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**BANK LENDING TO SMALL AND MEDIUM ENTERPRISES
THE REPUBLIC OF SERBIA**

**Finance and Private Sector Development Department
Europe and Central Asia Region**

Serbia - Bank Lending to Small and Medium Enterprises Executive Summary

1. **This report presents findings of a study of Bank lending to small and medium enterprises (SME) in Serbia¹.** The study uses methodology developed by the Bank and already used in a number of studies in South America. The study is based on answers to standard questionnaires and detailed on-site interviews with eight banks. The interviewed banks are the most active in SME lending in Serbia and account for about 70 percent of the total market.

2. **The SME segment has become strategically important for Serbian banks.** The large corporate sector entities were the focus of attention in the early days – but most of the larger corporations have already decided where they will do their banking business. The most successful large clients are dealing directly with “mother” banks. In the next phase of banking markets development, banks’ attention has focused on consumer finance, which has resulted in very fast credit growth and borrowing from abroad. The recent banking market trend, however, is the increasing focus on small and medium corporate clients – the markets perceived as having a good growth and profit potential. Banks are competing in developing specific products for this market, in broadening access, as well as in improving the quality of financial services provided to the SMEs.

3. **Banks are currently offering a fairly broad range of both tailored and standardized products and are increasingly flexible with product pricing.** This includes checking, savings and time deposit accounts; export and import loans; overdrafts for working capital and investment loans; business credit cards; various types of payment services; Internet and phone banking. Other banking services, such as payroll and social security payments are also available. The product offer generally depends on the type of customer. When offering their products, most banks do not use any particular sequencing -- they simply offer what the client needs.

4. **The majority of Serbian banks have well developed and effective lending procedures.** Branch offices still play critical role in providing access points for SME lending and financial services. Significant changes to further improve efficiency and reduce cost are taking place. Technological advancements (better databases, better telecommunications and connectivity, better software packages) are actively exploited to increase flexibility and improve risk management techniques.

5. **Basel II Capital Adequacy Standard is likely to have an important impact on the SME lending in Serbia.** Larger banks in Serbia are, almost without exceptions, owned by large banks from the European Union (EU). The EU banks are currently

¹ The report was written by S. Brajovic Bratanovic, ECSPF. She prepared the study and interviewed seven of the eight banks included in the study. M. Edwards, ECSPF, participated in interviews with two banks and interviewed one bank. A. Popovic, ECSPF, helped with general data collection and documented financial infrastructure and state programs for SME finance, in Annex I to Annex III to this report. C. Zapalla, ECSPF, prepared the tables and charts summarizing interviews with banks, which are provided as Attachment to this report.

subject to a major change in the process of implementing the new Basel II capital standard. The Basel II implementation directly affects banks' risk management policies and practices and especially the policies and practices for risk management related to the SME lending. The Basel II implementation requires "mother" banks to prepare consolidated financial statements, including their foreign subsidiaries. The use of internal models in capital management and capital adequacy calculations implies that their subsidiaries would be requested to use the same models, possibly with some changes in the value of parameters for certain types of risks.

6. **Banks that are a part of international banking groups have already changed (or are well advanced in changing) the terms of access, the risk analysis and risk management practices both for small enterprises (SE) and medium enterprises (ME) groups.** In other words, there are no more "SME clients" in Serbia, but rather the SE and the ME clients. The SE group has become part of banks' "retail lending" arms and the ME group has become part of banks' "corporate lending" arms. In general, there seems to be a learning process with banks focused on developing access methods that are more efficient and more cost effective.

7. **Risk management is separated from sales, mostly centralized and increasingly automated.** For the SEs, the risk assessment is based on scoring models. Banks with majority domestic ownership or with the foreign non-bank ownership are a bit slower, but generally following the trend and planning to do the same. While supported by internal modeling techniques, the ME credit risk appraisal and management is more traditional and conceptually similar to that of large enterprise clients.

8. **The existence of financial infrastructure, such as credit Bureau of the Banking Association and the Solvency Center in the NBS, have been of major importance to allow introduction of modern credit risk appraisal techniques.** In addition to assistance with risk appraisal, the Solvency Center has also been used as part of SME targeting process. The NBS is trying to be innovative and broaden the range of services to banks and other potential creditors.

9. **The Government plays an active role in stimulating SME market development through credit programs.** A number of Government entities provides credit and guarantee facilities for the SMEs. While banks stressed the importance of financial infrastructure, they did not feel that the SME credit and guarantee programs introduced or managed by Government entities are particularly relevant. A more systematic assessment of impact of government-sponsored programs would be useful.

10. **The most pressing issue is the high cost of regulatory compliance, which increases the cost of banking and, therefore, the cost of credit.** This is a problem for SME clients. While the credit is generally available for SMEs, their profitability is not high enough to be able to use the credit in a significant way as a source of investment or working capital. Statistics shows that, at the current level of interest rates, none of the enterprises in Serbia can afford to carry credit in excess of about 8-10 percent of the total liabilities.

Serbia - Bank Lending to Small and Medium Enterprises

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1. INTRODUCTION

1. **Small and medium enterprises (SME) typically account for significant share of employment in a developing country, so their growth is directly related to the capacity of job creation.** Large companies often start as SMEs, so the SMEs capacity to develop and invest becomes an important precondition for economic growth. The SMEs in different countries have different financing structures, determined by both firm-specific characteristics and countries' financial market and business environment. SMEs' financing structure, and the mix between internal and external financing, are influenced by both the demand and the supply side factors.

2. **From a public policy perspective, it is important to distinguish between the demand-side and the supply-side of access to finance, as both need to be adequate to assure a sustainable financing of the SME sector.** In the presence of market imperfections, any financing constraints will reflect on SMEs' investment decisions. Financing constraints on the supply side are typically analyzed by looking into the sensitivity of investment with respect to internal funds². However, the SMEs typically do not file detailed (externally audited) financial statements and they do not nor raise equity or debt in public markets, so there is little data needed for empirically testing financing constraints.

3. **The approach used for the study of SME finance was an interview based assessment of the supply side factors that reflect the conditions of firms' access to finance.** In addition to collecting the available data on bank lending to SMEs, the approach taken in this study was to use of a tabulated questionnaire, followed by on-site interviews with banks' top management. The questionnaire was developed for analysis of the South American SME credit markets. It includes 92 questions divided in three sections covering:

- (i) Bank's strategic interest in SME business;
- (ii) Details of the bank's SME financing, including: (a) demand factors, (b) competition; (c) bank's corporate strategy; and (d) macroeconomic, regulatory, institutional factors; and
- (iii) Business model and risk management processes used by the bank when dealing with SMEs, including: (a) financing – how is financing promoted; (b) cost – how is costs minimized: and (c) credit risk management – how are risks controlled.

4. **We interviewed eight banks in Serbia, which are the most active in SME lending and account for about 70 percent of the total SME credit market.** The interviewed banks are different types of banking institutions. Of the eight banks, five are

² Due to information asymmetries, are external funds are assumed to be more costly than internal funds. Higher sensitivity of investment to internal funds suggests the presence of financing constraints.

subsidiaries of major banks in the European Union³, one is an international bank specialized in SME lending⁴ and two are larger locally owned banks⁵. The interviews were confidential, so banks felt practically no constraint in sharing their information, with an understanding that the data would be reported in an aggregate way, without disclosing each bank's strategy or positions.

5. The questionnaire covered three topics of interest for SME finance, including strategic interest in SME markets, SME business model and SME risk management.

Questions on strategic interest in SME market were answered by the manager who has an overview of the bank's SME business. Business models used in dealing with SMEs were discussed with the SME business manager and the credit risk manager. Questions on risk management were discussed with the credit risk management. In general, banks were open and friendly and provided the information that they had on how their bank deals with the SME segment, what business models it uses, and how they conduct their risk analysis.

6. However, it has to be mentioned that the questionnaire has not been formulated to effectively address the specifics of Serbian SME market⁶.

The questionnaire was originally designed for the South America Region and geared to capture the specifics of these SME markets. Also, some of the Serbian banks did not have at-hand the required data or statistics: because they are not systematically collecting such statistics; because the volume of non-performing loans is so small that there is practically no statistical information; or because the persons that we interviewed did not have or know the details. The areas lacking significant responses are related to capital charges, the contribution of SMEs to the bank's revenues, costs, and risks, growth projections of the segment, and information related to the non-performing loans portfolio.

7. The percentages referred to in this study were calculated based on the sample of total banks interviewed. By definition, each bank accounted for 12.5 percent of the total sample⁷. Although the size, ownership and business characteristics of the

³ The major international banks interviewed are Raiffeisen from Austria, Societe Generale from France, Hypo Alpe Adria (HAA) from Austria, Intesa Bank from Italy and UniCredit from Austria.

⁴ ProCredit Bank is well known in the area and specialized in SME lending, with shareholders including EBRD and a number of German banks.

⁵ Komercijalna Banka is the largest domestically owned bank with major shareholders being the state (40%) and EBRD (25%). Agro-Industrijska Komercijalna Banka - AIK is a local bank with minority share of HAA (about 7%) and the remainder are about 3000 small (local) private investors.

⁶ The questionnaire was originally developed for use in South America, where banking and SME markets have somewhat different characteristics and banks conduct their business using different models, as compared to subsidiaries of large banks from the European Union.

⁷ For example, if six out of eight banks responded positively to a question, the quoted percentage would be 75 percent.

banks interviewed in Serbia were different, the percentage was not related to the size of the bank or of its SME portfolio⁸, or to its specialization⁹.

8. **The report is organized as follows:** Section 2 describes the banking sector and markets in Serbia, reviews definition of SMEs and provides key characteristics of the SME finance market in Serbia. Section 3 discusses details of SME access to finance. It describes the drivers and obstacles, government programs, and characteristics of the market environment. Section 4 focuses on how banks engage in lending to SMEs, describing their business models and their risk management. Section 5 provides a number of conclusions on the conditions of access and future trends.

2. BANKING SECTOR AND SME MARKETS IN SERBIA

2.1. Banking Sector in Serbia

9. **Access to banking services in Serbia is generally is good.** Banking sector in Serbia comprises 36 banks¹⁰, with the total assets of RSD 1,376 billion (USD 22.93 billion) as of end-June 2007, total capital of RSD 260 billion (USD 4.3 billion) and employment of about 29,000 persons. There are about 2250 access points, of which 86 are classified as “business units”, 452 as “branches”, 1,437 as “branch offices”, and 275 as “teller units”. Table 1 shows the banking sector in Serbia by bank size. The banks that were interviewed included **all** banks in the “Over RSD 100 billion” group and **four** (out of five) larger banks from the “RSD 50-100 billion” group.

