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FINANCIAL SECTOR ASSESSMENT PROGRAM

MONTENEGRO

TECHNICAL NOTE

FINANCE FOR GROWTH

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This Technical Note was prepared in the context of a joint World Bank-IMF Financial Sector Assessment Program mission in Montenegro during September 2015 led by Alexander Pankov, World Bank and Peter Lohmus, IMF, and overseen by Finance & Markets Global Practice, World Bank and the Monetary and Capital Markets Department, IMF. The note contains technical analysis and detailed information underpinning the FSAP assessment's findings and recommendations. Further information on the FSAP program can be found at **www.worldbank.org/fsap**.

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ABBREVIATIONS

ATM	Automated Teller Machine
CAR	Capital Adequacy Ratio
CRS	Credit Reporting System
ECA	Europe and Central Asia
EBRD	European Bank for Reconstruction and Development
EU	European Union
FX	Foreign Exchange
GDP	Gross Domestic Product
HHI	Herfindahl-Hirschman index
IMF	International Monetary Fund
IFC	International Finance Corporation
IFIs	International Financial Institutions
LMI	Low Middle Income
LTD	Loan-to-deposit ratio
FSAP	Financial Sector Assessment Program
MoF	Ministry of Finance
MSME	Micro, Small and Medium Enterprise
MFI	Microfinance Institutions
NBFI	Non-Bank Financial Institution
NPL	Non Performing Loan
POS	Point of Sale
ROA	Return on Asset
ROE	Return on Equity
SME	Small and Medium Enterprise

EXECUTIVE SUMMARY[1]

This technical note reviews with the status access to finance for enterprises in Montenegro, identifies key bottlenecks, and provides recommendations on how to address main challenges. In particular, the note focuses on SME finance by assessing (i) bank SME lending, and (ii) current constraints facing further development and deepening of the non-bank credit sector. The note develops key findings presented to the authorities during the FSAP mission and summarized in the aide-mémoire.

The Montenegrin financial sector has yet to recover from the collapse of the real estate bubble in 2008. The crisis has exposed important weaknesses in the financial sector's governance, oversight and infrastructure which had fueled years of unsustainable credit growth leading up to the crisis. The resulting balance sheet deleveraging and restructuring process has reduced the banking sectors' ability to finance the corporate sector, which continues to suffer from slow economic growth and remaining weaknesses in the business environment.

The financial system is dominated by the banking sector, followed by a small, but growing segment of non-bank financial institutions. The banking sector accounts for about 90 percent of financial system assets and comprises 14 banks which are predominantly foreign-owned. Banks' assets are concentrated in lending products, most of which is provided for corporates and households (mostly mortgages), each representing about 38 percent of total credit. The insurance sector and capital markets remain small despite recent growth. Leasing and factoring companies exist, but their size and contribution to corporate finance is unclear due to the lack of reliable data and weaknesses in the regulatory and supervisory framework. Micro-credit institutions (MCIs) has emerged as an important source of financing for microenterprises, but their size remains limited, with total assets slightly over 1 percent that of banks.

The banking sector remains the main source of formal external finance for Montenegrin SMEs. The size and growth of the SME finance market is difficult to measure due to a wide range of definitions used by financial institutions. Leasing firms provide some equipment financing for corporates, but they have focused on moveable assets. MCIs have focused on cash-flow based short term loans to microenterprises, which are associated with comparatively high operational costs and lending rates. The Investment and Development Fund (IDF), a state owned financial institution established to promote economic development during the financial crisis in 2009, has emerged as an important provider of financing to the private sector, but important questions pertain to targeting and additionally.

Banks consider weaknesses in transparency, governance and management capabilities of SMEs as key impediments to finance SMEs, which on the other hand complain about the cost and availability of bank credit. Shortcomings pertaining to the availability and reliability of corporate financial statements are reported to be more common in the SME segment, which show increased information gaps between banks and firms and associated risks. Banks also cite poor governance and management practices of SMEs as a key challenge, which reduces their capability

[1] This technical note was prepared by a team led by Teymour Abdel Aziz and includes contributions from Johanna Jaeger, Fredesvinda Montes, Adolfo Rouillon, Kalina Sukarova and Gynedi Srinivas (all World Bank). The technical note was prepared within the framework of the Montenegro FSAP update, which was led by Alexander Pankov (World Bank) and Peter Lohmus (IMF), and visited Podgorica in September 2015.

to absorb operational and financial shocks and ultimately increases their default probability, resulting in higher risk premiums charged to this segment. The availability and affordability of bank credit is seen as a key challenge by SMEs to start and operate their businesses. Survey data[2] suggests that smaller sized enterprises face relatively higher constraints to access formal sources of finance compared to the rest of SMEs.

The analysis of the structure and evolution of the banking sector since the crisis validates the arguments of both sides. The collapse of the real estate bubble and resulting credit contraction has had a negative impact on corporate credit through various channels. The rapid rise in NPLs and associated losses has induced a prolonged period of credit contraction by banks. The drop in real estate prices reduced the value of collateral held by banks, inducing them to raise their collateral requirements, require additional guarantees and raise interest rates for new loans. These combined effects impacted the ability of firms to access new credit, leading up to calls for government action. The authorities responded with the expanding the IDF operations, the issuance of more banking licenses and initiatives to cap lending rates in an effort to spur competition and lower lending rates for firms.

The perceived high lending rates observed in Montenegro are in line with the regional averages and largely a result of high overhead costs and risks, not profit margins. The analysis of the evolution of lending rates reveals that they have significantly dropped since their peak in 2010 to reach levels comparable to other countries in the region. The lending rate decomposition is led by overhead costs and risk premia, not profit margins, which have been negative since the crisis and only turned positive in 2014. Banking sector profitability remains very thin and risks to deteriorate further if policy measures such as the proposed blanket ceiling on lending interest rates.

The authorities should focus on policies aimed at reducing information asymmetries and improving the financial infrastructure which are the drivers of the SME finance gap. On the demand side, reforms should focus on increasing the capacity and transparency of SMEs and reduce their cost of doing business. Reforms include improvements in the corporate financial reporting framework to improve the quality and availability of financial information for SMEs as well as improvements in the enabling environment to reduce the cost of doing business and the size of the informal economy. On the supply side, reforms should focus on improving the enabling environment for financial service providers, with the dual objective of promoting competition and creating a level playing field. The financial sector framework should be reviewed to ensure that all credit institutions, including leasing and factoring firms, are subject to adequate oversight and reporting arrangements commensurate to their risks. Improvements in financial infrastructure, including in scope, quality and granularity of credit information, would help financial institutions to better appraise and price the risk of SMEs. In addition, the authorities should review and improve the oversight, governance and business model of the IDF to strengthen the effectiveness and efficiency of this support instrument and monitor the financing conditions for SMEs, which includes data collection and monitoring to support effective decision making.

[2] WB Enterprise Survey for Montenegro (2013)

Table 1: Summary of Main Policy Recommendations

	Recommendation	Timeframe
Regulation and Supervision		
Regulatory and Supervisory Architecture	Strengthen the legal and supervisory framework for leasing, factoring, and other nonbank entities providing credit, with the view to promoting a level playing field (CBM)	NT
	Enhance market conduct supervision and disclosure of loan terms by all entities providing credit, as an alternative to introduction of interest rate caps (CBM/MOE)	I
Financial Infrastructure		
Credit Reporting	Expand the coverage, granularity, and timeliness of information collected and distributed by the CBM's credit registry	NT
Corporate Financial Reporting	Adopt new accounting and auditing legislation consistent with EU norms (MOF)	I
	Introduce simplified financial reporting standards for SMEs and improve verification and publication of reported financial statements by tax authorities (MOF)	NT
Insolvency and Creditor Rights	Strengthen the voluntary debt restructuring framework (MOF)	NT
	Amend personal bankruptcy regime to clarify creditors' rights regarding existing and future loans secured by mortgages (MOF)	I
Government Policies and Programs		
Financial Support Instruments	Strengthen the IDF's oversight, corporate governance and business model (MOF/CBM/IDF)	NT

Note: I-Immediate" is within one year; "NT-near-term" is 1–3 years

I. SMEs: Overview of Economic and Financial Conditions

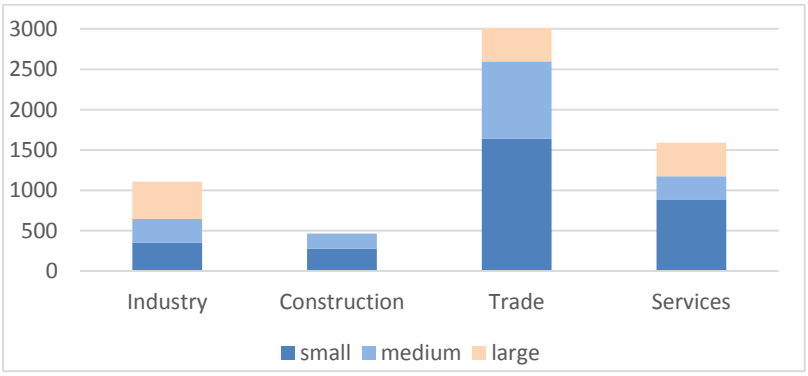
1. The SME sector is the backbone of Montenegro's economy, contributing to its growth and competitiveness. Official statistics define a small and medium enterprise as a firm which fulfills two of three criteria on the number of employees, the company's turnover and assets (Table 2). The latest available statistics from 2013 estimate the number of active Montenegrin SMEs at 22,313[3]. Small firms account for the vast majority of enterprises (99 percent of all firms), while medium enterprises account for only one percent of firms (255 firms). The size of the SME sector is also reflected in its contribution to Montenegro's Gross Domestic Product (GDP), which is estimated at 65 percent (Table 2). Most of the SME sector's turnover is generated in the trade and services sectors, followed by industry and construction (Figure 1).

