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## GROWTH THROUGH INCREASE IN ACCESS TO FINANCE: RECOMMENDATIONS FOR SEE\*

Rast kroz bolji pristup finansiranju – preporuke za JIE

### Abstract

Since the impact of the global financial crisis of 2007/2008, and a subsequent impact of EU sovereign debt crisis of 2010, transition countries of South East Europe (SEE) have been in recession, stagnation or had very low growth rates. The debate on how to initiate growth in SEE is frequently focusing on austerity measures, attraction of FDI, structural reforms, fiscal policy stimulus or simplification of business procedures. This paper is focusing on a set of potential measures in the area of increasing access to finance for local small and medium-sized enterprises (SMEs) and other local companies capable of achieving competitive output in tradable part of gross domestic product (GDP). In other words, how to ease financing of endogenous entrepreneurs and help them evolve into competitive local, regional and eventually European companies? Analysis in this paper is focused on five important areas for better access to finance: non-performing loans (NPLs), collateral valuation, credit risk guarantees, nonbanking financial institutions (both credit institutions and securities institutions), and monetary policy and bank regulation and supervision. In all of these areas important improvements are possible.

**Key words:** *access to finance, endogenous growth, SMEs competitiveness, tradable GDP, SEE transition economies*

### Sažetak

Od prvog udara globalne finansijske krize 2007/2008, kao i od narednog negativnog uticaja krize suverenog duga EU od 2010, zemlje Jugoistočne Evrope (JIE) u tranziciji nalaze se u recesiji, stagnaciji, ili na nivoima vrlo niskih stopa rasta. Debata o tome kako podstaći privredni rast u JIE uglavnom je fokusirana na mere štednje, privlačenje stranih direktnih investicija (SDI), strukturne reforme, subvencije i druge podsticaje iz budžeta i pojednostavljivanje administrativnih uslova poslovanja. Ovaj rad se fokusira na skup potencijalnih mera u oblasti jačanja i olakšavanja pristupa finansiranju za domaća mala i srednja preduzeća (MSP) i druga domaća preduzeća sposobna da budu konkurentna u delu razmenjivog dela bruto domaćeg proizvoda (BDP). Drugim rečima, kako olakšati finansiranje endogenih preduzetnika i pomoći im da izrastu u konkurentne lokalne, regionalne i konačno evropske kompanije? Analiza u ovom radu daje fokus na pet oblasti bitnih za poboljšavanje pristupa finansiranju: problematični krediti, procenjivanje kolaterala, garancije kreditnog rizika, nebankarske finansijske institucije (kako kreditne, tako i institucije HoV), i monetarna politika i regulacija i supervizija banaka. U svim ovim oblastima moguća su značajna unapređenja.

**Ključne reči:** *pristup finansiranju, endogeni rast, konkurentnost MSP, razmenjivi BDP, JIE zemlje u tranziciji*

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## Introduction

Catching up of Central and Eastern European (CEE) and South Eastern European (SEE) countries with developed Europe was well underway in the years prior to the global crisis. It seemed that, with country-specific differences, the so-called convergence within Europe was working. Financial systems of new Europe countries were providing credit expansion, and macroeconomic position was on a path of inflation decrease and stabilization with relatively higher rates of economic growth and, on average, solid fiscal position. So, on average, things seemed to have been moving in an expected direction.

However, CEE countries on average proved to be doing better than SEE countries and it became clear that divergence was going on between these two groups of countries. Global financial crisis of 2007/2008 has revealed structural weaknesses of pre-crisis growth in SEE. Very often it was consumption-based and import-led growth model backed by inflow of capital and increase in debt. Growth of GDP was going on predominantly in non-tradable sectors, with current account deficits high, and competitiveness of local economies low. With unfolding of the crisis and sudden stop in inflows and FDI, it became obvious that many of the SEE countries are on a path of stagnation, high unemployment and increase in public debt. This unsustainable path needs to change, without delay.

Three broad mid-term goals of all of the governments in SEE wanting to create grounds for long-term growth, most probably are:

- Strengthening the capacity and independence of institutions;
- Increase in average level and quality of education;
- Increase in the level and quality of infrastructure.