Table 1 - Serbian Banking Sector

| Balance Sheets Total In RSD billion | 30 June 2007 | | |
|--|--------------|----------------|---------|
| | No. of Banks | In RSD billion | % Share |
| Over 100 | 4 | 537 | 39 |
| 50-100 | 5 | 349 | 25 |
| 10-50 | 16 | 424 | 31 |
| Under 10 | 11 | 66 | 5 |
| Total | 36 | 1,376 | 100 |

10. **Loans account for about 47.5 percent (RSD 653 billion) of the total banking assets. Lending to enterprises (58.7 %) and households (38.4 %) dominate in the composition of lending.** The high credit growth continued in 2007 with total credit

⁸ The largest bank interviewed, Raiffeisen, has assets of Euro 1.7 billion. The smallest, AgroBanka Nis has assets of about Euro 300 million.

⁹ Although the bank’s specialization could well influence bank’s organization, its business processes or risk management practices. For example, Raiffeisen - a large international bank- is likely to have a different approach as compared to ProCredit – a bank specialized in SME lending, or AgroBank Nis – a small local bank.

¹⁰ 22 banks are foreign owned and account for about 76.4% of the total banking assets; 6 are with majority ownership of physical and legal persons domiciled in Serbia and account for about 9.6 % of the total banking assets; and 8 are majority state owned and account for about 14% of the total banking assets.

increasing by RSD 109.3 billion (20%) relative to the end-2006. Five banks with the largest amount of approved credits accounted for about 43 percent and ten banks with the largest amount of approved credits for 66 percent of the total lending activity of the banking sector.

Table 2 - Credit Market Volume in Serbia

(In USD billion, end of period)

| | December 2006 | | June 2007 | |
|----------------------------|---------------|---------|-----------|---------|
| | Domestic | Foreign | Domestic | Foreign |
| TOTAL | 9.1 | 1.6 | 11.1 | 1.6 |
| o/w Economic Agents | 5.2 | 1.1 | 6.3 | 1.2 |
| % Economic Agents | 57% | 69% | 57% | 75% |
| o/w Households | 3.4 | - | 4.2 | - |
| % Households | 37% | - | 38% | - |

2.2. Definition of SME Clients

11. **The definition of small and medium enterprises is provided by the Law on Accounting and Auditing.** The Law defines MEs as firms meeting three criteria: (i) average number of employees is 50 to 250; (ii) annual turnover is €2.5-10 million (in RSD equivalent); and (iii) average property value is €1-5 million (in RSD equivalent). The Solvency Center in the NBS (which maintains enterprise information in Serbia) reports 2,412 enterprises that meet these criteria as of end 2006. The SE enterprise has the value of at least two criteria lower than that specified for the MEs. The Solvency Center reports 73,547 enterprises in the SE category as of end 2006.

12. **Of the eight banks interviewed, only one uses the criteria formally specified in the legal framework.** Other (seven) banks typically use annual turnover to classify clients in the SEs and MEs segments. Three banks also take into account the total bank's credit exposure to the client as part of the definition. However, the ranges of turnover significantly vary between the banks. The cut-off point between the SEs and MEs is modified from time to time. Two banks have recently increased the cut-off amount. The summary of banks' definitions of SEs and MEs is provided in Table 1 and Table 2 in the Attachment.

13. **The fact that banks do not use the same definitions for SMEs reflects the heterogeneity of interviewed banks and the banking system** (See Annex 1). The turnover that defines the SE ranges from Euro 500,000 to Euro 3 million and it varies from bank to bank. The ranges for the total credit exposure defining SE client are Euro 25,000 to 200,000. Companies with turnovers below the specified SE values are classified as micro-enterprises. The ranges for turnover for the MEs clients are from Euro 750,000 to Euro 10 million, again ranging from bank to bank. Larger (international) banks tend to use higher turnover amounts.

14. **The lack of single definition for SEs and MEs makes comparison between bank lending practices and somewhat inconsistent.** Moreover, it would be very difficult to construct a single definition of SEs and MEs to be used for the study. Therefore, in line

with the mentioned SME finance methodology, the heterogeneity of ranges observed in the definition of SMEs have been ignored in analyzing the SME finance practices. The banks' references to SE and ME was kept as such, without getting into further details.

2.3. Credit Market Structure and SME Lending Volumes

15. **Enterprises generally dominate the composition of lending.** (Table 3). While the growth of banks' loan portfolio has been high, it has been higher for households than for the enterprise sector. Household lending was predominantly consumer finance, but mortgages are becoming increasingly important.

Table 3 - Lending Activity In Serbia

(In RSD billion)

| | 31 Dec 2005 | | 31 Dec. 2006 | | 30 June 2007 | | Growth Q2 2007 | Growth 2006 |
|-----------------------------|-------------|------|--------------|------|--------------|------|-------------------|----------------|
| | Amt. | % | Amt. | % | Amt. | % | % | % |
| Enterprises | 282 | 64.8 | 323 | 59.2 | 384 | 58.7 | 110 | 115 |
| Households | 125 | 28.7 | 196 | 36 | 251 | 38.4 | 113 | 157 |
| Housing construction | 23 | 5.4 | 47 | 8.7 | 63 | 9.6 | 113 | 203 |
| TOTAL | 434 | 100 | 545 | 100 | 654 | 100 | 110 | 125 |

16. **The SME segment is becoming an increasingly important client of banks in Serbia.** (Table 4). Of the large enterprises, about 73 percent have received loans from the banking sector in 2005 and 2006 and the total credit amount with over one year maturity fall by 11 percent in the same period. The amount of credit to SMEs dramatically increased over the same period, with growth rates as high as 255 percent for entrepreneurs.

17. **The credit growth trends are strong, and the opportunities for further growth are still significant.** For MEs, the number of enterprises with loans from banks stands at 57.4 percent, which is still significantly smaller than for the large ones. The small enterprises with a term loan account for only 10.8 percent of the total number and the percentage is still smaller for entrepreneurs – about 5.2 percent, indicating that serious competition is yet to take place.

Table 4 - Term Credit in Serbia

| Enterprise Type | 2004 | 2005 | 2006 |
|---------------------------|---------------|---------------|---------------|
| Entrepreneurs | | | |
| Number | 13,662 | 19,575 | 21,431 |
| o/w with term credit | 180 | 843 | 1,109 |
| % with term credit | 1.3% | 4.3% | 5.2% |
| Total assets | 26,181,023 | 48,927,537 | 62,546,052 |
| Total credit amount | 423,039 | 1,080,245 | 2,331,366 |
| % of total assets | 1.6% | 2.2% | 3.7% |
| % annual increase | - | 255% | 215% |
| Small Enterprises | | | |
| Number | 73,556 | 72,888 | 73,549 |
| o/w with term credit | 3,988 | 6,574 | 7,955 |
| % with term credit | 5.4% | 9.0% | 10.8% |
| Total assets | 971,723,860 | 1,170,423,165 | 1,493,142,496 |
| Total credit amount | 62,938,268 | 89,214,300 | 123,779,195 |
| % of total assets | 6.4% | 7.6% | 8.3% |
| % annual increase | - | 43% | 39% |
| Medium Enterprises | | | |
| Number | 2,146 | 2,288 | 2,412 |
| o/w with term credit | 932 | 1,200 | 1,385 |
| % with term credit | 43.4% | 52.4% | 57.4% |
| Total assets | 729,325,469 | 834,101,973 | 1,039,864,719 |
| Total credit amount | 48,245,457 | 63,408,861 | 87,390,430 |
| % of total assets | 6.7% | 7.4% | 8.4% |
| % annual increase | - | 31% | 29% |
| Large Enterprises | | | |
| Number | 670 | 702 | 677 |
| o/w with term credit | 461 | 518 | 500 |
| % with term credit | 68.8% | 73.8% | 73.8% |
| Total assets | 2,742,270,790 | 3,460,045,395 | 3,826,518,048 |
| Total credit amount | 276,423,707 | 425,747,955 | 408,255,238 |
| % of total assets | 10.0% | 12.3% | 10.6% |

Source: Solvency Center, National Bank of Serbia

18. **There is no standard pattern of entering the SME market segment, which could be an indication that the market is still underdeveloped.** Some banks first offer some form of payment services to get to know the client and then offer loans and investment products. Other banks prefer to attract clients with lending products and then offer payroll or cash management services.

19. **However, all banks are ultimately offering both deposit and loan products and all kinds of financial services to micro, small and medium clients.** The loan products include working capital and investment finance, as well as other credit-related products (e.g., credit cards, overdrafts, guarantees; see Attachment, Figure 2). The most important lending products are short-term loans and overdrafts. In principle, the type of products offered to SMEs is not much different from what is offered to larger companies. The larger foreign banks seem to offer the larger range of products and more sensitive pricing than the domestically owned banks. There are no structured finance products available in Serbia.

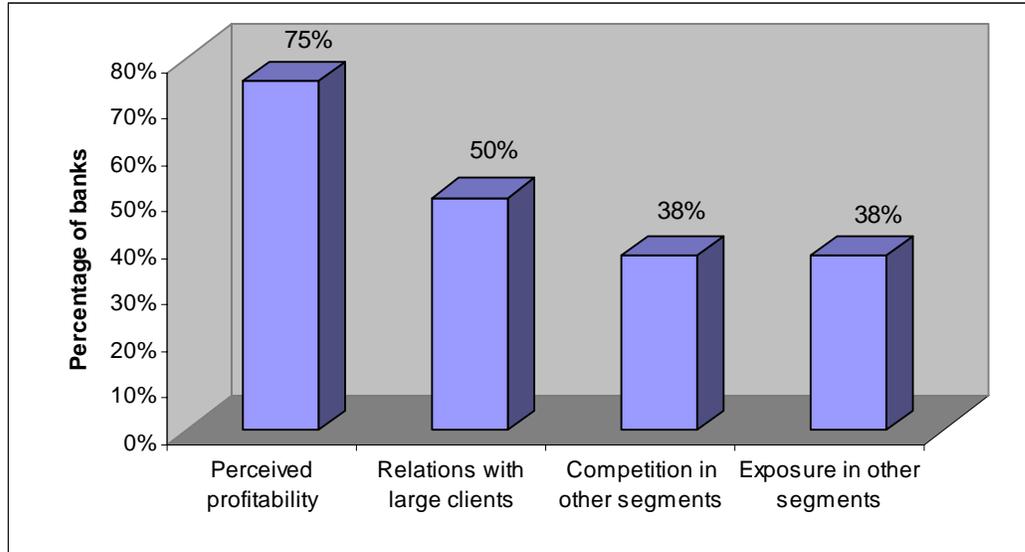
3. WHAT IS BEHIND THESE FACTS?

20. This section aims to describe the factors that drive banks' increasing focus on SMEs. It starts with discussing drivers that foster this involvement followed by review of the market environment regarding size, prospects, level of competition and demand. The next theme is obstacles to SME lending, as identified by banks. The section discusses Government's programs that aim to increase SMEs' access to finance. The final topic is financial infrastructure identified by banks as being a major contribution to increased SME lending.

