

REPORT on context analysis

FOR d.o.o

IPA CBC 3C4SME

4/25/2020

TABLE OF CONTENTS

1. DISCLAIMER	2
2. INTRODUCTION.....	3
2.1. THE PURPOSE OF THE REPORT	3
2.2. THE METHODOLOGY APPROCH	4
2.3. LIST OF ABBRIVATIONS	5
3. RESEARCH RESULTS SUMMERY	6
3.1. SUMMERY OF RESULTS OF BANKING SECTOR ANALYSIS.....	6
3.2. SUMMERY OF RESULTS OF FIELD RESEARCH	6
4. PUBLIC AND PRIVATE CONTEXT AND NEEDS	7
4.1. BACKGROUND.....	7
4.2. NEEDS OF SME SECTOR.....	8
4.3. LEGISLATIVE FRAMWORK FOR ACCESS TO FUNDING	12
4.4. Analysis of banking sector as key loan provider to SMEs	18
4.5. Public funding support	39
5. FIELD RESEARCH.....	42
5.1. APPLIED APPROACH	42
5.2. RESULTS	44
5.3. CONCLUSIONS.....	50
6. POSIBILITIES OF INNOVATIONS.....	51
6.1. CREDIT GUARANTEE SCHAME COMPARATIVE EXPERIENCE	51
6.2. PROPOSAL FOR MONTENEGRO	53
6.3. MODELING OF THE PROPOSAL	55
7. RECOMMENDATIONS	58
8. FURTHER STEPS THAT COULD BE UNDERTAKEN	59

1. DISCLAIMER

The Report on context and needs for SME financial support in Montenegro (the "Report" or "FR") contains information with relation to the project " External expertise services -Analysis of the credit access system, preparation of Pilot Action Experimentation on the application of model of guarantee and law proposal on implementation on changes and improvements of guarantee cooperatives in Montenegro" with reference Ref: 04-305/20-422/8.

The Report has been prepared by FOR d.o.o – financial consulting firm based on completed tender procurement producer and Contract no 04-305/20-422/8. Signed with the Government of Montenegro – Ministry of Economy („Client,,) as the requested by the Tender for the sole purpose of conducting research and technical assistance as a part of IPA cross border project, which aim to enhance funding support to SME sector in Italy, Albania and Montenegro.

„FOR,, based on the information provided by the Client (Terms of references -ToR) and conducted assessments, research, assumptions and forecast made by „FOR,, is providing the Client with a research of context and needs related to funding possibilities for SME sector in Montenegro. The objective of the Report preparation is defined by ToR.

FOR d.o.o does not make any representation of warranty of any kind regarding the accuracy or completeness of any data collected from external sources or other information or the responsibility of any projection, assumptions or opinion contained in this Report.

In particular, but without prejudice to the generality of foregoing, no representation or warranty is given as to the achievement or reasonableness of any projections, targets, estimate or forecasts, and nothing in the Report or any other written or oral information made available to the Client, is or should be relied on as a promise or representation as to the future.

The information contained herein shall constitute no promise or statement whatsoever as to the past, present or future situation or performance of SMEs sector in Montenegro.

2. INTRODUCTION

Improving the micro, small and medium-sized enterprises (in further MSME) has been declared strategic orientation of Montenegro for more than twenty years, which is one of the key pillars of accelerated economic development. The MSME incentive policy has been formulated and has been continuously developing since 2001, and the efficiency of incentives is to be achieved by integrating activities into three directions:

Strategic / macro level - policy making;

- Institutional support / operational level - policy implementation;
- Enterprise / micro level - performance growth.

Micro, small and medium enterprises are an extremely important component of the European Union's (EU) economy. There are about 25.1¹ million small and medium-sized enterprises in the Union that employ two thirds of the total private sectors and provide about 80% of new jobs. Micro, small and medium enterprises (MSMEs) have the same, if not more important role for Montenegro and make up 99% of the total number of existing companies. They employ 75.5% of total employees, while they participate with 75.2% in exports. In total investments in fixed assets, which amounted to 652.8 mil. in 2016, the participation of SMEs was around 56.7% or 370.2² million €. MSME, like foreign direct investments, restructuring and privatization, have a significant impact on the stable economic development of Montenegro and significantly contribute to the dynamic transitional process of the country and creating conditions making the Montenegrin membership to the EU possible. The development of MSME in Montenegro contributes to the growth of the social product, opening new jobs and reducing unemployment, are a significant source of innovation and they increase competitiveness on the domestic market with strong influence and role in more balanced regional development. The particularly important role of the SME sector is reflected in the development of competitiveness at the level of national economy in the function of improving the international business of the domestic economy and successfully market positioning in the global market.

2.1. THE PURPOSE OF THE REPORT

The sub objectives of the Report preparation are:

- Analysis of needs of MSME for credit support in Montenegro and regulatory framework;
- Research efficiency, best practice and weaknesses of current credit access banking facilities available to MSME sector with focus on trends in last several years;

¹ „Financing SMEs and Entrepreneurs 2020,, AN OECD SCOREBOARD, www.oecd.org/

² „Strategy of development MSME in Montenegro 2018-2022

- Analysis of public sector role and public sector loan support to SME sector in Montenegro;
 - Study of comparative innovative approaches that could be doable for Montenegro,
- One of the strategic goals, developed to the operational goals and measures that they represent the basis for the development of the Action Plan for the implementation of the Strategy is Improving access to funding sources for the SME sector, which includes the following specific objectives:
- Improving the offer and the use of existing financial instruments
 - Improving the offer and use of credit and factoring arrangements;
 - Improving the offer and the ability to use non-refundable support (grants).

One of the purposes of the Report is to provide objective assessment of the current financial support to MSME by the banking sector and non – bank credit institutions with expert views on current and possible weakness and treats. In that context, the Report should provide incentive for innovative approaches or tuning of the current system of financial support to MSME.

2.2. THE METHODOLOGY APPROACH

The Report has been done using wide range of methodology and approaches:

NO.	METHODOLOGY	DESCRIPTION	IMPORTANCE	Scope & limitations
1	Comparative approach	Benchmarking against best practice and EU legislation: directives, guidelines, and other documents	High	Chapter 4,6
2	Gap analysis	Difference between practice and regulatory framework of MNE and selected comparable peer group that prefers to comply with or EU legislation and practices	High – delivered from Approach 1	Chapter 4,5,6
3	Interviews and onside validations	Usage of the communication and examination tools	Moderate - valuable source of relevant assessments	Chapter 5
4	Data processing	Usage of modern tools of data processing and modelling	High - should be directed toward business modelling approach	Chapter 4
5	Heuristic approach	Expert judgments and historical knowledge upon practice and regulation that need to be assessed against expectations	High -Realization of the Work Plan has been determined by sophistication, knowledge, and experience of experts	Chapter 4, 7
6	Standards of risk management	Modern practice and tools in identification, measurement, control, and monitoring of materially important risks	High - seeks for modern risk management knowledge in operational, and strategic risk management	Chapter 4, 7
7	Audit practice and tools	Approach driven by International Audit Standards and best audit practice	High - needed for risk management and controlling	Chapter 4
8	Macro-prudential analyses	Usage of macro-prudential indicators for determination of bank's systemic importance and categorization of institution	Moderate - needed approach for financial sector analysis	Chapter 4
9	System integration and decomposition	Assessment of system consistence, functionality and security	Moderate - authority needs to have capacity for self-valuation	Chapter 4,5,6, 7

2.3. LIST OF ABBRIVATIONS

Abbreviation	Meaning
MSME/SME	Micro, small and middle size enterprises in accordance to local legislation framework
ADDIKO	Addiko bank A.D., Podgorica
AECM	European Association of Guarantee Institutions
ATB	Atlas bank A.D., Podgorica
AWEIR	Average weighted effective interest rate
CEB	Council of Europe Development Bank
CEFTA	Central European free trade Agreement
CGO's	Credit Guarantee Organization(s)
CKB	Crnogorska komercijalna banka A.D., Podgorica
CRBE	Central Registry of Business Entities
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
C&I	Commercial and Industrial
DDSME	Directorate for Development of Small and Medium-sized Enterprises
EFTA	European free trade Association
EIB	European Investment Bank
ENIF	Enterprise Innovation Fund
ERSTE	Erste banka A.D., Podgorica
FDI	Foreign Direct Investment
Gross Value Added	As the output value increase equals to the difference between gross output and intermediate consumption
HB	Hipotekarna bank A.D., Podgorica
HHI	Hirshman-Herfindahl index
IBM	Investiciona banka A.D., Podgorica
IDF	Investment and Development Found of Montenegro
IPA	Instrument for Pre-Accession Assistance
KBBD	Komercijalna banka Budva (Podgorica) A.D., Podgorica
LB	Lovćen bank A.D., Podgorica
MNLB	NLB Montenegro bank A.D., Podgorica
MONSTAT	Statistical Office of Montenegro.
Nova	Nova bank A.D., Podgorica
NPLs	Non-performing loans as been defined by local legislation
OECD	Organization for Economic Co-operation and Development
PBCG	Prva banka osnovana 1901 A.D., Podgorica
ROE	Return on Equity
SOG (PGB)	Podgorička banka A.D., Podgorica (Societe General bank)
Turnover	Comprises the total accrued incomes from market sales of goods or services to third parties, with the exception of VAT.
UCB	Universal Capital bank A.D., Podgorica
UNDP	United Nations Development Programme
WTO	World Trade Organization
Zapad	Zapad bank A.D., Podgorica
Ziraat	Ziraat bank A.D., Podgorica

3. RESEARCH RESULTS SUMMERY

3.1. SUMMERY OF RESULTS OF BANKING SECTOR ANALYSIS

Key results of the banking sector analyses, as financial support to MSME, could be summarized as following.

- Credit support volume, even growth in last ten years, is not sufficient to satisfy needs of MSME sector;
- Financial intermediation could be significantly improved especially in loan granting activities, which could not be assess as in track with GDP growth;
- Banking sector seems to be competitive but with visible signs of growing concentration and fast changes on marketplace which is not supportive to crediting MSME;
- Notable, there are a lot of positive issues related to long – term activities of the banking sector but implementation of risk-based supervision and newest EU approaches in regulation of it could additional enhance positive effects and current efficiency of the banking sector;
- Innovative credit guarantee products and other missing banking products could inevitably make loan-granting process more favorable to MSME.

3.2. SUMMERY OF RESULTS OF FIELD RESEARCH

Key results of the field research could be summarized as following.

- Need for financial support to MSME is much higher than usage of banking products;
- MSME sector has lack of collateral and credit worthiness for satisfactory support by banking sector;
- Most of MSME entities needs channel for more intensive cross border cooperation;
- Most of interviewed MSME entities have not used credit guarantee facilities as additional financial instruments that could be supportive to their financial needs;
- MSME entities are very much willing to communicate about their needs and possible partnership relations;
- MSME entities would need financial expertise and usually do not understand loan granting process and way banks have been assessing their credit worthiness;

4. PUBLIC AND PRIVATE CONTEXT AND NEEDS

4.1. BACKGROUND

The progress made in the field of SME policy was presented through the accession process of Montenegro to the European Union, in the Progress Reports of the European Commission, as well as through the negotiating chapter 20 - Entrepreneurship and Industrial Policy, officially opened on December 18, 2013.

Progress has been made in the following areas:

- Improving the business environment for SMEs - simplifying existing and eliminating unnecessary administrative procedures; Reform of ease of doing business in the part of enabling the single-parent system for registration of economic entities; electronic filling of applications for registration of an enterprise; reform business licensing and establishing E-registry licenses; reforms in the field of credit bureaus; registration of immovable property; payment of taxes and employment of foreigners; introduction of an assessment of the impact of regulations on SME operations;
- Improving the availability of financial resources - Improved existing and established new financing instruments (loans, factoring, guarantees, grants, etc.);
- Encourage competitiveness at the SME level by improving the availability and coverage of advisory services and information - supporting the internationalization of SMEs and strengthening exports; encouraging innovation; introduction of entrepreneurial competencies in education, formal and informal education in SMEs; the effectiveness of a private partnership in the design and implementation of SME policy; development of institutional infrastructure for SMEs (establishment of business centers and technological parks); support for SME clustering in clusters;
- Promotion of entrepreneurship and SMEs - improvement of social responsibility; strengthening the role of women in business; Comprehensive support to beginners in business (establishment of incubators; availability of specific financial instruments; access to information and accessibility, advice and assistance when establishing enterprises).

Despite the significant results and the positive effects achieved on the further development of the SMEs sector, the objective is domestic analyzes and assessments resulting from communication with the European Commission, as well as expressed views and attitudes.

4.2. NEEDS OF SME SECTOR

4.2.1 Macroeconomic environment for SME sector

Montenegro, with a small and market-oriented economy, has made significant progress in previous year's growth rates, and also the development of the economy measured by the increase in national income and living standards of the population was significant. Gross domestic product (GDP) in 2016 was 21.1% higher than the value of this parameter in 2011. In 2019, GDP real growth rate was 3.1%. On the international level, Montenegro was rated third in 2018 with real GDP growth rate of 5.1%. Montenegro's GDP Per Capita reached 8,758.453 USD in Dec 2018, compared with 7,788.346 USD in Dec 2017. The inflation rate in Montenegro was recorded at 0.90 percent in February of 2020. Inflation has been reduced, and the number of employees has increased by 9.1% compared to 2011. As for the 2019 statistics, Long Term Unemployment Rate in Montenegro increased to 12.20 percent in the third quarter of 2019 from 11.40 percent in the second quarter of 2019.³

According to the Global Competitiveness Index (Report of the World Economic Forum on Competitiveness of countries, 2019), Montenegro is ranked 73rd out of 141 countries (two positions lower rank in relation to the previous year).

On the World Bank's list of terms and conditions for business, (Doing Business 2020) Montenegro has occupied 50th place from 190 countries.

Changes in the GDP structure show that the economy of Montenegro has accelerated over the previous years, and shifted from traditional industrial to service sectors. In relations with foreign countries (trade balance), Montenegro's economy is constantly recording a deficit, which is partially mitigated with a surplus on the service accounts, predominantly on the basis of tourism revenues. Deficit is financed with FDI inflows, which are the main driver of development in recent years. Montenegro is a leader in the group of countries in transition in central and Eastern Europe in terms of FDI per capita. The FDI inflow in the period 2011-2016 ranged between 9.4% and 16.6% of GDP. In the latest reports of Montenegro, Current Account recorded a deficit of 375.7 USD mn in Dec 2019. Montenegro's Direct Investment Abroad expanded by 2.6 USD mn in Dec 2019. Its Foreign Portfolio Investment increased by 526.6 USD mn in Dec 2019. The country's Nominal GDP was reported at 1.8 USD bn in Sep 2019. Favorable tax treatment in business, free trade regime and transfer of capital, with constant improvement of business ambience, make the Montenegrin economy attractive for foreign investments⁴.

The number of employees in the period 2011-2017 increased by 12.7% or 20.746 newly

³ Source: <https://tradingeconomics.com/montenegro/indicators>

⁴ „Statistical Year Book 2019,,, MONSTAT

employed, and the number of unemployed at the end of 2017 it amounted to 43,900, or about 9% less than in 2011. The number of employed persons in Montenegro increased to 203,123 in November of 2019 from 202,787 in October of 2019.

The growth of the number of unemployed persons expressed in 2016 is caused by an increase in the number of newly registered women on the record unemployed, as a consequence of the implementation of the Law on Amendments to the Law on Social and Child Protection. Unemployment is particularly pronounced in less developed municipalities in the north. At the same time, a significant number of non-residents from the countries of the region are engaged in permanent or seasonal jobs, mainly in tourism, construction and agriculture.

In recent years, special attention has been paid to investments in infrastructure. Large capital projects, in transport, tourism and energy sectors are completed, started or are under preparation. In this period Montenegro became a member of the WTO, and free trade agreements, which it signed with the EU, EFTA, CEFTA, Russian Federation, Turkey and Ukraine providing Montenegrin companies with access to the market of over 800 million inhabitants.

According to World Bank growth projections, in the coming years the Montenegrin economy will be the fastest growing in the region.

4.2.2 Estimate of needs for MSMEs sector financing

Size of the MSME sector in Montenegro

According to publication of MONSTAT⁵ legal entities in Montenegro are classified by size based on following criteria:

Size of company	Employment	Turnover (in euro)	Assets (in euro)
Small	< 50	< 8 000 000	< 4 000 000
Medium	> 50 < 250	> 8 000 000 < 40 000 000	> 4 000 000 < 20 000 000
Large	>250	> 40 000 000	> 20 000 000

MONSTAT offers classification over size of legal entities based on numbers is as following:

Size	2017		2018		2019	
	Number	%	Number	%	Number	%
Small	29,954	98,9	33,456	98,9	34,348	98,9

⁵ „Number and structure of legal entities in Montenegro, year 2019,,MONSTAT.

The Report on context and needs

Medium	284	0,9	304	0,9	305	0,9
Large	48	0,2	52	0,2	54	0,2

Basic indicator of performance of enterprises⁶ by their size are as following for year 2018: (thous. EUR)

Size	Gross output		Intermediate consumption		Gross Value Added	
	Number	%	Number	%	Number	%
Total economy	5 254 744	100.00	3 233 545	100.00	2 021 199	100.00
SMEs	3 947 102	75.12	2 546 219	78.74	1 400 882	69.31
Small	2 536 201	64.25	1 697 610	66.67	838 590	59.86
Medium	1 410 901	35.75	848 609	33.33	562 292	40.14
Large	1 307 642	24.88	687 326	21.26	620 317	30.69

Our estimate based on private platform of data disclosure - Business Intelligence Consulting and based on different type of classification by size of turnover is as following:

Segmentation based on turnover	Number of enterprises	Turnover (thous. EUR)	Share in turnover	Share in number
> 50 million	15	1,474,659	13.47	0.06
> 10 million	95	3,289,814	30.06	0.38
> 1,5 million	660	5,432,029	49.64	2.66
< 300.000	14,730	677,883	6.19	59.47
< 30.000	18,500	69,315	0.63	74.70
Total	34,000	10,943,700	100	100

Conclusion is that Montenegro economy is MSME oriented and driven economy.

Estimate of qualitative needs of MSME sector in Montenegro

Representatives of the MSME sector, which were questioned through a field research similar to broader perception⁷, have identified the need for further improvement of MSME policy and implementation specific measures and activities. This primarily refers to the need:

- (i) further improvement of the business ambient, with the strengthening of the dialogue between the public and private sectors and the cooperation of all

⁶ „Statistical Year Book 2019,,, MONSTAT.

