business services. More often than not, an SME is unwilling or unable to pay for business services. Many SMEs have difficulties compiling information necessary to complete a loan application.

3. **Business Information.** Business information is hard to come by, and when available, it's often fragmented and difficult to obtain, usually warehoused in different ministries and/or agencies. In particular, information regarding various government credit schemes is not well coordinated and easily accessible to SMEs.

4. **Access to Finance.** Numerous government and donor loan programs have been created and are operational. The banking sector is viewed as the most advanced in the economy and it boasts a high percentage of foreign ownership and substantial liquidity. Three investment funds are working in Croatia. Still, many SMEs complain of access problems.

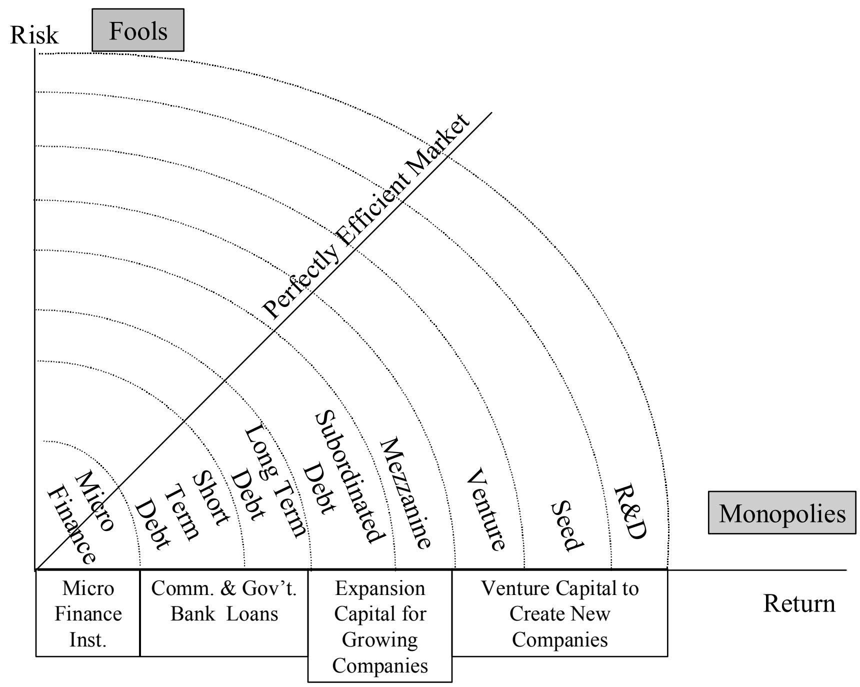
Solutions Undertaken

To offset these impediments, SME-specific infrastructure has been established, and other industry-support tactics have been deployed. At the government level, the Ministry of Crafts and SMEs was developed as were the Croatian Agency for Small Business and the Croatian Agency for Reconstruction and Development. Numerous donor initiatives have been created to benefit the sector. European Union ascension issues are helping to set the pace of development in the sector.

VISUALIZING EFFICIENT FINANCIAL MARKETS

Financial markets operate best when capital flows from all available suppliers to consumers at a cost and under terms that most completely reflect risk. That is, there is a "risk-adjusted rate of return." The following chart depicts the risk-return trade-off.

Visualizing Efficient Financial Markets



A perfectly efficient market splits the middle between risk and return. During nascent stages of development of a particular sector like commercial banking, the higher the degree of relative risk. In each of the sectors listed on the x-axis, there is a great risk of being foolish, often times very foolish, i.e. making loans or investments that are high risk and low return. The risk of being foolish is even greater in emerging market SME lending, which requires even more rigorous risk management than conventional commercial lending.

In many and almost all economies of the world, foreign and even domestic banks had near monopolies at one time or another in their local markets which allowed them to skim low risk, high return deals. Today in the United States and western Europe, the banking industry is too competitive for that to occur (in most markets). The banking industry in Croatia is much less competitive; as a result, the general assumption implies that banks would try to seek out high returns for low risk, creating monopolies that ration good risk adjusted rate of return deals out of the market. The end result would therefore produce SME loans.

Banks do, in Croatia, skim low risk, but they do not price for high return. Banks take no risk because they require high levels of collateralization, higher than the value of each loan. Banks skim deals from the market that have adequate collateral, excluding all others even though they might be better businesses and more profitable to the bank. Generally, banks do not perform credit analysis or conduct business assessments at the SME level; banks verify and value collateral.

The imperfections in the flow of capital to support SME development can be systematically analyzed as a set of identifiable market imperfections:

- Insufficient risk pricing, pooling and spreading mechanisms,
- Market-distorting government policies,
- High information and transaction costs,
- Market prejudice, and
- Insufficient market competition (i.e. monopoly)

These market imperfections create powerful deterrents to private sector SME lending in the emerging economies like that of Croatia.