3.1. Drivers

21. **The key driver for the growth of SME lending in Serbia is the perceived profitability of an enterprise.** The summary of banks' answers on what drives their interest in SME lending is shown in Figure 1 (below). Banks estimate that the profit potential from SME lending is high, in fact much higher than for the large enterprises, and that the potential profits and capacity for market growth will more than compensate the higher cost of lending and more unstable risk profile in the SME segment. The earning capacity stems not only from loans, but also from the potential to earn fees from various banking services and to cross sell other banking products.

Figure 1 - Drivers of Banks Involvement with SMEs



22. **The second important source stems from relationships with large clients.** Most banks are systematically asking their larger clients to recommend their SE and ME suppliers and customers. Getting to a SME client through its major customer or supplier would typically reduce the credit risk: if a SME supplier, he already has first hand knowledge of the financial condition and payment capacity of the SME; if a SME buyer, he can attest to the quality of its products or services. Getting useful information

simplifies credit assessment and reduces cost. In some cases, large clients also provide some sort of guarantees for the related SMEs.

23. Competition is also mentioned by a number of banks. Indeed, as the competition in the traditional segments is increasing, putting the pressure to move towards sub-prime borrowers, banks are inclined to move to market segments that have better growth potential. In Serbia, the SME segment clearly belongs to so far under-banked market segments. As confirmed by the recently published “Doing Business” indicators, business environment in Serbia is improving. And the negotiations with the European Union have started. Both were seen by banks as very good signs attesting to the future growth potential.

24. Over-exposure and the need for diversification has also been mentioned by a number of banks. Indeed, there were some pressures in the retail segment, with consumer loans, which is where the banks concentrated in the past couple of years. Risk diversification has become important, especially in a period where banks are trying to position themselves and establish presence in all banking market segments.

3.2. Market Environment¹¹

25. Large banks are the main players in the SME market in Serbia. In most cases, these are local subsidiaries of large EU banks. The same banks are also present in other countries in Eastern Europe and Balkans, i.e., former socialist economies that are in different stages of transition. They are offering in the Serbian market products that have done well in other regional markets. The products are structured and priced in a similar way, and banks are organizing regional meetings inviting people from both headquarters and subsidiaries to share ideas and experiences. The feeling is that the small banks, even specialized niche players, to not have a serious chance to be successful.

26. Most interviewed banks perceive that there is a first mover advantage. This is because most banks offer similar products. Another reason is that the SMEs generally use fewer banks than the larger enterprises (typically one or two). They tend to exhibit greater loyalty and do less shopping around than larger corporate clients. Given this kind of behavior, the majority of banks developed business strategies trying to reach out to clients, in spite of strong demand.

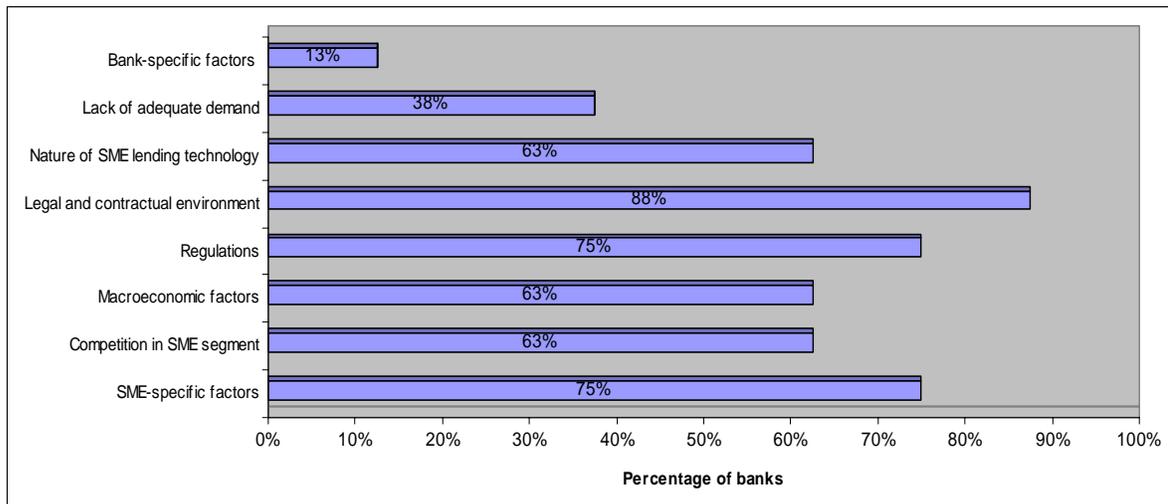
27. The SME market keeps changing, but banks are optimistic about the prospects of SME market segment. The feeling is that that it is still not yet saturated and will continue to grow, but with somewhat slower pace. The competition is expected to increase as the market starts to saturate. However, there is no consensus about what new products or services might be needed to keep or expand the market presence.

¹¹ Appendix, Figure 4.

3.3. Obstacles

28. **Banks have identified quite a few obstacles, including many that are policy related.** Figure 2 summarizes results of discussion on obstacles for SME lending. Further summaries of obstacles to bank involvement in the SME market are provided in Appending Figures 5, 6 and 7 in the Attachment.

Figure 2 - Obstacles for SME Lending

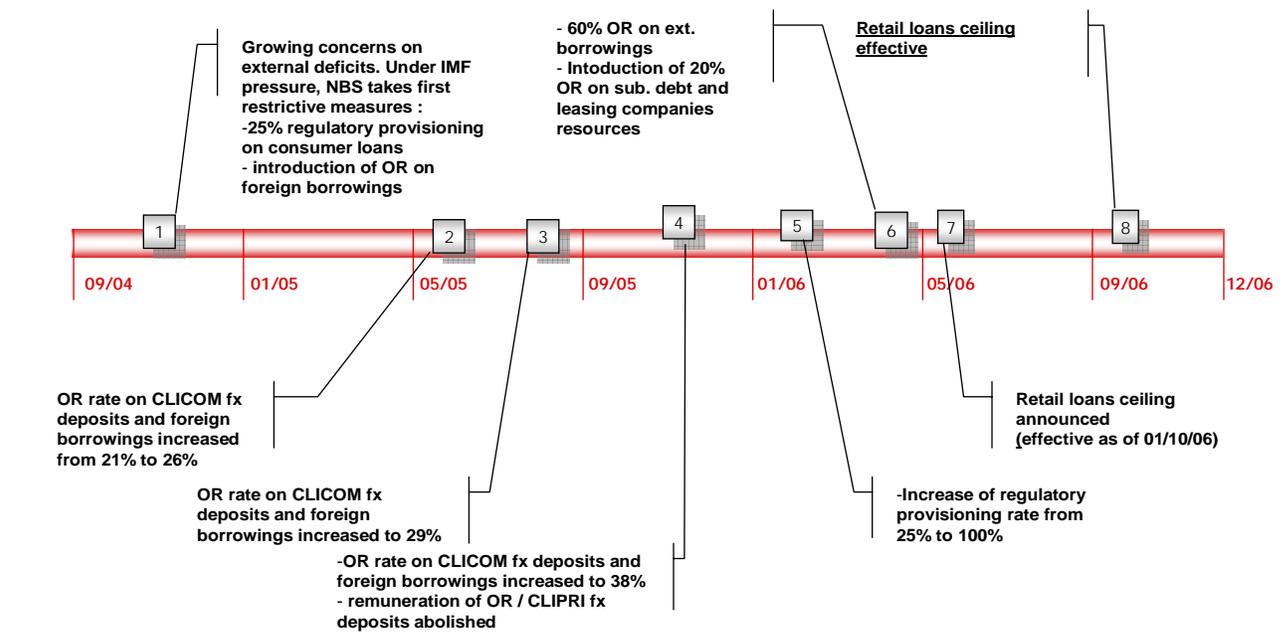


29. **The most serious obstacle is the legal and contractual environment.** Issues mentioned in the discussion of legal and contractual environment included weak protection creditor and property rights, problems with contract and collateral enforcement, judiciary inefficiency and slow and costly bankruptcy procedures. As expected (and discussed below), when asked about the possible areas where Government involvement might help, legal and judicial environment were at the top of the list. In the meantime, banks are trying to deal with these inefficiencies by asking for high levels of collateral for practically all types of credit products. Banks avoid filing for bankruptcy and try to have some sort of out-of-court settlement.

30. **Macroeconomic factors related regulations are identified as a second most worrisome impediment to SME finance.** The evolution of the regulatory framework time-line is shown in Figure 3. Problems started with increasing inflation. In an effort to get inflation under control, the NBS decided to adopt an increasingly tight monetary policy. External borrowings were included in the calculation base for reserve requirements and mandatory reserve requirements continued to increase. By 2007, reserves on foreign currency were raised to the level of 45 percent. The remuneration to banks for mandatory reserves was abolished in December 2005.

31. **The NBS monetary policy conduct has significantly increased the cost of banking in Serbia.** In fact, Serbian banks are least profitable in the neighborhood. Low profitability has a number of consequences. One is that the domestically owned, smaller banks are not able to compete and survive in such environment. The second is that the cost of credit and of banking services is very high.

Evolution of the regulatory framework / timeline



Legend: OR = obligatory reserve; CLICOM = corporate clients; CLIPRI = retail clients; fx = foreign exchange

- **Credit expansion significantly accelerated since 2004**
 - ▶ Credits to households boomed by 96% in 2004 and 79% in 2005
 - ▶ Credits to companies also registered a strong increase (32% in 2004; 30% in 2005)
- **Leading banks to resort to external funding**
 - ▶ Domestic credits grew faster than deposits, leading banks to resort to external funding
 - ▶ Foreign borrowings increased by a record 1,101 M EUR in 2005 (after a rise of 672 M EUR in 2004 and 76 M EUR in 2003)
- **...And the NBS to adopt an increasingly tight monetary policy and include external borrowings in the calculation base of reserve requirements**
 - ▶ In late 2004, IMF expressed concerns about the pace of credits growth
 - ▶ Pushing the NBS to use the only tool at its disposal to regulate the situation : obligatory reserves
 - ▶ In December 2004, NBS introduced required reserves on foreign borrowings
 - ▶ Mandatory reserves rate on external borrowings –initially 21%- was raised 4 times in 2005, and reached 38% at year-end
 - ▶ In May 2006, it was increased to a **record high level of 60%**
- **Reserves requirements on other resources were strengthened, too**
 - ▶ Obligatory reserves on FX commercial deposits **raised to the level of 40%** in May 2006
 - ▶ Reserves are required on subordinated debts (rate of 20%) since April 2006
 - ▶ **Remuneration of obligatory reserves on retail deposits abolished** in December 2005
- **Reserves requirements on foreign currency resources were eventually equalized to the level of 45% in January 2007 (apart from subordinated debt)**

32. **Prudential regulations are also seen to be a serious impediment** (Attachment, Figure 10 and Appendix to the Attachment Figure 5. B). Seven out of eight banks interviewed believe that prudential regulations negatively impact SME lending. The mentioned issues are prudential regulations, including provisioning and reserve requirements. For example, the strict requirements related to the terms of approval of a second loan to an enterprise that has already borrowed consider and the related provisioning requirements are an issue. It would seem that the regulations that intended to prevent any change of loan terms in effect preclude the bank to provide support to SME clients. Overall, most banks consider the burden posed by regulatory requirements to excessive in almost all products.