⁷ „Financing SMEs and Entrepreneurs 2020,, AN OECD SCOREBOARD, www.oecd.org/

- institutions, at national and regional level, at local level, including the enhancement of the institutional framework for the support of SMEs;
- (ii) relief access to finances and the use of new instruments;
- (iii) raising competitiveness and innovation enterprises by enabling them to acquire different kinds of knowledge and skills of management and employees and close cooperation with SMEs with research and development centers);
- (iv) the realization of specific, targeted programs of support to SMEs according to their expressed needs, (certification of quality standards, transfer technologies, the development of e-commerce, the promotion and development of new products and services, the development of the supply chain and clusters, strengthening access to foreign markets, etc.);
- (v) promoting entrepreneurship within a specific framework target groups (women, young people).

Meeting these needs and further growth of SMEs would make a significant contribution to the overall faster economic growth of Montenegro, further transformation of the structure into a modern and environmentally friendly economy, which enables integration of rural and urban units. To that end, it is necessary to provide complementarity and linkage of the MMSP policy with other strategic policies.

Estimate of financial support needs of MSME sector in Montenegro

In Montenegro the level of demand for credit support has not been disclosed as a measure of financial support needs even if that was exactly the case in some of neighboring countries as in North Macedonia is for exemplar. Demand for loans has not been compared against supply of loans as macroprudential supervisory tool and reporting system required by the banking sector has not been covering segmentation of the aggregate loan portfolio by micro, small, medium and large enterprises. This fact makes impossible exact disclosure of financial needs by MSME sector.

In following chapter (4.4. – Analyses of the banking sector) we have estimated, using two different ways, total yearly support by the banking sector to MSME and came up with similar result of 600 – 670 million euro. That we could assign as **executed credit support** by the banking sector.

Hereby, we used two methods to estimate yearly financial need of the MSME sector that should be covered by loans or similar financial facilities and which is not executed by the banking sector.

Frist method is based on our field research where every second MSME use some kind of loan support and that loans support is not sufficient. We could reasonably assume that out of other half of MSME sector 50% would need and use credit support but they are not recognized by the banking sector as credit worth enterprises. If we have around 30.000 active (as was pointed out in statistic disclosed in this chapter) that would apply that around 25% of them (7,500 in number) have lack of financial support. If average loan of this segment would be equal as half of average loan granted to legal entities (table 7: 73,500/2 euro) than

we could estimate that unexecuted yearly demand would be **275,625,000** euro, which is close to ½ of amount supported by the banking sector.

Second method is based on comparative analyses. North Macedonia⁸ and Serbia were taken as peer countries, which has similar percentage share of approved loan applications comparing to received loan applications of corporate sector.

This share is between 70 – 75% year – to year, which means that around 25-30% (Serbia⁹ 38.5% in 2017 and 27% in 2018) of applications for loan granting have been rejected by North Macedonia banking sector. In loan granting process there is additional percentage of applications which have never been formalized or which are rejected in initial acquisition interview. Could be assumed that percentage of such applications is at least half of rejected applications, which drives to 35 – 45% of rejected loan applications out of total loans granted in one year. If we apply this percentage to total granted new loans to corporate sector in Montenegro in 2019 (table 13 chapter 4.4. amount **1,234,620,000 x 55%¹⁰ = 679,041,000**) we shall calculate that there is around 238 million euro of unsatisfied demand for credit support of MSME sector.

Results of two applied methods could be understood as benchmarks for unsatisfied demand for credit support of MSME sector in absolute value. So the very approximate, as result of applied methodology, demand for credit support of MSME sector, which has not been meeting supply, is between **250 – 275** million euros. That could be assessed as very high need for credit support by MSME sector, which requires attention.

4.3. LEGISLATIVE FRAMWORK FOR ACCESS TO FUNDING

4.3.1. Loan founding framework

1. The Law on banks – in period of expiration
2. The Law on credit institutions – which should take place in 2021
3. The Law on Investment development fund
4. The Law on financial security
5. The Law on financial leasing, factoring, purchase of receivables, microcredit, and credit guarantee operations

The law on banks – expiring framework

This law regulates the establishment, management, operation and control of the operations

⁸ „Financial Stability Report for 2017,, National bank of republic of North Macedonia Chart 54, www.nbrm.mk/content/Financial_Stability_Report_RM_2017.pdf

⁹ FINANCING SMES AND ENTREPRENEURS 2020: AN OECD SCOREBOARD © OECD 2020, pg.35

¹⁰ Share of corporate loans in total loans

of banks and microcredit financial institutions and credit unions and regulates the conditions and control of the operations of persons dealing with credit and guarantee operations in order to establish and maintain a sound and stable banking system that provides protection of depositors' interests and other creditors.

The Article 3 defines the concept of credit guarantees:

"credit-guarantee transactions are the issues of issuing guarantees for the proper settlement of the obligations of the loan user;"

The Article 6 defines banking operations:

"In addition to the activities referred to in paragraph 1 of this Article, the bank may perform the following activities: 1) issuing guarantees and taking other off-balance sheet liabilities;"

The Article 158 deals with the concept of a credit union:

"The Credit Union is a financial institution owned by members of the Union, organized on the principles of voluntariness of association, connection, reciprocity and equality of members of the Union, which primarily approves loans and provides other financial services to members of the Union from its own funds and deposits of members of the Union."

Article 159:

"The Union may be established by at least 30 able-bodied natural persons or entrepreneurs who are professionally or otherwise connected, under the conditions determined by this Law. The connection referred to in paragraph 1 of this Article is especially considered as a connection between the person performing the same activity, belonging to the same association, territorial affiliation, employment with the same employer, belonging to the same trade union, and other forms of connection acceptable to the Central Bank."

Article 160:

The minimum amount of the founding capital of the Union is € 10,000. The capital referred to in paragraph 1 of this Article shall be considered as members' contributions and donations.

Article 161:

The Union can perform the following tasks:

- 1) receives deposits from members of the Union;
- 2) approve loans to members of the Union from own funds, deposits of members of the Union and funds obtained on the money market;
- 3) issue guarantees and undertake other similar obligations for members of the Union;

Article 164:

Conditions for performing credit guarantees:

"Legal entities may be engaged in credit-guarantee operations which, for the performance of these activities, obtain the appropriate approvals from the Central Bank.

The Central Bank shall decide on the application for issuing the approval referred to in paragraph 1 of this Article within 120 days from the date of submission of the request.

The regulation of the Central Bank shall regulate the conditions for issuing the approval referred to in paragraph 1 of this Article, including minimum initial capital, operations, control of business operations and seizure of the approval referred to in paragraph 1 of this Article."

The Law on Investment and Development Fund

This Law regulates the establishment, activity, powers and organization of the Investment and Development Fund of Montenegro (hereinafter: the Fund).

The Fund operates in order to support the economic policy of the Government of Montenegro and to stimulate: accelerated economic development of Montenegro, dynamic growth of micro, small, medium and large economic entities, more balanced regional development, competitiveness and liquidity of business entities, production and services oriented towards exports, the reduction of import dependence, financing of infrastructure projects, water supply projects, wastewater treatment and environmental protection, efficient implementation and completion of the privatization process through the sale of capital acquired in the process of ownership and management transformation, as well as encouraging the financing of other projects of local, regional and state importance. In order to support the development of entrepreneurship, and in order to facilitate access to the funds of the loan beneficiary, within the Fund, the Guarantee Fund is formed as a separate organizational part, in accordance with the Statute of the Fund.

Article 12:

"The Fund's activities are:

- 1) loan approval, factoring and other forms of purchase of receivables and issuing guarantees, in particular:
 - Encourages the establishment, development and sustainability of micro, small, medium and large business entities and entrepreneurs;
 - provides support to infrastructure projects, water supply projects and environmental protection;
 - finance projects of local, regional and state importance;
 - Encourage the competitiveness of Montenegrin products and services;
 - encourages employment;
- 2) issuing guarantees for the proper settlement of the obligations of the borrower, whose cover is made up of the Guarantee Fund assets;
- 3) insurance of exports of goods and services from Montenegro from non-market risks (hereinafter: export insurance);
- 4) lending in the function of supporting social entrepreneurship, self-employment, initiating a new investment cycle, developing, and strengthening the initial business;
- 5) performing activities related to the sale of capital in the Fund's portfolio;
- 6) carrying out other activities and activities that provide support to the promotion of entrepreneurship and economic development, and
- 7) performing other tasks determined by law. The Fund may perform other tasks entrusted to it by the Government when it deems it to be in the interest of the economic development of Montenegro. The Fund approves loans directly or indirectly, through a bank and other legal entity authorized to approve the loan. The Fund carries out the activities of export insurance on behalf and for the account of Montenegro. Detailed conditions and manner of carrying out export security activities shall be regulated by a regulation adopted by the Government.

Article 16a:

“Within the Fund, the Guarantee Committee operates.

The Guarantee Board makes recommendations and opinions to the Board of Directors of the Fund regarding the issuance of guarantees for the proper settlement of the obligations of the borrower from the Guarantee Fund.

The composition and number of members of the Guarantee Committee shall be determined by an act of the Government. Professional and administrative-technical tasks for the Guarantee Board shall be performed by the expert service of the Fund.

The Law on credit institutions – future framework

Unlike the previous Law i.e. Law on banks this Law does not define credit institutions such as factoring and microcredit institutions. These instruments are defined through the Law on Financial Leasing, Factoring, Purchase of Receivables, Micro-Lending and Credit-Guarantee Operations.

The Law on financial security

This law regulates the manner and conditions for concluding and executing financial security contracts.

Financial security, for the purposes of this Law, is the transfer of property rights or the establishment of a pledge right on a financial instrument, cash or credit claims, as defined by the financial security contract, in order to secure the execution of certain financial obligations.

Financial security referred to in paragraph 1 of this Article shall include income from financial instruments or funds transferred to security unless the contract referred to in paragraph 1 of this Article is otherwise regulated.

This Law applies to the financial security provider (hereinafter: the security provider) and the recipient of the financial security (hereinafter: the recipient of security), as follows: This Law shall apply to the provider and the recipient of security with headquarters in Montenegro, namely: state authorities responsible for managing public funds, the Central Bank of Montenegro, banks, microcredit financial institutions, persons dealing with credit and guarantee operations, the Central Depository Agency, The Health Insurance Fund of Montenegro, the Pension and Disability Insurance Fund of Montenegro, the Investment Development Fund of Montenegro and the insurance company, investment funds, investment fund management companies and authorized participants in the securities market.

The persons referred to in paragraph 2 of this Article may provide certain financial obligations to perform in accordance with this Law or other regulations governing security means.

The Law on financial leasing, factoring, purchase of receivables, microcredit, and credit guarantee operations

This Law regulates the activities of financial leasing, factoring, purchase of receivables, microcredit and credit and guarantee operations, as well as the establishment, operation and control of the business of companies engaged in such business (hereinafter: financial services provider).

Credit guarantee operations:

Credit-guarantee operations, within the meaning of this Law, shall be the operations of issuing guarantees by a credit-guarantee fund for regular meeting of obligations of loan beneficiaries. Credit-guarantee operations, in accordance with this law, can only be performed by credit-guarantee funds.

Credit-guarantee fund shall be a business organization with registered office in Montenegro performing as its sole activity the credit-guarantee operations, pursuant to a license issued by the Central Bank. Credit-guarantee fund shall be established as a joint stock company. Application to register a credit-guarantee fund with the CRBE shall be submitted no later than within 30 days as of the day a decision on issuing a license is received.

Minimum amount of the monetary part of initial capital of a credit-guarantee fund shall be 1,000,000 euro.

Donated capital shall not be treated as initial capital referred to in paragraph 1 of this Article.

Micro-Lending Operations Article 88

Micro-lending operations, within the meaning of this Law, shall be the operations of granting micro-loans to natural persons, entrepreneurs and micro, small and medium-sized business organisations.

Micro-loan, within the meaning this Law, shall be: 1) Earmarked loan granted to a natural person in the amount up to 20,000 euro, 2) Earmarked loan granted to an entrepreneur in the amount up to 30,000 euro, and 3) Earmarked or non-earmarked loan granted to a micro, small or medium-sized business organisation in the amount up to 50,000 euro.

Micro, small and medium-sized enterprises referred to in paragraph 1 of this Article shall be deemed to be micro, small and medium-sized enterprises defined by the law governing accounting.

4.3.2. Other financing possibilities

Directorate for Investments, Development of SMEs and Management of EU Funds

The main institution for the realisation of the policy and for providing support for SMEs in Montenegro is the Directorate for Investment, Development of SME and EU Funds Management.

As result of reorganization of the Ministry of Economy this organization part has become the most important for creation and implementation policies and programs directed toward support of MSME as well as entrepreneurship in Montenegro. This Directorate continuously works on enhancement of business environment and providing of incentive measures for development of MSME.

ENIF

Active since 2016, the Enterprise Innovation Fund is a venture capital fund focusing on an investment portfolio consisting of innovative SMEs at various stages of business development, from the seed to expansion phase, in the Western Balkans. ENIF aims at reinforcing the financial structure of innovative SMEs resulting in a strong and bankable balance sheet.

ENIF focuses on highly specialized, innovative SMEs in the Western Balkans (Albania, Bosnia and Herzegovina, Croatia, Kosovo*, Former Yugoslav Republic of Macedonia, Montenegro and Serbia). It provides equity and quasi-equity finance to stimulate and support commercially viable research in innovative SMEs.

IPA II ASSISTANCE - INSTRUMENT FOR PRE-ACCESSION ASSISTANCE

This action will contribute to the increase of the private sector competitiveness and innovation capacity, with a focus on SMEs. In addition, it supports the increase of administrative capacity and level of alignment to the EU acquis in the field of Competitiveness and Innovation. As regards private sector competitiveness, the action will focus on improving access to finance of private sector for competitiveness and innovation by developing new Financial Instruments and grants; supporting business development through the provision of advanced advisory service for private sector; as well as promoting the internationalization of the national economy. Concerning innovation, the action will improve the research and innovation infrastructure available to SMEs in order to support their development in this regard. As regards, administrative capacity development, IPA support will be used for the provision of horizontal assistance for the capacity development of the relevant institutions involved in competitiveness and innovation management, as well for the alignment of national legislation and strategies with EU acquis for the chapters included in C&I Sector. This Activity aims to improve and, in some case, to create the access to financing for enterprises overcoming the traditional difficulties they face regarding the lack of adequate financing. Studies show that the SME Innovation Management capacities are at a low level and further assistance is needed in accessing financial sources to upgrade the current situation. In order to achieve this result.

4.4. Analysis of banking sector as key loan provider to SMEs

4.4.1. Objective of the research and methodology

Key objective of this research is assessment of efficiency of banking sector in supporting SME founding needs in Montenegro.

The objective could be achieved by in debt evaluation of following performance indicators:

- banking sector financial intermediation;
- business model, risks awareness and countercyclicality of the banking sector;
- it's competitiveness;
- development trends related to most important aggregate indicators for assessment of MSME credit support;
- interest rates as price component of the banking sector support;
- financial capacity of banking sector to support SME especially on long term;
- quality of credit risk management and loan processing.

Data presented herein have been collected from official web site of Central bank of Montenegro and web sites of commercial banks and further classified, aggregate, compared and produced by our self. Publications of Central bank of Montenegro that we have used for collection of data for period of then years are: Annual Reports, Financial Stability Reports and Bulletins (monthly edition). According to Central bank of Montenegro regulation¹¹ banks are obliged publicly disclose information and data on financial position and operations of the banks as well as method and deadlines for public disclosure of such information and data. This information are publicly disclosed on web sites of commercial banks. Additionally, as source of data was used Business Intelligence Service as private service provider which has been producing reports on performance of the banking sector. **Hereby we have not covered research of type of credit product offered by the banking sector, which has been already emphasised by publication of Ministry of economy – Information on financial and nonfinancial sector support to Montenegro economy.**

4.4.2. The banking sector as financial intermediary

Internationally mostly recognised indicators of financial intermediation assessed in terms of a banking sector development are as following:

¹¹ DECISION on public disclosure of data and information by banks (Decision no. 0101-4014/24-2-2010, „Official Gazette of Montenegro no 02/12)

- Trends of growth in long term period which should cover more than one investment circle;
- Banking total assets and aggregate loan portfolio against GDP level,
- Number of banks, branches and ATM machines per habitant.

Observed trend of growth of key performance indicators of banking sector in Montenegro lead to conclusion that growth of the banking sector is pretty much cyclical.

Namely, observation of growth of aggregate assets, loans on deposits from 2001 until end of 2008 could be assessed as impressive compering to other countries in SEE. After 2008 till 2015 trend of mentioned representative indicators are mostly unfavourable and from than up to present are again favourable but moderate in terms of intensive growth of loans granting and external founding providing. The conclusion could be supported by following tables:

Table 1: Growth rates of assets, aggregate loan portfolio and deposits of banking sector in Montenegro- Period 2001. – 2008. years

AGGREGATE	Growth rates (%)						
	02/01	03/02	04/03	05/04	06/05	07/06	08/07
ASSETS	44.7	2.9	26.9	56.8	105.6	107.5	11.5
LOANS	50.6	60.8	39.8	33.8	125.3	165.2	24.5
DEPOSITS	42.1	2.4	29.4	78.8	120.5	94.3	-6.4

Table 1a: Growth rates of assets, aggregate loan portfolio and deposits of banking sector in Montenegro- Period 2008. – 2019. years

AGGREGATE	Growth rates (%)										
	09/08	10/09	11/10	12/11	13/12	14/13	15/14	16/15	17/16	18/17	19/18
ASSETS	-8.6	-2.7	-4.15	-0.41	5.3	5.6	10.72	9.17	10.32	5.37	4.47
LOANS	-14.3	-8.3	-11.1	-4.8	-3.0	2.6	2.0	5.97	13.24	12.95	4.52
DEPOSITS	-6.8	-2.3	1.5	9.0	7.0	7.4	13.5	9.31	13.65	5.82	0.48

Growth rate of aggregate loan portfolio in period from 2008 till 2020 could be assessed as moderate 9,64 % and key contribution to that growth is prevailed in last two years due to the negative growth rate from 2008 till end of 2017 which was -7,4%.