Insufficient Risk Pricing
In Croatia, bank fee structures and interest rates are not tailored to the individual SME borrower and do not properly reflect the risks or costs of financing. This is true for both banks and MFIs. Leasing companies behave differently. While it is very good for MFIs to be lending in an underserved market, they are unnecessarily overexposed by not identifying client risk and pricing up to it. This is a frequent error of micro and SME lenders. These practices contribute to constrain the growth and development of the small business sector in the demanding and underserved market of Croatia.

Western banks know and understand the concept of pricing to risk. These banks are extremely good at assessing business risk. Based on their assessment of a potential loan, a banker will price up to risk, tailoring loan conditions to individual SMEs, and ultimately stimulating economic activity and fostering employment generation.

Banks perform best when they are at risk themselves. Currently, in Croatia, banks carry little credit risk because loans are fully collateralized, often over collateralized. As the overall market for SME finance becomes more competitive, banks operating in Croatia will be forced to pursue loans that are less than fully collateralized and price-to-risk.

Proper incentives and structures are critical to the success of SME lending. SME lenders under perform if they are not compelled to earn a risk-adjusted return on capital. In the absence of proper incentives backed by organizational structures designed to win, bankers tend to be slow in making loans, too conservative in assessing risk, and unwilling to dig deeply to understand proper pricing. These tendencies are exacerbated in less competitive markets like Croatia.

Banks in Croatia fall into a risk averse or risk-taking profile based on collateral, not on incentives or structures.

Market-Distorting Government Policies

Government policies have dramatic, and often unintended, effects on every economy. Even in the United States, there are many examples of policies designed to accomplish essential public goals that often indirectly and unintentionally increase market concentration, impose added information and transaction costs on investment decisions, or distort the negotiation of risk-adjusted rates of return between suppliers and consumers of finance.

Nevertheless, in today's highly competitive global market economy, most advanced and emerging market economy governments seek to create a market economic system that encourages the creation and growth of new and small companies. When a complete system is in place, public sector regulation is structured to enable an entrepreneur with a unique concept to access the finance necessary to take an idea and build a company around it. (In the economies of the ENI and in developing markets, the system is never quite finished. Much of this has to do with the inability of those countries to turn property into capital.)

As the emerging market governments of the world have gained sophistication, there has been an identifiable shift in the way they address their financial markets, as outlined in table below. In the past, economies were more centralized, with the government taking the lead in deciding where limited resources should be focused. Governments usually had one policy for all regions of the country, and did not account for local needs. Subsidies often supported industries that were considered strategic, despite having little support from the market. These industries were focused more on government cash flows, than those derived in the competitive marketplace.

GLOBAL ECONOMIC STRATEGIES	
Old Strategies	**New Strategies**
Centralized Approaches	Decentralized Approaches
Top Down Command and Control	Bottom Up Empowerment
One Policy Fits All	Policies Vary to Fit Market Conditions
Government Subsidizes Monopoly	Government Catalyzes Private Investment
Focus on Retaining Low Wage Jobs and Failed Enterprises	Focus on Creating High Value Jobs and New Wealth
Staff Entitlements	Performance-based Compensation
Opacity of Decision-Making	Transparency of Decision-Making

In order to remain competitive in the global marketplace, the economies of the world began to change with increasing velocity during the last twenty years. Both governments and industries became more market focused, tailoring products and services to local needs. Decentralized approaches took hold that promoted innovation from the bottom up. Governments channeled their funds into investments that leveraged private sector capital, and began to measure outcomes. Companies downsized, retaining only those jobs that produced returns to the bottom line. Compensation was no longer expected, it had to be earned based on performance. Financial markets have moved to become more vastly more efficient on a global basis. Transparency became the common expectation of all decision making in the public, private, and not-for-profit sectors.

Croatia is still in the process of addressing many structural inadequacies that are too restricting, or that do not exist in a form enabling financial institutions to support the growth of new and rapidly expanding industries, sectors and clusters.

The problems of inadequate, restrictive, or insufficiently transparent laws regulations coupled with a less than supportive market infrastructure cripple many small to medium enterprises in Croatia. However, these policy and market flaws do not unduly constrain the most successful banks doing business in Croatia.

High Information and Transaction Costs
High information and transaction costs pose equally severe barriers to finance in emerging markets. High information and transaction costs affect perception throughout financial markets and especially in underserved areas, such as regions of special state concern.

Technically-skilled bankers, capable of looking at highly-specialized and/or unique companies like SMEs, have been able to lower information and transaction costs necessary to identify, evaluate, approve and track loans in targeted sectors or geographical areas. The capacity to reduce information and transaction costs are the hallmark of successful banks engaged in micro and SME lending endeavors.

Market Prejudice
Market prejudice is a definable market barrier, as well as a social reality. Market prejudice is a pre-judgment by resource suppliers about particular industries, geographic areas or other key features of consumers, based on a shorthand assessment of a few key factors. Market prejudice is caused by a kind of technical lethargy as a substitute for investing in adequate information. The banks in Croatia fall into this category with regard to SME finance.