Table 2. Definition and Size of SME Sector

Firm size	Definition			Data			
	Employees	Turnover (EUR mn)	Assets (EUR mn)	Number of firms	%	Value Added	%
small	1-49	< 10	< 10	22,058	99	480,038	36
medium	50-249	10 to 50	10 to 43	255	1	384,396	29
large	>250	> 50	> 43	38	0	474,745	35
Total					100	1,339,179	100

Source: Monstat (2013)

Figure 1. Sectoral Distribution of SME sector (turnover; in EUR mn)



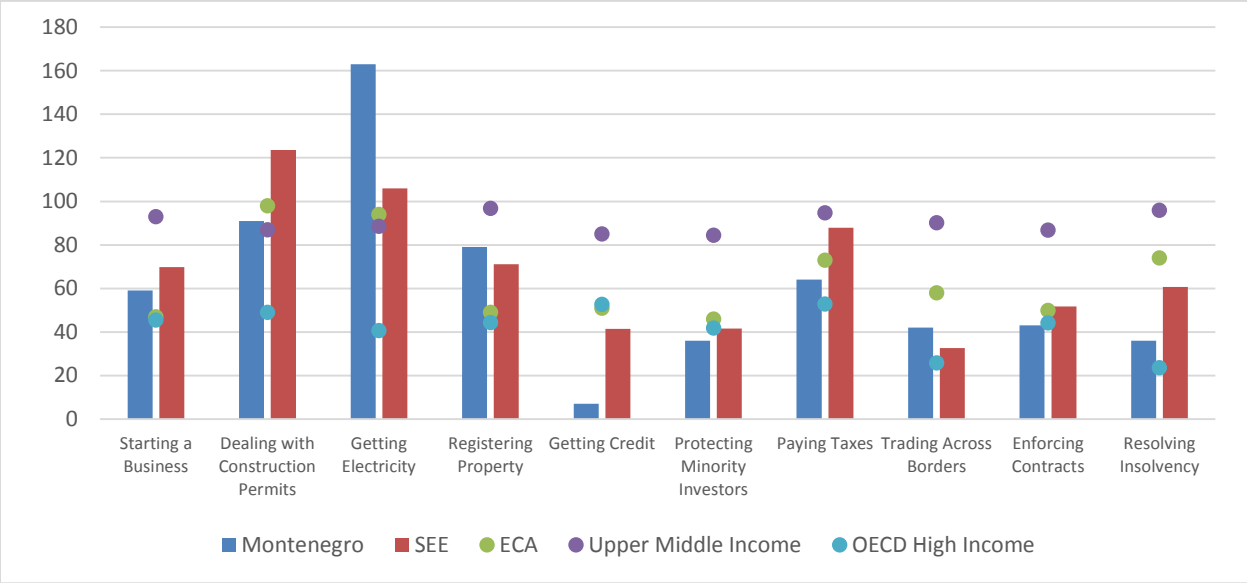
Source: Monstat (2013)

2. The prolonged period of sluggish growth and credit contraction following the collapse of the 2008 lending boom continues to aggravate the operating environment for firms. The combination of weakened external and domestic demand, foreign direct investment and credit growth impair the growth perspectives and financing conditions of Montenegrin enterprises. The difficult economic and financial environment represents a particular challenge for SMEs, which often lack the size, skills and financial buffer to weather economic and financial shocks. Their operating environment is further aggravated through the existence of a sizeable informal sector, which competes with formal firms without being subject to administrative or fiscal obligations.

[3] Source: Monstat http://www.monstat.org/userfiles/file/registri/ANALIZA%20I%20KVARTAL%202012%20GODINE%2028%2005%202012%20-%20ENG.pdf

3. The overall regulatory framework to start and operate a business in Montenegro is conducive to entrepreneurial activity, but important weaknesses remain. Montenegro was ranked 46th out of 189 economies covered by the World Bank's Doing Business 2016 Report[4], which provides a global benchmarking of business regulations for domestic SMEs and their enforcement in ten key areas. The 'Distance to Frontier' score, which measures the 'absolute distance to the best performance in each indicator, has risen 61 in 2009 to 72[5] in 2015, driven by improvements in business licensing and permit issuance processes. The overall sound regulatory framework is mirrored in data on firm creation. Montenegro's new business entry density, defined as the number of newly registered corporations per 1,000 working-age adults (ages 15–64), amounted to 6.9 in 2014, more than twice as high than the average in the western Balkans (3.3)[6]. However, the Doing Business report has identified remaining weaknesses in certain areas of business regulations, in particular construction permits, electricity connections and property transfer/registration (Figure 2).

Figure 2. Enabling Environment for SMEs: Ease of Doing Business Rankings



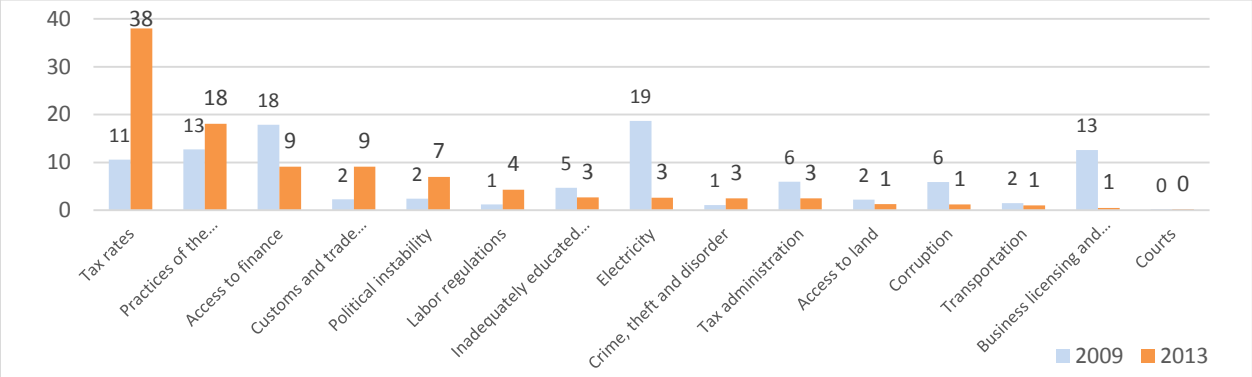
Source: Doing Business 2016 Report

4. Improvements in business regulations are reflected in recent enterprise survey results, with high tax rates, informal sector competition and access to finance as top three constraints. The World Bank's Enterprise Survey, a global standardized survey of a representative sample of enterprises in an economy, was conducted in Montenegro in 2009 and 2013. The question of the firms' biggest obstacles to their business reveals that 'business licensing and permits' dropped from 13% in 2009 to 1% in 2013, the largest shift in relative terms (Figure

[4] The full report can be viewed here: www.doingbusiness.org
[5] 100 is the highest score, 0 the lowest score. More details are found at: www.doingbusiness.org
[6] The western Balkans includes the following economies: Albania, Bosnia and Herzegovina, Croatia, Kosovo, Macedonia, FYR, Montenegro and Serbia. Source: http://www.doingbusiness.org/data/exploretopics/entrepreneurship