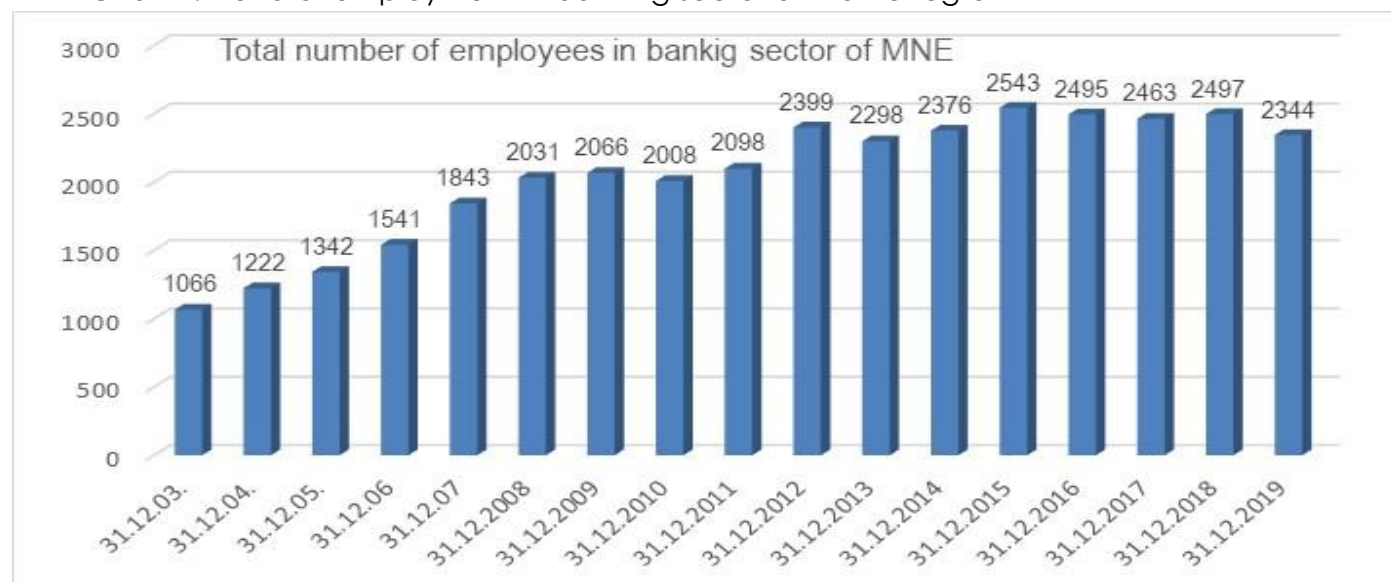
The level of aggregate loan portfolio of banking sector in Montenegro at the end of 2019 is 3,062 thousand which is in constant prices 4,832 thousand¹². That would get 63.4% loan

¹² Statistical office of Montenegro, <http://www.monstat.org/eng/page.php?id=1544&pageid=18>

portfolio of banking sector again GDP. According to FSAP (Financial Sector Assessment Program)¹³ and general recognised macroprudential practise any ratio of loans /GDP below 100% is insufficient and this one in Montenegro could be considered as low. Comparison with first group of EU countries, where financial intermediation measured by this indicator is 2,5 – 3 times GDP observing some of the countries, highlights that this indicator of financial intermediation in Montenegro is not on level should be expected and that financial intermediation by the banking sector could be improved. Additional evidence for mentioned conclusion is that in last several years Montenegro has recorded intensive licencing of new banks but with very different efficiency and contribution to financial intermediation, which will be more thoughtful analysed in following parts of overall analyses of the banking sector.

Currently in Montenegro operate 13 banks which is, on total population of 620,000 around 1 bank on 47.7 thousand people or on population over 10 years of age (around 542,700) is 1 bank on 41.7 thousand people that could be active in usage of banking services. Number of employees in banking sector of Montenegro has been recording continues growth except last year when two banks had left in bankruptcy procedure.

Chart 1: Trend of employment in banking sector of Montenegro



Source: Data compiled from the individual banks' profiles

One banks' employer serves 264.5 citizens which is very good financial intermediation. Banking sector in Montenegro on end of 2019 has 195 branches all over the country and 413

¹³ FSAP has been conducted by Ineternational Monetary Fund and Word Bank.

ATMs that could be assessed as satisfactory infrastructure coverage for financial intermediation compared with size of the country and number of municipalities.

4.4.2. Business models, risk awareness and countercyclicality of the banking sector

Montenegrin banks have been licenced as universal banks¹⁴ but in spite of that fact banks have different business models of running their operations.

Business models of Montenegro banks could be, conditionally, defined as follows;

- model of high cyclicity against models of contra cyclical behaviour;
- models of dominantly retail or dominantly corporate banking;
- models of dominantly short term or dominantly long-term loans granting;
- models of classical dominant classical banking products against models of more innovative and high diversified products; and
- models of high diversification against models of high concentration.

Each of above mentioned business models have different impact on ability and willingness of banks to support SMEs. More banks are procyclical more risk averse they are in bad times and less support could be expected to SMEs. More banks are retail (physical persons¹⁵) oriented less support could be expected to SMEs. More banks are oriented toward short term financing less support for start-ups, investment loans, equity and project financing could be expected to SMEs which needs are mostly long-terms profiled. More banks are, in modelling their approach, oriented to concentration against diversification less support could be expected to SMEs.

Insite in trends of total assets growth of the banking sector we could diagnose level of procyclical or contracyclical behaviours:

Table 2: Total assets of banks at the end of year (in mill. Euro)

	Banka	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
1	CKB	1,026	1,134	840.7	718.1	691.3	645.4	618.9	572.0	585.6	594.7	614.9	691.4	816.6
2	PBCG	414	489.7	367.2	313.3	252.4	241.3	250	276.3	322.4	376.1	439.8	396.0	392.2
3	ADDIKO	468	482.3	507.2	447.8	282.8	248.9	240.6	237.8	229.2	253.8	263.9	237.9	227.3
4	MNLB	402	468.5	515.2	523.5	525.7	476.5	513.8	516.7	486.6	475.0	459.8	489.0	547.2
5	SOGE	178	222.4	240.2	260	284.6	312.2	348.5	380.8	436.1	450.2	483.3	530.5	542.7
6	ERSTE	169	168.5	182	240	299.8	348.4	351	376.8	369.2	450.5	491.7	520.3	605.0
7	ATB	146	157.6	160	182.2	182	204	240	242.7	262.8	259.4	256.5	231.4	
8	KBBBD	77	77	71.8	82.4	89.2	96.6	108	116.6	110.4	111.0	125.0	142.2	155.7
9	HB	69	74.8	100	128.8	155.6	173.8	224	292.7	411.3	429.5	494.1	506.9	530.5
10	IBM	19.5	21	24.2	28	37	39	37.7	44.3	48.2	46.3	45.3	41.0	

¹⁴ Article 6 Law on banks

¹⁵ In EU legislation retail covers also micro and small business but in Montenegro banking practise under this term mostly is understood loan granting to physical persons.

The Report on context and needs

11	UCB	6.4	13.8	16.5	19.5	20.8	24	26.5	59.4	86.0	115.9	228.6	266.9	317.2
12	LB								19.9	58.3	118.9	135.6	170.3	198.7
13	Zapad									53.1	57.7	68.3	90.8	162.1
14	Ziraat									13.2	40.3	52.7	66.3	83.0
15	Nova										11.7	22.6	25.9	25.5
Total		2,975	3,309.7	3,025.2	2,943.6	2,821.5	2,810	2,959	3,136	3,472	3,791	4,182	4,407	4,603.9

Source: CBOM Financial Stability Reports for years 2010-2018 and CBOM Bulletins for 2019

Table 3: Growth rates of total assets of banks year-to-year (in %)

Banka	2009/2008	2010/2009	2011/2010	2013/2012	2014/2013	2015/2014	2016/2015	2017/2016	2018/2017	2019/2018
1 CKB	-14.59	-3.73	-4.10	-7.57	2.37	1.55	3.39	12.44	18.11	816.6
2 PBCG	-14.68	-19.43	3.63	10.49	16.68	16.66	16.94	-9.95	-0.98	392.2
3 ADDIKO	-11.70	-36.85	-3.33	-1.16	-3.63	10.72	3.97	-9.84	-4.46	227.3
4 MNLB	1.60	0.43	7.83	0.56	-5.83	-2.38	-3.20	6.36	11.89	547.2
5 SOGE	8.19	9.51	11.62	9.28	14.52	3.24	7.35	9.75	2.32	542.7
6 ERSTE	31.92	24.95	0.72	7.40	-2.03	22.00	9.14	5.83	16.28	605.0
7 ATB	13.82	-0.07	17.66	1.13	8.29	-1.30	-1.11	-9.80	-100.00	
8 KBBBD	14.70	8.37	11.71	8.04	-5.38	0.62	12.58	13.76	9.52	155.7
9 HB	28.66	20.81	28.93	30.63	40.54	4.43	15.03	2.58	4.66	530.5
10 IBM	15.78	31.56	-3.44	17.55	8.81	-3.91	-2.12	-9.48	-100.00	
11 UCB	18.71	6.64	10.42	124.43	44.85	34.77	97.14	16.72	18.87	317.2
12 LB					191.50	103.93	14.05	25.62	16.68	198.7
13 Zapad						8.68	18.46	32.95	78.48	162.1
14 Ziraat						204.03	30.90	25.77	25.30	83.0
15 Nova							93.47	14.66	-1.44	25.5
Total	-8.59	-2.70	-4.15	5.30	5.99	10.72	9.17	10.32	5.37	4.47

Source: CBOM publications and web sites of commercial banks

Growth rates of total assets of the banking sector clearly suggests that the banking sector as a whole is procyclical because after huge growth rates till middle of 2008 for several years growth rates were negative and that had started to recover on moderate level which is not in consistence with GDP growth rates.

Loan granting and deposit collection has remained the key generator of the assets growth and observation on loan granting activities are even more interesting for analysis of the support that banking sector have provided to SME. On aggregate level, loan portfolio has been performing even more procyclical then total assets changes. Those banks that had been very active before financial crises in 2008 have become very risk averse in post crises period and those which were less active before the crises have change their attitude towarded more aggressive loan lending activities. The conclusion could be supported with observations of aggregate (and by banks) loan portfolio changes and trends of growth rates of loan portfolio by banks.

Table 4: Loan portfolio by banks on end of year (in mill. Euro)

Banka	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
1 CKB	725.7	943	844.6	658.6	339.7	298.4	504	447.9	381.2	308.24	350.7	466.5	531.3
2 PBCG	408.9	463.8	310.5	244.2	182	158.7	173.5	182.7	185.5	197.0	211.6	220.3	226.7
3 ADIKO	359.7	466.6	449.3	360.3	210.7	192.6	212.6	180.3	166.0	187.4	203.9	210.1	207.4
4 MNLB	322	382.5	418	435.5	428.7	388.8	365.6	327.7	313.4	297.3	306.2	342.8	411.3
5 SOGE	125.7	174.5	177	197.3	233.3	245	275	281.4	317.9	316.7	364.0	412.6	453.3
6 ERSTE	100.3	119.7	144.6	192.8	238.5	245.3	284.4	263.7	247.4	269.7	330.9	354.3	448.6
7 ATB	91.2	110.6	97.5	107.4	117.6	114.9	188.4	183.4	183.5	155.5	151.2	157.6	0
8 KBBD	46.9	60.9	47.9	49.5	54.5	61.8	68.3	65	67.3	55.9	75.2	98.2	105.4
9 HB	58.2	61	76.8	101	113.5	117.5	174.5	192.1	210.6	232.0	265.9	267.6	263.6
10 IBM	7	10	10.7	14	23.7	25.4	25.5	31.7	29.0	25.7	24.9	30.7	0
11 UCB		4.9	6.8	11.8	13.3	14.2	18.4	42.8	65.3	79.9	87.9	109.5	105.6
12 LB								14	45.7	81.1	106.4	137.5	160.3
13 ZIR B									36.9	46.9	55.3	55.3	71.3
14 ZAP B									6.9	33.8	46.6	50.7	63.0
15 NB										2	12.6	15.5	13.8
Total	2,245.7	2,792.6	2,397.8	2,200	1,955.7	1,862.6	2,303.7	2,213.2	2,257.2	2,290	2,593.3	2,929.2	3,061.8

Source: CBOM publications and web sites of commercial banks

Table 5: Growth rates of loan portfolio by banks year-to-year (in %)

Banka	09/08	10/09	11/10	12/11	13/12	14/13	15/14	16/15	17/16	18/17	2019/2018
1 CKB	-30.16	-26.22	-30.08	-12.18	68.94	-11.14	-14.87	-19.16	13.79	33.00	13.89
2 PBCG	-3.70	-19.81	-41.50	-8.62	-1.07	-5.33	-7.97	12.86	8.81	3.07	-1.30
3 ADDIKO	-33.06	-21.33	-25.43	-12.85	9.32	5.31	1.54	6.19	7.42	4.07	2.93
4 MNLB	9.32	4.14	-1.56	-9.31	-13.26	-2.82	-4.36	-5.16	2.99	11.96	19.98
5 SOGE	1.39	11.50	18.22	5.00	12.33	2.27	12.98	-0.39	14.95	13.34	9.86
6 ERSTE	20.76	33.36	23.66	2.86	15.96	-7.26	-6.19	9.01	22.66	7.09	26.60
7 ATB	-11.86	10.25	9.45	-2.33	64.02	-2.63	0.05	-15.26	-2.77	4.19	-100.00
8 KBBD	-21.39	3.36	9.98	13.59	10.38	-4.93	3.73	-17.04	34.47	30.64	7.31
9 HB	25.88	31.55	12.35	3.51	48.52	10.16	9.62	10.14	14.60	0.64	-1.48
10 IBM	7.56	31.97	68.34	7.25	0.69	24.21	-8.57	-11.20	-3.29	23.03	-100.00
11 UCB	39.73	72.71	12.78	7.16	29.03	132.87	52.60	22.36	10.02	24.71	-3.50
12 LB							224.45	77.12	31.15	29.27	16.56
13 Zapad								27.14	17.82	-8.35	24.42
14 Ziraat								389.39	37.97	18.70	28.90
15 Nova								363.35	23.33		-11.18
Total	-8.59	-14.14	-8.25	-4.7	20.27	-1.2	-1.20	1.45	13.24	12.95	4.33

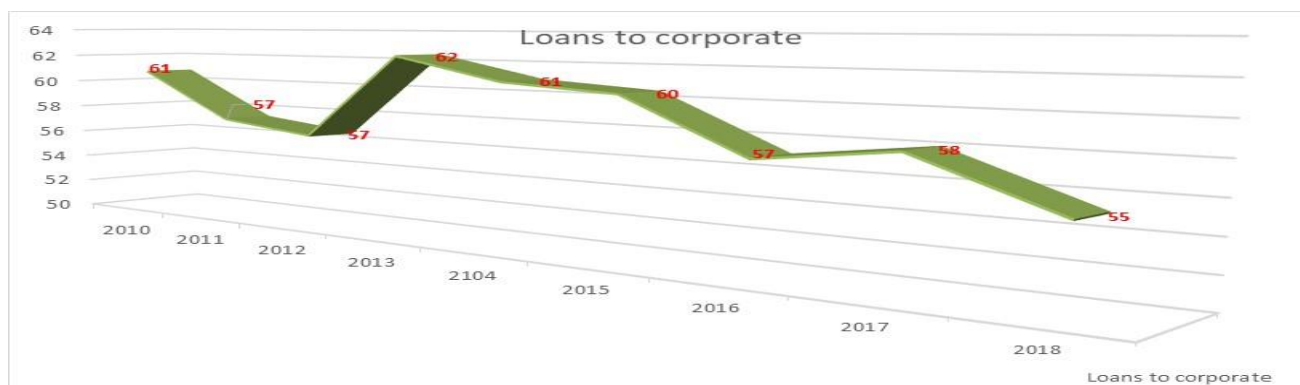
Above table highlights (negative growth rates) that banks have had intensive growth rates before 2009 (mostly big banks) have acted more procyclical after and there is rare number of cases with continuity in loan portfolio growth rates (HB, Erste and UCB). New

licenced banks could not count because of short observation period and natural high growth rates due to the very low starting point.

Based on presented analysis the conclusion is that banking sector has been behaving procyclical, which is not favourable for MSME and especially during slowing down of the economy.

Share of corporate loans in total loan portfolio is in low decline in period of 10 years, which is not favourable trend for MSME credit support by the banking sector:

Chart 2: Share of corporate in total aggregate loan portfolio for period 2010 -2019



Total loan portfolio share granted to corporate is about ½ of the total loan portfolio and that share is in period of ten years in slow decline. In this aspect, support of MSME could be assessed as satisfactory in overall scope of banking activities. This average picture of the banking sector related to preferable model of corporate against retail banking has been painted by large and medium sized banks within the system while small banks are more corporate oriented but at same time with higher concentration within their loan portfolios.

The deeper analysis has to go into the estimate of share of MSME loans within total loans in aggregate loan portfolio that are related to corporate sector. Following table could offer better inside in support to MSME sector by the banking sector over last ten years:

Table 6: Estimate of aggregate loan portfolio to MSME year-to-year (in 000 euro)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Loans to private companies	1,199,084	926,085	882,441	886,075	842,118	884,895	893,775	935,464	1,001,965	1,038,022
Entrepreneurs	6,219	6,278	4,718	5,067	4,634	5,892	5,935	5,421	5,613	5,848
Total	1,205,303	932,363	887,159	891,142	846,752	890,787	899,710	940,885	1,007,578	1,043,870
Estimate of participation of loans to large enterprises	35%	35%	35%	35%	35%	35%	35%	35%	35%	35%
Loans to LE	421,856	326,327	310,506	311,900	296,363	311,775	314,899	329,310	352,659	365,355
MSME	783,447	606,036	576,653	579,242	550,389	579,012	584,812	611,575	654,926	678,516

Estimate of Share of loans that have been granted to large enterprises was conducted based on research of the loan portfolio in three representative banks where share of large companies in corporate segment of the loan portfolio was between 30 – 40%.