33. **Obstacles in legal and contractual environment negatively impact investment climate in Serbia.** Investment Climate Assessment surveys (ICAs) deal primarily with business perceptions of the investment climate, and also include questions related to financing practices. Banking practices in Serbia are significantly below median of the 58 countries that are subject to ICA surveys (Table 5).

Table 5 - Financing Obstacles and Collateral Practices

(Summary of ICA surveys in developing and transition countries)

| Financing is major obstacle (%) | Collateral needed (% of loan) | Loans requiring collateral (%) |
|--|--------------------------------------|---------------------------------------|
| Tunisia 0.0 | Pakistan 69.5 | Slovenia 58.7 |
| Namibia 1.7 | China 80.8 | South Africa 61.1 |
| Egypt 10.8 | Thailand 87.0 | Cambodia 61.5 |
| Slovenia 11.0 | Bangladesh 92.5 | Ethiopia 62.0 |
| Cambodia 13.0 | India 94.0 | China 66.9 |
| Top 5 | | |
| Serbia (2005) 55.0 | Serbia (2005) 194.6 | Serbia (2005) 91.0 |
| <i>Median 38.5</i> | <i>Median 141.9</i> | <i>Median 86.1</i> |
| Bottom 5 | | |
| Belarus 62.5 | Bosnia and Herzeg. 196.4 | Georgia 93.6 |
| Moldova 64.4 | Nicaragua 204.0 | Bosnia and Herzeg. 95.9 |
| Kyrgyz Republic 66.7 | Syrian Arab Rep. 206.7 | Macedonia, FYR 96.6 |
| Haiti 74.4 | Morocco 226.2 | Albania 96.8 |
| China 75.0 | Zambia 311.3 | Morocco 98.9 |

34. **High cost of credit, which is due to the high cost of compliance to NBS regulations, is also an important factor in Serbia.** Many of the traditional areas of SME business are not particularly profitable. In other words, enterprises are not profitable enough to be able to afford significant level of indebtedness at the prevailing interest rates in Serbia. As indicated in Table 6, even large enterprises in Serbia rarely carry on their balance sheets credit volume larger the about ten percent of the total liabilities. The level is even smaller for the SMEs, and the banks believe that the problems with access to credit are the most important reason.

Table 6 - Monthly Lending Rates (%)

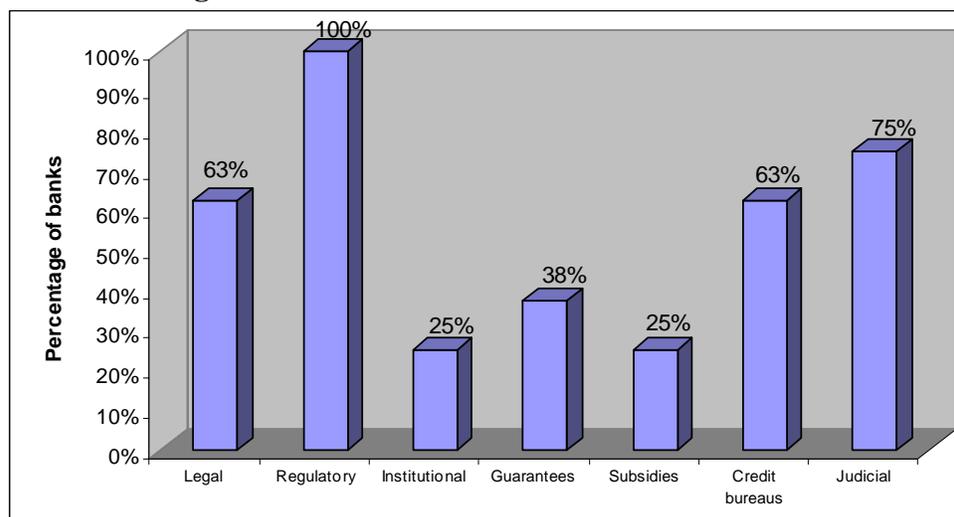
| Type Of Loan | Dec. 2006 | June 2007 |
|---|-----------|-----------|
| Short Term Export Loans | 0.90 | 1.07 |
| Long Term Loan for Equipment and Fixed Assets | 0.70 | 0.77 |
| Other Long Term Loans to Businesses | 0.73 | 0.76 |
| Weighted Average Interest Rates on Short Term Loans | 1.31 | 0.98 |
| Weighted Average Interest Rates on Long Term Loans | 0.82 | 0.85 |
| Weighted Average Lending Rates | 1.26 | 0.96 |

35. **SME specific factors are mentioned as the next most serious obstacle** (Attachment, Appendix, Figure 6. A). As elsewhere, unavailability and unreliability of financial statements, lack of collateral informality and heterogeneity in their activities, low managerial capacity and (often) their family-owned nature complicate banks' assessment of creditworthiness and increase transaction costs.

36. **The nature of lending technology to SMEs has also been mentioned, especially the high cost of transactions, difficulties to standardize products and procedures, and difficulties is supervision and monitoring** (Attachment, Appendix, Figure 6. B). Banks are dealing with this in a number of ways, the most prominent is using better standardized appraisal techniques (e.g., scoring) and reorganizing the credit risk appraisal process to reduce the cost of applying traditional credit assessment techniques. The lack of demand and bank-specific factors (e.g. limited geographic coverage, inflexibility in lending procedures) were mentioned in few cases, but were not critical factors.

3.4. Government Programs

37. **Banks were very positive about the need for the Government to take an active interest in trying to facilitate lending to SMEs.** Figure 4 summarizes answers of banks of key elements of government programs to stimulate SME lending.

Figure 3 - Areas for Government to Facilitate SME Lending

38. **Areas in which government actions could promote SME lending included the following:** *legal and regulatory environment*, which was related both to favorable conditions for banks' operations and the enabling business environment for SMEs; *judicial environment* which was specifically mentioned in terms of general protection of creditors rights and in the context of fast and effective collection on collateral; *credit information* as a means to facilitate credit appraisal and reduce the cost of processing credit applications. To a much lesser extent, and mostly domestically owned banks mentioned the availability of government *guarantees and subsidies*.

39. **There is a number of government-sponsored programs aiming to stimulate the SME development and some have been institutionalized, such as Development Fund and Guarantee Fund¹².** *Development Fund* (DF) is an independent state-owned institution providing (subsidized) financing through a number of programs related to economic and regional development, SME development, increasing competitiveness and so forth. In 2006, DF approved 1,258 loans in the total amount EUR 171 million, of which EUR 130.3 million were promptly disbursed. *Guarantee Fund* (GF) is a non-profit institution aiming to improve access to credit for enterprises with a very short business history, for start-ups, for loans with longer maturities and for higher risk projects. As of end 2005, GFs approved 1,981 guarantees for SMEs and agricultural projects in the total value of about EUR 7 million. The NBS administers a number of credit lines, including European Union credit fund, European Investment Bank credit line and credit line for Italian imports. The total funding administered by the NBS is about EUR 67 million, which has financed about 370 projects.

40. **When asked to evaluate the Government-sponsored credit programs, banks responded that the programs have little or no real impact on the market or the SME development** Attachment, Figure 8). Such an opinion was expressed even by banks that are acting as intermediaries in these programs. One explanation for such an opinion is that the total amount of funding available from the government-sponsored sources is actually rather small. Enterprise credit extended by banks as of end 2006 totaled about EUR 4.6 billion (including for large enterprises), while the total administered through Government sponsored programs in 2006 was about 7.8 percent of that amount.

41. **Some of the subsidized programs have interest rates that were significantly smaller than that of banks.** At end 2006, the least cost long-term investment loans extended by banks had a monthly interest rate of 0.73 percent. The weighted average monthly interest for long-term loans was 0.82 and weighted average *monthly* lending rates were 1.26 percent (falling to 0.96 percent as of end June 2007). The *annual* lending rates for loans extended by Development Fund were between 1 and 5 percent, depending on the program. However, the volumes were so small that the market rates were not affected.

¹² More detailed description is provided in Annex II.

A more systematic assessment of impact of government-sponsored programs would be useful. The point is that such programs have to be well focused. While banks did not feel that government-sponsored programs are important, EUR 363 million is still a rather significant amount. It could have made a real difference for the start-ups or if extended to business in underdeveloped areas, where banks were not ready to take credit risks. The spill-over and demonstration effects could also be significant. Therefore, the effect of these programs should be better understood.

3.5. Financial Infrastructure for Credit Risk Management

42. Banks emphasized importance of financial infrastructure facilitating appraisal of credit risk. All interviewed banks were highly appreciative of the facilities provided by the two pieces of financial infrastructure established in 2004 and 2005, the Credit Bureau established and maintained by the Banking Association and the Solvency Center in the NBS. They have pointed out that the dramatic increase of SE lending actually coincides with the start of services by these two facilities. Annex III provides further details on Credit Bureau and Solvency Center.

43. Credit Bureau is a central (national) register of information about the level of indebtedness/liabilities and timeliness of individuals and legal entities in meeting their liabilities. Initially, the Bureau was only covering individuals. In 2006, it added legal entities and entrepreneurs. Currently, the Credit Bureau contains information about 483,000 legal entities and entrepreneurs (both active and inactive ones), as well 4 million individuals. The Bureau gathers information directly from creditors - from banks, leasing companies, and state funds (e.g., Development Fund), insurance companies, and other creditors whose list is constantly increasing.

44. The NBS mandates review of a credit report prior to credit decisions. Since 2004, the Bureau has issued about four million credit reports related to individuals and (as of October 2006) some 130,000 for legal entities and entrepreneurs. The establishment and operations of Credit Bureau have ensured better credit risk management and decreased the time necessary for loan processing. The availability of credit information has prompted an increase in financial discipline, allowed banks to introduce new products, contributed to a decrease in interest rates due to lower risks, eliminated the possibility of heavy indebtedness, and ultimately contributed to easier access to credit.

45. Solvency Center reports on individual companies are available for a fee to any interested party. Solvency Center maintains financial statements of business entities, entrepreneurs, and other legal entities, in the form of financial reporting mandated by the respective legal framework. Additionally, all medium and large enterprises must also submit external audit reports (as of 2005), which essentially confirms the validity of data for these particular entities. In 2004, Solvency Center has issued over 21,000 reports for some 18,000 registered users. Since 2004, the number of reports increases by roughly 20 percent per annum.