Market pre-judgments avoid the high information cost of making individual resource allocation decisions by arbitrarily ruling out whole classes of potential consumers. In Croatia, SMEs that are unable to satisfy collateral requirements are ruled out as consumers of commercial debt finance.

The SME sector is often overlooked based on perceptions of managerial weakness, government interference, political instability, or the ongoing influence of proto-socialist philosophy in the marketplace. Market prejudice toward small business is amplified as compared to large business, especially former state enterprises. The banking sector in Croatia has this prejudice.

Properly incentivized banks and trained bankers can overcome these kinds of market prejudice.

Insufficient Market Competition

Insufficient competition can lead to monopoly. Monopoly can lead to skimming because the few suppliers in the market can generate a high return while taking only low risk. When financial institutions can price low risk for high return, this custom drives both higher risk and all other rate of return investments out of the market. A form of this practice is commonplace in Croatia. In other words, banks skim deals from the market that can meet their collateral requirements. All others are excluded, even though they might be sound businesses, profitable to the bank. With proper credit and business analysis, some collateral, and a risk pricing orientation, some of these deals could be done. The strict collateral requirements allow banks in Croatia to operate as pseudo monopolies and do far fewer deals.

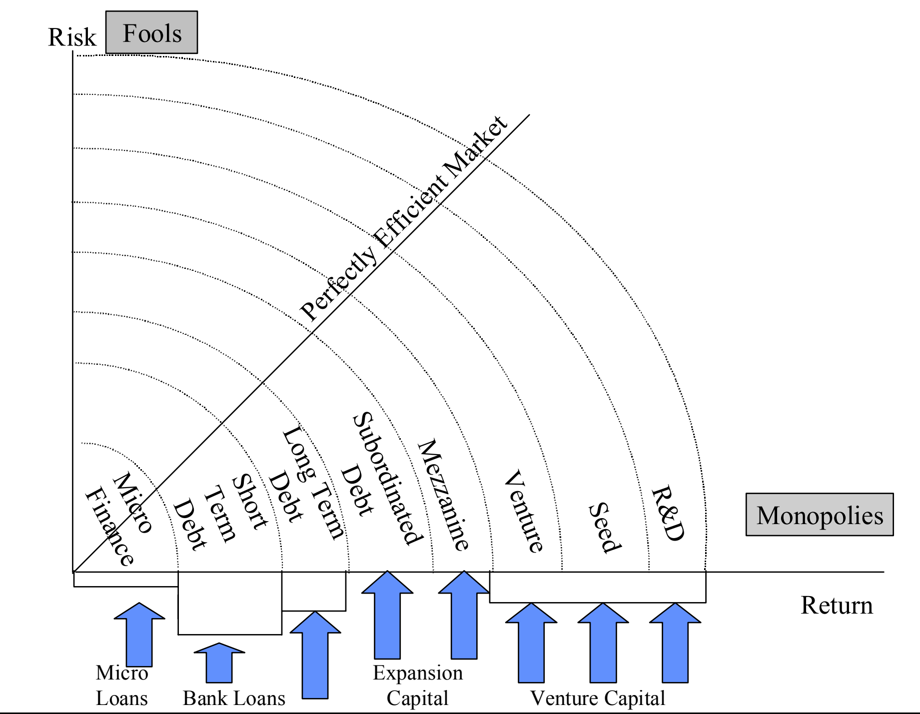
Excluded from commercial debt markets, many profitable and growing small businesses refrain from pursuing business opportunities that would add to local economic development and job creation.

GAPS IN THE CROATION FINANCIAL MARKET

Croatia, other Eastern European and the former Soviet Republics, were founded on the belief in a centralized economy, and thus have had a greater struggle to meet the parameters of the evolving global capitalist marketplace.

Croatia has worked to construct a financial market system, enabling it to privatize state owned industries, providing an improved foundation for an entrepreneurial environment that grows new companies, and becomes more competitive in global markets. Progress is being made, but major gaps still exist across the spectrum of financial products.

GAPS IN THE FINANCIAL MARKET OF CROATIA



Microfinance suppliers are very limited in number and operate in restricted operational areas, with a much of the country undersubscribed. Most of these organizations are hampered by a narrow range of products limiting growth and profitability.

Short term and long term debt are basically supplied by the banks and especially by those with foreign ownership having greater access to financial resources. To a degree, these banks are constrained by banking laws, imperfections in the property system, and poor industry infrastructure. Banks rely on collateral and the vast majority of loans are short term. Banks are not rewarded for taking risk, and subsequently do not engage in the practice. In fact, 100 percent of the risk must be covered before making a loan. The entry into the market of some banks, founded on western banking principles, will help demonstrate that certain markets avoided by Croatian banks can be operated both safely and profitably. Success will promote success, and gradually laws will be changed to accommodate more successful banking structures, practices and behaviors.

Subordinated debt and mezzanine finance are riskier than micro and bank loans, but provide for a greater return in successful ventures. Unlike venture capital, subordinated debt and mezzanine capital allow the founding entrepreneur to continue to own and manage his or her own business. Based on interviews conducted and the research undertaken in Croatia, no institutions are actively engaged in these markets.