Broadly, used indicator for assessment of diversification of an aggregate loan portfolio in banking industry and assessment of banks' business model is level of the average loan. Data on average loans in Montenegro indicate high level of diversification but in same time 93% up to 95% of loans granted each year have been granted to physical persons which is indicator of dominant retail strategy and high concentration of loans in corporate segment of the aggregate loan portfolio. Following table represents above mentioned conclusions:

Table 7: Average size of loans year-to-year (in 000 euro)

	2012	2013	2014	2015	2016	2017	2018	2019
Total No of new loans granted	28,756	57,191	34,533	57,467	60,769	66,141	62,540	71,961
Physical persons	26,709	53,178	31,641	52,912	56,629	62,067	58,382	62,059
Corporate	2,047	4,013	2,892	4,555	4,140	4,074	4,158	9,902
Average size of new loans	14,0	13,0	14,8	16,8	18,8	16,6	18,8	17,2
Physical persons	4,7	5,2	5,4	6,4	8,3	7,7	8,2	8,2
Corporate	113,0	115,5	116,7	132,9	163,0	151,7	157,5	73,5

Banking in Montenegro has remained very conservative with classical set of activities immanent still undeveloped banking sector. Structure of the assets of Balance Sheet of the banking sector is fairly simple where prevail cash and many market instruments and loans:

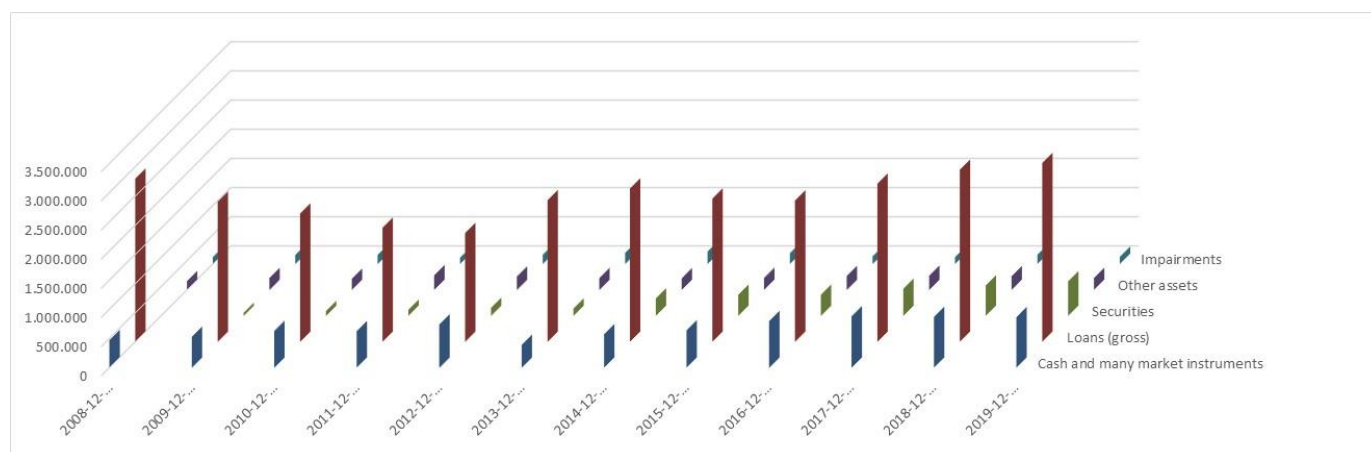


Chart 3: Structure of aggregate assets of the banking sector from 2008

The aggregate loan portfolio by products to corporate sector is very simple with dominance of investment loans and loans for long-term working capital. Retail loans are dominantly mortgage loans (38%) and cash loans (51.7%).

4.4.3. Competitiveness of the banking sector

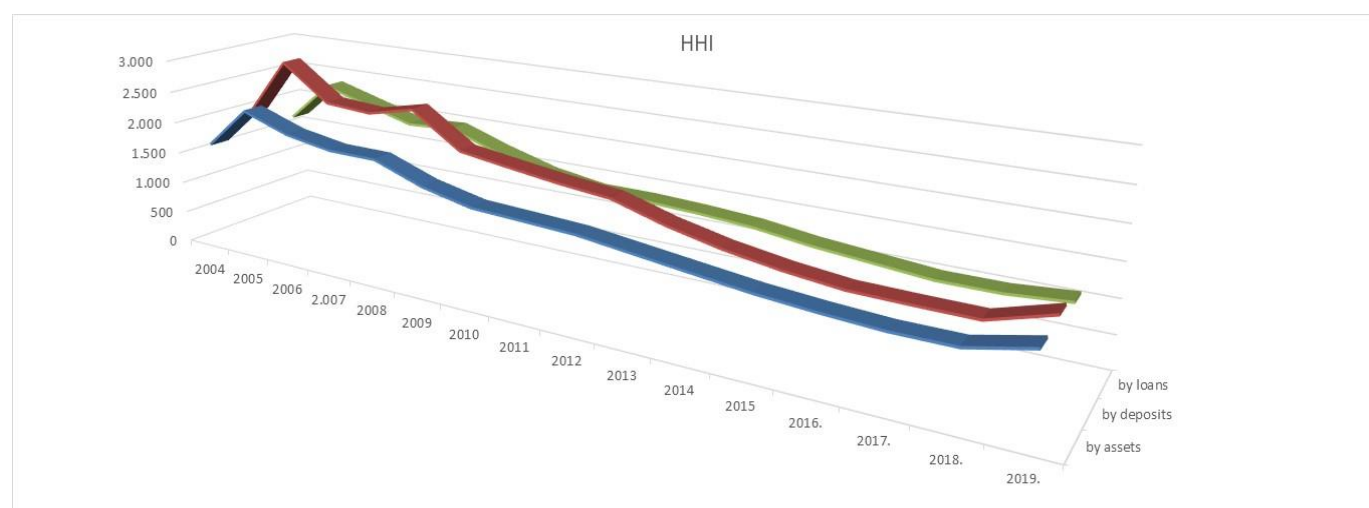
Most commonly used indication for measurement of competitiveness of a banking sector is Hirshman-Herfindahl index (HHI) on assets, loans and deposits¹⁶. For a banking market with an HHI of less than 1,000 is considered to be a competitive marketplace, an HHI of 1,000 to 1,800 to be a moderately concentrated marketplace, and an HHI of 2,500 or greater to be a highly concentrated marketplace.

Table 8: HHI for banking sector in Montenegro year-to-year

HH Index	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Assets	1,641	2,296	2,042	1,918	1,911	1,636	1,467	1,431	1,392	1,295	1,198	1,102	1,059	991	993	1,191
Deposits	1,991	2,898	2,350	2,298	2,465	1,943	1,831	1,727	1,646	1,407	1,226	1,097	1,055	995	991	1,258
Loans	1,699	2,336	2,126	1,917	1,959	1,699	1,479	1,356	1,354	1,320	1,265	1,156	1,107	1,008	1,011	1,082

Concentration and competitiveness of banking sector in Montenegro has risen since 2009. Last year that positive trend was changed with perspective to keep being worsen in following year due to the expected acquisition of large banks.

Chart 4: The HHI trend 2004 – 2019



Another measure of concertation within banking sector is market share of peer group of banks. Bellow table suggest that concertation on the banking marketplace has been decreasing except last year:

¹⁶ HHI is calculated as sum of multiplications between measurable values (assets, loans or deposits) for each banks and market share that a bank has related to measurable value.

Table 9: Concentration for banking sector in Montenegro for period 2008 - 2019

Concentration in marketplace (%)												
	31.12.2008				31.12.2015				31.12.2019.			
	Assets	Loans	Deposits	Capital	Assets	Loans	Deposits	Capital	Assets	Loans	Deposits	Capital
1 bank	34.46	34.06	42.19	19.45	16.84	16.89	18.12	19.17	17.74	17.35	17.54	27.95
3 banks	63.42	66.64	77.40	43.34	42.65	44.86	44.62	41.56	42.40	40.61	40.35	51.75
5 banks	84.42	86.75	88.23	61.77	65.82	65.16	67.74	63.18	66.08	68.85	63.71	74.44
7 banks	94.36	95.05	94.82	76.45	82.62	81.51	85.30	76.63	81.48	79.72	81.67	83.74

In period of ten years marketplace has significantly been changed:

Table 10: Market share and it's changes since 2008

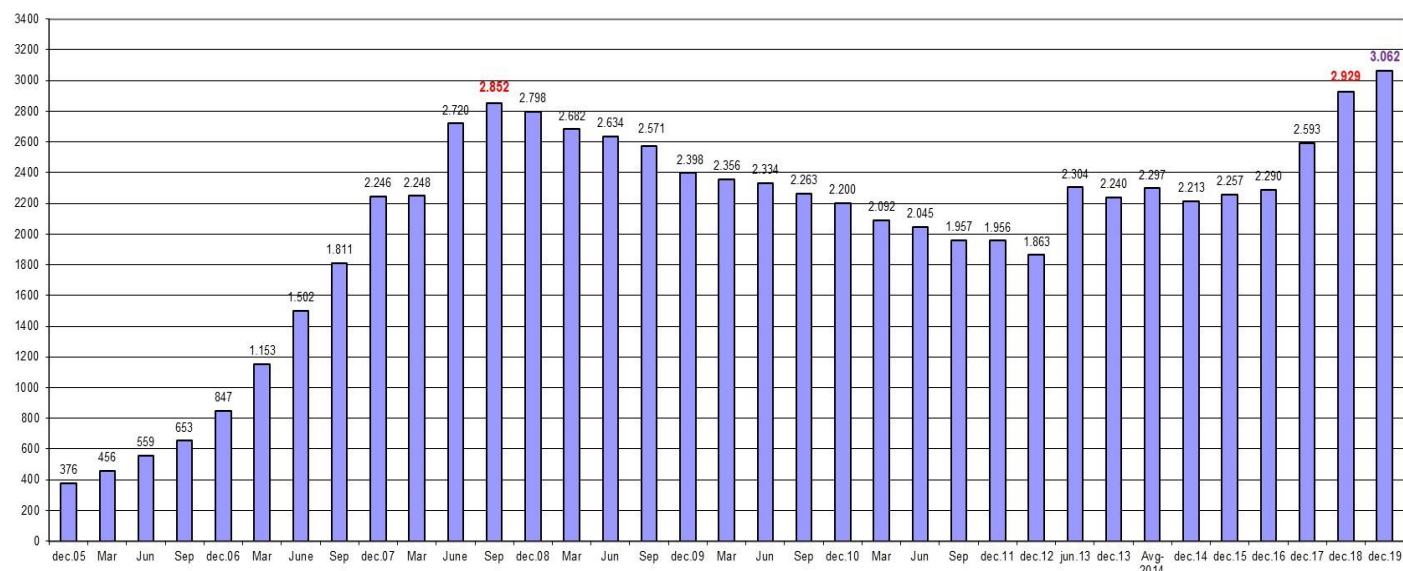
Market share 2019 (%)						Market share 2008 (%)				Change % (2019/2008)			
	Bank	Assets	Loans	Deposits	Capital	Assets	Loans	Deposits	Capital	Assets	Loans	Deposits	Capital
Large banks	CKB	17.74	17.35	17.54	27.95	34.46	34.06	42.19	19.45	-48.53	-49.05	-58.42	43.69
	Erste	13.14	14.65	10.77	15.15	2.28	2.20	2.20	6.48	476.43	565.93	389.42	133.76
	Soc. Gen.	11.79	14.80	10.26	11.44	6.75	6.28	4.39	7.85	74.65	135.74	133.72	45.72
	NLB	11.89	13.43	13.10	11.26	14.25	13.38	18.45	10.58	-16.60	0.40	-29.01	6.38
	Hipotakarna	11.52	8.61	12.04	8.65	5.14	4.33	4.65	7.85	124.38	98.68	159.12	10.20
Middle banks	Addiko	6.20	7.53	6.04	4.07	14.65	16.87	1.32	10.24	-66.29	-59.83	270.48	-59.86
	Prva	8.52	7.41	9.75	6.26	14.31	15.71	18.34	13.65	-40.48	-52.86	-46.80	-54.12
	Atlas banka	0	0	0	0	4.80	3.97	6.18	9.56	-100	-100	-100	-100
Small Banks	Universal Cap	6.89	3.46	8.20	3.03	0.40	0.18	0.26	2.39	1,644.0	1,814.8	3,111.9	26.95
	Lovćen banka	4.32	5.23	4.35	3.24								
	Komerc. PG	3.38	3.44	3.58	3.65	2.34	2.20	1.84	6.83	2.34	2.20	1.84	6.83
	Zapad banka	3.52	2.06	4.15	1.92								
	Ziraat banka	1.80	2.33	0.82	2.37								
	Invest banka	0	0	0	0	0.64	0.36	0.20	5.12	-100	-100	-100	-100
	Nova banka	0.53	0.46	0.39	1.40								
	Total	100	100	100	100	100	100	100	100				

Erste bank, Podgorička bank (formal Societe General Montenegro, Hipotekarna bank and Universal Capital Bank recorded significant positive changes in market share. Two banks are in bankruptcy procedure. Four new banks have licenced and others recorded significant decline in market share. Those banks had have very aggressive penetration on the market before 2008 that is one more proof of procyclicality of the banking sector. Smallest changes on market share have been recorded related to capital, which brings to conclusion that changes in capital level have not followed other changes on market share to most of banks that share the marketplace.

4.4.4. Trends of unobserved aggregate indicators relevant for assessment of credit support to MSME by the banking sector

For purpose of assessment of efficiency and ability of the banking sector toward needs of MSMEs one of the important aspect is trend of overall loan granting activates and trend of aggregate loan portfolio segmentation by maturity, industries and products.

Chart 5: The trend of aggregate loan portfolio 2005 – 2019 (in mill. Euro)



Additionally, to that analysis of above chart indicates that on end of 2018 has reached volume of aggregate loan portfolio that was recorded in September 2008 before global crises hit the Montenegro banking system and before Government had guaranteed for all deposits for one year under the special legislation that was passed.

Based on this trend and reconciled with theoretical and practical paradigms, credit support from the banking sector have not followed GDP growth of the country¹⁷.

Maturity structure of the aggregate loan portfolio of Montenegrin banking sector was not change much in last 10 years. Namely, on 31 of December 2008 72.3% of outstanding loans were long-term loans. On 31 of December 2018 that figure was 78% and on end of 2019 was 82.3%. Most of long- term loans are with maturity higher than three years: 2008 – 50.85%; 2018 – 78.0% and 2019- 69.6%.

¹⁷ Based on theories of macroeconomic modeling and credit multiplication, as part of monetary theories could be expected growth of aggregate loan portfolio to be at least 2 up to 5 times higher than growth of GDP.

Participation of loans that have been granted in other currencies than euro is very small in period of last ten years between 2-5% (last years that was 3.7%).

In total aggregate loan portfolio share of loans granted to resident legal persons is between 40-45% during period of ten years. Last year outstanding amount of this segment of aggregate loan portfolio was 1,375,455 thousand euros (gross). Participation of different business sectors in loans granted to legal entities has not significantly been changed over the period of ten years except participation of trade industry and real estate industry. Bellow table offers highlights of changes in segmentation of aggregate loan portfolio by industries over 10 years period with growth rates presented in last column:

Table 11: Segmentation of aggregate loan portfolio by sectors 2008 – 2019 (in 000)

Sector / industry	2008		2019		Average		Difference	
	Amount	%	Amount	%	Amount	%	Amount	GR%
Agriculture, forestry, fishing etc.	15,419	0.55	29,759	0.97	22,624	0.96	14,340	93.00
Mining	35,553	1.27	26,749	0.87	29,654	1.26	-8,804	-24.76
Energy	9,233	0.33	22,759	0.74	10,826	0.46	13,526	146.50
Construction	201,979	7.22	174,366	5.69	153,787	6.56	-27,613	-13.67
Trade	632,747	22.62	365,756	11.95	401,427	17.11	-266,991	-42.20
Tourism and complementary services	216,604	7.74	186,843	6.10	123,934	5.28	-29,761	-13.74
Transport, communications, store	85,551	3.06	95,155	3.11	64,128	2.73	9,604	11.23
Financial sector	68,680	2.46	38,358	1.25	38,001	1.62	-30,322	-44.15
Real estate	117,984	4.22	16,999	0.56	47,705	2.03	-100,985	-85.59
Administration and other public services	56,684	2.03	289,536	9.46	131,188	5.59	232,852	410.79
Physical persons	1,018,928	36.42	1,686,304	55.08	1,062,648	45.30	667,376	65.50
Rest	338,173	12.09	129,175	4.22	259,757	11.07	-208,998	-61.80
Total	2,797,535	100	3,061,759	100	2,3456,80	100	264,224	9.44

Source: CBOM Financial Stability Reports and web sites of commercial banks

Under item „rest,, in last row of above table has been calculated manufacturing industry, water supply industry, science and education activities and activities of external organisations and bodies. This segment decreased also substantially over the observing period.

MSME sector mostly is presented in agriculture industry, energy sector, tourism and services, real estate to certain extend. Trade industry, which has high exposure to banking sector, is very concentrate industry in 4-5 main distributors with big retail network and MSME is not any more relevant contributor to generation of revenues in this industry.

Our estimate of participation of MSME in outstanding loan aggregate portfolio, based on research of portfolio structure of 4 big banks, come up with similar amount as was presented in table 6 calculated on different methodological approach:

Table 12: Estimate of MSME segmentation in aggregate loan portfolio 2019 (in 000)

Sector / industry	2019	
	MSME (%)	Amount
Agriculture, forestry, fishing etc.	100%	29,759
Mining	20%	5,350
Energy	80%	18,207
Construction	50%	87,183
Trade	10%	36,576
Tourism and complementary services	100%	186,843
Transport, communications, store	50%	47,578
Financial sector	5%	1,918
Real estate	50%	8,500
Administration and other public services	50%	144,768
Physical persons	0%	0
Rest	80%	103,340
Total	21.88	670,021

Combining segmentation view by industries with segmentation of loans granted to physical persons by products (high participation of residential loans and similar products) could be noted very high exposure of banking sector to construction industry and real estate (over 50%) directly or indirectly through loans granted to physical persons as residential loans with collateralisation.

Trend of new granted loans is very important for understanding supportive behaviour of the banking sector to overall economy. That trend in Montenegro since 2012 is positive. Growth of the new granted loans is significantly above growth of the aggregate loan portfolio (table 5) which indicates that significant amount of new granted loans are actually outstanding loans closing and type of loans restructuring. Restructured loans, as separately reported loans, in 2019 were around 181 million euro, which is 5.9% of total loans.