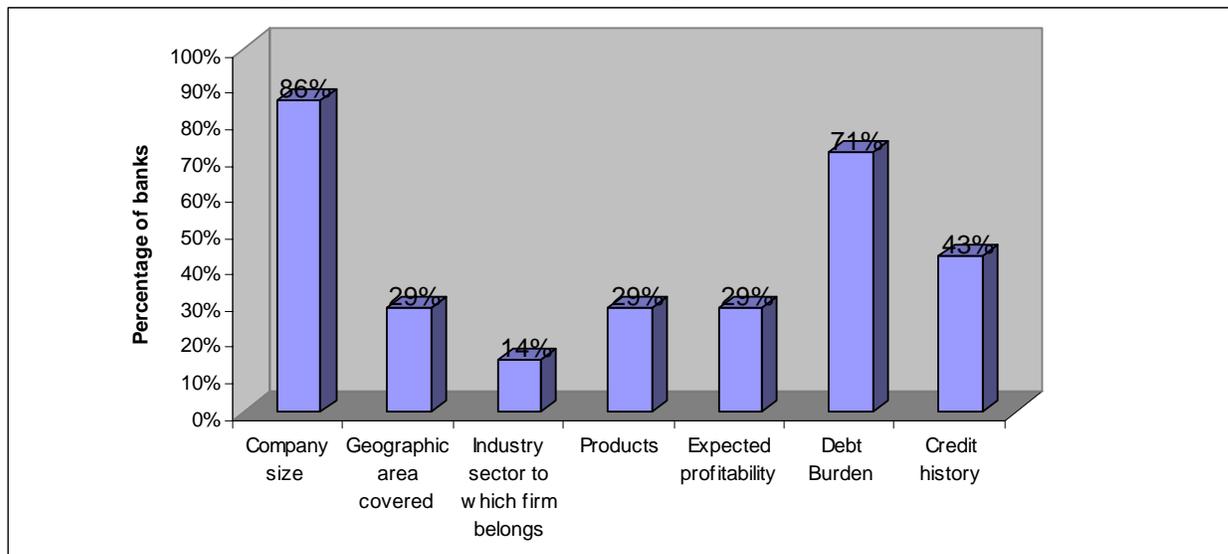
46. **In addition, Solvency Center started to offer customized reports tailored for specific needs. The latest addition – scoring and opinion on solvency – will further facilitate lending to small and micro-enterprises and to individuals.** It will also facilitate implementation of the Basel II capital accord, as it would provide parameters necessary for the scoring models. Models for scoring and opinion on solvency have been developed in line with the models applied in developed market economies, which are dominated by small- and medium-sized enterprises.

4. HOW DO BANKS ENGAGE IN LENDING TO SMES?

4.1. Business model

47. **Banks in Serbia treat MEs and SEs as different types of business and, therefore, apply different business models, different risk appraisal models and different risk criteria.** In all foreign owned banks interviewed, ME customers are considered as corporate customers and are typically part of the corporate lending structures. SE customers (and entrepreneurs) are considered to be just another form of retail customers. They are typically part of the retail lending structure. The two structures have different organization and management, different lending processes and apply different risk appraisal and risk management techniques. Credit reviews and approval processes are very different, as are write-off and collection policies and mechanisms. The two locally owned banks are converging to the same model.

Figure 4 - Criteria Used to Target SME Clients



48. **The majority of banks business model actively targets SE and ME clients.** The targeting involves on-going and active collection and systematic review of information about potential clients. The criteria that are typically reviewed are illustrated in Figure 5 and include company size, credit history, geographical area covered by its operations, industry to which it belongs, products and competitiveness, expected profitability, credit

history and indebtedness. Banks are likely to consult the existing public databases and the Solvency Center on details of potential clients credit history and financial condition.

49. **Branches remain the key SME sales and distribution channels for the SME markets, although the solutions differ** (Attachment, Appendix Figure 13). For the majority of banks, branches also perform at least some of the back-office functions (63%). In one case, branches are considered to be mostly delivery and client service channels. Another extreme (also one case) is that the (larger) branches function as small banks within the bank, practically covering the same functions as the headquarters.

50. **Despite the increasing importance of SMEs, most banks are not yet able to precisely measure their involvement in terms of income, costs, or risk.** Bank are not able to quote the share of the total net income generated by the SMEs business or how much SMEs contribute to the banks' total risk or to the banks' total costs. Banks not seem to systematically collect or evaluate this information, probably because they do not consider the SMEs to be a single business group.

4.1.1. Structure

51. **The typical model for MEs comprises of relationship managers (RMs) residing in all branches and business leadership and credit risk appraisal functions operating in headquarters.** Branch-personnel typically concentrate on building relationships and on customer service-related issues, rather than sales. The branches' natural orientation is centered on service. Focusing on sales opportunities and pitching products and services are outside their branch bankers' comfort zones. Most banks do not have any particular sequencing when offering products to clients.

52. **Relationship managers are close to becoming a standard.** They are looking for new clients, trying to developing relationships and preparing information for the regional centers or at headquarters. They are the ones that maintain a relation with the client and, typically, prepare credit applications. In some banks, they participate in pricing products and are involved in the process of credit appraisal. They also play an important role in case of any problems.

53. **On-site visits and interaction with the owners remain important ME business practices.** The traditional banking model based on on-site visits and direct interaction are persisting, probably as a means to address the lack of available information and informality in their business practices. Also, close relationship remains an important element of competitiveness.

54. **Typically part of retail business, the SE operations have a bit different structure. They also maintain some sort of relationship managers, but with a more sales-oriented focus.** As most client outreach and product delivery still takes place through bank branches, banks are offering incentives to sales personnel. Incentives are still rather straightforward, with number of clients and loan volume mentioned as key incentives by most banks (Attachment, Appendix Figure 13). There is space for

improvements, as attested by the litany complaints, including: insufficient product knowledge; little, if any, sales training for branch bankers aimed at the business customer; products too many in number and too complex for branch personnel; branch personnel lacking the time to focus on small businesses; and, incentives still inadequately encouraging the branch to focus on businesses.

55. Business centers or regional centers are becoming an increasingly important standard for the SE (and retail) business. As banks perceive SE segment as costly and risky, business centers also aim to improve operational efficiencies (e.g. by standardizing products) and reduce lending risks (e.g., by supporting the credit risk appraisal and management function) Business centers typically play an important role in designing the SE product portfolio and in developing strategies for targeting new SEs and for cross-selling products. In addition to helping with banking-related processing functions, some are also operating advisory services for small businesses.

4.1.2. Products

56. Banks are currently offering a fairly broad range of deposit and loan products and other banking services to SMEs. This includes checking, savings and time deposit accounts; export and import loans; overdrafts for working capital and investment loans; business credit cards; various types of payment services; Internet and phone banking. Other banking services, such as payroll and social security payments are also available. Banks in Serbia do not engage in leasing and factoring is still not an important product in SME services. Similar to findings in other countries, SMEs typically deal with one (and no more than two) banks. The product offer generally depends on the type of customer.

57. Banks offer both tailored and standardized products. MEs, which are typically part of corporate lending function, are likely to get tailored products, if this is what they need. In significant percent of cases (57%), ME clients select tailored products. The SE, which are typically part of retail lending, are offered mostly standardized products (a policy with 71 percent of banks). However, there are exceptions, even for the SEs.

58. When offering their products, most banks do not use any particular sequencing -- they simply offer what the client needs. Working capital is typically financed through overdraft accounts. Working capital loans are also available, with maturity of up to one-year and typically with variable interest rate. Investment loans have maturities of up to three years, and the available maturity is lengthening. Some banks have started to offer five years maturity to trusted clients and most banks are contemplating seven or eight years. Interest rates on investment loans are higher than on working capital loans, the interest curve is inverted, indicating market instability.

59. Banks are increasingly flexible with product pricing. Only half of the banks interviewed maintain standard pricing for SMEs products (Attachment, Appendix Figure 14). The other half are more flexible, which is especially the case for ME lending¹³. The

¹³ For large enterprises, the product pricing is completely flexible, one might even use the term “negotiable”.

degree of flexibility, however, differs. In more advanced banks, product pricing (within limits) can be changed already at the branch level. In more old-style conservative banks, only headquarters can change the standard price.

4.2. Risk Management

60. **In general, branches and headquarters complement each other in SME lending and in loan supervision.** Branches are typically in charge of sale of both lending and non-lending products. They are (almost) always engaged in loan pre-screening and in collection of information related to project feasibility analysis, the appraisal of clients' financial condition and the appraisal of collateral and its value. Headquarters are typically in charge of later stages of credit risk appraisal and loan approval. Headquarters also oversee non-performing loans and control loan recovery.

61. **However, the exact division of responsibilities between branches and headquarters is different for the ME and the SEs. It also depends on whether a bank maintains the regional/business centers or not, and what sort of internal models the bank is using for its risk management functions.** The majority of foreign owned banks has adopted different risk management procedures for MEs and SEs. The one that has not yet started, plans to do it in the near future. Of the two locally owned banks, the larger one has the same approach as the large foreign owned banks interviewed. Only one of the banks treats SMEs as one group and has not intention to change the approach.

62. **All banks employ lending limits, while the actual numbers differ from bank to bank.** Lending limits that are inherent to the credit risk appraisal process. It specifies the capacity of branch offices to review and approve loans up to the certain limit, without having to go through headquarters. Loans that involve higher amounts are appraised and approved by the headquarters' loan committee. The branch limits are, in some banks, adjusted based on actual performance of loans that are approved by the respective branch. Beyond the branch level, there is a typically a number of limits involving different-level credit committees in headquarters, and (ultimately) at the mother bank. The rules on changing the limits differ. Generally, they are decided about by the management board.

63. **Limits also apply to the amount of loan in relations to the size of clients' balance sheet, profitability or value of collateral.** (Appendix, figure 22) This kind of lending limits are motivated by the NBS prudential regulations and the particular risk profile increasingly decided about at the home (i.e., mother) bank. There is no standard practice related to monitoring of lending limits: some banks monitor daily, other monitor Monthly and some quarterly (Attachment, Appendix Figure 19). Lending limits are also adjustable. In about two-thirds of interviewed banks, only top management is authorized to adjust the limits. The remaining banks are more flexible and allow that the smaller limits be adjusted. In fact, some banks prescribe ranges of allowed limit adjustments.

64. **Banks use a number of techniques to mitigate the credit risks to which they are exposed.** Exposures may be collateralized in whole or in part with cash or securities, a

loan exposure may be guaranteed by a third party, or a bank may buy a credit derivative to offset various forms of credit risk. Additionally banks may agree to net loans owed to them against deposits from the same counterparty.

65. Nevertheless, the most prominent technique is the use of collateral. Banks' credit policies specifically address collateral requirements relative to the exposure amount, including the ability to easily liquidate the collateral, the ability to establish objectively its price or market value, the frequency with which the value can readily be obtained (including a professional appraisal or valuation), and the volatility of the value of the collateral.