Venture capital does exist in Croatia, however it is still a much smaller market than it could be. Three funds operate in Croatia, with varying degrees of market penetration and success. The market is still young, with plenty of room for growth.

THE BANKING SECTOR

The Good News

The banking sector is considered the most developed in the Croatian economy, and it is dominated by large foreign-owned banks, including HYPO Alpe-Alpia-Bank, Raiffeisen Bank Austria, Dresdner Bank, etc.

Ownership structure of banks—Croatia

Ownership	**Number of banks: 1999, 2000, 2001**
State	10, 3, 3
Private, domestic	30, 19, 16
Private, foreign	13, 21, 24
Total	53, 43, 43

Source: Croatian National Bank

Approximately, 90 percent of all banking assets in Croatia are foreign owned.

Ownership structure of banks—Croatia

Ownership	**Percentage of assets owned: 1999, 2000, 2001**
State	46 6 5
Private, domestic	14 8 6
Private, foreign	40 86 89
Total	100 100 100

Source: Croatian National Bank

Many of these banks have extensive operations throughout Central and Eastern Europe, and they are known leaders in the area of SME finance. One such bank is Raiffeisen. As is widely acknowledged, foreign banks and even large domestic ones lend less to small businesses. Small domestic banks, however, tend to fill this void often eschewed by their larger rivals. In transitional and developing countries, the mere presence of foreign banks creates conditions beneficial to the overall marketplace: reduced fees, lower interest rates, less bureaucratic requirements, longer maturities, etc. Even though foreign banks are less inclined to lend to small businesses, their existence enhances competitive forces and thereby improves access to finance for SMEs.

When a foreign bank enters a new market, the bank usually focuses on its competitive advantage relative to other institutions. In many cases, these banks exploit and advantage proprietary products, knowledge, experience, and skills to create markets or build share. More likely than not, a foreign bank would have a competitive advantage over a smaller domestic bank in the area of derivative trading or even leasing, while a smaller domestic bank would be better positioned in SME finance, since foreign banks generally have a distinct disadvantage in their understanding of local conditions, customs, norms, habits, etc. In Croatia, this assumption does not appear to reflect reality.

In most cases, foreign-owned banks are staffed with Croatian nationals. These skilled individuals possess the local knowledge requisite of successful SME lending. Moreover, some of these foreign-owned banks are industry leaders in SME finance, such Raiffeisen which has taken a market leadership position in the countries of Central and Eastern Europe. Raiffeisen has stated that this segment is more profitable than large corporates in Croatia. As a result, it has embarked to aggressively pursue SME lending. Larger, foreign-owned banks are stimulating interest in Croatian SME finance. Others in the market are HYPO and Privredna banka Zagreb, in addition to regionally-based, smaller domestic banks.

SME lending has taken time to develop as the country transitioned from socialism to a market economy. Lending, in Croatia, has steadily increased overtime. Foreign entry and ownership hastened this trend as did special government programs designed to stimulate lending in the sector. Organically, further encroachment into the SME market is likely to continue a pace as banks build and establish bricks and mortar operations throughout the country since servicing small businesses requires an established branch network.

The Not-So-Good News

The current banking environment that is characterized by foreign ownership and increasing levels of competition are still not enough to produce the effects sought after by the GOC and SMEs themselves. The conditions are not yet right for banks to dramatically expand their penetration into the SME sector since risk is perceived as too high, absent strict collateral requirements and high loan-to-value ratios. Credit decisions, in Croatia, are primarily weighted toward valuing collateral. In fact, at least 100 percent of a deal must be backed by collateral before disbursal. Unlike commonly accepted types of collateral used in secured lending throughout the United States and Europe – trade goods, negotiable instruments, title documents, intangibles and leverageable cash – collateral in Croatia is primarily physical-asset based.

Internal bank policies mandating fixed levels of collateralization exclude many SMEs from commercial debt markets, due in large part to inadequacies in the titling system (especially in the war-affected areas). As a result, the current environment creates a disincentive for banks to price-to-risk by prescribing fixed levels of required collateral beginning at 100 percent of the loan value. Many businesses, especially those smaller in scale and scope of operations, cannot meet set collateral requirements. Small business development and enterprise growth is therefore restricted.

Only an improved operational environment will yield the results desired by SMEs. Next to the titling system, the two most obvious impediments to market and product growth are a moveable collateral registry and a nation-wide, private, credit reference bureau. As these two features become permanent fixtures in the Croatian marketplace, banks will likely move to expand product and service offerings, benefiting small business.

FINA is working toward creating a moveable collateral registry, and the expected implementation date is sometime in late 2003 or early 2004. The Croatian Banker's Association (CBA) is working with a private company to establish a national credit reference bureau. Under Croatian law, the CBA has the exclusive right to coordinate a credit bureau on behalf of the banking sector. The CBA plans that a fully-functional credit bureau will become operational in 2004 with the majority of banks participating.