Leaders in new loans granted are big banks (CKB, HB, Erste, PGB, NLB) and in last several years very aggressive and supportive bank to MSME sector is Lovćen bank, which started operations in fourth quarter of 2014. Table below summarises the marketplace behaviour in loans realising to the economy:

Table 13: Trend of new granted loans bank by bank (in 000)

		2012	2013	%	2014	2015	%	2016	2017	2018	2019	%
1	CKB	85,263	155,807	19.29	80,848	124,111	12.89	117,004	165,300	218,276	194,347	17.74
2	SOGE	195,028	187,439	23.21	173,115	150,437	15.63	112,587	98,613	94,312	124,154	10.06
3	HB	80,230	106,706	13.21	149,286	184,535	19.17	196,971	160,934	157,172	148,623	12.04
4	ERSTE	86,080	114,310	14.15	61,814	93,284	9.69	129,472	149,466	126,782	183,195	14.84
5	NLB	121,718	80,221	9.93	132,759	104,034	10.81	107,868	102,752	137,566	147,238	11.93
6	ATLAS	33,606	58,160	7.20	60,987	61,541	6.39	42,403	36,440	29,949		0.0
7	ADIKO	48,943	42,165	5.22	50,057	69,845	7.25	143,358	97,396	98,918	93,664	7.59
8	KBPG	19,652	26,640	3.30	25,697	31,903	3.31	25,750	43,167	43,694	56,264	4.56
9	PRVA	23,425	18,596	2.30	41,139	58,881	6.12	87,694	102,371	69,482	87,937	7.12

10	IBM	3,322	11,098	1.37	10,104	23,168	2.41	6,378	5,549	4,921		0.0
11	UCB	5,374	6,480	0.80	4,951	22,161	2.30	37,259	14,584	45,574	37,225	3.02
12	LOVČEN				10,703	29,788	3.09	58,595	62,375	72,383	74,254	6.01
13	ZAPAD					6,531	0.68	43,377	22,231	28,808	30,855	2.50
14	ZIRAAT					2,503	0.26	33,776	22,488	36,351	49,256	3.99
15	NOVA						12.89	2,153	11,023	12,242	7,601	0.62
Total		702,641	807,622	100	801,460	962,722	100	1,144,645	1,094,689	1,176,430	1,234,620	100

Source: Data compiled from the individual banks' profiles

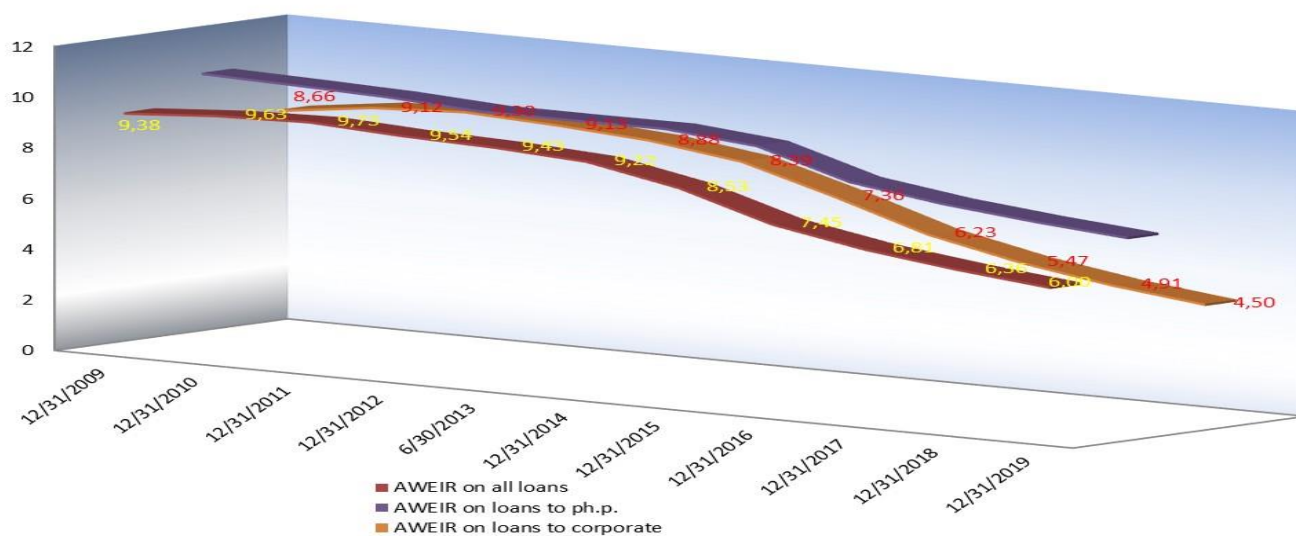
Support to MSME by the banking sector is very important in providing guarantees as standard banking products, which bear credit risk similar to loans. The banking sector provides two types of guarantees to their clients: guarantees for payment obligations and guarantees for performance. Aggregately observing, out of 330 million euro of issued guarantees, first mentioned type covers 45% and second one 42%.

These banking products are very expensive for MSME. Based on our research average price between 0.25 – 0.35% of exposure is charged quarterly. Some innovation in this area, as credit guarantees scheme introduction could highly support MSME instead of using such an expensive guarantees issued by banks.

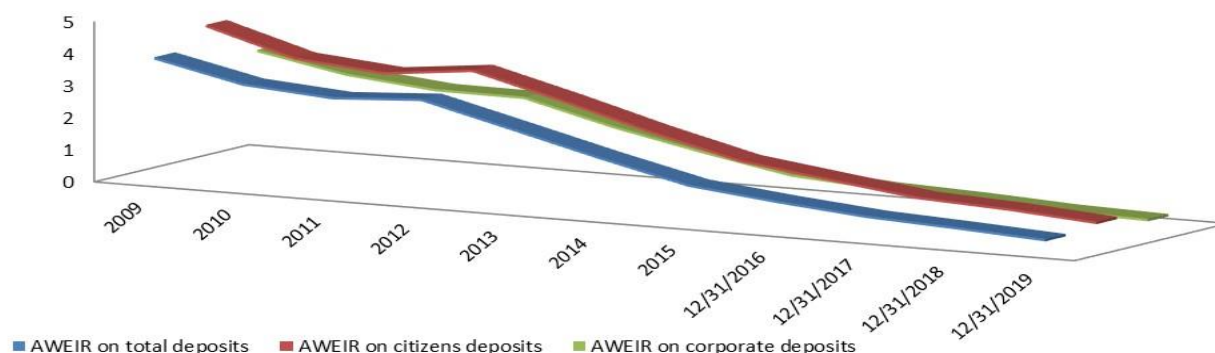
4.4.5. Interest rates and other pricing components of credit support to SME from the banking sector

The level of interest rates and other terms of loan support by the banking sector is quite important for assessment of quality and possibility of the MSME sector financing and satisfaction of its needs by the banking sector. Trend of banking interest rates in Montenegro was quite stable until two years ago when interest rates, aggregately observed, have started to deteriorate and more significantly on loans have been granted to legal persons:

Chart 6: Trend of interest rates 2009 – 2019 (%)



Decline of interest rates on loans was mainly caused by sharp decline of interest rates on deposits from 2013. Currently deposits bearing interest rate, which is below 0.5 % and for legal persons 0.26% yearly. Decline in interest rates on deposits was more intensive compared to decline of interest rates on loans that preserved high spread of the banking sector close to 4.5%.



Interest rates on loans to corporate sector are different on bank by bank bases but with pattern that big banks have very similar interest rates and quite lower compared to middle and small size banks, which have much more differentiation in interest rates.

Table 14: Trend of interest rates bank by bank 2016-2019

BANKS		12/31/2016		12/31/2017		12/31/2018		12/31/2019	
		AWEIR on loans to corporate	AWEIR total	AWEIR on loans to corporate	AWEIR total	AWEIR on loans to corporate	AWEIR total	AWEIR on loans to corporate	AWEIR total
1	Prava	6.66	7.66	5.75	6.91	5.16	6.41	4.84	6.14
2	IBM	8.84	8.79	8.73	8.86	8.98	9.14	0.00	0.00
3	CKB	6.64	7.81	5.55	6.83	4.20	5.65	3.69	5.28
4	PGB	5.50	7.46	4.68	6.65	4.20	6.35	3.72	5.85
5	NLB	5.84	6.80	5.27	6.44	5.34	6.41	3.95	5.71
6	HB	6.76	7.81	5.73	7.14	5.40	6.76	5.16	6.41
7	Atlas	7.44	8.55	6.96	8.03	6.99	7.91	0.00	0.00
8	Erste	5.68	7.83	4.79	6.83	4.47	5.65	4.14	6.20
9	KBBB	5.92	7.03	5.36	6.28	5.22	5.95	5.40	5.97
10	Addiko	5.67	6.85	5.34	7.20	4.95	7.30	4.75	7.28
11	UCB	4.37	4.84	3.95	4.27	3.18	3.36	3.93	4.05
12	Lovćen	8.18	9.15	7.65	8.43	7.15	7.95	6.69	7.58
13	Zapad	7.01	6.98	6.51	6.50	6.15	6.15	6.00	5.99
14	Ziraat	4.66	4.68	4.37	4.39	4.90	4.92	5.55	5.57
15	Nova	6.16	6.48	5.93	6.28	5.76	6.03	6.16	6.41
Total		6.23	7.45	5.47	6.81	4.91	6.36	4.50	6.00

Observation of interest rates per sector and industries drives to conclusion that lower interest rates are on loans to public legal entities- 3.36% yearly nominal and 3.56% effective. Highest interest rates are to private sector and more precisely to MSME sector – 6.33% effective on yearly bases.

Related to other terms of loans granted to MSME the most unfavourable are:

- required rate of collateralisation which MSME sector due to its intrinsic nature of business is not able to accomplish especially for long term loans and project financing;
- high costs for loan processing which are 0.75% up to 2% of total exposure,
- high fee for prematurity payments of loans which refinancing makes more costly and difficult.

4.4.6. Financial capacity of the banking sector to support SME

Dominant way of financing banking sector in Montenegro are deposits, which form 76% of total financial capacity of the banking sector. Growth of deposits has been higher than growth of loans. Due to that fact loan to deposit ratio on level of the system is 88%.

Segmentation of deposits by sectors and industries against same segmentation of loans gives overview which sectors and industries have been providing net founding (more deposits than loans) to the banking sector, which offers additional and more analytical insight into the financing abilities of the banking sector and expectation related to the deposit collection as key source of founding of the banking system:

Table 16: Difference between deposits and loans 2013 – 2019 (in mill. euro)

SECTOR / INDUSTRY	Difference D - L	Difference D - L	Difference D - L	Difference D - L	Difference D - L	Difference D - L	Difference D - L
	2013	2014	2015	2016	2017	2018	2019
I. Legal persons – residents	-212.130	-48.791	189.771	207.599	259.530	127.697	25.811
1. Agriculture, forestry, fishing etc.	-23.349	-25.827	-19.216	-22.247	-18.495	-20.173	-25.202
2. Mining	-33.064	-14.240	-16.567	-14.602	-4.238	-9.623	-6.471
3. Manufacturing	-61.153	-42.301	-22.136	-7.336	-4.683	-15.031	-8.730
4. Energy	179.112	233.780	251.130	303.533	314.711	220.725	111.299
5. Voter supply	-8.120	-4.951	2.299	8.909	6.977	4.886	-674
6. Construction	-41.320	-47.941	-42.301	-46.367	-13.130	-30.372	-37.286
7. Trade	-242.938	-262.250	-199.523	-159.066	-163.253	-197.011	-159.632
8. Transportation	5.719	6.302	24.844	25.664	33.075	26.749	42.557
9. Accommodation and food services	-20.616	-41.500	-33.431	-68.911	-78.596	-107.099	-129.041
10. Information and communication	33.328	53.921	57.183	42.243	53.341	103.081	22.700
11. Financial industry	55.603	48.399	67.447	45.087	77.154	54.460	55.973
12. Real estate	15.092	12.065	32.193	14.633	24.967	30.228	72.071
13. Science and technology	3.412	19.412	29.624	54.577	53.761	67.091	113.541
14. Administration and public services	10.496	12.369	19.882	16.519	16.878	17.481	23.682
15. State agencies and institutions	-96.669	-26.332	1.461	-25.450	-81.110	-83.258	-134.790

The Report on context and needs

16. Education, health and social care	-6.765	-5.271	-7.554	-2.205	-6.687	-6.514	16.605
17. Others activities	129.846	176.472	205.978	184.258	198.972	138.590	21.749
II. Physical person – resident	110.742	140.897	161.541	141.640	150.114	66.507	-62.963
III. Physical person – non-resident	-23.521	47.862	-105.687	247.826	249.988	335.770	451.175
Total (I+II+III)	-124.909	139.968	245.625	597.065	659.632	529.974	414.023

Above table clearly indicates that two sectors are key net suppliers of the deposit base: state and physical non-resident persons, which could not be asses as sustainable sources due to high indebt of state sector and due to sensibility and moral hazard inbuilt in those deposits. Participation of the State-owned deposits (state owned companies, central Budget, municipalities and public service companies owned by municipalities, regulatory agencies and state founds) has been constantly growing since 2008 when they were 215.5 mill. Euro to 2017 when they were 501.4 million Euro. Last two years due to the mentioned reasons, this type of deposits have declined to 430.7 million euro in 2109. The biggest part (around 50%) of state deposits are related to state owned companies.

Participation of loans and borrowings to the banking sector, as source of founding, have constant decline from 2008 when they were close to 840 million euro or 25.4% of total liabilities to level of close to 370,8 million euro or 9.3% of total liabilities (6.7% in 2018). Out of total borrowings 73% are foreign borrowings.

Within that trend support of mother banks and other members of banking groups to subsidiaries in Montenegro has been even above mean of the borrowings decline. Credit support of mother banks or other member of banking groups to subsidiary banks in Montenegro was almost whole amount of foreign borrowing in 2008 till in 2018 that amount was 120,4 million euro which is more than 6 times shrinking and in 2019 187,5 million euro.

Due to analysed deposit structure and decline in other source of financing, we could expect that banks in Montenegro will have to use more on borrowings from commercial and institutional creditor. Index of changes in borrowings year – to-year and 2013 as index base:

Table 17: Index of changes in borrowings year to year

	Banka	2019/2018		2018/2017		2017/2016		2016/2015		2019/2013	
		Total borrow.	Ino borrow.	Total borrow.	Ino borrow.	Total borrow.	Ino borrow.	Total borrow.	Ino borrow.	Total borrow.	Ino borrow.
1	Addiko	13.5	17.2	-28.8	-77.9	-51.1	-55.8	-2.8	-3.0	-72.4	-92.4
2	Soc. Gen.	47.2	46.2	16.2	17.2	52.2	52.4	-12.0	-17.0	116.2	104.7
3	NLB MNE	19.2	-100.0	-33.5	-77.7	-20.2	-47.6	-4.2	-34.7	-75.3	-100
4	Erste banka	40.2	48.8	59.4	67.7	3.8	-0.8	147.8	171.8	81.2	69.5
5	CKB	410.5		-16.3	-100.0	8.2	-50	-7.2	-33.3	62.4	67.9
6	Hipotekarna	-11.5	-23.8	-15.7	-34	-15.2	-23.5	-14.2	-18.8	-11.8	-73.6
7	Prva banka	-76.5		-34.1	-10.3			32.0		-42.4	
8	Kom.PG	24.1	-48,4	33.7	-16.9	-24.6	-24,60	-0.1	-19.7	-36.2	-90.4

The Report on context and needs

9	UCB	-25	-53.3	-33.5	14.1	-34.4	-34.42	34.8	-25.0	-2.6	-90.1
10	Lovćen	5.6	100.0	-3.4	-12.5	-42.3	-42.31	125	100		
11	Zapad	-24.0		-17.9	-2.3			252.7			
12	Ziraat	29.4	35.6	44.5	-7.0	-7.0	-6.98	532.4	532.4		
13	Nova	725.9		-27.5							
Total		24.8	40.3	-9.67	-13.24	4.68	-8.98	18.7	18.1	14.8	-8.23

Source: Data compiled from the individual banks' profiles

Capital as source of founding in banking should be mostly used to absorb expected and unexpected losses related to risks that banks have undertaken in their business activities. Measure of capital adequacy – solvency ratio could give as indication which part of the capital still could be used as permanent source of founding. Legislative minimum is 10% but in accordance with Basel III that was published in December 2010 and in 2013 it was implemented in the Directive 2013/36/EU (CRD IV) and Regulation (EU) No 575/2013 (CRR) level of 12.5% is preferable for contracyclical buffer and absorption of all risk especially on emerging market.

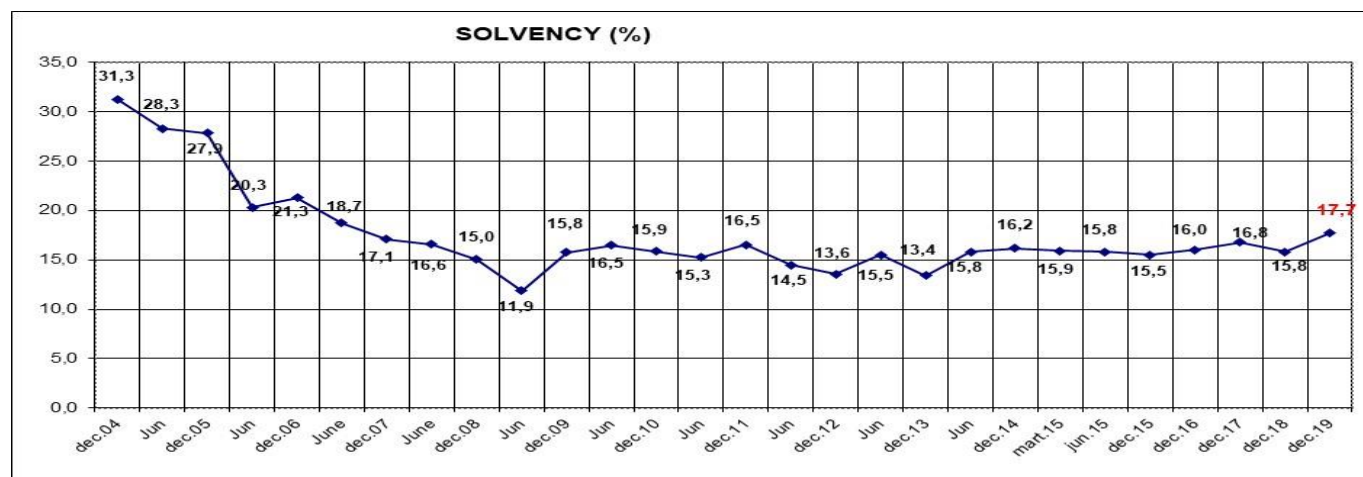
Table 18: Solvency ratio bank by bank

Banka	2007	2008	2009	2010	2011	2012.	2013	2014	2015	2016	2017	2018	2019
1 CKB	13.25	13.01	13.43	13.95	14.61	14.52	13.17	15.71	16.3	22.88	20.88	22.55	23.67
2 Prva	14.59	11.50	10.67	11.36	11.39	12.89	11.56	13.58	11.94	11.09	12.17	12.84	13.04
3 NLB	11.09	13.08	12.46	13.49	12.77	1.45	9.8	14.34	15.93	15.03	19.75	16.45	14.96
4 Atlasmont	20.67	16.24	15.66	14.16	14.88	11.84	11.93	10.13	12.09	12.77	13.05	2.67	bankrupt
5 Addiko	16.16	15.17	17.46	15.65	21.58	19.16	19.79	22.03	13.22	15.39	13.65	14.01	15.30
6 PGB	14.44	11.37	18.29	15.83	14.85	12.11	11.4	13.17	12.57	22.83	14.33	14.62	16.15
7 Erste	17.63	23.02	17.01	15.61	13.66	13.95	11.33	17.45	20.53	20.85	22.93	20.91	20.18
8 Kom. PG	50.97	43.17	32.52	45.61	43.29	35.98	29.52	30.19	25.32	18.33	18.61	17.17	16.45
9 Hipotekarna	37.70	41.31	22.02	15.54	16.98	15.29	13	15.25	12.93	12.40	13.01	12.50	16.29
10 IBM	129.34	78.90	56.96	52.02	37.99	30.99	40.24	26.79	23.30	13.07	14.31	-20.75	bankrupt
11 UCB	876.37	177.66	77.21	64.45	43.56	31.94	17.09	20.35	16.19	11.34	13.33	25.40	20.08
12 Lovćen								35.93	14.01	12.86	11.48	14.38	14.92
13 Zapad									14.19	34.53	23.38	24.36	18.21
14 Ziraat									12.9	30.43	28.52	28.08	19.85
15 Nova										395.24	132.97	45.62	42.24
Aggregate	17.12	16.00	15.75	15.85	16.51	13.5	13.42	16.18	15.49	16.0	16.78	15.83	17.73

Source: Data compiled from the individual banks' profiles

Presentation of solvency ratio by banks suggests that adequacy of the capital is satisfactory and that banks could keep on with more aggressive and less risk averse loan granting policy. Trend of the solvency ratio is very stable over last several years:

Chart 8: Trend of the bank sector solvency



4.4.7. Loan processing and credit risk management

Averagely, loan granting process in Montenegro banking is very fast according to the research of the World Bank¹⁸ - Doing Business. Central bank of Montenegro has been since 2018 analysing loan granting efficiency of the banking sector¹⁹. As was indicated in introduction part of the Report on bank lending survey results:

„ The survey consists of twelve questions that refer to the approval of retail and wholesale loans. The respondents (banks) answered the questions on the change in their credit standards¹, as well as the impact of factors contributing to this change, change in terms and conditions² of the loan approval, the number of rejected loan applications, change in demand for loans and impact of factors contributing to such a change. The questions were divided into two sets, of which the first six questions referred to wholesale loans and/or their credit lines, while the remaining six questions referred to retail loans. . . This Report sums up the results of the survey that was conducted in the third quarter of 2019. The survey disclosed positions of banks on the changes in their credit policies during the third quarter and expected changes in the fourth quarter of 2019. With a view to providing statistical representation, the responses of individual banks are weighted by their market share, whereas the response of the bank with higher market share gains higher importance. The survey results are displayed as net percentages. „

The survey results suggested that, according to the banks' responses, credit standards for wholesale and retail loans eased in 2019, which was in accordance with the previous quarter expectations. In future, expectations of the banks are further easing of credit standards for wholesale loans, whereas a tightening of credit standards is expected for retail loans

¹⁸ Source: www.doingbusiness.org/reports/

¹⁹ REPORT ON BANK LENDING SURVEY RESULTS THIRD QUARTER 2019, Central Bank of Montenegro.