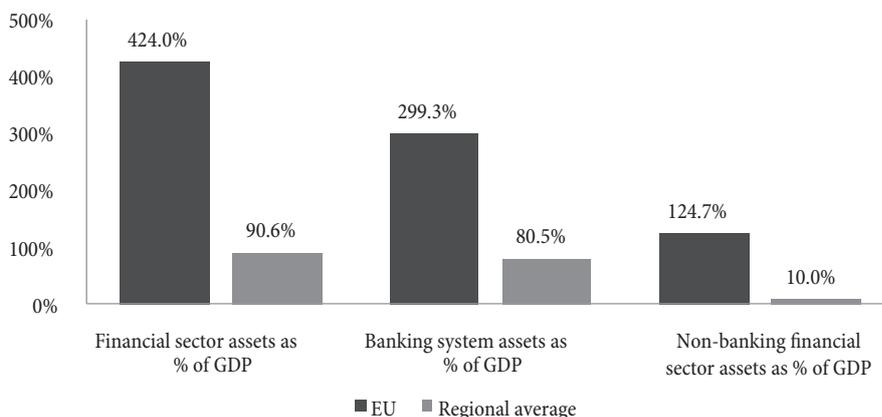
However, in the short run there is much that can be done as well. FDI cannot realistically be a predominant source of growth in SEE in a near future i.e. before substantial recovery in developed economies, most of all in Europe. Government investments are most probably limited in most SEE countries due to post-crisis fiscal restraints. Therefore, local private investments need to be considered as very important source of economic growth and new employment. Focus on this sector needs to be coherent in terms of simultaneously promoting entrepreneurship, substantially simplifying business operating standards, and increase in access to finance. This paper will deal in more detail with access to finance as one of the most important elements for every business environment, and especially important for endogenous growth.

Analyses will focus on five important areas for better access to finance: non-performing loans (NPLs), collateral valuation, credit risk guarantees, nonbanking financial institutions (both credit institutions and securities institutions), and monetary policy and bank supervision. In all of these areas important improvements are possible.

## NPLs

Financial sector as a whole and its segments (banking and nonbanking sectors) are underdeveloped in SEE

Figure 1: SEE\* Financial sector overview, comparison with EU, 2013



\* Data is for Albania, BiH, Macedonia and Serbia (including Kosovo) Source: CREF Research

compared to the EU (Figure 1). There is obvious room for growth, but the activities in both sectors are stagnating in recent years.

Bank NPLs are relatively high and are burdening the banking sector in SEE (Figure 2). High NPLs are decreasing access to finance from banks throughout SEE. Most regulators are addressing this issue with stricter regulation in terms of loan loss provisioning and capital requirements. By doing so, they may decrease an immediate risk to financial stability, but that does not solve the problem of NPLs.

Banks themselves are also becoming more conservative in times of rising NPLs, low economic growth and strict regulation by the regulators.

High NPLs are decreasing access to finance by more requirements imposed to borrowers both by banks and the regulators. High NPLs are increasing the cost of financing for potential borrowers due to stricter regulation in terms of loan loss provisioning, capital requirements, etc. In addition, high NPLs are increasing the cost of financing for borrowers since average cost of financing for the banks with high NPLs increases as well.

Banks, as a rule, tend to prolong individual dealing with high NPLs, since that can sometimes as a result deteriorate their balance sheets or nominal market positions. However, increase in NPLs is also a self-fueling problem. More conservatism in bank business conduct due to high NPLs decreases credit growth and further deteriorates the ratio of NPLs to Total Loans. That makes a problem of NPLs relatively persistent and tends to postpone credit

growth and economic recovery, especially in bank-centric economic systems as are the ones in SEE.

That is a reason why high NPLs have to be taken very seriously both in terms of their negative financial stability impact, and in terms of their negative credit growth and economic recovery impact.

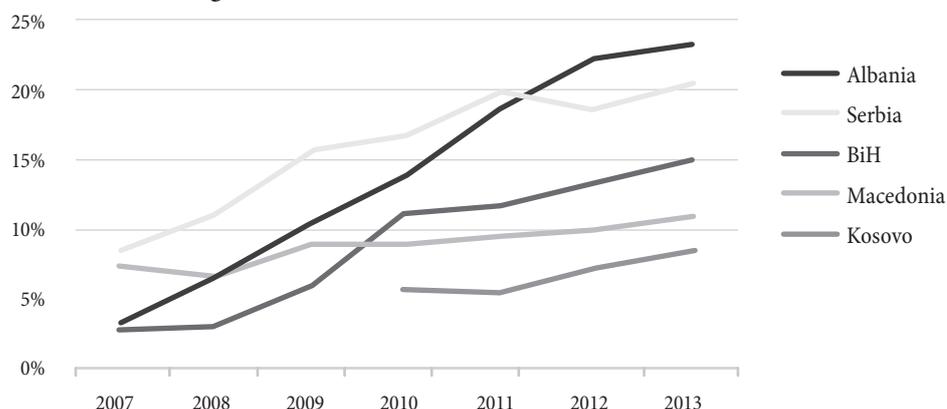
Dealing with this issue should be based on several principles:

- Centralized initiative conducted by central bank and ministry of finance, potentially in coordination with parent banks of local banks and their supervisors;
- Banks comprising dominant market share should commence NPLs cleansing in a same fiscal year;
- Regulatory and tax incentives for NPL decreasing procedures conducted by banks;
- No taxpayers' money involvement, i.e. private market solution for NPL problem;
- Involvement of private equity, distressed financing and other non-traditional institutions in the process;
- Credit biro keeps records of exposures until repayment, conversion into equity or other financial transformation that eliminates obligation of the borrower.

On these lines a specific NPL resolution plan could be formulated in cooperation between the banks, central bank and ministry of finance.

Substantial decrease of NPLs in banks would initiate credit growth and increase access to finance, both very much needed to increase economic activity and employment in SEE.

Figure 2: Bank NPLs to Total Loans 2007-2012 in SEE\*



\* Separate data is provided for Kosovo in line with United Nations Security Council Resolution 1244/99  
Source: World Bank

## Collateral valuation for lending purposes

Imprecise collateral valuation presents a very important issue for bank and even non-bank access to finance. There are several important aspects in which collateral valuation may hamper access to finance.

The first obvious possibility is that imprecise collateral valuation is recognized as an unacceptable risk for the bank and that potential borrower is denied when requesting a loan.

Second, is the situation in which the bank does not reject the client, but accepts him or her as a borrower of lower credit quality and therefore with a higher interest rate to pay. Higher interest rate deters borrowing and therefore lowers access to finance, but also increases the average interest rates of borrowers as well as the likelihood of loans becoming non-performing.

Third, the bank does not reject the client, but accepts him or her as a borrower and demands an additional credit risk mitigant (additional collateral, guarantee etc.). This increases the total cost of borrowing, again lowering access to finance and increasing the likelihood of a loan becoming non-performing.

Fourth, vague collateral valuation may lead to bank granting a loan but more conservatively imposing a lower loan-to-value (LTV) ratio. In this way, the bank achieves overcollateralization as a well-known method of reducing credit risk exposure, but decreases the total loan amount available on collateral, thereby reducing access to finance.

Fifth, without precise collateral valuation, the regulator may be more restrictive and therefore increase the cost of financing. Namely, if there is uncertainty about the loss in the event of a borrower's default because of imprecise collateral valuation, the regulator may impose higher required loan loss reserves (LLRs) on a bank for such a collateralized loan. These higher LLRs pose an additional cost to the bank and induce a rise in interest rates. Again, this lowers access to finance.

Sixth, another regulatory response to imprecise collateral valuation may be for a regulator to impose lower loan-to-value (LTV) for collateralized loans if they are to be treated as a lower-risk asset with lower-risk weights

when calculating risk-weighted assets (RWAs) and capital adequacy ratio (CAR). This potential measure again reduces the loan amount per pledged asset, decreasing access to finance.

Seventh, collateral overvaluation can have yet another negative impact. Namely, overvalued collateral may induce banks to keep the overvalued loan and its overvalued collateral in the bank books. This may artificially increase bank capitalization and bank profits, motivating further delay in the process of bank balance sheet cleansing, thereby delaying a supply of fresh loans. And this directly lowers access to finance.

Therefore, more precise collateral valuation in SEE could decrease or eliminate all of the mentioned weaknesses in collateralized lending and improve access to finance and growth prospects in SEE.

How to achieve this?

SEE countries need to develop collateral valuation standards in line with international standards in this area. For a well-functioning system of collateral valuation for lending purposes it is important to significantly improve the accuracy and quality of collateral valuations (especially real estate). There is an obvious need to establish trust and confidence in valuers and their valuations both among the lenders and borrowers, but also among the regulators and the general public. If we want to see a substantial and long-lasting increase in collateral valuation credibility and better access to finance as a result, it is important to achieve results in several important segments:

- Standards of valuers' professional practice and conduct;
- Competence of valuers;
- Licensing and supervision of valuers;
- Databases for precise valuations;
- Adequate regulatory treatment of collateralized lending.