These barriers, as they currently exist, inhibit the development of the banking sector. Moreover, these obstructions affect both the supply of and demand for commercial finance. For example, the lack of a properly developed banking sector is caused by market distorting structural inadequacies, leading to inappropriate risk pricing, high information and transaction costs, and insufficient market competition (vis-à-vis product innovation and diversity). As a result, risk pricing and risk management are hard to evaluate. Information and transaction costs required to pierce market and firm-level opacity are extremely high. In the absence of cheap information, market prejudice rules and competition and innovation are stifled.

It must be recognized, however, that banks have little incentive under current conditions to price-to-risk without additional risk pooling and information sharing systems in place.

Banking-sector level constraints inhibiting access to SME finance

- Majority of loans are short term and restricted to working capital
- Virtually all loans require asset-backed collateral as security, regardless of loan use
- Asset valuation costs are viewed as expensive, costing an average of $150 per inspection (limiting micro and small businesses)
- Asset registration often involves three months or more
- Assets are conservatively valued, especially in war-affected areas where property is often considered worthless
- A moveable asset (collateral) registry does not yet exist
- Inadequacies in the secured transaction framework limit the growth and diversity of products/services
- Newly imposed GOC 16 percent annual growth limitation on banks inhibits expansion of SME lending and product development/innovation
- High percentage of loan applications are rejected upon submission due to the inadequacy of information provided (e.g. Raiffeisen reports a 20 – 30% rejection rate at first contact)
- Many entrepreneurs lack the requite skills to produce a business plan

GOVERNMENT OF CROATIA SPECIAL SUPPORT PROGRAMS

Ministry for Crafts, Small and Medium Enterprises

The Ministry for Crafts, Small and Medium Enterprises was developed to support the growth and diversity of business throughout Croatia. The Ministry has numerous activities that support its goal of business development, including entrepreneurship promotion, information exchange and technical assistance, an enabling environment of infrastructure and support, education, technology development, and finance. In terms of financial support and assistance, the Ministry works together with cities, counties and commercial banks. All three entities contribute capital for lending to SMEs. The Ministry subsidizes interest rates charged by the commercial bank to business owners; the city and/or county reduce or eliminate tax burdens and they sometimes create special entrepreneurial zones or business incubators. Banks leverage committed government funding by adding their own capital to the revolving loan pool.

At present the Ministry has four lending programs:

1. **Snowball (entrepreneur)** provides loans to businesses acting together in partnership with cities and counties. The program joins state and local funds to leverage commercial bank capital. Entrepreneurs receive subsidized interest rates.

2. **New Technologies** offers loans to businesses so that they can develop or purchase new technology in the form of machinery, equipment or intellectual property.

3. **Export** supplies loans to businesses for export purposes under favorable conditions.

4. **Tourism** provides loans to businesses in the tourism industry.

Under these programs, the Ministry has the following procedures.

- First, local government creates a fund for SME lending purposes

- Second, the Ministry makes a contribution to the local fund

- Third, local government negotiates terms and conditions with the local bank for lending, including: percentage of the commercial bank's leverage, client profiles, interest rates, repayment schedules, loan documentation requirements, disbursement procedures, etc.

- Fourth, a loan review committee is formed, consisting of representatives from local government, the local Chamber of Commerce, the local Chamber of Crafts, the Ministry, and the commercial bank

After the four procedures have been satisfied, the loan application moves to the commercial bank's credit committee, which reverses the exclusive right to judge creditworthiness and disburse the loan.

Published results are difficult to access, however, anecdotal evidence suggests that less than one-third of submitted applications are ultimately funded. As of December 2001, the Ministry reported that 14 million euros from its budget and 17 million euros locally had been programmed for lending. Banks had set aside 280 million euros as additional leverage. 107 million euros had been disbursed in 1,574 loans, ranging from 3,000 to 200,000 euros with an average of approximately 70,000 euros. These figures validate information obtained during interviews that less than 50 percent of all funding set aside for lending had been utilized. In late 2003, GTZ will undertake an independent and detailed analysis of the Ministry's lending programs.

Due to the success of the programs as a mechanism to spur lending in the sector by commercial banks, and in combination with steady and incremental improvements to the state of SME finance in general, GTZ claimed the Ministries' programs will be discontinued in the near future.

Croatian Agency for Small Business (HAMAG)
In March 2002, the Government of Croatian passed a law enabling the creation of HAMAG, an agency designed to provide credit guarantees for SMEs. Formerly, GOC guarantees were provided by the Croatian Guarantee Agency (HGA).

In January 2003, USAID Croatia commissioned a paper that outlined recommendations for the creation of HAMAG. Necessary to the achievement of the Agency's goals, the paper identified five strategies and activities that call for:

1. Establishing efficient structures and processes assuring the delivery of cost effective support services to SMEs nationwide

2. Creating a central information bank of business information, accessible by SMEs and relevant stakeholders

3. Improving access to finance, coordinated with appropriate guarantee schemes

4. Adding process to enhance SME competitiveness

5. Building or adding to existing mechanisms employed by SMEs to address policy constraints inhibiting business growth

HAMAG was scheduled to be fully operational in early 2003. The Agency is not yet functional.