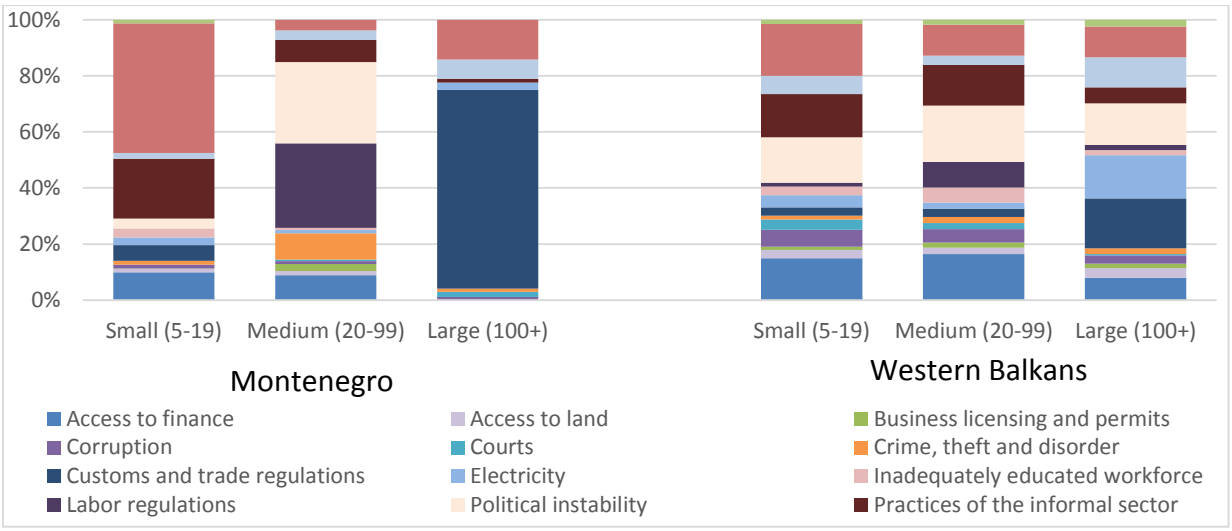
3). Declining responses citing 'tax administration', 'corruption' and 'electricity connections' as primary obstacles are further indications of improvements of the overall enabling environment. The rise in 'tax rates' as the leading top constraint is partially a result of the improved business environment and a common pattern in high income OECD countries featuring 'tax rates' as top constraint (18.3%). The rise in 'informal sector competition' as key constraint is common to countries with a sizeable informal sector, evading the tax and administrative duties of formal firms. The analysis of constraints by firm size reveal that this concern is particularly pronounced for smaller firms (Figure 4).

Figure 3. Biggest Obstacle to Businesses: 2009-2013[7]



Source: Enterprise Surveys (2013)

Figure 4. Biggest Obstacle to Businesses: By firm size[8]



Source: Enterprise Surveys (2013)

[7] Business owners and top managers were asked to choose the biggest obstacle to their business.
[8] Business owners and top managers were asked to choose the biggest obstacle to their business.

5. Demand side data indicates that access to financing remains an important constraint for Montenegrin SMEs. The share of SMEs which do not have a loan or line of credit is at 42 percent (Table 3) and about 10 percent of SMEs consider access to finance as the biggest obstacle to their business (Figure 4). SMEs which do have a loan or line of credit face comparatively high collateral requirements: Almost all SMEs loans are collateralized, and the value of collateral needed to access bank credit rose from an average of 152 percent in 2009 to 227 percent in 2013, reflecting the tightening credit conditions of the banking sector following the collapse of the lending boom.

Table 3. Financial Access Indicators for Montenegrin SMEs[9]

	Montenegro	SEE	Albania	BiH	Croatia	Kosovo	Macedonia, FYR	Serbia	Slovenia
SMEs with a checking or savings account (%)	97.5	95.7	78.3	97.9	99.2	98.0	95.8	100.0	99.4
SMEs with a bank loan/line of credit (%)	57.6	56.6	38.8	67.2	55.8	69.0	54.0	41.5	69.3
Proportion of loans requiring collateral (%)	94.0	83.4	91.8	81.9	87.0	91.5	92.3	65.4	63.2
Value of collateral needed for a loan (% of loan)	227.3	227.0	257.8	185.9	197.0	308.5	320.5	160.2	158.7

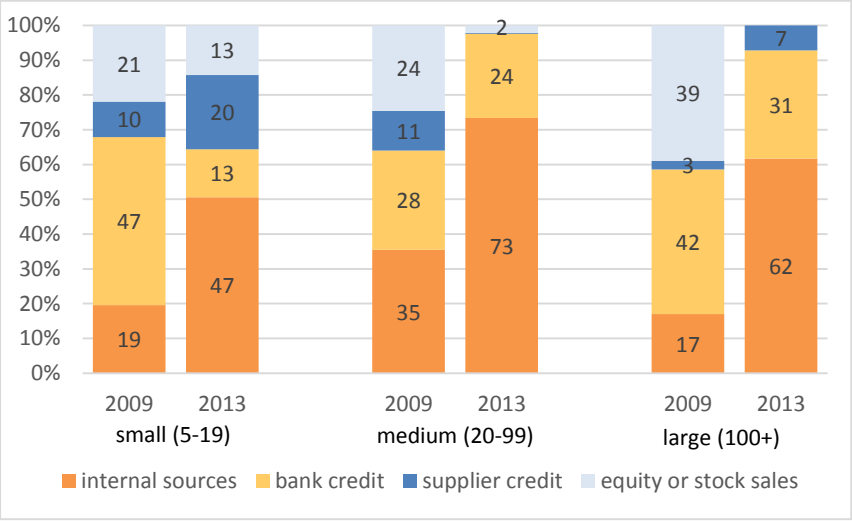
Source: WB Enterprise Surveys (2013)

6. The analysis of the evolution of financing sources for SMEs reveals that the post-crisis credit crunch was particularly pronounced for investment loans. Enterprise survey data reveals a sharp contraction of the share of investments financed by bank credit from 2009 to 2013, forcing Montenegrin firms to rely increasingly on internal financing sources and supplier credit. This trend is observed for all firm sizes, but is most accentuated for small firms, where the share of bank credit contracted from 47 percent in 2009 to 13 percent in 2013 (Figure 5). The results are in line with official statistics on the share of investments financed by credits from financial institutions (22% of total investments)[10]. These findings mirror the analysis of supply side data over the same period, which shows an overall contraction of credit to the corporate sector (Figure 8) and a shift in the maturity structure of the banking sector's corporate loan book from long/medium term loans to shorter term loans and facilities. Data on the evolution of corporate sector investments in fixed assets shows a moderate recovery since 2012 and indicates that the decline in bank financing is unlikely to be explained by reduced demand (Figure 6).

[9] The team has selected the following comparator countries consistently throughout the technical note: Bosnia and Herzegovina, Albania, Serbia, Macedonia, Croatia and Slovenia.

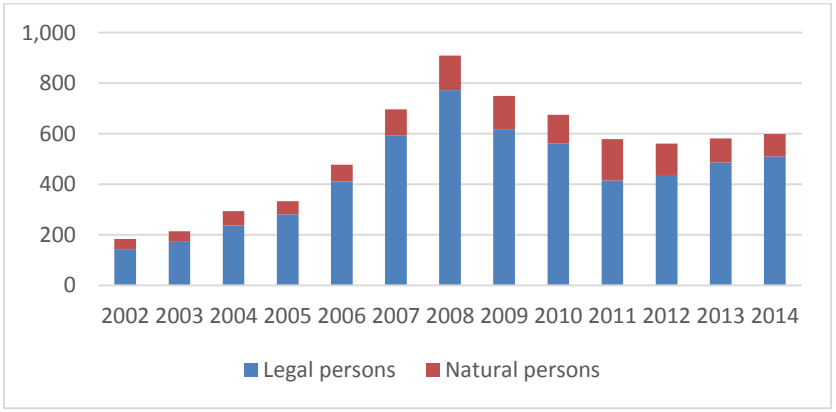
[10] Source: MonStats (2013). http://www.monstat.org/userfiles/file/publikacije/godisnjak%202014/investicije.pdf

Figure 5. Evolution of Investment Financing Sources (% of investments, by firm size)



Source: WB Enterprise Surveys

Figure 6. Evolution of Investments in Fixed Assets (mn EUR)[11]



Source: Monstat

7. The authorities have aimed to address the credit crunch and difficult lending conditions through a combination of financial and regulatory interventions. The authorities have attributed weak credit growth primarily to banks' overly-high risk aversion and to insufficient competition in the banking sector and focused on policy responses aimed at increasing the number of credit institutions. The Investment Fund for Development (IDF), a state owned development institution, was established by law[12] in 2009 in an effort to facilitate access to credit to the corporate sector through the provision of financing, both directly and through financial

[11] Source: Monstat, 2015. Annual reports on investment in fixed assets (Form INV-01) at current prices covers legal persons, if they are direct investors, regardless of regular or temporary work, construction or liquidation. The criteria for coverage of legal persons are the number of employees (five or more). Realized investments by the private sector without legal persons (investments from natural persons) are result of estimation done by Statistical Office of Montenegro and include investments built by citizen and private sector.

[12] Law on the Investment Fund for Development of Montenegro JSC (OGM 88/09 of 31 December 2009).

intermediaries (a more detailed discussion of the IDF is provided in section VI). The persistence of perceived high lending rates has led authorities to consider the introduction of lending rate caps.