More precise and credible collateral valuation for financing purposes can increase the credit quality of borrowers and, with adequate regulatory treatment of loans with precisely-valued collateral, may further decrease the cost of borrowing. Therefore, improved collateral valuation may increase both demand and supply of bank credits and support credit growth and economic recovery in SEE.

## Credit risk guarantees for tradable SMEs

Public development programs in SEE have very often been compromised throughout transition period. However, some assistance is badly needed for SMEs and other companies in SEE tradable sector which are facing very serious challenges for growth:

- Strong EU and other foreign competition (China, etc.) in highly liberalized domestic markets;
- Relatively higher average cost of capital compared to their main competitors;
- Underdevelopment or nonexistence of brands<sup>1</sup>;
- Real exchange rate increase in past fifteen years, making locally produced goods and services less competitive.

Therefore, if SEE is expected to grow, a form of public assistance is needed in order to help local competitive tradable sector GDP economy to grow. This assistance however needs to be on a new and much more effective basis. Old subsidies need to die off. New, effective, targeted support frameworks need to be established.

Despite some unfortunate experiences with public development funds and public credit risk guarantee schemes, these types of programs should not be abandoned.

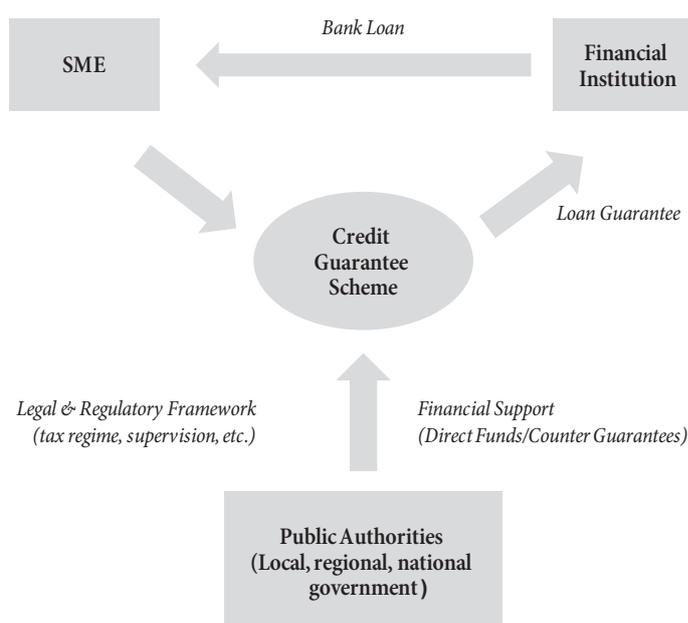
Rather, they should be reformulated in a way that they cost less, target better, and have a well-defined way out strategies (procedures that follow potential SME or other beneficiary default). They also need to be formulated in a way to minimize possibilities of moral hazard conduct of any form (corruption, political pressures, etc.).

Credit risk guarantees issued by the government or a government agency, may be one of the models with high potential to increase access to finance in SEE (see Figure 3). Credit risk guarantees should be issued only to tradable sector projects. With these guarantees, local tradable SMEs could regularly approach the bank and expect decrease in interest rates from three sources:

- Credit risk with a guarantee goes down, and so should the interest rate;
- Risk weight for this credit line goes down, so does the needed capital based on risk weighted assets – interest rate should go down;
- Loan loss provisions should go down even in case of default with a guarantee – interest rate should go down.

Credit risk guarantees have a vast international experience in implementation. If well-organized, it has been shown that these schemes can substantially decrease

**Figure 3: Credit guarantee scheme example**



Source: [11]

1 With some regionally established brands from the second part of 20th century being left to complete demise in unsuccessful privatizations

the cost of borrowing and enable viability to many projects and companies that would otherwise stay undeveloped. They can be treated as an indirect public support to SME development. Important is to limit this support to entities and projects in tradable sector of GDP. This would then contribute not only to economic growth and growth in employment, but also to the achievement of sustainable external macroeconomic balance i.e. from decrease in current account balance to long-term sustainable values. At the same time, that would also be a path to increasing national economy's competitiveness.