Croatian Bank for Reconstruction and Development
The Croatian Bank for Reconstruction and Development is a state-owned investment Bank (commonly referred to as HBOR, the Croatian acronym). HBOR functions as a development bank and provides three services as part of its mission to advance the Croatian economy: export finance and insurance, economic growth and infrastructure construction, and SME finance and support activities.

HBOR's SME finance and support activities are geared to provide incentives to banks lending to SMEs and start-ups. SMEs or entrepreneurs considered craftsman have the opportunity to participate in eight government SME programs, viz:

1. **Small Entrepreneurship in Areas of Special State Concern** promotes business growth in the areas of special state concern by targeting crafts, small business and agriculture with medium and long-term loans.

2. **Development of Islands** encourages the sustainable development of islands through small business loans.

3. **Private, Small and Medium Entrepreneurship** supports business by providing long-term loans for the expansion and modernization of existing enterprises.

4. **Private, Small and Medium Entrepreneurship (Direct Lending)** supports business by providing medium and long-term loans that comply with European Bank of Reconstruction and Development (EBRD) and Council of Europe Development Bank (CEB) conditionalities.

5. **Family-run Tourism** supports small, privately-owned and operated businesses.

6. **Small Enterprise Start-ups (Through On-lending Banks)** supports business by providing medium and long-term loans in cooperation with Deutsche Investitions und Entwicklungsgesellschaft (DEG - German Investment and Development Company).

7. **Small Enterprise Start-ups (Direct Lending)** supports the creation of new business by providing medium and long-term loans.

8. **Company Equity** promotes business development through direct investment and HBOR ownership.

Each loan program has its unique set of terms and conditions. In general, those requirements correspond to the table below.

Category	**Term/Condition**
Loan amount	Up to 12 years, including grace period
Grace period	Up to 3 years
Interest rate (to client)	3 to 7.5%
Interest rate calculation	HBOR determined
Commercial bank fee	2% discount from HBOR loan
Management fee (to commercial bank)	1% of loan amount
Commitment fee	.25% quarterly on undisbursed amounts
Disbursement	Up to 12 months
Security	Real estate, moveable property, and guarantees
Documentation	Up to 20 forms

GOC level constraints inhibiting access to SME finance

- Time intensive application and approval process, i.e. deals must be approved by the lender, the state-sponsoring agency and others
- Documentation requirements are burdensome with more than ten attachments included in each loan file
- Lack of coordination between various state-sponsored SME finance programs limits market penetration
- Inadequate marketing and distribution of information to prospective SME finance end users
- GOC special programs do little to influence bank behavior, i.e. increasing risk profiles, reducing collateral requirements, expanding product lines, etc.
- GOC product offerings are viewed as confusing and bureaucratic by consumers

BI- AND MULTI-LATERAL INSTITUTIONS

United Nations Development Programme (UNDP)
The UNDP/UNOPS and the International Labor Organization (ILO) with the European Quick Impact Facility (QIF) has originated ten guarantee funds for Croatia. These funds are arranged with the Croatian banking system to provide financing for agriculture, livestock, crafts, cooperatives and micro and small businesses. The European Union has set aside 10 million euros for the guarantee fund. Commercial banks are required to match their participation in the fund at a 1 to 1 ratio.

The fund normally guarantees 50 percent of each loan; however, if the loan is for a SME, then the guarantee can be increased to 70 percent. Loans are approved by commercial banks and disbursed using their own capital.

Under the Retail Banking “Family Crafts,” 1,528 loans were made, totaling 5,589,835 euros with an average loan size of approximately 3,700 euros. As of early 2002, default rates have ranged from approximately 3 to 20 percent.

The Corporate Banking “Guarantee Fund for SMEs” disbursed 59 loans totaling 1,624,600 euros with an average loan size of approximately 28,000 euros.

European Bank for Reconstruction and Development (EBRD)
The EBRD has maintained an active presence in Croatia with its commitments growing to over 1 billion euro. The EBRD’s portfolio has grown to 738 million euro with co-financing in the range of 2 billion euro. With this, the EBRD has increased its involvement in the infrastructure and enterprise sectors. Going forward, the EBRD intends to focus on the following core activities:

1. Improving **infrastructure and the environment** working at the local and national levels, and in conjunction with banks and other International Financial Institutions (IFIs)

2. Engaging the **enterprise sector** directly through local banks and also by promoting greenfield and foreign direct investment, particularly in the tourism sector, and using warehouse receipts in the agriculture area

3. Supporting the **financial sector** by providing longer term funding and institution building to better service the SME and retail mortgage lending sectors, in addition adding new emphasis on leasing and insurance

United States Agency for International Development (USAID)
USAID has directly supported microfinance retailers described later in the final section. It has also devoted resources to removing barriers to financial access, improving the efficacy of the land cadastre system, upgrading the collateral registry, and supporting other industry architecture such as a credit reference bureau through the Banker's Association.