(especially for consumer and other loans). The survey results are public available and hereby we would like to refer to those results as one more way of analyzing loan processing by banking sector in Montenegro.

Our approach to this topic is heuristic based on significant supervisory and commercial banking experience of members of our team.

Significant supervisory and banking experience of members of our research team and conducted research for this Report offers firm ground for following conclusions related to loan processing and loan granting in Montenegro banking system:

- Loan processing is very centralised within most of the banks which generally is not favourable for MSME support;
- Only two banks (Erste and Kom.PG) have rating system especially calibrated for MSME and even then, systems are designed for foreign developed markets without understanding of local specifics;
- Loan processing on level of limits to executive director has result in decisions of credit committees with different composition and with mixture of risk taking and risk management responsibilities;
- Loan granting process is not transparent within most of the banks and on beginning of the process applicants are not sure of probability that a loan will be granted and timing related to the process,
- Limits of large exposures of small banks with low level of the capital are obstacle for support of investment projects;
- Because lack of rating systems loan granting process is based on ratio analyses and scoring which is to quantitative approach unfavourable for MSME due to lack of history, imperfection of financial statements, low capitalisation or liquidity. MSME very often have no capacity for cash flow projection or business planning which gives them disadvantage in applying for long term loans;
- Loan granting has been followed by high collateral coverage which MSME are not able to provide;
- Risk management and pricing of loans have not been relating which makes loans to MSME expensive and hardly feasible;
- Cross selling for MSME has not been developed and stimulate;
- There are only few products that could be treated as designed for MSME (loans for preparation of touristic season, some product for agriculture, women in business loans etc.).

New loans facilities or credit guarantee scheme in synergy with supervisory actions, which would eliminate some of above listed weakness of the loan granting processes, could significantly enhance financial support to MSME by the banking sector.

Risk management within the banking sector still needs to be significantly improved. Credit risk is the most important risk for managing. Liquidity risk, operational risk, strategic risk and reputational risk have been of continues growing importance (see table 19). As consequence of global financial crisis, the banking sector was recording very high level of NPLs (more than 25% in 2010). Most part of those NPLs has been lifted from balance shite of

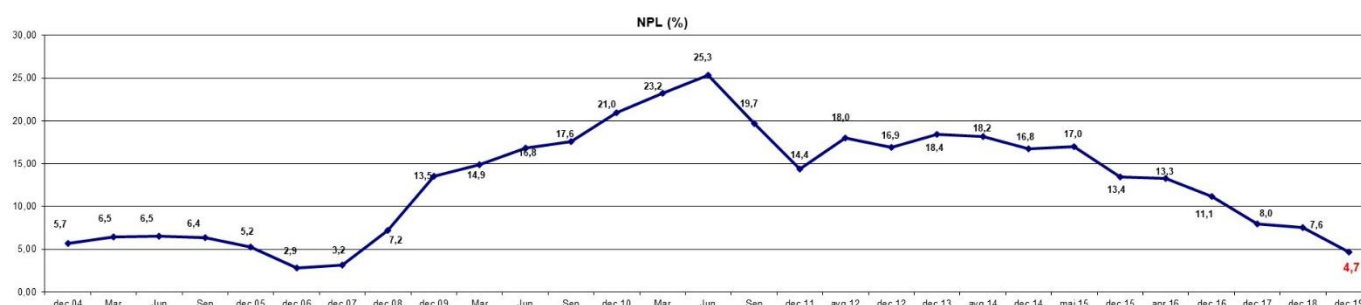
banks, which were with highest burden of NPLs. Even now if we add to the level of current NPLs those that are recorded off balance sheet (180 million euro) the level of NPLs would be still very high or almost doubled (see chart 9).

Table 19: Required capital for different types of risk on aggregate level for 2019 (in 000)

	Capital required for country risk	Capital required for other risks	Capital required for credit risks	Capital Required for Market Risks	Capital Required for Operational Risk
Total	5.750	21.500	223.000	32.457	50
	1,99	7,45	77,31	11,25	0,02

Source: Data compiled from the individual banks' profiles

Chart 9: Trend of NPLs 2004 - 2019



Compliance with EU legislation on risk management in credit institutions²⁰ will most probably put small banks in difficult position, which would need additional funding and additional capital. Currently in Montenegro regulations on liquidity risk management are in compliance with regulation in EU and neighboring countries. Application of new regulation on that issue which should be more complied with EU regulations, based on our research, will bring additional liquidity requirement to most of Montenegro banks, which would mean less loan granting activates for those banks if other aspect of their founding would remain the same.

Some of banks in Montenegro has critically low level of impairments for loan losses and regulatory reserves against loan portfolio or against NPLs. Requirements for recapitalization of some banks with low coverage of NPLs and their fast growth or with low solvency ratio proved to be effective micro and macro prudential policy to stimulate banks for more effective behavior and more active leading to MSME because ROE, which is primer goal of banks' shareholders, in such case could be higher only by more active lending and more diversified portfolio which consequently applies more credit support to MSME.

²⁰ Directive 2013/36/EU (CRD IV) and Regulation (EU) No 575/2013 (CRR), Technical standards for Own Funds requirements for institutions – RTS 241/2014 (amended by RTS 2015/488, 2015/850, 2015/923), Technical standards on supervisory reporting of institutions - ITS 680/2014, EBA GUIDELINES ON LCR DISCLOSURE etc.

4.5. Public funding support

Most important public support to MSME and whole economy has been coming from IDF. The IDF was established by the Law on Investment and Development Fund of Montenegro JSC ("Official Gazette of Montenegro" No. 88, dated December 31 2009). The IDF was established with the purpose of encouraging and facilitating economic development of Montenegro. By establishing the Investment and development Fund, the Government of Montenegro has provided an efficient mechanism of supporting economic development. Loan granted activity of IDF has been growing over last decade:

in million euro							
2010	2011	2012	2013	2014	2016	2017	2018
12.2	21.9	33.7	65.9	71.2	128.5	175.6	209,4

Loan granting by IDF (including factoring) has based on two lines:

- Direct placements to applicants and
- Indirect line through banking sector, which is way of founding banks for granting specific loans approved by banks and IDF.

Table below shows segmentation of total loans granted by IDF throughout two lines of activities:

In million euro				
Line of placement	2015	2016	2017	2018
Direct	60.7	91.2	149	174
Indirect (throughout banks)	46.5	37.2	26.6	35
Total	107.2	128.4	175.3	209

Regional segmentation of the IDF's loan portfolio (Central region, North region and South region) is almost equally distributed following goals to contribute to more balanced regional development of Montenegro.

In comparison to interest rates of banking sector IDF's interest rates are much more favorable averagely 3,4% in 2017 and 3,2% in 2018. Average interest rates granted by IDF have recorded continues decline contributing to decline of interest rates granted by commercial banks:

In %						
Years	2012	2013	2014	2016	2017	2018
Average IR	4.52	4.05	3.48	3.35	3.4	3.2

During 2018 IDF has approved 33 credit lines as financial support to:

- Entrepreneurship,

- Agriculture,
- Tourism,
- Production,
- Services,
- Liquidity management,
- Infrastructure development,
- Competitiveness and
- Green field and brown field investment.

IDF has been supporting equity investment on very limited scale and has been very active in offering non – financial support to MSME sector.

IDF has developed organization structure including risk management structure. Governance and organization has been in compliance with specific legislation and is not as robust and standardized as are requirement for commercial banks. Founding of IDF is based on very favorable loan facilities provided by institutional investors. Liabilities to founding sources on end of 2018 where 222,351,264 EUR (end of 2017 – 157,849,446 EUR). Main creditor of IDF are EIB and Development Bank of Europe Council. Hereby we have no intention to list of all credit facilities offered by IDF because they are presented in publications of IDF and Ministry of economy. Several of those credit facilities are very important for support of MSME and therefor worth to be emphasized and they are mutual effort of IDF in partnership with relevant financial or public institutions.

Support to Entrepreneurship Development Program

IDF in cooperation with the Ministry of economy, Directorate for investments, development of Small and Medium Enterprises and management of EU funds and the Employment Agency of Montenegro, announced non-financial and financial support for improving conditions for development of entrepreneurship in Montenegro.

Objective of this credit line is to support interested parties planning to register their own business. In this way, they will be given the chance to finance a small business and to make it available to the market. The facility is develop for different target groups: young people who wish to develop their entrepreneurial ideas, women who want to ensure their existence and independence by establishing their own businesses, students who are able to start their own business even before they finish education, persons with university degree and persons with secondary school education, who are registered as unemployed with the Employment Agency, persons with disabilities and similar. Loans are intended for investments in fixed assets and working capital without limitations. IDF may finance up to 75.00 % of the total investment value. The applicants for the loan can provide their own share in the amount of 25.00 % of the total investment value within one year since the day of signing the loan agreement.

Development credits for micro, small and medium business - CEB



Adresa: Đoka Miraševića broj 19
Žiro račun: Hipotekarna Banka broj 520-13428-46
PIB: 03076008
E-mail: office@forpg.me
Web: www.forpg.me

The aim of the program is to support the development of entrepreneurship in cooperation with the Council of Europe Development Bank. Loans are intended for investments in fixed assets - tangible assets (buildings, equipment and appliances, small inventory ...) and working capital. IDF may finance up to 70.00% of the total investment value. Loan amount dedicated to investing in working capital may be up to 30.00% of the total loan amount. Loan beneficiaries may be companies and entrepreneurs and all forms of organizations established by the Law on Business Entities, as well as subjects engaged in business activities governed by the rules of their corresponding area of activity (entrepreneurs, etc.). IDF MN JSC implements this Programme through direct lending to the loan beneficiaries.

Programme of financing permanent working capital for micro, small and medium business - CEB

The aim of the program is to support the development of entrepreneurship in cooperation with the Council of Europe Development Bank. Permanent working capital encompasses funds required for financing current obligations arising from regular business activities of the end loan beneficiary, pertaining to raw material and material, inventories, other production costs, accounts receivable. In accordance with the above, loan funds may be used for:

- purchase of raw material, production material, intermediate products, inventory;
- overheads.

Loan funds may not be used for:

- Repayment of existing loans (except in the part of the funds obtained through the refund of the investment);
- Strictly financial activities (i.e. purchase of securities);
- Lending to buyers or other natural persons and legal entities;
- Procurement of fixed assets.

Support to Women in Business Programme - UNDP

Programme for Gender Equality IPA 2010 is designed to stimulate faster and easier economic empowerment of women through the creation of a more favourable business environment and support for the development of their entrepreneurial potential, which will also contribute to the development of the existing and creation of new enterprises, job creation and employment growth, a thus also to the overall development of the SME sector and entrepreneurship in accordance with the Strategy for the Development of Women Entrepreneurship 2015-2020. The specific objective of the Programme is to strengthen capacities, improve mechanisms and advance appropriate policies, in accordance with international framework (UN and EU), national policies and development priorities of the country.

5. FIELD RESEARCH

Field Research had the main goal to detect, clarify and map needs and the basic necessities of MSME sector in Montenegro related to financial support and financial instruments that could fill the gap in current financial intermediation. The Survey intended to gather information related to awareness of participants about reference markets and cross-border cooperation opportunities.

The Research aimed to disclose positions of the Montenegro MSMEs development potential, the implementation level of instruments and credit services available. The Survey was also taken notice of their unsatisfied needs and requests. Suggestions and intentions of the MSMEs sector were also highlighted to achieve possible shared development and cooperation strategies to be realized. For this purpose, some investigation tools were developed and applied, in order to be shared with the representative sampler of companies, such as:

- Surveys distributed to the local companies which operate in different industries and local communities;
- Interviews consisting of open-ended and closed-ended questions, for more in-depth evaluation and investigation;
- Brainstorming sessions with the MSMEs representatives.

Therefore, the Field Research followed a precise methodology consisting of 3 distinct phases:

Phase 1: Development of the investigation tools: the Questionnaire;

Phase 2: Meetings for the submission of the Questionnaire and for the explanation of purpose of the Research;

Phase 3: Data Analysis and Final Report writing.

5.1. APPLIED APPROACH

Key methodological approach applied was interview. List of interviewed companies is submitted in Appendix 1.

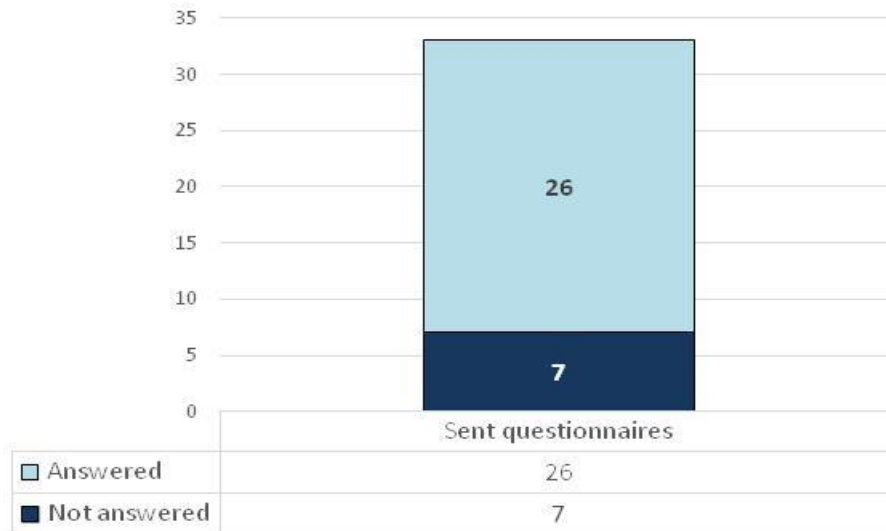
Very representative MSME entities of all the Montenegro territory have been involved in the Research, in order to guarantee sample representativeness, with particular attention to the involvement of the key decision makers and of the operators of the selected sector. Achieving representativeness asked certain criteria in selection of sampler for conducting the interview:

- History of doing business not less than 10 years;
- Geographical distribution based on contribution to Montenegro economy;
- Investment history,



- Sophistication and satisfactory reputation of management;
- Expectation of interest for cross border cooperation,
- Market share which is not neglectable;
- Relatively low indebtedness;
- Classification of credit worthiness by the banking sector not less than C₁.

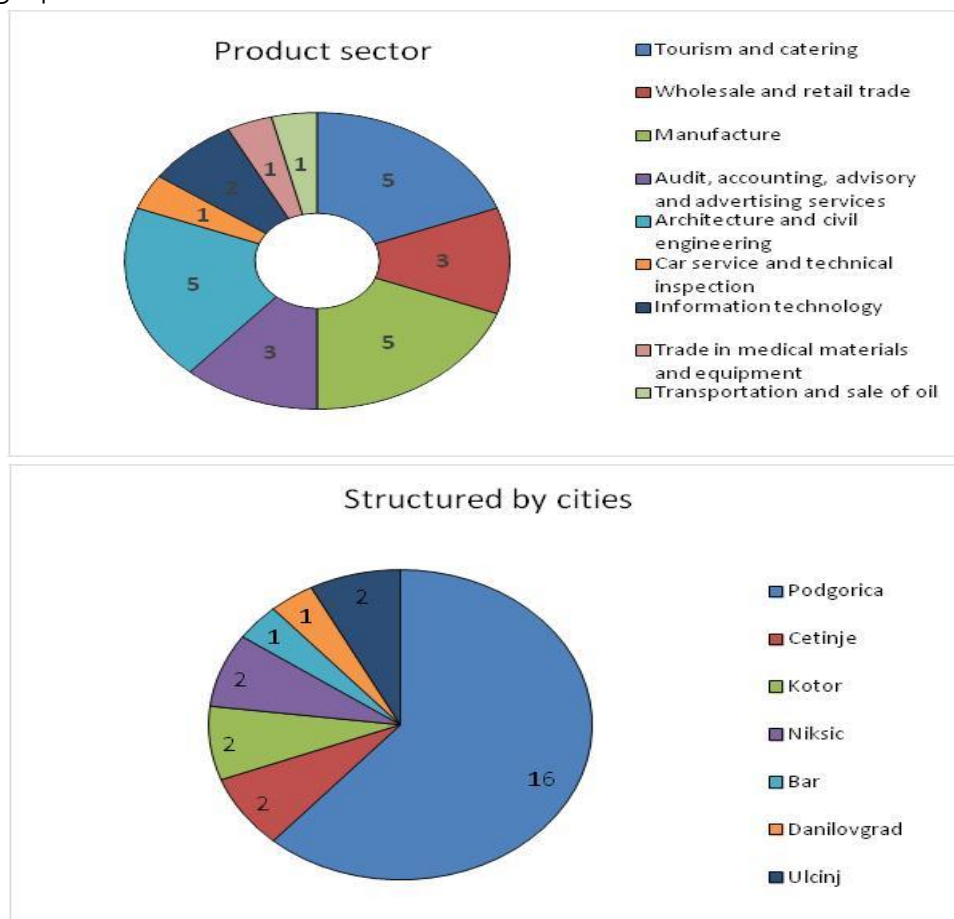
During the field research small and medium sized enterprises from Montenegro received questionnaire with seven questions relevant for researched subject. From the total of 33 sent questionnaires 78.8% was answered, this relation is shown in the graph bellow:



Even all of selected respondents (MSME companies) declared that they are very much interested in responding to the Questionnaire 21% of them have not submitted fulfilled and signed the questionnaire. These companies were from agriculture and handicraft industries. All of companies, which have formally not attached signed the questionnaire were very active in communication with research team and asked for clarifications related to asked questions.