8. The team shares the assessment on deteriorating financing conditions for firms, but believes that policy responses should put greater emphasis on addressing the underlying causes. This note aims to provide the authorities with an assessment of Montenegro's financial sector and its enabling environment with regards to its current ability and future potential to support greater access to finance for SMEs. The remainder of the note is structured as follows. Section **Error! Reference source not found.** provides an overview of the key financial service roviders in Montenegro. Section II focuses on the banking sector's financial intermediation capacity and efficiency. Sections IV and V discuss key improvements in the financial sectors' regulatory and supervisory framework and financial infrastructure which are of particular relevance to support greater access to finance for SMEs. Section VII provides a more in depth discussion of the IDF as the government's main policy instrument in support of SME finance. Section VII summarizes the recommendations of the note.

II. FINANCIAL SERVICE PROVIDERS

9. The banking sector dominates the financial system and accounts for about 90 percent of financial system assets and about 93 percent of GDP[13]. There are 14 banks operating in Montenegro, up from 11 in 2013, and is predominantly owned by foreign subsidiaries (Table 4). Non-bank financial institutions (NBFIs) exist, but remain underdeveloped. The insurance sector has been growing steadily at an average annual rate of 3 percent in the past five years, but remains limited in size, accounting for 2 percent of GDP. While the nascent stock exchange's market capitalization is significant, the turnover is very low and the bond market is thin. The total size of the five micro-credit organizations is 2 percent of GDP with assets slightly over 1 percent that of banks. The leasing market is small and has been declining since the crisis.

Table 4. Structure of Financial Sector: Credit Institutions

	2007	2008	2009	2010	2011	2012	2013	2014	2015 1/
Number of Institutions									
Banks	11	11	11	11	11	11	11	12	14
Domestic-majority owned	3	2	2	2	2	2	2	5	5
Foreign-majority owned	8	9	9	9	9	9	9	7	9
Leasing companies	4	4	4	4	5	5	5	5	5
Microcredit organizations	5	5	5	5	6	6	6	5	5
Assets									
Banks	2,975.4	3,309.7	3,025.2	2,943.7	2,809.7	2,808.3	2,959.2	3,136.3	3,138.6
Domestic-majority owned	634.2	510.7	391.5	341.4	289.4	280.0	288.9	642.7	653.0
Foreign-majority owned	2,341.3	2,799.0	2,633.8	2,602.3	2,520.3	2,528.3	2,670.3	2,493.6	2,485.6
5 largest banks	2,488.6	2,797.1	2,470.6	2,262.7	2,073.2	2,029.9	2,082.2	2,139.1	2,132.1
Leasing companies	167.9	246.5	252.1	203.3	170.6	143.4	117.9	75.6	72.9
Microcredit organizations	54.4	79.1	75.4	58.7	44.4	36.2	34.6	38.3	41.0

Source: CBM, MEF

A. The Banking Sector

10. Banks are the main source of external finance for SMEs. Most banks count SMEs as part of their clientele and offer a broad range of financial products and services for this segment (Table 5). Precise information on the volume of credit to SMEs is not available due to the absence of data by banks and authorities. There is no uniform definition of an SME that is used by banks and the authorities to measure and track their access to financing over time. Most banks do not have a separate internal definition of SMEs, which are typically integrated within the global corporate finance units. Calculations from interviews and bank balance sheet data yield estimate bank credit to SMEs to account for 10 – 20 percent of corporate credit. Most banks have not developed delivery models which are adapted to the characteristics and needs of SMEs and rely largely on conventional relationship lending business models. The microfinance sector plays an important role financing microenterprises and small firms with operate in the informal sector.

[13] As of June 2015.

Table 5. Overview of Available Financial Products for MSMEs in Montenegro

Product / service	Banks	MFIs	Other NBFIs
Deposits			
Sight, savings and term deposits	✓		
Long-term savings	✓		
Loans			
Microloans		✓	
Loans to SMEs	✓	✓	
Lines of credit	✓		
Issue credit and debit cards	✓		
Other Services			
Leasing	✓		✓
Factoring	✓		✓
Domestic and international remittances	✓		✓

Source: Interviews conducted during FSAP mission

11. The deterioration of lending conditions for the corporate sector have had particularly negative impact on the availability and affordability of bank credit for SMEs. The rise in NPLs and risk premia has led banks to adapt more stringent credit underwriting policies to allocate resources to the most profitable segments while managing risks. The resulting shift from pre-crisis lending practices, which primarily relied on real estate collateral, to conventional credit appraisal methods increased the importance of complete and reliable financial statements which many SMEs are struggling to meet. The greater share of informal activity and blending of personal and business finances are additional features which are more common to SMEs, increasing the information asymmetry and associated risks. The challenging economic environment leaves many SMEs more vulnerable than their larger peers as they are less likely to absorb economic shocks due to their size and limitations in management capabilities, product diversification and alternative financing sources. Most banks have not developed delivery models which are adapted to the characteristics and needs of SMEs and focus on other segments with a better risk/return profile, with a focus on larger firms and consumer lending.

B. Non-bank Financial Institutions

12. The leasing market is small and has been on a declining trend since the 2008 crisis. The number and value of leasing contracts has been on a declining trend and reached EUR 15 million – about 0.4 percent of GDP – in 2014, which is below regional and income group averages. Leasing services are provided by four leasing companies having legal entity status, and by two banks. Leasing has the potential to play important role as a financing instrument for equipment SMEs, which often lack sufficient collateral to obtain conventional investment loans, but the sector's growth requires improvements in the legal, regulatory and fiscal framework. A discussion of the current leasing framework in Montenegro is provided in section IV.

13. Montenegro has active factoring companies, but information on the sector is scarce due to the absence of supervision. Similar to leasing, factoring could be an important source of financing for SMEs as it enables them to obtain short term financing without the collateral requirements of conventional bank loans. However, weaknesses in the legal, regulatory and supervisory framework prevent factoring from realizing its full potential. The supervisor lacks any oversight over factoring companies, which further reduces the transparency of the financial system as around EUR 600 million worth of loans have been effectively transferred by banks out of the oversight of regulator. A draft law on factoring companies has been under discussion, which should grant the supervisor powers of direction over the use of factoring companies and create transparent and verifiable standards for recording assets held by such vehicles. A discussion of the current factoring framework in Montenegro is provided in section IV.

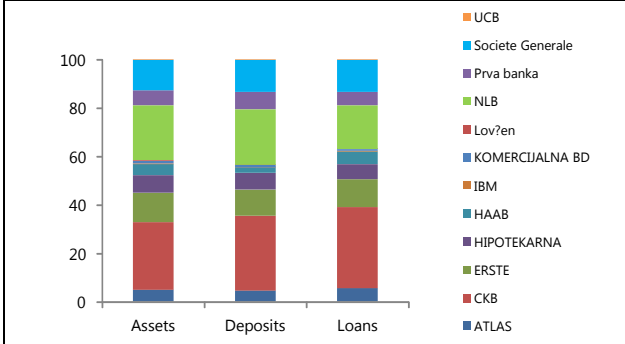
III. BANKING SECTOR: STRUCTURE, EVOLUTION AND EFFICIENCY

A. Banking Sector Structure and Credit Growth

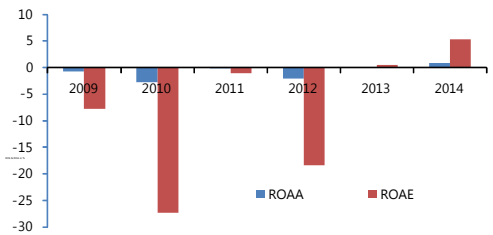
14. The banking sector is characterized by comparatively high market concentration, but continues to struggle with low levels of profitability (Figure 7**).** Banks' assets are concentrated in lending products (60 percent) with most of the lending in the trade sector and households (mostly mortgages), each representing about 38 percent of total loans. Loans to nonresidents represent 18 percent of the total. Liabilities are concentrated in deposits (75 percent of the total), which are split closely between demand (46 percent) and time (53 percent) deposits. Foreign deposits represent about 20 percent of the total deposits. However, the comparatively high market concentration does not translate into high profitability. The banking sector has only returned to positive results since 2013, and the profitability indicators remain significantly below averages of regional and income group peers.