Donor constraints inhibiting access to SME finance
- Donor contribution (e.g. financial and other) seen as insufficient
- Lack of donor coordination and leveraging of resources

LEASING

Leasing is an important source of medium and long-term finance for companies throughout the globe, offering opportunities to increase production and grow assets. In fact, leasing is the largest single source of equipment finance in the world. In the United States, four of every five companies lease equipment, even though many have access to alternative forms of finance. 230 billion dollars in equipment is leased per annum in the United States alone.

In Croatia, leasing is a young industry, although a relatively well-established one with six institutions dominating the market, the top two being HYPO and Raiffeisen. Based on interviews with industry participants, HYPO holds approximately a 40 percent share of the market, followed by Raiffeisen with a 20 percent share, and the remaining 40 percent spread among four others. Ten leasing companies have foreign ownership. The larger, more successful companies are affiliated with a parent financial institution, thereby enhancing access to funding from sources outside Croatia.

When leasing took hold in the late 1990s, it was heavily weighted toward vehicles. This makes perfect sense because secondary vehicle markets are generally easier to establish as vehicle prices are more predictable, thus reducing risk for leasing companies. With the vehicle market being saturated and as leasing companies gained more experience in the marketplace, they have slowly moved into other segments such as equipment. Some equipment suppliers have begun offering buy-back guarantees, a signal that the secondary equipment market is in the early stage of development.

Leasing is gradually demonstrating its ability to finance the SME sector, and it has the potential to fuel economic growth.

One company, in particular, has current portfolio concentration of 60 percent in passenger vehicles and 40 percent in equipment, with the share in the latter increasing. Many of the referrals for equipment originate either from a supplier or its parent bank. This company views equipment leasing to individuals and SMEs as future growth area. Its minimum deal size is approximately 8,000 euros, with no absolute upper bound. All leasing firms interviewed indicated that demand exists for amounts less than 8,000 euros; however, servicing the volume of small leases to generate adequate profitability requires large infrastructure modifications and/or investment to current operations.

An informal industry association has been in existence for one year. Its major success to date has been the resolution of a licensing, use and ownership issue. The association also shares a client black list among its members. The main task confronting the leasing industry is legal and regulatory: currently, Croatia has no leasing law. The association intends to prepare a draft law, but it has not done so yet.

Leasing constraints inhibiting access to SME finance

- Large leasing companies are less established in remote, rural areas
- Regionally-based, smaller, domestic banks are undercapitalized and less likely to expand leasing operations
- Insufficient laws and regulations that legalize and govern leasing companies
- Inadequate protection of property rights
- Weak secondary equipment markets
- Almost non-existent access to long-term lending through the banking sector
- Poor knowledge of leasing by individuals and SMEs requires educational work with clients which increases costs (especially with smaller lease sizes)

MICROFINANCE INSTITUTIONS

The first Croatian microfinance institution (MFI) began operations in 1996. It was started with financial support from the United States Agency for International Development. Later, two other MFIs joined the field, again with financial support from USAID. Funding agreements required these MFIs to service areas of special state concern. Generally, these locations were war affected, and the MFIs had to overcome lingering socio-economic issues as operations were undertaken. Today, each MFI has a different focus, a specific geographic location, and a distinct array of product offerings.

Microfinance as practiced in Croatia is unique: loan sizes extend up to 50,000 euros, and even the most micro-oriented of the group lend upward of 5,000 euros. Under most definitions, microfinance as practiced in Croatia is something very different to what is seen in developing world. The more advanced state of the Croatian economy dictates an upmarket mode of operational behavior. As Croatia continues its progression toward membership in the European Union, chances are microfinance will become much more niche oriented. In order to survive, MFIs will be forced to operate at the borders of the financial services industry as specialized providers, possibly as subprime lenders of last resort.

As the financial services industry continues to evolve, MFIs have role to play servicing segments excluded from the formal sector, in loans under $8,000 or where businesses lack immoveable collateral up to prescribed level mandated by commercial banks.

For now, Croatian MFIs have a valuable role to play in Croatia. The question is for how long and in what form?

NOA

NOA was founded by Opportunity International as a savings and loan cooperative (SLC) in 1996. Originally, NOA's mission was to provide loans to small businesses in war-torn areas of eastern Croatia, creating employment and a stable environment for returning Serbian refugees. Since then, NOA has expended into other areas of Croatia, and it offers numerous products in the lower spectrum of the SME marketplace, including the agribusiness sector. The maximum loan amount is 50,000 euros. As of March 2003, NOA had 626 clients with an outstanding portfolio of over $3 million. NOA ranks as the third largest SLC out of a total population of eighty-eight.