It is important to emphasize that the number of interviewed SMEs is reduced due to the COVID-19 pandemic crisis. During this crisis, many SMEs were temporarily out of work of working from home, which disabled them from participation in our research. Situation caused SMEs that were interviewed are from various business sectors, from tourism and catering to production and sale of oil. In addition, through our research we tried to cover different Montenegrin cities in order to collect as much accurate data as possible. In percentage, 19.2% of interviewed SMEs are from manufacture, same percentages of interviewed SMEs are from tourism and catering sector as well as from architecture and civil engineering. Furthermore, 11.5% of interviewed are from wholesale and retail trade, 11.5% from audit, accounting, advisory and advertising services and 7.7% from informational technology. One

enterprise i.e. 3.8% of interviewed is from production and sale of oil sector as well as from trade in medical materials and equipment and car service and technical inspection. Divisions of interviewed SMEs by production sector and by address headquarters are shown in following graphs:



All the interviewed enterprises are carefully chosen with aim to collect information and experiences that are as relevant and valuable as possible.

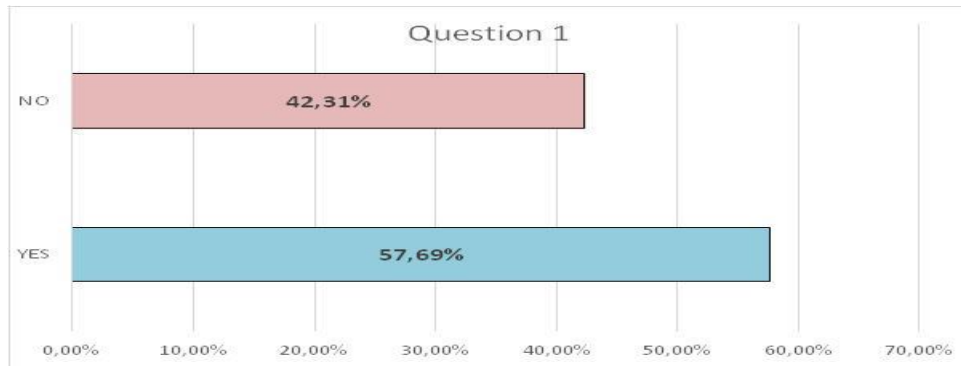
5.2. RESULTS

The questionnaire that was used as a main tool for the conducted field research contained seven relevant questions. Used questions as well as collected answers given by the SMEs are furtherly elaborated.

Question 1: Has your company used loan instruments in the past?

The purpose of this was assessment of financial support needs and relation with financial sector in terms of experience and knowledge of financial intermediation possibilities in Montenegro.

Answers are shown in the graph bellow:



The result that very high segment of interviewed have had no usage of credit instruments was a bit surprising asking for research of cause for such lack of credit support history.

Therefore, the SMEs that answered NO on this question were additionally asked why did not they use loan instruments? Most of them (85%) answers that offered credit support was unfavorable for them and that banks have difficulty lending loans to MSME mostly cause collateral system and requirement where too hard to comply with.

To the SMEs that answered YES on the first question were further asked two more questions:

- What were the loan instruments used for?
- Which loan instruments did you use?

On first sub question most of the answers were that they were used for procurement of import products, for liquidity and investment and for buying the tangible assets (offices, cars etc.).

On second sub question the answers where: commercial investment credits, short-term loans for liquidity, overdraft, investment loans with high collateralization, leasing and investment credits from the IDF.

Our perception, which has been driven by communication with the respondents, was that usage of loan instrument would be much more frequent with easing of loan granting procedures especially with lower collateral requirement and less formal assessment of credit risk exposures. High risk awareness of the banking sector in period since 2009 till 2015 influenced orientation of MSMEs not to use credit support by the banking sector and during that period support by non-banking financial intermediation was not so exhaustive and rich able.

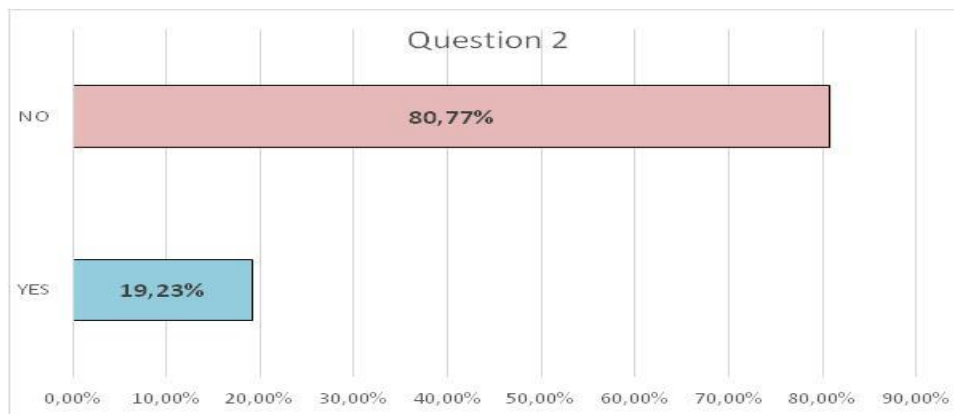
Question 2: Has your company used credit guarantee instruments in the past?

The question was designed to assess scope of usage of credit guarantee instrument and needs this instrument has been used for.

This question has been very useful also to gather experiences related to the special needs of the different business typologies, being considered:

1. The actual application or the type of guarantee instrument used;
2. Whether, or not, there was the possibility to access further funding for other investments.

The answers were as follows:



Five SMEs that answered YES on this question explained that these instruments were used for the purposes of collection of credit claims (as credit risk mitigation tools) by banks and mostly for the investment loans. Throughout further communication we have concluded that understanding of this credit facility is mainly wrong. Credit guarantee instrument is understood and mixed with corporate guarantee used by treed parties as collateral for loans. This conclusion is formed due to the explanation of YES respondents that credit guarantee was provided by legal entireties, which could not be authorized for issuing of credit guarantee instruments.

In addition, questioned SMEs mentioned using other instruments such as: mortgage collateral, promissory notes, goods from sales inventories for this purpose.

Other SMEs that had the negative answer to this question elaborated that the reasons for not using these instruments were:

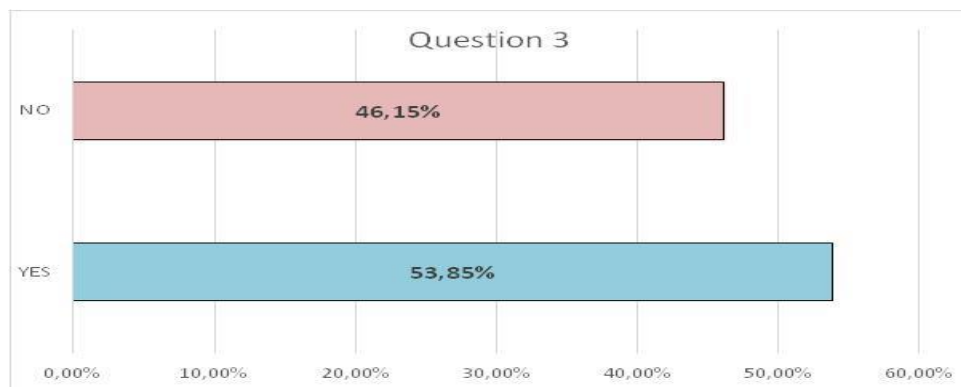
- They had no need so far;
- They were insufficiently informed;
- Credit guarantee instruments were not available for them or they have not been informed of existence of such credit instrument.

Overall conclusion is that there is very low understanding (or high misunderstanding) about nature of credit guarantee instruments and purpose such instrument could be used for.

Question 3: Do you have to make other investments for activities to be carried out in Montenegro in the next three years for your company?

The question was designed for assessment of investments needs and strategic orientation of MSME related to development as well as for funding support.

The answers were:

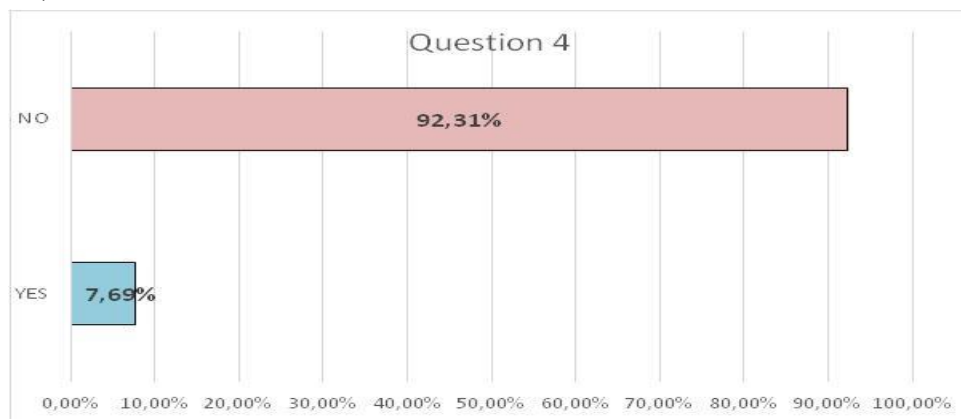


Majority of respondents have investment plans for next three years. They have no finalized business plans for investment they plan to carry on and they are not able to specify investment volume. Investment plans are related to investment in new technology or development of capacity and import of goods.

Interviewed SMEs that answered YES to question three were additionally asked if they plan to use a guarantee instrument for access to credit. Most of the interviewed SMEs answered that they would prefer credit guarantee instruments as a replacement of other collateral and easier approach to long-term loan financing.

Question 4: Do you plan to make investments, joint ventures, cooperation with companies in Albania and/or in Italy in the next 3 years for your company?

To this question, answers were as follows:

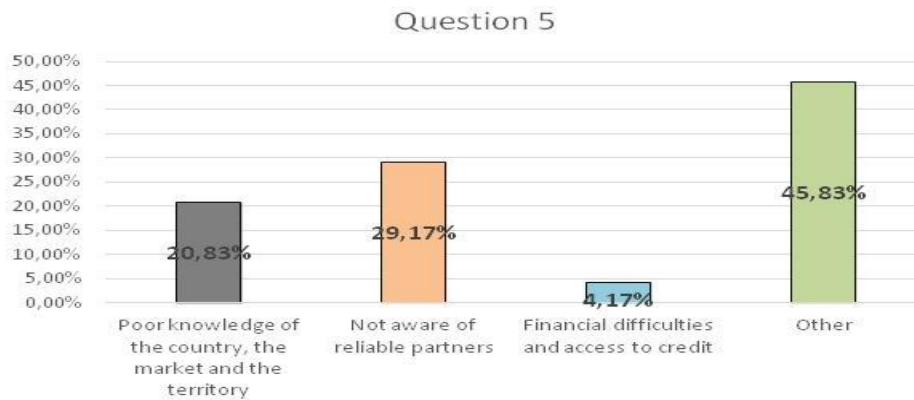


To the question concerning the possibility to set up a joint venture and/or cooperation with societies in Albania and/or in Italy in the next 3 years, 92.31% of the surveyed subjects said resolutely that they do not have any intention to realize these kind of investments, while only 7.69% gave positive feedback. Such result indicates that selected surveyed subjects are highly oriented toward Montenegro market because of the size of their companies. Research goals asked for additional clarification and explanation of possibilities for cross boarder cooperation.

Question 5: If you answered NO to question 4: Why? Which are the reasons?

The question was logical continuity of survey on possibilities for development of cross boarder cooperation with Albania and Italy market.

To this question, three answers were offered to the SMEs and they have chosen following:



The SMEs that had different answer from what was offered to them mostly elaborated that their businesses are oriented only to the Montenegrin market. The interviewees in highest percentage (50%) answered that lack of cross boarder cooperation is based on lack of the knowledge whether markets and country specifics or possible partners. This applies need for additional information sharing and enhancement of channels of communication.

Question 6: If you answered YES to question number 4?

- What kind of investment do you intend to do?

The answers were - project cooperation and/or strategic partnership; investments in agricultural, national products. Obviously that the most of interviewees see strategic partnership as a way of carrying on joint venture arrangements, making of products and/or services in the other country or access new markets to gain more customers. Answers on the question proves an awareness of their own expertise and common purposes to share with the stakeholder of the eventual Partner Country.

➤ *What kind of Partner are you looking for?*

The answers were - reliable partner, strategic partner or investment found; partner with years of experience. Gained answers where not sufficiently clear and they were very much similar addressing that preferred partner should be the added value capable of proving economical support and a business enterprise to their own project as well as knowledge transfer oriented.

➤ *What kind of support do you need as a support?*

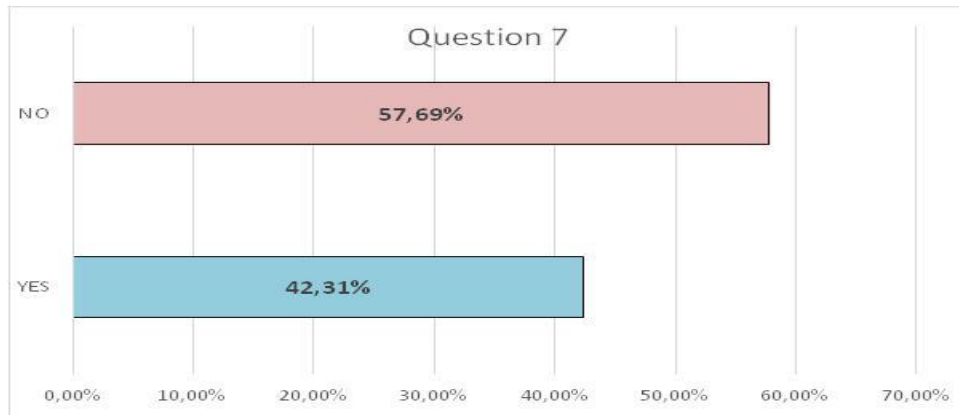
The answers submitted are: support for participation in tenders and long-term funding for investment in technology and technological and logistical support. This implies that interviewees would prefer long-term equity or loan support oriented to investment in new technology that could provide higher productivity and competitiveness. The answers also imply that MSME sector in Montenegro is technology oriented even in cases these companies operate in working intensive industries.

➤ *What financial instruments would you use?*

The answers were - long term founding and equity founding; loans. The interviewees answered that they would use their combination of own resources and/or co-findings from the foreign partner; only small number of them would use banking loans and the majority would apply public findings based on EU funds available. Only a very small part of the interviewees answers that they would use other kinds of investments support like: asset-based finance, which comprises all forms of finance that are based on the value of specific assets, rather than on the cash flow/creditworthiness or debt capacity of firms, and represents a well-established alternative for many SMEs. The answers that were collected on this question show certain level of financial consultancy need for MSME in Montenegro.

Question 7: Are you available for a short-term interview in order to gather your experience and/or your considerations about the guarantee instruments for access to credit and cooperation with companies in Italy and Albania?

We received following feedback:



High share of negative responds to this question comes from micro and some percentage of small companies as result of lack of knowledge related to financial instrument and potential of their usage as additional financial support.

5.3. CONCLUSIONS

The summary of field research results is presented in chapter 3.2. page 6.

Additionally, we would like to emphasize that received feedback from the interviewed SMEs from Montenegro, it is clear that there is very low availability of credit guarantee instruments in Montenegro but also a huge potential and interest on the market for making these instruments more available and developed. Loan guarantees could be the most widespread instrument at the disposal of governments and private promotional institutions to tackle market failure in the area of SME finance. Financial support measures, as credit guarantees, could enable SMEs to become active in foreign markets and innovative financial support instrument should be introduced or strengthened in Montenegro. In particular, focus should be on expanding knowledge and use of credit guarantee schemes, public export finance and export insurance instruments.

The SME population is very heterogeneous, and financing conditions and challenges differ substantially along parameters such as the age of the firm, its size, location, sector, growth potential as well as the characteristics of the principal business owner, such as their gender or business experience. This heterogeneous profile of the MSME sector affected answers related to cross – border cooperation as very heterogeneous and with lack of clarity. Strategic planning and strategic management related to export of goods and services is very much positively connected and correlated to Montenegro association into EU market. Weigh from current banking loan support for financing SME development needs will be transfers exponentially on more innovative forms and instrument as has been recently globally recorded.

6. POSSIBILITIES OF INNOVATIONS

Based on results of our research and our recommendations, design of innovation for improvement of credit support to MSME should satisfied set of criteria. We would like to emphases following criteria as of most importance:

- Innovation should focus on risks mitigation to creditor and transaction costs associated with lending to SMEs;
- Innovation should provide and perceive as risk sharing techniques;
- Limited fee should be associated to a non-profit function;
- Accompaniment and follow-up of the business should be in focus;
- Strengthens the capacity of financial institutions to serve smaller clients, promotes sustainable lending to SMEs;
- Innovation should create learning process related to MSME functioning;
- That should be less bureaucratic procedures, simplified credit file, easier decision making, accessible language;
- Any innovative should focus on comparative experience and shaped for local market conditions and specifics.

Credit guarantee scheme comparative experience within EU is, according to our opinion, very relevant candidate for innovation on Montenegrin financial market and worth addressing more of attention to it.

6.1. CREDIT GUARANTEE SCHEME COMPARATIVE EXPERIENCE

Summary of comparative experience related to functioning of credit guarantee scheme could offer AECM, which is the only European business association concerned with the guarantee business. AECM²¹ has currently 48 member organizations operating in 29 EU countries, Azerbaijan, Bosnia and Herzegovina, Kosovo, Serbia, Russia and Turkey. Its members are mutual, private sector guarantee schemes as well as public institutions, which are either guarantee funds or Development banks with a guarantee division.

Hereby, we have no intention to explore and elaborate in all details functioning of guarantee scheme within EU region due to availability of this information in publications of AECM. Nevertheless, we have found that certain set of information is useful for better understanding of framework and model design, which could be applicable for Montenegro.