4.2.1. Risk Analysis

66. Most banks have established independent credit-risk control units that are responsible for the design or selection, implementation and performance of their internal rating systems. (Attachment, Appendix Figure 18). The credit risk control units actively participate in the development, selection, implementation and validation of rating models. These units are functionally independent from units responsible for originating or approving credits. Typical responsibilities include: (i) testing and monitoring internal ratings and production of respective reports; (ii) verifying that rating definitions are consistently applied across departments and geographic areas; (iv) monitoring of trends in key rating criteria and evaluating if they remain predictive of risk.

67. The split to MEs and SEs has been, to a large extent, motivated by obligation of home banks to apply the BASEL II capital standards¹⁴. BASEL II capital standard is becoming obligatory in the EU and some countries have already transferred to the new capital adequacy calculations. According to BASEL II, banks are allowed to use Internal Rating Based (IRB) models in calculation of capital adequacy. If using IRB, they are also obliged to consolidate their balance sheets, including all their subsidiaries. The move of SEs to the retail banking segment results in a possibility to use the risk weight of 75 percent (rather than 100) for the calculation of regulatory capital purposes.

68. For the SE lending, banks mostly use credit scoring models, which are one version of the internal rating based approach (IRB). This is partly because the use of scoring models – based on rather mechanical rating procedures -- significantly reduces transaction cost and speeds up credit decisions. The overarching principle behind the design of scoring models is that rating systems¹⁵ and processes provide for a meaningful

¹⁴ Under Basel II, banks have a choice between two broad methodologies for calculating their capital requirements for credit risk. One alternative is the standardized approach that measures credit risk in a standardized manner, supported by external credit assessments. The other alternative is the Internal Ratings-based Approach that allows banks to use their internal rating systems for credit risk appraisal and capital adequacy calculations.

¹⁵ The term “rating system” comprises all of the methods, processes, controls, and data collection and IT systems that support the assessment of credit risk, the assignment of internal risk ratings, and the quantification of default and loss estimates.

assessment of borrower and transaction characteristics; a meaningful differentiation of risk; and reasonably accurate and consistent quantitative estimates of risk. About 40 percent of the interviewed banks state that the scoring models used in Serbia are both country and sector specific (Appendix, Figure 17).

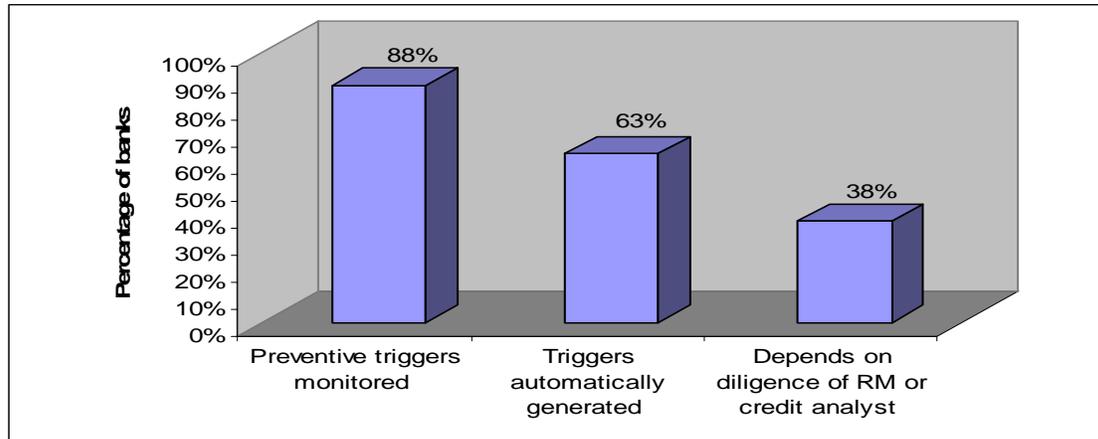
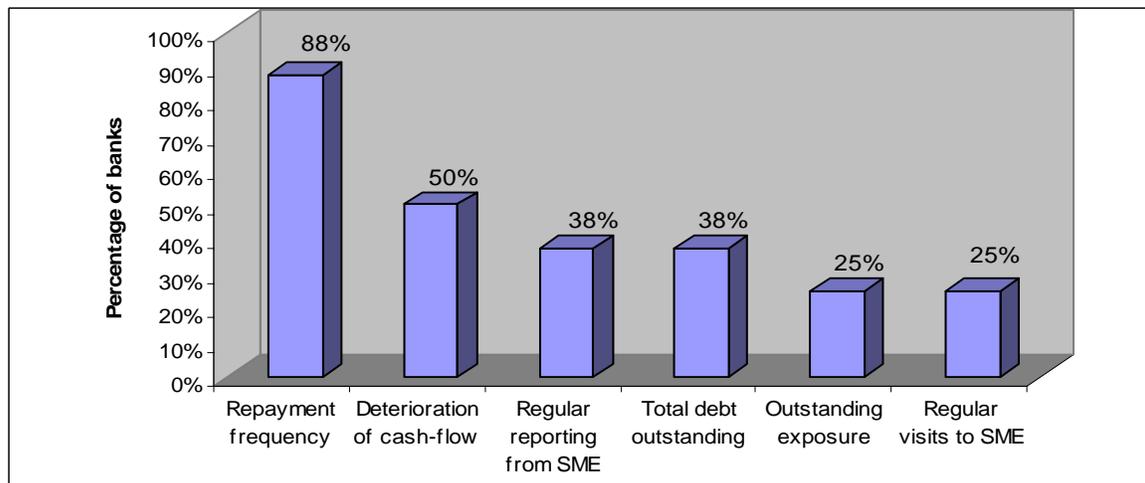
69. The main variables used in scoring models are payment discipline and credit history, financial conditions and ratios and ownership (Attachment, Appendix Figure 18). Information used in the scoring models comes from the variety of sources, including internal sources (for 100 percent of banks), information collected from clients (80 percent), credit bureaus (60 percent) and other public sources (60 percent). However, additional human judgment and human oversight is also necessary. This ensures that all relevant and material information, including that which is outside the scope of the model, is also taken into consideration, and that the model is used appropriately.

70. For the MEs, banks typically use more conservative credit risk appraisal techniques, which are less automated and rely on both qualitative and quantitative risk assessments. (Attachment, Appendix Figure 19). The most important qualitative elements are the quality of the owners and managers and corporate governance quality. Other elements of qualitative assessments typically include historical payment discipline, the degree of informality, the years of activity in the sector, an analysis of the clients' competitiveness (products, demand and market structure). Quantitative assessments include income structure and profitability, cash flow and liquidity, solvency, quality of assets, structure of the balance sheet and capacity to increase capital. Banks collect most of this information either from internal sources and the client, or from credit bureau data.

4.2.2. Monitoring and Credit Exposure Analysis

71. Most banks have are experimenting with defining reasonable internal model review standards. The issue is who leads the review – mother or bank headquarters – and to what extent the models developed and used by mother-bank should be applicable to all its subsidiaries. This especially important for situations where actual results significantly deviate from expectations (say, because of differences in macroeconomic or legal environment, differences in business cycles, of systemic vulnerabilities) and where the validity of the internal model could be questioned.

72. The general, techniques and internal models used by banks have been designed by their mother-banks, alone or in consultation with Serbian subsidiaries. However, the parameters used in these models often reflect specifics of the Serbian macro-economic and business environment, of its markets and of its SMEs. In general, almost all parameters used for the SE scoring models are likely to be specific to Serbia. For the ME internal rating models, some of the parameters are supplied by the mother-bank or regionally determined, and some are specific to Serbia. All banks use some sort of triggers (Figure 5, A and B). The triggers are defined by banks' policies with the tendency to increase the reliance on automatically generated triggers, especially for the SEs. One example of the automatically generated trigger used by most banks is payment discipline.

Figure 5 - A. Use of Triggers**B- Key Triggers Monitored**

73. **Banks are also using rating systems designed and developed by or in cooperation with mother-banks. Locally owned have also started to use similar models.** Banks have customized credit risk rating systems for all types of clients (e.g. SE, ME and large corporate, industries). Large foreign owned banks have increasingly started to use grading structures that meet the BASEL II requirements of a minimum of seven borrower grades for non-defaulted borrowers and one for those that have defaulted. A borrower grade is defined as an assessment of borrower risk based on a specified set of rating criteria.

74. **Collateral is also subject to a number of rather strict operational requirements in the context of credit risk exposure analysis.** This includes: (i) frequent revaluation, whereas the bank are requested to re-evaluate collateral on a frequent basis and at a minimum once every year; (ii) maintaining objective market value, at (or less-than) the

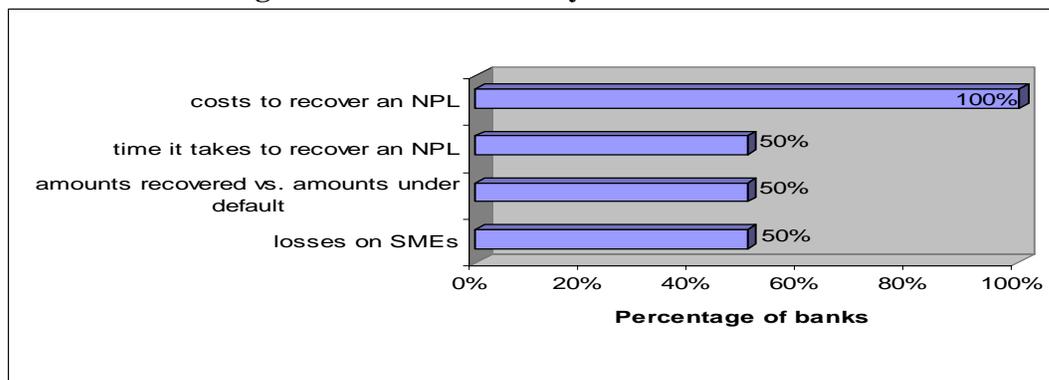
fair value under which the property or equipment could be sold under private contract between a willing seller and an arm's-length buyer on the date of valuation; (iii) legal enforceability of any claim on a collateral in all relevant jurisdictions; (iv) claim on collateral must be properly filed on timely basis. However, the real issue whether banks in Serbia would be able to realize the value of the collateral within a reasonable timeframe.

75. **Bank also practice stress tests** (Attachment, Appendix Figure 21). Stress tests try to identify possible events or future changes in economic conditions that could have unfavorable effects on a bank's credit exposures and assessment of the bank's ability to withstand such changes. Examples of scenarios used are (i) changes in RSD exchange rates; (ii) economic or industry downturns; (ii) market-risk events; and (iii) liquidity conditions. In addition to the more general tests described above, bank banks a credit risk stress test also include certain internal conditions.