Within NOA's SME niche, competition is increasing from the commercial banking sector; banks generally offer more favorable pricing, although NOA's collateral requirements are less stringent as it offsets risk with personal guarantees. Likewise, NOA funds under collateralized start-ups, unlike most if not all banks. NOA has witnessed a decrease in loan applications, and as a result it has undertaken a Croatia-wide advertising campaign.

Recently, the Ministry of Crafts and SMEs has proposed the creation of a Bank for Small Entrepreneurship, the founding members consisting of SLCs. Membership in the new bank would afford SLCs admission to GOC special finance programs, and access to privileges allowed only to commercial banks.

DEMOS

DEMOS as founded by the International Catholic Migration Commission (ICMC) as a savings and loan cooperative in 2000. DEMOS serves economically disadvantaged populations that are excluded from the commercial banking sector. DEMOS has two primary loan products, micro and individual loans, with amounts ranging from $1,500 to $12,000. 80 percent of its clients are engaged in agriculture.

Much of the work DEMOS undertakes is guided by a funding relationship with the Economic and Community Revitalization Project (ECRA), a three-year project funded by USAID. Through ECRA, DEMOS works in targeted municipalities of war-affected areas. The ECRA agreement terminates by the end of calendar year 2003.

MikroPlus

MikroPlus was founded in 1999 by Catholic Relief Services (CRS). MikroPlus has a special permit from the National Bank of Croatia, and it operates under the protections afforded to CRS as an NGO. MikroPlus is advocating for the creation of a special law legalizing and regulating microfinance institutions, granting certain tax and regulatory exclusions. MikroPlus is also a beneficiary of ECRA, and likewise it is required to operate in specific geographical zones. MikroPlus also administers the portfolio of CRS. It has more flexibility to operate outside the ECRA areas of special interest. CRS operations end in early 2004, and MikroPlus will assume ownership and control of all credit operations under the CRS umbrella of activities.

MikroPlus employs a group lending methodology, and it has 1,600 clients. Loan sizes range from $500 to $4,500. MikroPlus primarily lends to pretty traders and small-scale service providers.

MFI level constraints inhibiting access to SME finance

- Microfinance expansion is constrained by a lack of grant funding needed to move into new geographical areas since Croatian MFIs are marginally, if at all, profitable
- Past and current agreements with various funding agencies are predicated upon humanitarian needs and not business fundamentals or economic analysis, i.e. MFIs needs are secondary to social and political concerns
- The ability of MFIs to service a wider range of SME needs is restricted by alliances with international PVOs
- The lower end of the SME market is becoming more competitive as banks enter the market, forcing MFIs in that niche to pursue riskier deals
- The market for microfinance in Croatia is thin compared to developing countries, or even other transitional economies, which causes difficulties in achieving economies of scale

OTHER GROWTH OPPORTUNITIES

Mezzanine finance

In market areas where there are virtually no current providers of equity, growing SMEs are forced to alter their enterprise plans to use only debt capital, even if the terms offered are not in the company's best interest. Since there are real limits to the amount of debt a company can absorb, the consequence of no equity is usually to stop growing.

In markets characterized by a scarcity of providers of small cap mezzanine finance, otherwise profitable and growing small-to-mid-size businesses (i.e. SMEs) might refrain from pursuing business opportunities that would add to local economic development and job creation.

Subordinated debt and mezzanine finance are standard features in the toolbox of western financiers. Unlike venture capital, subordinated debt and mezzanine capital allow the founding entrepreneur to continue to own and manage his or her own business.

It does not appear that any of the three Croatian equity funds are engaged in mezzanine finance.

Warehouse receipts
Through USAID support, the Ministry of Agriculture and Forestry drafted inventory credit legislation intended to allow agricultural producers to leverage farm outputs as collateral for financing. The law would provide a framework to develop a regulated grain depository system, thus creating a system of improved protections for the trade and storage of products, while increasing solvency in the agricultural sector. The law is awaiting final adoption by the government.

Direct finance
Some of the better, large companies are turning to direct finance, which places further pressure on banks to move down market into the SME sector. These new competitive pressures will force banks to innovate, especially as manufacturers and suppliers move further down into the SME market.

Supplier credit
The use of supplier credit at the SME level, particularly at the lower end, is not yet prevalent or widespread in Croatia. It is beginning to appear in the agricultural sector as some microfinance practitioners have stated. There is opportunity for growth in this product area.

Forfaiting
Forfaiting is underdeveloped as a financing mechanism for SMEs. Given the importance attached to developing Croatian exports, forfaiting is another area that can contribute to the development of the SME sector.

Factoring
Factoring is a financing mechanism that is wholly underdeveloped. Given the gap between demand for and the supply of credit, factoring is seen by many as a growth opportunity and another means to support the SME sector of the economy. Development of the legal and regulatory framework is required.

Revolving lines of credit (e.g. credit cards)
Credit cards are extensively used in Croatia. Credit cards are used by SMEs, in the owner's name, as a means to finance short-term working capital. Further refinement and development of credit cards to match needs of SMEs is another area that has been identified as important.