²¹ <https://aecm.eu/>

According to the Douette- Pombo definition the European guarantee activity is based on a broad national **consensus** between authorities, SME lenders and borrowers. It is exercised by **specialised institutions**. CGO's are a part of the financial industry, subject to **legal regulation and financial supervision**, which creates the conditions of their sustainability and trust with lending partners. Working in a global economy, **respecting competition and market rules**, they propose a better access to credit for sustainable projects of viable SMEs in the private sector. They all have in common the mission of providing loan guarantees for SMEs who have an economically sound project but cannot provide sufficient bankable collateral. In 2018, AECM member organizations had a total guarantee volume in portfolio of 125.1 bn. EUR, issued a total volume of over 45.3 bn. EUR of new guarantees and supported 3.1 million SMEs.

Guarantee schemes are formed of a mix of private and / or public initiatives and tend to involve entrepreneurs directly or indirectly in the shareholding, decision and management (mutuality). SMEs that have not gained access to different type of loan support, mostly due to the lack of sufficient collateral or only insufficient history, could use this credit guarantee schemes, which have been providing variety of guarantee products on behalf of the SME to the bank replaces this missing collateral and enables the bank to grant the loan. In essence, the guarantee is a financial commitment by the guarantee society to repay up to a certain percentage of the loan to the financial institution in case the SME customer should not be able to honour his payments. The guarantee usually does not cover more than 80% of the bank loan, leaving 20% of the risk with the lender. The SME remains liable for the loan. The SME customer usually pays a once-off processing fee and an annual guarantee fee, which are variable from guarantee institution to guarantee institution.

Public support usually provides equity and protection in order to reach higher leverage and efficiency. Way of additional founding of CGO's are very different combining borrowings, issue of securities, donations, founding by institutional investors etc. A special feature is the existence of **national counter-guarantees and a platform of supra-national counter-guarantee** organised and funded by the EU Commission and managed by the European Investment Fund.

Generally speaking, apart from other governmental programs, there are:

- Serve specific target groups:
 - Always: viable SMEs and sustainable projects
 - SMEs lacking adequate collaterals
 - SMEs without reliable track records (start-ups, "frog jumps" linked with technology, markets or simply fast growth)
- Serve different financial needs:
 - Investment: term loans, micro-credits, project financing, structural financing etc.
 - Working capital and liquidity,
 - Technical guarantees (performance bonds, guarantee to bank guarantees...).

CGO's, broadly speaking, are functioning in two main ways: as guarantee funds or mutual guarantees schemes. Main features of those two forms are as follows:

GUARANTEE FUNDS

- **Initiative taken by Public Authorities (State, Region...)**
- **Mainly public shareholding**
- **Directory Board elected with public prevalence**
- **Mission of SME support.**
- **Solvency: scheme's responsibility with public umbrella.**
- **Administration or Ltd Cy**
- **Other goals: subsidies...**

MUTUAL GUARANTEES

- **Initiative from SMEs and representative organizations**
- **Mainly private shareholding**
- **Directory Board composed of SMEs, bankers,**
- **Mutuality principles**
- **Self-protected solvency, with public support**
- **Coop. Ltd Cy or Ltd Cy.**
- **Other missions : no**

The main debtor remains liable for the full amount of its commitments to a lender. The guarantor receives a protection on behalf of a second level of protection. Banking legislation and supervision treatment of these guarantees is usually equal as guarantees issued by supervised banks that means credit risk mitigation compared to other types of collateral. Effects of such protection are numerus:

- On risk taking: Upwards risk sharing mechanisms are an incentive to take sharper risks and consequently more additionality leading to MSME sector;
- On the leverage: a counter-guarantee of 50% allows to double the outstanding commitments which provides acceleration or
- On the capital adequacy: a counter-guarantee of 50% allows a two-fold smaller capitalisation.

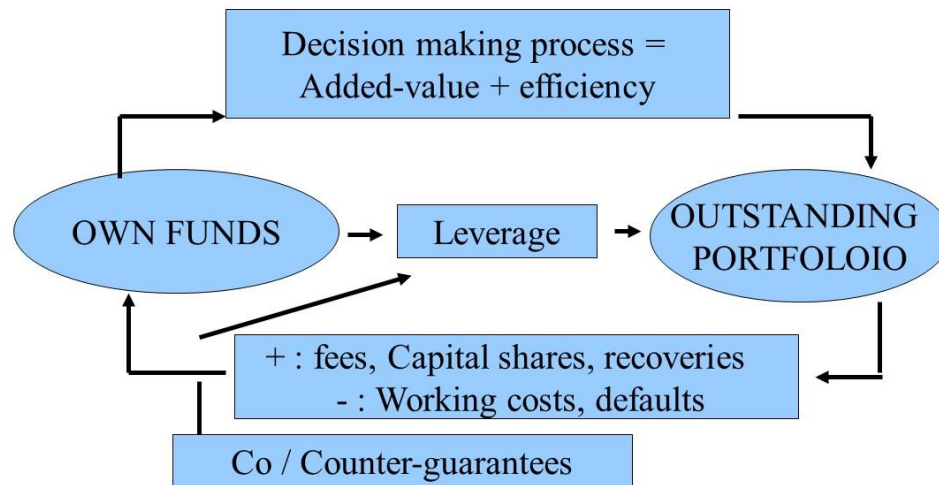
Financing SMEs and Entrepreneurs 2020: An OECD Scoreboard provides a comprehensive framework for policy makers and other stakeholders to monitor access to finance by SMEs and entrepreneurs. This report also constitutes a valuable tool to support the design and evaluation of policy measures, and to monitor the implications of financial reforms on access to finance and financing conditions for SMEs more generally. The 2020 report provides information about SMEs and entrepreneurs' access to finance over the 2007-18 period. Based on data collected for the country profiles and information from demand-side surveys, it includes indicators on debt, equity and asset-based finance, as well as on financing framework conditions, complemented by information on recent public and private initiatives to support SME access to finance.

6.2. PROPOSAL FOR MONTENEGRO

Proposal of establishment of credit guarantee scheme in Montenegro should be based on certain principles. Hereby, we would like to emphasis following principles:

1. Minimization of initial organization and operational expenses which applies that efficient CGO should be well integrated in the financial network;
2. Maximization of effects of the guarantee performance indicators which would assume high market relevance or capacity **of the instrument to fill / reduce market gaps in SME lending and access to credit for applicants that would otherwise be rejected** (+/- 15% credit rejections in EU) **+ Access to better credit terms;**
3. High Leveraging, which means that CGO would be able to provide easy access to additional founding on level that would be several times higher than own funds Of CGO;
4. High efficiency of decision-making process of future CGO which asks that the decision-making process should be highly transparent and automatized with added value;
5. Flexibility which should be understood as:
 - a. Modulated risk coverage (50 to 100%); duration etc. Examples:
Germany, Hungary, Czech Rep: 80% of the loan
Italy: fifty- fifty with lender / 10 years
Belgium, Estonia: 75% / 10 years
SIAGI France: 40%...
6. Procyclicality which would assume less risk aversion in period of a down turn of the economic cycle;
7. Adaptable to legal situations and banking cultures;
8. Highest corporate culture and corporate governance which ask that future CGO should has corporate governance based on highest standards adopted in EU member countries;
9. Supervision consistency which should be understood that such institution shall be supervised by Central bank of Montenegro;
10. Maximization of transparency, which should be gained by high disclosure requirements, even higher than those prescribed to banking sector.

As illustration of fulfillment of most of the above principles and way of functioning of CGO proposal for Montenegro see following chart:



Revolving character (annual rate of portfolio gearing: 20 to 50% according to preference to short / long-term loans).

Leverage (ratio: Outstanding guarantees to Own Funds): on average 6 to 7 times, meaning that 1 EUR own funds can lever 6 EUR of guarantees, 10 EUR of loans and 15 EUR of underlying investment. Examples:

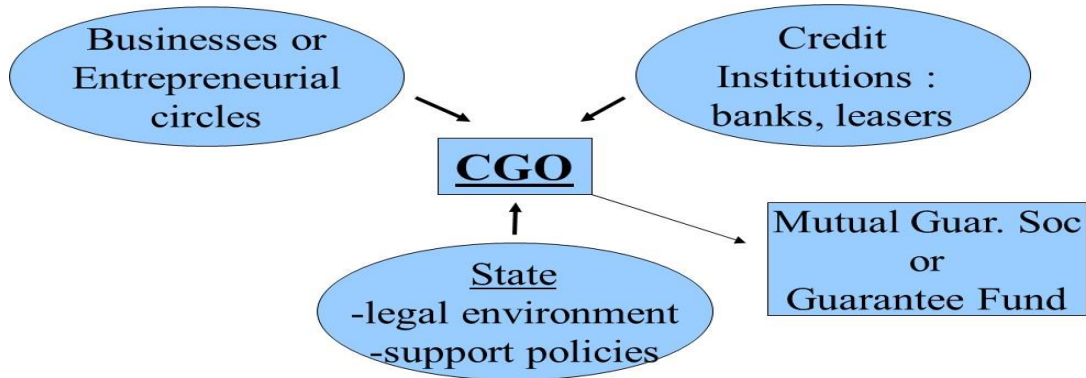
- France Socama- France: 20x but liaison with Banques Pop.
- Germany Bürgschaftsbanken: 7x in real terms
- Italian Confidis: 5 to 7 times.
- Hitelgarancia Hungary: 7 x

6.3. MODELING OF THE PROPOSAL

Our proposal for Montenegro is that CGO should be new institution, licensed under current or amended legislation. That institution could be established by IDF or as IDF and associations of entrepreneurs and some of development banks from EU (public-private partnership). Alternative approach could be that CGO is established as temporary partnership of the Government, banks and some of institutional investor from abroad (DEG, EIF, EBRD etc.).

Such approach could provide the best **position in the finance chain**: midway to:

- Lenders: credit risks protection + own funds mitigation
- SMEs: more credit and better credit conditions
- State: help achieving virtuous macro objectives



In such positioning guarantee fee could be minimized and effectively serve following objectives:

- purpose of risk coverage after considering other supports like a counter-guarantee
- not for profit schemes: earnings go to equity strengthening and leverage enhancement
- modular and flexible: fixed fees, variable fees, risk based oriented fee, paid annually or up-front,

Depending on duration, risks, position of the business in the life-cycle curve etc. guarantee fee, based on our research, should be initially on average level of 1,2 p.a. (range: 1 to 3% p.a.).

The idea is not to make twice the job of bankers: looking into financial hard facts (solvency, working capital, profitability...) or to conduct rating of applicants but, though considering them, to put the focus on:

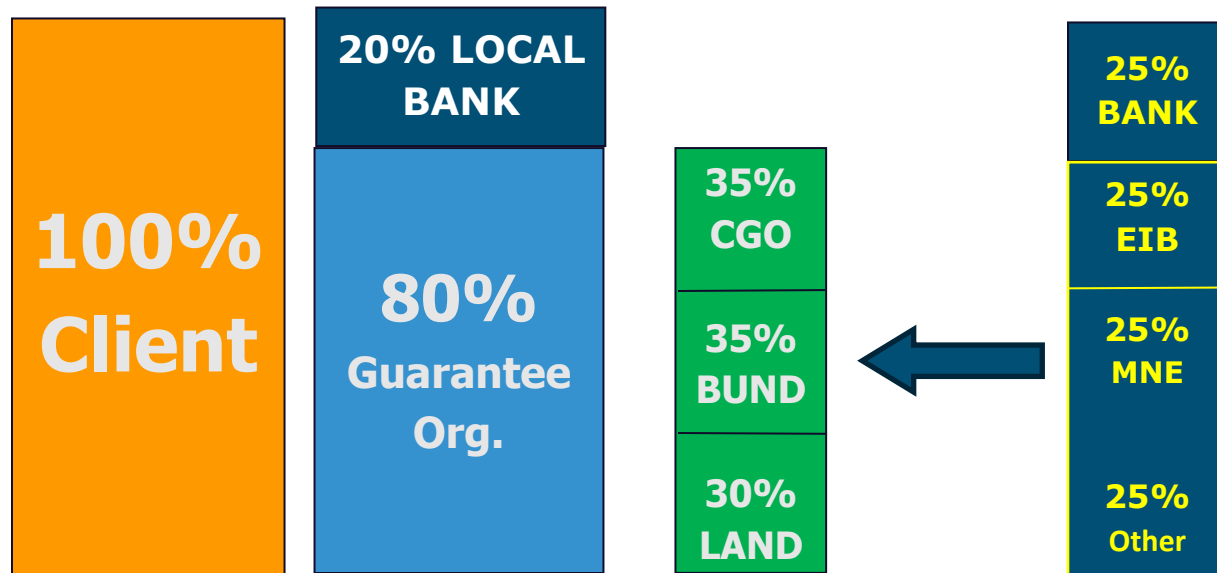
- Proximity with SMEs: ability to understand their projects and risk awareness of banks related to this projects and needs,
- Specific decision criteria: space to personal elements and soft facts reduces information asymmetry and adverse selection,
- Specific to Mutual Schemes: the decision by peers.

Such proposal could offer the most effective direct protection with recognition of State counter-guarantee. Legal risk as part of operational risk should be mitigate by explicit and explicitly documented granting procedures with clear and incontrovertible contract. Contracts should be efficiently enforceable under all relevant jurisdictions in case of default. Proposed organization structure should be very cheap in terms of CIR, operational expenses and other indicator of operational costs. That could be achieved throughout externalization of operational activities on banks, IDF or other stakeholders. The CGO in such governance framework would just organize prompt decision-making process partially, based on established limit, on level of executive officers and for exposures above limit for executives decision would be made by governance body.

Defaults should be payable on a timely manner, but recognition of "loss sharing systems" and proposed infrastructure offers that outcome.

Proposal is that guarantee scheme shall oriented for covering all types of payments of the main obligor BUT claim for recognition of principal only guarantees. Bank may pursue the guarantor instead of obligor in any time after negotiated past due period.

Credit risk coverage would be split between bank creditor and the CGO. The CGO guarantee part could be leveraged by own funds of CGO, issuing of securities and by borrowing many on local and global financial market. Financial construction and risk transferring is presented in following chart:



Whole process of establishment of CGO we propose to be conducted based on principles of project management based on business modeling for period of at least five years.

Our very rough estimate, based on comparative analyses, suggest that **minimum CGS's initial share capital should be € 2 500 000.**

MUTUALISM could be gained if MSME must or may buy shares = minimum 1% of guarantee value.

COLLATERAL POLICY: as a rule, no real collateral is requested by CGO. Some conditions must be established some as: *negative pledge, ownership commitment, cross-default, promissory notes, limits for large exposures and connected parties etc.*

Initial support of Montenegro CGO should be reconciled with Strategy for development of MSME, which is recently adopted.

7. RECOMMENDATIONS

Recommendation that could be emphasized out of our researchers are as follows:

1. Reporting from banking sector to Central bank of Montenegro should be enhanced to cover demand for loans over loans granted and to cover segmentation of aggregate loan portfolio on micro, small, medium and large enterprises as well the reasons demand for loans was rejected by the banking sector;
2. Supervisory policy should issue specific standard for loan granting process related to MSME and ask for rating systems used by banks which would address creditworthiness of local MSME sector on specific way;
3. Credit guaranty scheme could be very supportive innovative financial facility for additional satisfaction of MSME financial needs;
4. The banking sector should be stimulating to has more transparent loan granting process and disclosure of pricing and other terms of credit policy,
5. Exploring of comparative EU experience in development of CGO throughout communication with AECM.
6. The Government should increasingly explore the use of online tools, such as artificial intelligence, to inform entrepreneurs and small business owners about public support measures tailored for their business needs.
7. Support for equity instruments could be developed through a variety of channels, and policymakers should seek to increase MSMEs' access to capital markets.
8. Regulatory authorities on financial market have taken regulatory measures to foster and provide a framework for financial innovation but those measures should be further enhanced.
9. Provide data on non-performing loans for SMEs and for large firms, the latter to be used as a benchmark.
10. Provide more comprehensive data on alternative sources of financing, including crowdfunding and business angel investments.
11. Compile more complete information on the uptake and use of non-bank financing instruments, asset-based finance in particular.
12. Redesign and revise of Strategy for development of MSME and especially Action Plan which is part of the Strategy.
13. Provide competitive source of initial funding for future CGO.

8. FURTHER STEPS THAT COULD BE UNDERTAKEN

Development and use new financial instruments:

1. Model development and issuance of loan guarantees scheme;
2. Preparation of business plan and financial model for Montenegro CGO,
3. Development of new microcredit, factoring and debt purchasing instruments;
4. Development and improvement of the conditions for using the owner's instrument and capital;
5. Improving the use of available financial instruments within the framework EU programs (COSME, HORIZON, IPA, FP9, EASI, WB EDIF, etc.)

Improvement accessibility, capability financial management

1. Promotion of financing models and improvement of knowledge and skills in the field of financial management;
2. Strengthening the capacity to invest in alternative sources of financing (investment readiness).

Improvement regulatory framework for access to finance

1. Improving legal regulations for easier access to finance;
2. Provide a legislative framework for the establishment and functioning of funds entrepreneurial capital.

Appendix 1

List of companies interviewed:

Company name	Location	Contact person
Ambiente doo	Podgorica	Veliša Popović
AMSN doo	Podgorica	Ana Radulović
Audit company BDO doo	Podgorica	Vesko Knežević
Boka Gardens doo	Kotor	Sonja Vujović
CAU Centar doo	Podgorica	Predrag Babić
Civil Engineering Institute Ltd.	Podgorica	Ivana Tešović
Čikom doo	Podgorica	Vladan Tabaš
DAA Montenegro	Podgorica	Nikola Radonjić
Davos Company doo	Podgorica	Davor Vranić
Delishes doo	Podgorica	Goran Rakočević
Digit Montenegro doo	Podgorica	Branka Petrović
East Company	Podgorica	Vladimir Otašević
Farmalab	Podgorica	Vladimir Nikaljević
Imagemedia	Podgorica	Predrag Šćepanović
Inpek AD	Podgorica	Radivoje Bakić
Inprus Mont doo	Kotor	Spasoje Vujović
Kartonaža M&V doo	Cetinje	Veselin Vujović
Klikovac Company doo	Ulcinj	Predrag Klikovac
Montemlin Šajo doo	Danilovgrad	Nikola Rakčević
M-Projekt	Podgorica	Stefan Mitrović
Obodice-MNE doo	Cetinje	Miloš Vujović
Stroj-Servis	Bar	Larisa Katina-Vujačić
Štikla doo	Podgorica	Maja Ražnatović
Tapacir Kurti doo	Ulcinj	Kabil Kurti
VIA ING doo	Nikšić	Predrag Koprivica
VN Commerce	Nikšić	Gordana Nikčević