Figure 7. Banking Sector Concentration and Profitability

Market Concentration



Return on Equity and Assets

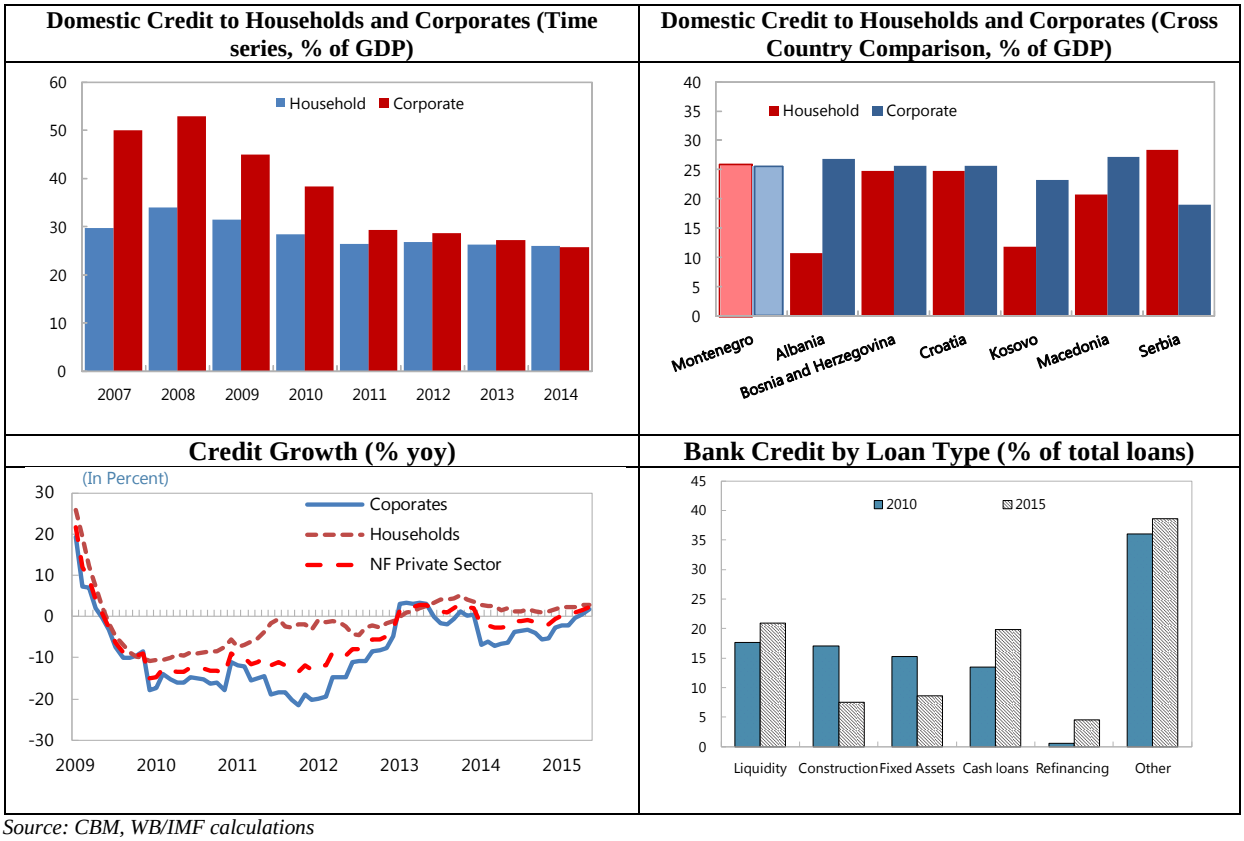


Source: CMB, WB/IMF calculations

15. The banking sector has undergone a prolonged period of credit contraction which disproportionately affected corporate credit (Figure 8). The five largest banks account for more than two thirds of total assets (Figure 7). The rapid rise in NPLs and associated losses has induced a prolonged period of credit contraction by banks. The drop in real estate prices reduced the value of collateral held by banks, inducing them to raise their collateral requirements (as % of loan value), require additional guarantees and raise interest rates for new loans. The protracted recovery of real estate prices and slow-down of economic activity in the aftermath of the crisis further reduced the risk appetite of the banking sector and decelerated the sector's recovery and credit grows. The banking sector's corporate credit balance sheet remains impaired with comparatively high NPL levels, which reflect both existing rigidities in the NPL resolution framework as well as structural weaknesses in banks' underwriting practices. These factors continue to obstruct the recovery of credit growth, reducing the availability and affordability of financing to the corporate sector.

16. The banking sector does not suffer from liquidity constraints, but its current funding structure reveals longer term vulnerabilities which may affect their ability and willingness to provide longer term financing. With an aggregate Liquidity Coverage Ratio (LCR) of 863 percent, banks have ample and possibly excess liquidity. The short-term resilience remains even when deposit outflows under the severe adverse scenario are assumed and sovereign bonds and required reserves are excluded from the pool of high quality liquid assets. However, with an aggregate Net Stable Funding Ratio (NSFR) of 124 percent and two banks below 100 percent, long-term liquidity resilience is lower. A stress test conducted as part of the 2015 FSAP[14] revealed that an assumed outflow of deposits could cause several banks to fall below the 100 percent NSFR threshold, mainly due to low asset quality and unstable funding sources.

Figure 8: Banking Sector Credit by Sector (% of GDP)[15]



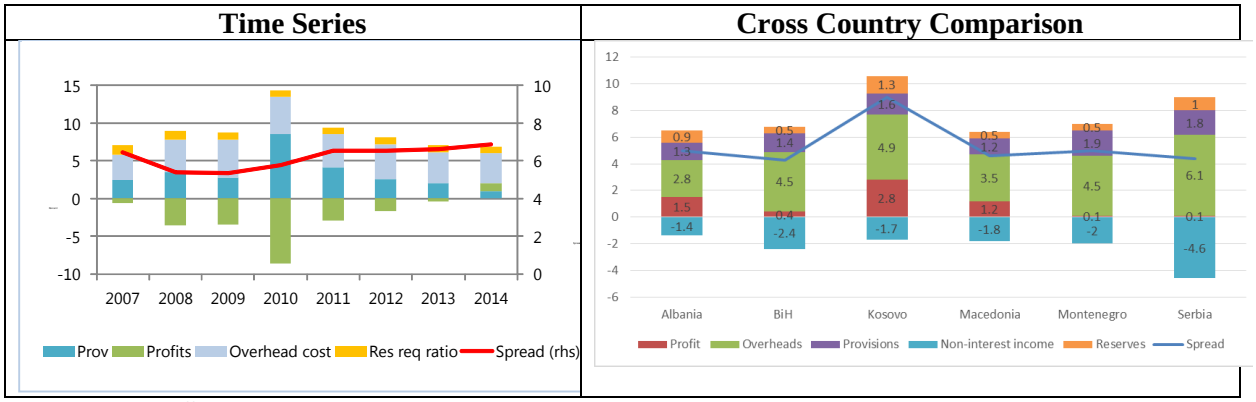
Source: CBM, WB/IMF calculations

[14] The details of the stress tests are provided in a separate technical note on Stress Testing.
[15] Due to implementation of IAS 39 in 2013, the definition of loans has changed thereby impacting data comparability.

B. Banking Sector Concentration and Efficiency

17. The analysis of the banking sector's interest rate decomposition suggests that bank spreads are not driven by profits, but mainly costs and risk premia. The banking sector's persistent weak profitability does not provide any evidence for low competition. Two studies conducted by World Bank and IMF staff using different methods come to the same conclusion. The first study, which analyzes the evolution of the interest rate spread decomposition over the 2007-14 period, shows that spreads are driven predominantly by overheads and provisions while profit margins are mostly negative, a finding which is also broadly observed for individual banks. The second study, a cross country analysis of interest rate spreads in countries in south Eastern Europe (SEE), confirms that overhead costs and provisions are the main drivers of bank spreads and reveals another important result (Figure 9). The share of profits to total income is the lowest in the sample, while the share of overhead costs to total income is the highest. The comparatively high share of overhead costs may be partially explained by the fact that the Montenegrin market is relatively small, limiting the opportunities to reach economies of scale in the presence of fixed costs.

Figure 9: Interest Rate Decomposition Analysis



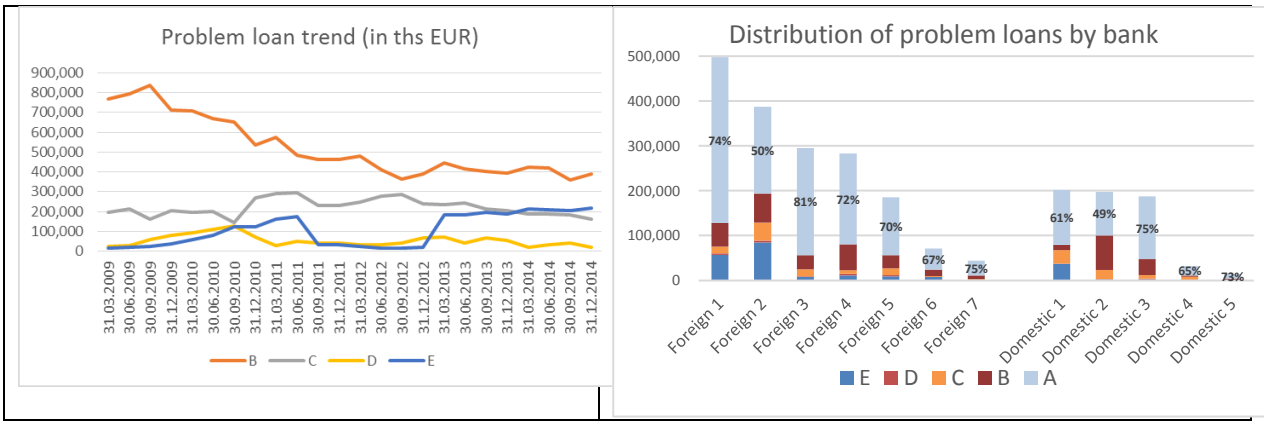
Source: WB/IMF staff calculations

18. The findings of lending rate decomposition analysis do not back the hypothesis of limited competition in the banking sector. The analysis of market concentration and market power do not provide evidence of dominance in the market. As of June 2015, the two largest banks held, respectively, 19 percent and 16 percent of deposits, and 18 percent and 14 percent of loans; while the top five banks held 70 percent of total deposits and two-thirds of total loans. The HHI was about 0.12 for each assets, deposits, and loans by end 2014, indicative of no market concentration. The index also shows a reduction in concentration in the period 2010–14.

