Improving new investment finance options in the Western Balkans

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Apparel manufacturing and access to finance in the Western Balkans

Despite expectations to the contrary, the apparel manufacturing industry in the Western Balkans is attractive to foreign investors. It is also a growth opportunity for domestic enterprise. This is confirmed by the findings of the report *Recommendation for a Regional Investment Strategy*, which analysed the apparel manufacturing industry and identified barriers to its development. The main strengths of the region are: geographic proximity, close links with European markets, cost competitiveness and strong history and knowledge in the sector. However, to fully exploit these advantages, firms need to make upgrades in business processes and technology. One of the biggest barriers preventing firms from making these improvements is the difficulty they have in accessing finance.

To address the difficulty apparel manufacturing firms, and small and medium sized enterprises (SMEs) in general, have accessing finance, the OECD is investigating good practice policies and institutions in OECD and non-OECD countries. The Western Balkans Conference on Access to Finance which took place in Skopje on 8 June 2010 provided a forum to present some of the findings and an opportunity for policymakers to discuss issues related to access to finance.

The Conference highlighted that access to finance is indeed a problem for apparel manufacturing firms and SMEs in general and there are measures which should be taken to improve the financing environment. In particular, private sector representatives highlighted that:

- Collateral requirements and interest rates are very high, and in general the only acceptable collateral is in the form of physical assets such as buildings and equipment. This makes obtaining loans for new investment very difficult.
- Apparel manufacturing and textile enterprises are increasingly required to provide full-process production (i.e. handling the entire production process from buying fabric to delivering the finished goods) to their buyers. However, these firms find it difficult to obtain affordable working capital loans needed to handle such sophisticated supply-chain management.
- The procedures for obtaining loans are long and arduous. Time consuming procedures reduce SMEs' ability to react quickly to customer demand. This is especially important in the textile industry where "fast-fashion" is the norm.

Access to Finance in the Western Balkans

High interest rates and collateral requirements typically signal weaknesses in the lending environment. For example, both may apply when a bank has difficulty assessing company risk or when collateral is hard to repossess. To give an overview of the environment for accessing finance in the Western Balkans, the OECD presented the results of the Access to Finance dimension in the recently published *Investment Reform Index 2010*. The general findings were:

- Most firms consider access to finance to be a significant constraint that they face. A lack of both collateral and project/borrower information contributes to firms' difficulty in getting loans.

- Measures are needed to improve the quality and scope of data in credit bureaus and collateral registries.
- Governments should explore developing the market for informal equity finance. In particular, the lending environment is heavily focused on bank financing. However, there are other forms of financing such as business angels and venture capital that might better address firms' funding needs.
- More effort is needed to improve the design and impact of credit guarantee schemes in the region.

Credit guarantee schemes

One policy response to high collateral requirements and interest rates is credit guarantee schemes. Credit guarantee schemes (CGSs) can help reduce information asymmetries between borrowers and lenders. Additionally, CGSs can alleviate the high collateral requirements demanded by banks. SMEs are perceived as a highly risky group. Thus, a bank wanting to offer an SME a loan would need to either apply a rate that covers this risk or demand a significant amount of collateral. However, when the SME provides a guarantee, the bank can make the loan at a lower interest rate.

For these reasons, many OECD and SEE countries have implemented programmes to offer eligible companies insurance against credit default. The Conference session on credit guarantee schemes looked at the design features of the most successful programmes.

The Portuguese Mutual Guarantee Scheme

The Portuguese Mutual Guarantee Scheme presented its experiences in mutual guarantees. Mutual guarantee schemes are also sometimes known as mutual guarantee associations, societies or funds. They are private and independent organisations formed and managed by borrowers with limited access to bank loans. Although they are largely funded from membership fees, etc., in many instances, they operate with some form of government support. Mutual guarantee schemes benefit from the active involvement and experience of their members.

The Portuguese Mutual Guarantee Scheme helps smaller companies access financing and helps reduce interest rates for larger companies. The Portuguese system includes not only a mutual guarantee society, but also a counter-guarantee fund. In fact, in Portugal, there are four mutual guarantee societies. Three of the guarantee societies operate on a local basis and one operates on the sector-basis. Typically, capital is provided both by members and banks; enterprises hoping to obtain a guarantee from one of the societies must become a shareholder in that society.