4.2.3. Management of the Non-Performing Loans (NPLs) Portfolio

76. **The level of non-performing loans in Serbia is generally low, attesting to the quality of the banks' risk appraisal process and generally good payment discipline.** Eighty percent of the interviewed banks report the NPL ratio of 2-3 percent. All banks keep track of the cost to recover the NPL loan, but only about half systematically collects details on length of time needed to collect on collateral (Figure 6). Banks expect to recover 100 percent of the loan amount, but are not able to predict with any degree of certainty how long it will take. In principle, the NPL losses would affect interest rate spreads in practically all banks. However, given the high capitalization of Serbian banks, the low NPL ratio and the 100 percent recovery rate, this information is not considered important in projecting banks capital adequacy.

Figure 6 - NPL Related Systematic Data Collection



77. **Most banks keep the loan recovery function in-house (88 percent) and two thirds (practically all banks in foreign ownership) have a dedicated loan recovery unit.** The process is typically the following. Once a loan is past due, relationships managers contact borrowers in order to understand the reasons for the late payment and to try to see if there is a potential for the client to repay. If unsuccessful, banks file the

matter with the judiciary and attempt an out-of-court settlement. In there is a guarantee available, banks call on guarantors. The loan is declared nonperforming, its rating is downgraded to doubtful and it is transferred to the recovery unit. Finally, once the loan is classified as a loss, banks initiate the formal procedure for collection on collateral.

78. Banks are generally not inclined to change loan terms, although the majority would ultimately consider the increase in maturity. One of the reasons may be the prudential regulations of the NBS requiring significant level of provisions for loans where there was a change in the original terms.

5. CONCLUSIONS

79. SME financing has grown significantly in recent years (albeit starting from a low base) and has become an important banking markets' segment in Serbia.

Banks appear eager to establish presence in this market segment, given its perceived profitability and cross-selling opportunities. All banks interviewed believe that the market's prospects are good and they expect it to continue growing, albeit at a slower pace than in the last couple of years.

80. The market is dominated by large banks, typically subsidiaries of major banks from the European Union. Getting established in the SE and ME markets is becoming more difficult, as the competition is increasing. Larger domestically owned banks behave and manage their business in a manner similar to that of larger foreign owned banks. The increasing competition is obvious and reflects in broadening the range of services and lending products offered to SME clients, the on-going reduction of interest rates and lending fees and the improved quality of banking service available to SMEs, not only in Belgrade, but in the whole territory of Serbia. Another aspects of increasing competition is that banks are actively targeting good clients. This is especially the case for MEs, where banks techniques that are similar to those used for large clients.

81. Banks are currently offering a fairly broad range of deposit and loan products and other banking services to SMEs. This includes checking, savings and time deposit accounts; export and import loans; overdrafts for working capital and investment loans; business credit cards; various types of payment services; Internet and phone banking. Other banking services, such as payroll and social security payments are also available. The product offer generally depends on the type of customer. When offering their products, most banks do not use any particular sequencing -- they simply offer what the client needs.

82. Banks offer both tailored and standardized products and are increasingly flexible with product pricing. MEs, which are typically part of corporate lending function, are likely to get tailored products, if this is what they need. In significant percent of cases (57%), ME clients select tailored products. The SE, which are typically part of retail lending, are offered mostly standardized products (a policy with 71 percent of banks). However, there are exceptions, even for the SEs.

83. **The majority of Serbian banks have well developed effective lending procedures, as well as risk assessment and management techniques.** Significant changes to further improve efficiency and reduce cost are taking place. Technological advancements (better databases, better telecommunications and connectivity, better software packages) are actively exploited to increase flexibility and improve risk management techniques.

84. **However, the most important trigger for changes was the new BASEL II capital accord.** It requires “mother” banks to consolidate their financial statements. Thus, the financial condition and the quality of financial statements and risk management processes in subsidiaries has become critically important in determining the capital adequacy of the whole group. SE lending techniques that involve the use of credit scoring models seem to be ahead of the ME lending techniques.

85. **The existence of financial infrastructure, such as credit Bureau of the Banking Association and the Solvency Center in the NBS, have been of major importance to allow the use of modern credit risk appraisal techniques.** Credit risk management function critically depends of availability of reliable and inexpensive financial infrastructure.

86. **A more systematic assessment of impact of government-sponsored programs would be useful. The point is that such programs have to be well focused.** While banks did not feel that government-sponsored programs are important, the amount made available for SME lending is still rather significant. However, it would be more useful if these programs also try to introduce certain new products and services, or to have a better focus on start-ups or underdeveloped areas, where banks were not yet ready to take credit risks.

87. **The NBS monetary policy conduct and certain prudential regulations have significantly increased the cost of compliance and, consequently, the cost of credit in Serbia. This is a problem for SME clients.** While the credit is generally available for SMEs, their profitability is not high enough to be able to use the credit in a significant way as a source of investment or working capital. The statistics shows that, at the current level of interest rates, none of the enterprises in Serbia can afford to carry credit in excess of about 8-10 percent of the total liabilities.

88. **Reforming the legal framework for secured lending would be another positive contribution to improve the SME access to finance.** Reforms to improve the framework for creditor rights and insolvency are on-going, but the efficiency of law enforcement and judiciary system still need to be improved. For the SMEs, which tend to rely more on the use of collateral than larger firms, what constitutes acceptable collateral is an important issue. Better use of movable collateral would also be helpful.

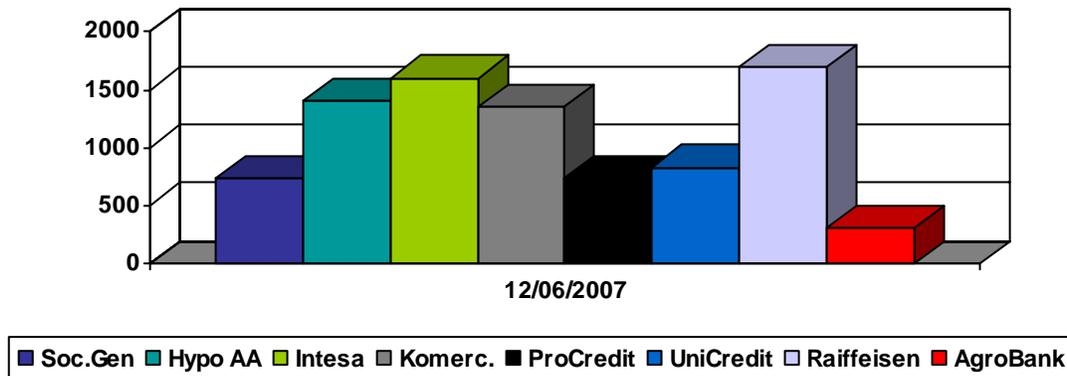
89. **The in SME markets’ characteristics and trends in other transition countries in South Eastern Europe, as well as in the countries that recently joined European**

Union, are likely similar to that in Serbia. Serbian banking sector is dominated by large banks from the EU. The market behavior, business practices, products and services offered, acceptable risk profiles and risk management policies and procedures for these banks are determined or to a great extent subject to strong influence from their mother banks. And mother banks pursue the same objectives and similar business strategies for all the subsidiary banks.

90. **Smaller banks or banks in local ownership are, at this time, following the same trends.** This may change in the future. But, for it will take some time until the ME and especially the SE markets mature enough to prompt the emergence of specialized niche players.

Annex I - Banks Interviewed for the SME Study

Figure 7 - Interviewed Banks Assets
(In EUR million, as of December 31, 2006)



Societe Generale Bank, Serbia

1. Societe Generale Group (France) is one of the world's leading banking groups employing over 103,000 people, managing 397 billion Euros in assets, and serving over 20 million customers in 76 countries. Societe Generale Group has been present in the Serbian market for some 30 years now, ever since it established a representative office in Belgrade in 1977. It started operating as a commercial bank in Serbia in 2001 when it established Societe Generale Yugoslav Bank (99.99% owned by SG) focusing on both on corporate and retail banking. Currently, Societe Generale Yugoslav Bank operates 75 branch offices and employs over 850 people serving 250,000 clients in Serbia. In 2006, SGYB recorded a profit of some 27.6 million Euros, while its total assets (as of March 31, 2007) reached approximately 737.7 million Euros.

Hypo Alpe-Adria-Bank, Serbia

2. Hypo Alpe-Adria-Bank started its operations in Serbia in 2002 (after it acquired Depozitno-Kreditna Banka). It is established and owned by Hypo Alpe-Adria-Bank International AG (99.89%) from Klagenfurt, Austria, a large financial institution serving some 750,000 clients in 11 countries in the Alpine-Adriatic region. Hypo Alpe-Adria-Bank focuses on offering a range of products and services to both corporate clients and consumers. Hypo Alpe-Adria-Bank operates a well spread network of branches in all larger towns in Serbia, employing a workforce of 718 people. In 2006, Hypo Alpe-Adria-Bank recorded a profit of around 10 million Euros, while as of 03/31/07 its assets totaled some 1.4 billion Euros.

Banca Intes, Serbia

3. Banca Intesa Beograd is a member of Intesa Sanpaolo Group, one of the largest banking groups in Italy, serving more than 18 million clients through a network of 7,000 branches in 34 countries. Banca Intesa Beograd is owned by Intesa Holding International (93%) and International Finance Corporation (7%) and it serves some 900,000 corporate and individual clients throughout Serbia. Banca Intesa entered the Serbian market in 2005 after successful privatization of Delta Bank (est. 1991) and it currently operates a network of 160 organizational units in over 100 towns in Serbia, and employs 2,447 people. In 2006, Banca Intesa Beograd recorded a profit of around 16 million Euros, while as of 03/31/07 its total assets amounted to approximately 1.6 billion Euros.

Komercijalna Banka, Beograd

4. Komercijalna Banka is one of the largest banks in Serbia and it was established 1970. Major shareholders include Republic of Serbia (40.31%) and European Bank of Reconstruction and Development (25%). Komercijalna banka operates 260 branch offices, and employs 2,900 people serving some 700,000 clients. In 2006, Komercijalna Banka recorded a profit of some 11.6 million Euros, while its total assets as of 03/31/2007 amounted to approximately 1.35 billion Euros.

ProCredit Bank, Serbia

5. ProCredit Bank is a development oriented full-service bank. It started with operations in Serbia in 2001, with a focus on lending to micro, small, and medium-size enterprises. ProCredit Bank is owned by several large institutions, with the following ownership structure: ProCredit Holding from Frankfurt, Germany (57.29%); European Bank for Reconstruction and Development-EBRD (16.67%); Commerzbank AG Frankfurt (16.67%), and Kreditanstalt fur Wiederaufbau Frankfurt -KfW (9.27%). ProCredit is serving over 172,000 clients through 52 branches throughout Serbia, employing 1,418 people. In 2006, ProCredit recorded a profit of approximately 2.8

UniCredit Bank, Serbia

6. UniCredit Bank Serbia is a member of UniCredit Group, one of the largest international banking groups in Europe employing 140,000 people, and operating more than 7,000 branches in 20 countries. UniCredit Bank entered Serbian market in 2001 (originally as HVB Bank which has in 2004 acquired Eksimbank) and is owned by Bank Austria AG (99.88%). UniCredit Bank has 46 branches throughout Serbia and it employs 651 people. At the end of 2006, it recorded a profit of some 17 million Euros, while its total assets as of 03/31/07 amounted to nearly 830 million Euros.