19. The persistence of high problem loan ratios over time in the banking sector points to remaining structural weaknesses which are not associated with the collapse of the real estate bubble in 2008. The share of problem loans for all impaired loan categories remained high over the last three years and are likely a result of structural factors pertaining to remaining high risks in the real sector. The presence of wide variations of problem loan ratios between different banks are in line with comparable gaps in other financial soundness and profitability indicators and point to

significant differences in risk taking and management between them. However, even the three 'best performing' banks in terms of problem loans have on average more than a fifth of their loan portfolio past due, and the analysis of the maturity structure of problem loans reveals the largest portion consists of more recently classified loans (category B and C). Older NPLs (one year or more past due) account for only 28 percent of all problem loans and are concentrated in three banks (Figure 10). Existing weaknesses the regulatory and supervisory framework for NPLs and restructured loans are likely to contribute to an understatement of NPLs and overstatement of their quality, which further aggravates the problem.

Figure 10: Problem Loans: Evolution and Distribution[16]



Source: CBM, WB/IMF calculations

20. The prevalence of high NPLs is particularly acute in the corporate loan portfolio amounting to around two thirds of the overall portfolio. Banks' loan portfolio reached 2.4 bn EUR in mid-2015, with 41.3 percent of corporate loans and 36.7 percent of household loans (Table 6). The NPLs in the corporate sector account for 71 percent of all NPLs. The average corporate credit NPL ratio is 29 percent, almost three times higher than the average household credit NPL ratio (10 percent). The sectoral distribution of corporate NPLs shows particularly high NPL levels in the manufacturing, construction and transport sectors. These results need to be treated with caution due to potential remaining biases from the real estate crisis. It may capture shell enterprises which were established to channel speculative real estate investments through, as well as enterprises which invested in real estate projects beyond their 'core business' to benefit from the boom. However, such loans are not likely to comprise a significant portion of the corporate NPL portfolio in light of the significant NPL sales to SPVs and write-offs. Even in the case of a significant adjustment, corporate credit NPLs would likely remain above average.

[16] Loan classification is based on the 'Decision on Minimum Standards of the Credit Risk Management' (2012), which classifies loans using the following past due days: A (<=30), B (31-90), C (91-270), D (271-365), E (>365). It is important to note that due to the implementation of IAS 39 in 2013, the definition of loans has changed thereby impacting data comparability.

Table 6. Decomposition of Banking Sector Loan Book in Montenegro

	Gross loans	% of total loans	Non-performing loans	% of total loans
Household loans, residents	879,968	36.7	91,570	3.8
Corporate loans, residents	989,098	41.3	284,021	11.9
Agriculture, forestry and fishing	28,455	1.2	1,789	0.1
Manufacturing	108,753	4.5	53,608	2.2
Wholesale and retail trade; repair of motor vehicles and motorcycles	406,908	17.0	120,457	5.0
Construction	111,266	4.6	42,988	1.8
Transport and warehousing	49,180	2.1	19,364	0.8
Accommodation, food, arts, recreation and other services	73,124	3.1	14,839	0.6
Public administration and defence	131,201	5.5	11,985	0.5
Real estate	24,313	1.0	4,599	0.2
Financial and insurance sector	15,624	0.7	2,067	0.1
Professional, scientific and technical activities	40,274	1.7	12,325	0.5
Loans to non-residents	433,724	18.1	12,104	0.5
Other loans	93,650	3.9	14,420	0.6
Total	*2,396,440*	*100.0*	*402,115*	*16.8*

Source: CBM

21. High levels of competition are expected to contribute to greater access for financial services, but may also produce risks if rising levels of indebtedness are not adequately monitored. The promotion of competition is expected to contribute to greater access for SMEs as the increased competition for saturated market segments will ultimately drive banks to explore new business opportunities in less saturated markets, including SMEs. However, rapid credit expansion may lead to the emergence of new risks, including over indebtedness of households and speculative investments, if credit growth is not adequately monitored. The rising level of banking competition in Montenegro has compressed interest rate spreads to the levels threatening the survival of some smaller banks with higher funding and operating costs and a weaker client base. Anecdotal evidence suggests that cost pressures on the funding side, coupled with declining lending rates in the fight for better clients, have driven some banks into a high-danger zone. In particular, some banks have been extending long-term loans with limited or no collateral based on their very short-term funding base.

22. The proposed introduction of interest rate caps may have an adverse impact on credit to SMEs as it could prevent banks from adequately pricing associated costs and risks. The authorities should consider adopting policy measures which address the underlying factors contributing to high lending rates. On a macro level, lending costs are elevated by structural rigidities which include the high cost of long-term funding, as reflected in high sovereign yields, a sluggish economy, high credit risks and low NPL recovery rates[17]. Improvements of the corporate financial reporting framework and credit reporting system would further contribute to

[17] Banks will also continue to confront significant competition from foreign intermediaries that directly finance investment and challenges in terms of limited bankable investment opportunities. Addressing these issues requires a broader structural reform agenda aimed at improving economic flexibility, including in labor markets, and promoting diversification through strengthened competitiveness.

reduce lending costs for SMEs as banks would be better equipped to appraise and price risks, lowering risk premia. Concerns on consumer protection are better addressed by strengthening market conduct oversight and enforcement, transparency provisions for financial service providers and financial literacy of consumers.

IV. FINANCIAL SECTOR REGULATION AND SUPERVISION

23. The main law governing the regulation and supervision of financial institutions is the banking law[18]. Banking law (Article 105) mandates the central bank to regulate and supervise banks, foreign bank branches, micro-credit financial institutions, credit unions and entities involved in credit guarantee operations. The banking law gives the CB the authority over all entities engaging in banking operations (collecting deposits and issuing credit), but does not cover other credit institutions such as leasing or factoring companies. The current banking law does not provide a legal framework defining prudential norms for non-bank financial institutions other than the categories listed above, and does not subject them to non-prudential norms applicable to regulated entities, which includes reporting requirements to the credit registry and market conduct regulation and supervision.

24. Leasing firms are licensed as regular commercial entities and are not subject to financial sector regulation or supervision. The current framework does not define permissible activities for leasing firms. The Law on Financial Leasing provides a legal framework for financial leasing transactions, but does not regulate the entities authorized to conduct such transactions[19]. As a result, leasing companies engage in a broad range of activities beyond financial leasing. The banking law allows banks and micro-credit institutions to provide financial leasing services, but does not restrict non-regulated entities from conducting such transactions.

25. The legal framework in Montenegro does not provide a definition of factoring and does not regulate or supervise factoring companies and their activities. The only mention of factoring is in the banking law (art 6.2), which stipulates that banks undertake the activity of "buying, selling and recovering debts (factoring and forfeiting)". As a result, factoring companies have engaged in a broad range of activities beyond conventional factoring transactions. The absence of a legal framework defining factoring transactions has contributed to legal uncertainty on the use and enforcement of such contracts.

26. The current regulatory and supervisory framework does not provide a level playing field between financial institutions and creates risks and vulnerabilities for SMEs. The absence of a requirement mandating non-regulated credit providers does not allow banks to effectively measure the full credit exposure of individuals and firms, which impairs their ability to

[18] Banking Act, Official Gazette of the Republic of Montenegro, No 17/08, 44/10, 40/11.