The Croatian Agency for Small Enterprises

Next, the Croatian Agency for Small Enterprises presented its credit guarantee scheme. The Agency was established in 1994. One of its main activities is issuing guarantees to the SME sector. The Agency has grown over the past six years. Most of this growth is because of the high demand from the SME sector. Moreover, the Agency has greater strength in negotiating with banks than individual entrepreneurs.

The procedures in the Agency are relatively standardised. Guarantees are first evaluated by the commercial bank, and if accepted, they are evaluated by the Agency. Borrowers that pass both evaluations are issued a guarantee. A key success factor is having qualified, competent staff capable of evaluating loan quality.

Zagorska Development Agency

The next speaker came from the Croatian Zagorska Development Agency, which issues guarantees on the local level in co-operation with local banks. The Agency was founded in 2006 with the help of USAID, and its purpose is to improve SMEs' chances of obtaining a loan. Guarantees are issued to firms with less than 50 employees. Despite the fact that the Agency was founded to primarily assist production firms, most guarantees are issued to the service industry.

Participant questions and responses

- Montenegro is looking into implementing a guarantee programme. The government is interested particularly in providing support to the agriculture sector and entrepreneurs. What has been Croatia's experience in issuing guarantees to these types of borrowers? The Croatian Agency for Small Enterprises is also committed to making a special effort to issue guarantees to firms in the agriculture sector and entrepreneurs. In fact, guarantees to the agricultural sector are funded by a special government fund. Typically, these two types of borrowers have the greatest difficulty in obtaining loans on their own. The Agency has found that, even with a 10% default rate, issuing loans to these sectors provides a positive impact.
- Kosovo under UNSCR 1244/99 also has no guarantee scheme, but it is looking to implement a partial guarantee scheme for the agriculture sector. What has been other countries' experience in implementing partial guarantee schemes for the agriculture sector, and what have they done to counter-act moral hazard? The Croatian Agency for Small Enterprises admitted that the agricultural sector is a risky one. So far, only a limited number of guarantees issued to the sector have been activated (meaning the borrower defaulted on the underlying loan), although it's possible that number will increase because of the economic crisis. Additionally, Croatia benefits from a special European Commission funded programme for agricultural producers. Countering moral hazard is difficult. But it is generally recognised that when the guarantee covers a smaller percentage of the loan, moral hazard is reduced.
- The Croatian Agency for Small Enterprises also makes a special effort to assist troubled firms who have a credit guarantee with them. The bank is required to inform the Agency of a firm's financial distress. The Agency can then provide the firm with services, including financial and production advice. In their opinion, such investment is worthwhile for the defaults it prevents.

Credit information sharing

Often, firms' access to finance is constrained by the availability of information on their credit worthiness. Public and private credit registries exist to improve the information available on borrowing firms (and individuals), in an effort to ease financing constraints. The information they make available – from a borrower's total number of current loans, repayment history, previous bankruptcies, etc. – can allow lenders to extend greater credit at more favourable interest rates. The conference session on information sharing looked at the regulatory and practical design of registries and bureaus in OECD and non-OECD countries.

The OECD opened the discussion with a presentation on the ideas behind a credit information sharing institution. Credit information sharing reduces collateral requirements and interest rates by lowering adverse selection, limiting moral hazard, reducing over-indebtedness and countering information monopoly. Based on research conducted by the OECD, it concluded that private credit bureaus tend to provide more comprehensive data, however they don't always develop on their own. In such instances, public credit registries play a role. Additionally, data protection and the right to privacy are fundamental to the success of a bureau.

The Bulgarian Credit Rating Agency

The Bulgarian Credit Rating Agency helps financial institutions, investors, suppliers and clients evaluate a company's creditworthiness. It was founded in 2002 and uses a variety of data sources as well as industry analyses to create credit risk assessments. As is likely the case with most rating agencies, it often suffers from poor data quality or data that is not sufficiently disaggregated. Additionally, it doesn't have access to certain government information, including company tax data.