An important element of this new credit guarantee public support for SMEs should be a well-designed and effective post-default process that could include private equity, distressed financing and other non-traditional private institutions. The aim of the post-default process should be to minimize any taxpayers' loss in medium term. Therefore, this mechanism basically allows for government balance sheet borrowing with no immediate government costs, and minimal potential costs in the future.

### Nonbanking financial institutions

Nonbanking financial institutions could be divided into two broad categories:

- Non-bank credit institutions are institutions that can provide credits but are not banks: microcredit institutions (MCIs), saving and loan associations (S&Ls), credit unions, etc.
- Securities markets and institutions: corporate bond markets, equity markets, institutional investors (insurance companies, money market funds, investment funds, private pension funds).

Improvements are possible in both areas.

*Non-bank credit institutions* should be introduced in order to increase competition on a supply side of credit markets and therefore provide better access to finance. There could be room for MCIs, S&Ls, credit unions, etc. These institutions might not often directly be involved in supplying loans to tradable sector SMEs, but can increase overall supply of loans in the market and ease access to finance for all potential borrowers.

However, it is important to introduce a good legal framework for these institutions and to provide adequate regulatory and supervisory capacity on national level prior to their introduction. Their emergence in an unregulated environment without adequate supervision in place in some transition countries has proven to have a negative effect on overall development and confidence in national financial system. Useful guidelines for proper regulation of these institutions could be to provide adequate answers to the following questions:

- Can they accept deposits from individuals? If yes, would there be an additional deposit insurance scheme for their deposits?
- How to constrain and/or eliminate financing with extremely high interest rates observed in some other countries?
- How to control moral hazard of borrowers (taking loans for one purpose and using it for a different purpose, etc.)?
- How to regulate the relationship between these institutions and commercial banks? Can these institutions be founded as subsidiaries of commercial banks?
- How to define the scope of their products, and how to avoid overlapping with products of commercial banks if the regulation is different?
- Can these institutions be included in an existing credit bureau system? If not, how to control the overall indebtedness of borrowers?
- How to define the scope of prudential supervision reporting of these institutions and to what authority?
- How to control the risk of some of these institutions supporting gray and/or illegal economy?

With careful consideration of this and other open issues for specific credit institutions, adequate regulation and supervision could be put in place and these institutions could contribute their potential fair share in improving overall access to finance.

*Securities markets and institutions* have been introduced twenty or so years ago with great expectations but with very slim results so far in SEE. They represent far less than normal, almost negligible portion, in overall gross fixed capital formation capacity of national financial systems

(Figure 1). To put it differently, this channel of financial system almost does not generate investments.

Why is that so?

Development of this financial market segment from the start has been undertaken without understanding the nature of this sector. We have been enacting laws, establishing asset management institutions, securities commissions, stock exchanges, forcing companies to trade on the exchange, etc. and still activity was there roughly only in a relatively brief post privatization period of time dominated with takeover activities. No real initial public offerings and sustainable depth in secondary trading of securities have evolved as an established practice in SEE financial markets. A top-down approach has been imposed in trying to develop this market sector, forgetting that only when the companies themselves realize the interest to regularly issue their securities these markets can start to grow.

Credibility, disclosure, competence, and institutional independence are core ingredients necessary for these markets to grow and to take their fair place and role in the overall development of financial systems in SEE countries.

The main problems of SEE securities markets are weak institutions, low disclosure, and a recent heritage of manipulative practices and investor rights abuse.

Major improvements in this area would be in:

- Strengthening institutional capacity in terms of independence, competence, and overall credibility (securities and exchange commission, stock exchange, association of auditors, association of accounting professionals, association of brokers and dealers, etc.);
- Better legal regulation of anti-manipulative practices and protection of investors' rights;
- Legal regulation and establishment of national rating agencies;
- Reevaluation of costs associated with securities issuance and trading, and putting in place a competitive overall fee structure attractive for trading in these markets.

Besides, the securities markets could and should be biased toward the needs of local economies, especially toward growth of SMEs by using the facilities of securities markets. There is no reason why even a startup company, especially with a credit risk guarantee (discussed in

the third part of the paper), could not approach these markets and use their financial capacity for its growth and development.