[19] In 2014, the Ordinance on the content and manner of keeping records of financial leasing companies (Official Gazette of Montenegro, no. 50/14 of 11/28/2014) has been adopted, in accordance with the obligation arising from the Law on Consumer Loans (Official Gazette of Montenegro, No. 35/13). Pursuant to the said Law, the Ministry of Finance is required to keep records of the creditor financial leasing companies and their financial intermediaries. To this end, the list of financial leasing companies is published on the website: http://www.mif.gov.me/biblioteka/

adequately assess their repayment capacity and associated risks (a more detailed discussion is provided in the section on The effectiveness **and efficiency of financial intermediation is contingent on the presence of an enabling financial infrastructure, which is particularly relevant for SMEs.** The key building blocks of the financial infrastructure architecture spans from payment systems, credit reporting, corporate financial reporting to collateral registries, contract enforcement and insolvency proceedings. A well-functioning financial infrastructure helps reduce information asymmetries and transaction costs between economic agents and the financial system, which are of greater importance to low-income populations and smaller enterprises. The following sections provide an overview on reforms in a subset of the financial infrastructure which are expected to have the strongest impact on increased access to finance for SMEs in the Montenegrin context: (i) Credit Reporting, (ii) Corporate Financial Reporting and (iii) Insolvency and Creditor Rights (separate technical notes provide a more detailed analysis on (ii) and (iii)).

27. Credit Reporting). This weakness is particularly relevant for the credit appraisal methods for SMEs, which rely more heavily on the creditworthiness of entrepreneurs compared to larger firms with qualified financial statements. Non-regulated financial entities which are not subject to market conduct regulation and supervision may engage in harmful market practices which cannot be sanctioned due to the regulatory gap.

28. The regulatory and supervisory framework governing financial institutions should be reformed to strengthen its stability, integrity and intermediation potential. Reform should be guided by the overarching principle of creating a level playing field between institutions providing similar type of financial services, which strengthens the stability (reducing risk of regulatory arbitrage through financial transactions between different legal forms to optimize tax burden and regulatory requirements), integrity (market conduct regulations) and efficiency (more providers of financial services competing at arm's length) of the financial system. The authorities should review the overall financial sector regulatory and supervisory framework with the view of a) creating an enabling regulatory and supervisory framework for leasing and factoring, b) adopt an activity based regulatory approach to provide a level playing field between financial institutions to allow the provision of equivalent financial services under the same rules (eg. leasing, factoring, microcredit, etc.).

V. FINANCIAL INFRASTRUCTURE

29. The effectiveness and efficiency of financial intermediation is contingent on the presence of an enabling financial infrastructure, which is particularly relevant for SMEs. The key building blocks of the financial infrastructure architecture spans from payment systems, credit reporting, corporate financial reporting to collateral registries, contract enforcement and insolvency proceedings. A well-functioning financial infrastructure helps reduce information asymmetries and transaction costs between economic agents and the financial system, which are of greater importance to low-income populations and smaller enterprises. The following sections provide an overview on reforms in a subset of the financial infrastructure which are expected to have the strongest impact on increased access to finance for SMEs in the Montenegrin context: (i) Credit Reporting, (ii) Corporate Financial Reporting and (iii) Insolvency and Creditor Rights (separate technical notes provide a more detailed analysis on (ii) and (iii)).

Credit Reporting

30. Montenegro has a well-functioning public credit registry, which is administered by the Central Bank. It has been operating since 2000 and currently collects and distributes data of banks, MFIs and the Investment and Development Fund (IDF)[20]. The CR collects positive and negative information on individuals and firms and is updated on a monthly basis, although banks are required to register new loans issuance. Data is submitted electronically and managed by a specialized unit within the supervision department of the central bank.

31. The legal framework is provided through the Central Bank Law[21] and bylaws[22], mandating the central bank to collect and distribute data from licensed credit institutions (banks, MFIs, credit guarantee companies). The CR is authorized to collect and distribute data from unlicensed credit institutions and non-bank institutions such as utility companies or mobile operators, but it is currently only done with the IDF. The data privacy and consumer protection provisions are regulated by the central banks law and bylaws as well as the Data Privacy Law. Participating financial institutions are required to maintain systems and processes to ensure the integrity and confidentiality of the data, and must receive client consent[23] prior to a credit information request. The CR data is used for banking supervision and to generate reports on the indebtedness of households and firms.

[20] The IDF is a public financial institution mandate to finance investment projects and support access to finance for SMEs. It provides direct loans to firms and indirect lending through commercial banks. It is not regulated or supervised by the Central Bank.
[21] Central Bank of Montenegro Law „Official gazette of MNE“ no.40/10,46/10,6/13, article 37
[22] Decision on Credit Registry („Official gazette of MNE“ no.27/11,64/12 + annex) and Decision on Reports to be Submitted to the CBCG („Official gazette of MNE“ no.64/12, article 10)
[23] Prospective clients may refuse access, provide authorization for one request (for loan inquiry) or provide consent for unlimited requests as long as the loan contract is active.

32. While the overall performance and governance of the CRS is sound, its performance could be significantly improved to advance financial inclusion. The key shortcomings are summarized below:

- **Data sources:** Important providers of credit are not mandated to submit or consult data to CR (the law allows for it), giving an incomplete snapshot of a borrower's indebtedness. This includes leasing firms and factoring firms, as well as store credit. The inclusion of data from non-regulated credit providers should be ensured to effectively measure the full credit exposure of individuals and firms. In the medium-term, the inclusion of additional information from non-financial institutions (eg. utility companies) should be considered to better predict payment behavior. The inclusion of non-regulated credit providers and non-financial entities in the CRS system may require a reform of the legal and regulatory framework.

- **Data quality:** The timeliness of data could be improved. Banks report that there is a lag between the reporting of a loan until it shows up in the database, ranging between 1-2 months, during which time borrowers can get additional loans without knowledge of banks. In addition, banks complain about insufficient history and granularity of data: Historical data is only available if the client has been in default for more than 270 days, in which case the letter 'E' is stored in the database. There is no record if an individual was past due eg. 100 days and paid back the loan (this info is not saved in the report given to consumers). In the medium-term, the quality of credit information could be further improved by linking up the CR to other databases to complement the information on the creditworthiness of borrowers with other relevant information sources (eg. company registry, tax authorities, court databases, etc.)

- **Data coverage:** The coverage of the CR has gaps due to weaknesses in the identification of foreign nationals. There are unique identifiers for nationals, but not for foreign residents, which represents a gap (different identifiers used such as passports; foreign ids; etc.).

33. The authorities should review and reform the CRS with the objective of expanding coverage, granularity, and timeliness of available credit information. The review could be guided by the comprehensive framework outlined in the 'General Principles for Credit Reporting', which were issued by the World Bank in September 2011. Priority should be given to ensuring that all credit issued in the economy are reflected in the CR, which would include loans given by stores/suppliers[24] as well as leasing and factoring companies. Additional improvements could target the granularity of financial information that is distributed, including more detailed information on the credit history and payment behavior of borrowers, and better identification and coverage of nonresidents in coordination with relevant home authorities. The CRS could benefit from further improvements to assure the comprehensiveness and quality of financial information on firms, which may include simplified reporting templates, strengthened enforcement and quality control of data reported by banks, and exploring the possibility to connect the CRS database with other vital sources of financial information for individuals and firms (eg. court databases; corporate

[24] One possible solution is to requiring all stores and firms who issue consumer credit or supplier credit to conduct their transactions through a licensed financial institution.

registries; etc.). A recent working paper entitled 'Facilitating SME financing through improved Credit Reporting[25]' provides more guidance on reform design and implementation.

Corporate Financial Reporting

34. Montenegro has undertaken important efforts to improve the corporate financial reporting framework since the 2006 FSAP, but further challenges remain pertaining to the application and enforcement of financial reporting. Notable progress was made in strengthening core accounting and auditing standards (including IFRS, ISA, and the Code of Ethics), publication requirements, and development of the accounting and auditing profession. Financial regulators have sufficient powers to enforce financial reporting and auditing standards for financial institutions. However, there is no legal definition of Public Interest Entity (PIEs), and there is no public oversight system (POS) or a mandatory system of quality assurance review (QAR) over the external audit function. Requirements to file financial statements and audit reports and make them public are in place, but in practice many companies fail to timely adhere to their filing obligations and published information is not complete. The application of full IFRS requirements for all legal entities presents a particular challenge to SMEs, which are often unable to apply the accounting standards adequately. Capacity constraints on all levels of the financial reporting chain have a negative impact on the quality of corporate financial information, which increases the cost and availability of financing.

35. Improving the quality of financial reporting requires further improvements in the legal framework and institutional capacity. The ongoing modernization of the legal framework should include: (i) a formal legal definition of public interest entities; and (ii) provisions for a public oversight system and a mandatory system of quality assurance review over the statutory audit function. Given the capacity constraints both in the SME sector and the audit profession, the authorities should consider introducing simplified financial reporting standards for smaller entities such as the "IFRS for SMEs,"[26] which would alleviate the workload of SMEs and audit professionals while still maintaining sound financial reporting standards. Finally, the tax authorities should be equipped with adequate resources and tools to effectively oversee and enforce the timely publication of financial statements and quality controls to promote the completeness and accuracy of reported financial information.