Raiffeisen Bank, Serbia

7. Raiffeisenbank established its operations in Serbia in 2001 and it is fully owned subsidiary of Raiffeisen International (Austria), one of the largest regional banks with 2,848 business outlets and over 52,700 employees serving 12.1 million customers. Raiffeisenbank in Serbia is offering a wide range of products and services in both corporate and retail banking, operating 67 branches throughout Serbia and employing 1,703 people. At the end of 2006, Raiffeisenbank recorded a profit of some 30 million Euros, while its total assets as of 03/31/07 amounted to over 1.7 billion Euros.

Agrobanka, Nis

8. Agrobanka is a legal successor of Yugoslav Agricultural Bank "Poljobank" established in 1959, while its roots date back to the times before World War II and operations of an agricultural bank from that period. Ever since 1959, Agrobanka has transformed several times, and in 1995 it was established as a joint stock company. Today, Agrobanka has over 3,000 shareholders, the largest of which are Hypo Alpe Adria Bank with 7.58% of shares and the Government of Serbia whose share has increased to some 20% due to a recent debt-to-equity swap. Agrobanka focuses on investments in agriculture related activities and is a member of International Association of Agrarian Banks - CICA Zurich. It has a client base of nearly 15,831 legal entities and some 140,000 consumer business and various savings accounts. Agrobanka has 94 organizational units (14 main offices, 65 branches, and 15 counters) spread throughout Serbia and a workforce of 808 people. In 2006, Agrobanka recorded a profit of around 3.5 million Euros, while as of 03/31/07 its assets totaled approximately 305.5 million Euros.

Annex II - Government Credit Programs

Summary of Objectives and Products

1. **Development Fund (DF)** is a state-owned institution established with a goal to provide (subsidized) financing for the programs related to economic and regional development, SME development, increasing competitiveness and so forth. DF has a number of credit products¹⁶. There are programs aiming to stimulate regional development in less developed areas, in the towns of Kragujevac, Bor, Vranje and 13 other least developed municipalities. Additionally, DF is implementing certain financing projects (crediting unemployed, micro credits, etc.) specified in the National Investment Plan. It is also serving as an agent for several Ministries in implementing various types of subsidy programs aimed for economic and agricultural development. In 2006, DF approved 1,258 loans in the total amount EUR 171 million, of which EUR 130.3 million were promptly disbursed.

2. **Guarantee Fund (GF)** is a non-profit institution established by the Law on Guarantee Fund in order to provide incentives for development of small and medium enterprises, entrepreneurship and agriculture. It underwrites bank loans to businesses with generally profitable projects that fail to fulfill some of the requirements necessary for obtaining loans¹⁷. The GF guarantees effectively improve access for enterprises with a very short business history, for start-ups, for loans with longer maturities and for higher risk operations. Currently, GF has contracts with over 30 commercial banks.

3. The GF guarantee decisions are based on its own credit risk assessments, including credit history, profitability of projects and quality of collaterals¹⁸. Priority is given to longer term credits (over 3 years), to projects financed through NBS administered credit lines (EAR, KfW, EIB, etc.), to enterprises with long-term contracts abroad (e.g., facilitating exports or contributing to technology transfers) and to enterprises whose founders are up to 35 years of age. The sectors of special interest are farming, production of organic/healthy foods, manufacturing, tourism, construction, and innovative and high tech activities. The GF is charging annual interest rate of 10 percent. As of end 2005 (the last one available), GFs approved 1,981 guarantees for SMEs and agricultural projects in the total value of about EUR 7 million.

¹⁶ (i) Long term credits, five years with grace period of one year and annual interest rate of 1-3%, depending on the level of regional development and municipal GDP; (ii) Short-term credits (6 months), with annual interest rate of 5%; (iii) Credit line through Erste Bank (6-12 months) with annual interest rate of 6%; (iv) Credits for financing development of production trades (craftwork) and services – entrepreneurial credits (5 years) with 1-year grace period and annual interest rate of 1-3%; (v) Credits aimed at stimulating employment (5 years) with annual interest rate of 1%.

¹⁷ Available GF funds are invested in government bonds and certificates of deposit with first class banks. In 2005 these investment were structured as follows: 5.8% in government bonds; 35.6% foreign currency savings bonds; and 58.6% short term CDs (6 months).

¹⁸ In order to approve the credit guarantee, the share of permanent working capital in the estimated value of the project could be up to 15%, whereas in cases of export oriented programs this share could reach up to 30%.

SME Credit Lines Administered by the NBS

4. The National Bank of Serbia (NBS) administers a number of credit lines, including credit lines from international development institutions and bilateral donors. The currently active credit lines include the following:

5. **European Union Credit Fund** (grant of EUR 15 million used as a revolving fund) from SME finance was approved in 2001¹⁹. It is administered by UniCredit Bank, Erste Bank, Zepster Bank, Cacanska Bank and Komercijalna Bank. The grant proceeds and revolving fund for the total amount of EUR 30 million have been used by 313 enterprises, with average credit amount per enterprise of EUR 96,000 of which 85 percent used for equipment.

6. **European Investment Bank Credit Line** (EUR 65 million) for SMEs and small-to-medium scale infrastructure projects of local governments²⁰. The EIB financed up to 50 percent of the project value. The first line of EUR 20 million was approved in 2002. It was administered by UniCredit Bank and Komercijalna Bank and used by 27 enterprises.

The second of EUR 45 was approved in 2004. In addition, Erste Bank, Kulska Bank, Privredna Bank Belgrade and Cacanska Bank were also admitted as intermediaries. So far, 30 projects amounting to EUR 16.8 million have been approved from this credit line.

7. **Italy Credit Line** (EUR 33.25 million²¹). The SME credit line funded by the Government of Italy is administered by three banks: Intesa Bank, UniCredit Bank and Komercijalna Bank. Credit proceeds may be utilized for purchase of equipment, spare parts and industrial licenses of Italian origin for the minimum of 70 percent of each credit. The intermediary banks have received over 90 credit applications, out of which 45 applications for the total amount of EUR 16.4 million were approved and realized.

¹⁹ Credit amount varies from EUR 20,000-200,000 with maturity of up to 5 year and grace period of up to 1 year. Interest rate is three-months EURLIBOR + 1,5% plus and 3% intermediary bank spread.

²⁰ Credit terms are EUR 20,000-200,000 with maturity of up to 12 years and grace period of up to 3 years (15 and 5, respectively, for infrastructure projects). Interest rate could be fixed at around 8 percent per annum or variable at EURIBOR plus 3 percent, plus 0.5 percent NBS spread and the intermediary bank spread.

²¹ Approved in October 2004. Operational since 2005, with a first tranche of EUR 5,125 million, and the second and third tranches of EUR 10 million each. A precondition for withdrawing of the last, fourth tranche amounting to EUR 8,125 million will be met by certifying that at least 2/3 of funds were utilized for intended purposes. The SME credit amount is EUR 50,000 to 1 million, with maturity of up to eight years and grace period of up to two years. The interest rate is fixed at 4.9 percent per annum.

Annex III - Financial Infrastructure to Assist with Credit Risk Appraisal

1. **Credit Bureau is a central (national) register of information about the level of indebtedness/liabilities and timeliness of individuals and legal entities in meeting their liabilities towards banks, leasing companies and other financial service providers.** It was established in 2004 by the Banking Association to facilitate assessment of credit worthiness of their clients. Prior to the Bureau's inception, it was difficult to assess creditworthiness, as there was no channel for creditors' information exchange. Currently, NBS mandate review of a credit report prior to credit decisions.
2. **Initially, the Bureau was only covering individuals. In 2006, it added legal entities and entrepreneurs.** Currently, the Credit Bureau contains information about 483,000 legal entities and entrepreneurs (both active and inactive ones), as well 4 million individuals. The Bureau gathers information directly from creditors - from banks, leasing companies, and state funds (e.g., Development Fund), insurance companies, and other creditors whose list is constantly increasing. The threshold for being flagged as a "late payer" is 60 days for individuals and 15 days for legal entities/entrepreneurs.
3. **Information is updated electronically, on a daily basis.** The database includes information related to current liabilities (credits, leasing, activated guarantees, etc.), potential liabilities (i.e., for loan co-signers) and payment delays. Any service provider (bank, leasing company, etc.), legal entity/entrepreneur, and/or individual could request credit history report about any legal entity and/or entrepreneur (but not on another individual) with a written authorization of that legal entity/entrepreneur. In case of individuals' credit reports, only banks, leasing companies and other service providers from which individuals are requesting certain services could obtain individuals' credit reports with their written authorization.
4. **Information can be accessed in a matter of seconds, allowing for swift information sharing and prompt decision-making.** Since 2004, the Bureau has issued about four million credit reports related to individuals and (as of October 2006) some 130,000 for legal entities and entrepreneurs. The establishment and operations of Credit Bureau has ensured better credit risk management and decreased the time necessary for loan processing. The availability of credit information has prompted an increase in financial discipline, allowed banks to introduce new products, contributed to a decrease in interest rates due to lower risks, eliminated the possibility of heavy indebtedness, and ultimately contributed to easier access to credit.
5. **Solvency Center.** All commercial entities (business entities, entrepreneurs, and other legal entities) in Serbia are obliged by law to submit financial statements (in a prescribed format that differs according to the type of enterprise) to Solvency Center. When it started in 2005, Solvency Center received some 126,000 financial reports. In case an enterprise fails to submit the report, Solvency Center reports this violation to prosecutor's office and the entity is held liable for their failure to submit the data. Solvency Center does not validate reports, but their format is such that the respective

amounts have to balance within the template. Additionally, all medium and large enterprises must also submit external audit reports (as of 2005), which essentially confirms the validity of data for these particular entities.

6. **Solvency Center reports on individual companies are available for a fee to any interested party.** In 2004, Solvency Center has issued over 21,000 reports for some 18,000 registered users. Since 2004, the number of reports increases by roughly 20 percent per annum. In addition, the Center started to offer customized reports tailored for specific needs. (Its services have been used in collecting data for this study).

7. **The latest addition – scoring and opinion on solvency – represents yet another activity whereby the National Bank of Serbia aims to build up an efficient financial system and a stable financial market.** Models for scoring and opinion on solvency have been developed in line with the models applied in developed market economies, which are dominated by small- and medium-sized enterprises. The main purpose of scoring is to shorten, facilitate and increase the efficiency of the business decision-making process, and to provide valuable support to analysts in the quantitative analysis procedure focused on the specifics of a given company.