The Association of Serbian Banks

The Association of Serbian Banks established a credit bureau for its members in 2004. The bureau maintains comprehensive coverage of individuals and companies with credit histories in Serbia. Information provided is both positive and negative. The database is maintained under tight security, however when errors are reported they are easily amended. The credit bureau had an immediate impact on the lending environment – new and more sophisticated banking products were created and the default rate has decreased substantially. In general, it is thought that the credit bureau contributed to both reduced credit risk and interest rates. Additionally, the credit bureau creates comprehensive reports on overall indebtedness of its members, and it is estimated that the level of indebtedness has decreased.

Participant questions and responses

- In general, who acts as a supervisory body to credit information agencies? In many countries the supervisory body is in the Central Bank. Other countries have established independent agencies to oversee bureaus and registries.
- Has Serbia ever suffered from a conflict of interest from its members? For example, a member of the bureau might purposely submit false data. In Serbia, this has never happened, but in other countries such situations have occurred.
- In Serbia, what is the relationship between the private credit bureau and the national bank? Currently, only the credit bureau reports information on borrowers. The central bank in Serbia does not provide this type of information.
- Have Serbia or Bulgaria begun exchanging information on borrowers outside their countries? Neither the Serbian Credit Bureau nor the Bulgarian Credit Rating Agency share data with bureaus from other countries, but they are starting to think about taking this next step.

Investment readiness programmes

Access to finance by SMEs is constrained by demand-side weaknesses. Most businesses are not investment ready. Their owners are unwilling to seek external equity finance and those who are willing do not understand what equity investors are looking for or how to "sell" themselves and their businesses to potential investors. These weaknesses, in turn, compromise the effectiveness of supply-side interventions, such as initiatives to stimulate business angels or which create public sector venture capital funds. This has led to the emergence of investment readiness programmes which seek to increase the pool of investable businesses.

A review of investment ready programmes reveals considerable heterogeneity in practice. First, there are differences in their starting point and orientation, with many focusing primarily on either the business plan or the pitch, or both. Second, programmes differ in terms of whether they are generic, and delivered through workshops, or company specific and delivered by mentoring, or both. Third, there are differences in the emphasis given to the investment process itself, with most programmes giving such issues only cursory attention. Fourth, there are variations in the length of such programmes, ranging from a couple of hours to four days. Fifth, there are signs of emerging diversity of focus, with examples of investment ready programmes targeted at women and at third sector (i.e. social) businesses and at deliverers of such programmes. One common element is that such programmes are generally linked to a funding mechanism.

While investment readiness programmes will necessarily differ according to their objectives and users, a few key success factors can be highlighted:

- Investment readiness is much more than preparing a business plan or developing a presentation. Investment readiness programmes need to be comprehensive and preferably offer a range of educational and mentoring services to their participants.
- Many programmes have developed and had success with a number of investment ready self-assessment products. These are software tools designed on the basis of how investors evaluate business plans to provide an automated assessment of a business's investment readiness. Although relatively expensive to establish and start-up, such software and online tools cost very little to maintain. Additionally, they are very efficient at targeting mentoring and educational sessions to areas that are needed for individual entrepreneurs. Such an approach can be very cost-effective in the long run.
- The most successful investment readiness programmes provide follow-up, advice and specialised assistance throughout the life of budding business. Such attention is often required to remove the barriers that prevent initial investment or growth. When entrepreneurs are left to take the initiative in rectifying deficiencies in their business, they may not be able address the situation.

Participant questions and responses

- How receptive have entrepreneurs been to the advice given by the investment readiness programme the presenter works for? In general, entrepreneurs have been receptive to the advice provided them. They are, actually, the segment of the population that is taking the initiative to find out more and improve their business operations.
- Entrepreneurs need to understand when equity is right for them and when it isn't. That is one of the key educational goals of any investment readiness programme – informing entrepreneurs of their financing options and helping them decide which is best for them.
- Quite a bit of European Union money is available for initiatives such as investment readiness programmes. However, there is a substantial amount of paperwork required to obtain the funding.

Conclusion

Credit guarantee schemes, credit bureaus and investment readiness programmes are three among many complementary programmes and institutions that help alleviate a constrained financing environment. South East European countries' success in establishing such initiatives is mixed. While most have implemented basic information sharing and credit guarantee schemes, few have set up comprehensive investment readiness programmes. ***Both the Portuguese Mutual Guarantee Scheme and the Association of Serbian Banks offer their help and advice to participants in setting up and maintaining a mutual guarantee scheme and a credit bureau, respectively.***