Insolvency and Creditor Rights

36. In recent years Montenegro has undertaken a number of legal and institutional reforms seeking to improve framework for NPL enforcement but certain gaps remain. Both secured and most unsecured claims can now be enforced using out-of-court procedures before the Public Enforcement Officers (PEOs). The workload of the courts that used to be in charge of

[25] World Bank. 2014. International committee on credit reporting: facilitating SME financing through improved credit reporting. Washington, DC: World Bank Group. http://documents.worldbank.org/curated/en/2014/05/24310503/international-committee-credit-reporting-facilitating-sme-financing-through-improved-credit-reporting

[26] The IFRS for SMEs are issued by the IASB and are a self-contained standard designed to meet the reporting needs of smaller companies.

enforcement cases has been alleviated since the appointment of 30 PEOs in 2014. Nonetheless, there remains substantial variability in the speed and quality of enforcing some legal provisions by the courts. The legal framework governing bankruptcy is comprehensive and security rights are adequately protected in liquidation. Business rescue culture is not developed. Reorganization is not extensively used and most bankruptcy cases end up in liquidation. Out-of-court reorganization ('workouts') is not a common practice. Land titling and cadastral information has been improving but gaps remain, especially in rural areas. Finally, the Secured Transaction Register is not interconnected with other databases that are related to movable property (notably, the Registry of Vehicles).

37. The recently enacted Law on Voluntary Restructuring of Debts should be complemented with additional legal measures. This law ('Podgorica Approach') establishes a framework to facilitate out-of-court negotiations and debt restructuring between a debtor and a plurality of creditors, providing tax and loan provisioning incentives. Eligibility for using such mechanism, however, is restricted to creditors holding claims classified as B and C exclusively, which could prevent the adoption of a reorganization plan that encompasses all claims as it is usually needed in cases of serious financial distress or insolvency. Also, the out-of-court debt restructuring mechanism needs to be complemented by a fast track procedure to confirm workout plans previously approved by a legally defined majority of creditors ('prepackaged plans'), making such plans obligatory with respect to all creditors. This would encourage creditors to participate in out-of-court negotiations and limit threatening attitudes from minority creditors ('hold-outs').

38. At the same time, the recent Law on Consumer Bankruptcy could negatively affect both the collection of existing NPLs and the issuance of retail and SME loans secured with mortgages. This new law establishes a radical exemption in favor of a bankrupt debtor's house, which cannot be sold in bankruptcy (not even to satisfy security rights created over such immovable asset), provided that this is "commensurate with the basic housing needs of the consumer." If such provision is applied to loans secured with a mortgage created before the entering into force of the Law on Consumer Bankruptcy, most of such loans would be considered unsecured and its collection perspective could be significantly reduced. As for the future, individual loans secured with mortgages will likely disappear from the market if the mentioned prohibition of enforcement of a consumer's house in bankruptcy remains in force, and no adequate safeguards are provided to protect the rights of secured creditors. The impact on financial inclusion, credit access, and cost (in particular for households and SMEs) should therefore be carefully considered.

VI. GOVERNMENT POLICIES AND PROGRAMS IN SUPPORT OF SME FINANCE

39. The authorities have introduced a number of initiatives and programs aimed at supporting the development of SMEs and their access to finance. Public support instruments can play an important role to address structural and cyclical market failures which may adversely impact access to finance for SMEs (which may be more accentuated in private-sector led financial sectors. The government's main financial support instrument is the Investment and Development Fund (IDF), which was established to support investment and economic development, including access to finance for SMEs. Products include a wide range of financing programs (direct and through banks) for firms in various sectors and regions, as well as factoring. The European Investment Fund has also been active in Montenegro through the provision of partial credit guarantees targeting SMEs through three programs which were introduced since 2012. Non-financial support to SMEs is mainly channeled through the SME Directorate within the Ministry of Economy, providing business development support and other technical assistance to strengthen the capacity of SMEs.

40. The Investment and Development Fund (IDF) has the potential to support greater access to finance for SMEs, but it requires operational and institutional reforms to avoid distortive impacts and to facilitate sound corporate governance. Since its establishment in 2010, IDF has significantly expanded its lending operations to around 85 million EUR at end-2014. While support for SMEs is included in IDF's mandate, there are few loan products specifically catered to SMEs' needs, and there is no sufficient evidence of additionality or effective use of the fund's resources. Interest rates are capped, and direct lending accounts for almost half of the operations with potential distortive effects on the market. The below-market interest rates are reported to have attracted mainly SMEs which had already access to bank financing, requesting comparable terms for existing or new bank loans. As a result, banks have undertaken efforts to lower interest rates to the extent possible or offer a blend of concessional IDF and market based credit to retain clients. The provision of concessional lending may have put pressures on lending rates, which benefits existing clients, but such policies could present risks in the medium/long run in in the context of a market with very low profitability. It may threaten the viability of small banks with higher funding costs and a smaller client base to engage in riskier lending to attract clients, and deter new entrants from entering the market. To increase its effectiveness and minimize market distortions, IDF should increase the share of SME-focused programs through commercial banks and gradually remove the formal caps on interest rates.

41. Additional questions pertain to the IDF's strategy, targeting, additionality and monitoring framework. The IDF's products are very fragmented and appear to cover a very broad spectrum of sectors and firms, raising question pertaining to its strategic vision and targeting. There does not seem to be a link with an overall SME development and financial inclusion strategy,

and there is no clear process which explains how the objectives are set and how the instruments are selected (eg. lines of credit vs other financing/support instruments). The absence of a targeting policy for the lines of credit, which are mostly open to all firms irrespective of their size, gives the opportunity to extend loans to larger corporations which may not face finance constraint (largest loan is EUR 4.5 million). As loans are offered at subsidized rates and bank margins are capped at 3 percent (for financial intermediary loans), banks are incentivized to select their best clients for IDF financing. The IDF does not appear to have a well-developed measurement and evaluation (M&E) framework which would allow to track the outcomes of its interventions, and has not conducted impact evaluations which would allow to assess the additionality of the fund. The authorities should consider introducing a robust M&E framework and conduct impact evaluations to assess the impact of its programs and link the findings to adjust the program as needed.

42. The current regulatory, supervisory and governance framework of the IDF should be reviewed. There is no supervisory body independent of Board of Directors which could help mitigate potential conflicts of interest. IDF is not regulated or supervised by the central bank, but volunteers to adhere selectively to certain standards. The absence of effective prudential regulation and supervision (eg. monitoring of prudential ratios and risk management) raises contingent liability risks given the government guarantee for any capital shortfalls, and impedes authorities to detect and address weaknesses in governance and risk management. Finally, the IDF is not subject to provisions on market conduct, which may put their clients at a disadvantage.

VII. POLICY RECOMMENDATIONS

Regulation and Supervision: The regulatory and supervisory framework governing financial institutions should be reformed to strengthen its stability, integrity and intermediation potential.

Recommendations

- Review the overall financial sector regulatory and supervisory framework with the view of a) creating an enabling regulatory and supervisory framework for leasing and factoring, b) adopt an activity based regulatory approach to provide a level playing field between financial institutions to allow the provision of equivalent financial services under the same rules (eg. leasing, factoring, microcredit, etc.) (CBM, MOF)

- Consider strengthening market conduct regulation and supervision as an alternative to the proposed cap in lending rates (CBM, MOF)

Financial Infrastructure: The financial infrastructure should be strengthened further to reduce information asymmetries and transaction costs and create an enabling environment for financial intermediation, facilitating greater access to financial services for individuals and SMEs.

Recommendations

Credit Reporting

- Expand the coverage, granularity, and timeliness of information collected and distributed by the CBM's credit registry (CBM, MOF)

- Improve the quality of financial information on firms though simplified reporting and strengthening enforcement and quality checks, and explore the possibility to connect the CRS database with other relevant databases (eg. court databases; corporate registries; etc.). (CBM, MOF, other relevant bodies)

Corporate Financial Reporting

- Adopt new accounting and auditing legislation consistent with EU norms (MOF)

- Introduce simplified financial reporting standards for SMEs and improve verification and publication of reported financial statements by tax authorities (MOF)

Insolvency and Creditor Rights

- Strengthen the voluntary debt restructuring framework (MOF)

- Amend personal bankruptcy regime to clarify creditors' rights regarding existing and future loans secured by mortgages (MOF)

- Improve the functioning of the secured transactions registry, which includes the interconnection with the database of the Registry of Vehicles and the introduction of electronic filing of secured transactions at the register.

43. ***Government Policies and Programs:*** The IDF has potential to enhance access to finance for SMEs, but should consider shifting its focus from a provider of concessional corporate finance to an enabling role supporting the provision of market based SME finance.

Recommendations

- Review the regulatory and supervisory framework of the IDF to ensure effective oversight according to global best practice (MOF, CBM)

- Review the governance and business model to ensure its effectiveness and efficiency while minimizing market distortions (MOF)

- Introduce a robust M&E framework and consider conducting impact evaluations to measure outcomes and impact over time (MOF)