## Monetary policy and banking regulation and supervision revisited

Monetary policy and banking supervision can sometimes limit access to finance. When countries are targeting an exchange rate officially or unofficially, one associated cost to that could be a relatively high reference rate of a central bank. This higher interest rate is sometimes there not to influence aggregate demand and bring down high inflation, but to support the local currency, prevent its depreciation, and provide relative exchange rate stability. This relatively higher interest rate may be hampering access to finance of all transactors in a financial system.

Reserve requirements as a monetary policy tool should be used in order to prevent excessive credit growth and aggregate demand. That is one of the ways to control the overall supply of money in the system. However, sometimes it can also be used for other non monetary policy purposes i.e. as a macroprudential policy tool. In times of recession and low inflation, these two applications of the same tool may become conflicting. By increasing reserve requirements, as a rule, there is a decrease in access to finance. Monetary policy stance would not call for that in times of disinflation or deflation. Therefore, if disinflationary and deflationary pressures persist in the financial system, it is wise to reassess existing reserve requirements. There is also a very sound reasoning for using reserve requirements as one of the countercyclical tools. Therefore, there is an additional impetus to reevaluate the reserve requirements, since in recession and low inflation they may be over excessive and unnecessarily hamper access to finance in times when it is badly needed for economic recovery.

Banking system that is burdened with NPLs, imprecise collateral valuations and FX risk is bound to have a significant regulatory burden in order to keep it relatively stable. At the same time it will be expensive and will not provide adequate access to finance to support growth and economic recovery. In such a situation,

borrowers will be unsatisfied because there is a high cost of borrowing. Bankers will not be satisfied because there will not be enough banking activities. Supervisors will not be satisfied since substantial risks are in the system that is controlled with heavy regulation. Government will not be satisfied in stagnant economy and low government revenues and the general public will not be satisfied since employment is not rising.

So dealing with these risks is very important for economic growth of a country. Eliminating or significantly decreasing the risks of NPLs, imprecise collateral valuation and FX exchange rate risks can substantially change the risk profile of a banking sector, and create an important opportunity for significant reduction in a cost of banking regulation without jeopardizing financial stability. And that would substantially increase access to finance.

In addition, Basel III should be implemented as soon as possible at least in some relatively important aspects. Such is an introduction of countercyclical capital buffers that could probably slightly ease financing in recession. Also, enhanced regulation of systemically important financial institutions (SIFIs) could possibly ease the burden for systemically unimportant financial institutions and improve access to finance. Dynamic provisioning could also be considered since its counter cyclicity should provide more access to finance in recession.

More effective supervision is also important for access to finance. Namely, if supervision is capable of more effective preventive actions, early detection of bank problems, and early intervention, then the regulatory burden on banks can be less heavy (costly) in any case, and that obviously improves access to finance. And improvements in this area are also possible.

Coming back to monetary policy again. It is futile and costly to proceed with a monetary policy framework without fulfillment of basic preconditions of its effective use. Namely, in the case of Serbia, inflation targeting without gradual but persistent increase in the use of local currency is producing costs without benefits, and is decreasing access to finance. In potential choice of alternative monetary regime, it is important to evaluate the capacity of every monetary model to eliminate or minimize inflationary expectations, eliminate or minimize

exchange rate movement expectations, and minimize FX risk on current exposures of: companies, households, and the government. The quality of monetary policy choice can substantially influence access to finance in every country.

## Conclusions

Waiting for FDI and not doing enough for local endogenous development in SEE is not an option. Economies are stagnant and FDI is low and not foreseen in the near future in adequate volumes. It is important to improve the system in many areas to be more stimulating for local entrepreneurship and SME development. This can be a vital source of new employment and growth for SEE countries. This paper has focused on access to finance as an important part of an overall business environment. Current situation is that financial systems are underdeveloped in all SEE countries, and at the same time access to finance is low. That is a clear signal that substantial improvements should be made in many areas to improve access to finance. It is important to deal with basic risks that are hampering bank credit growth. This paper has focused on NPLs, collateral valuation and credit risk of local competitive SMEs and other companies. Besides banks and their credit growth, more can be done for access to finance both through securities markets, and non-bank credit institutions. Last but not least, adequate monetary policy, and regulation and supervision of banks and other financial institutions can have a very important positive impact on access to finance in SEE.

Reforms leading to substantial increase in access to finance could prove to be one of the most important reforms for SEE countries and their economic recovery.

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