LETTING THE INVESTMENT FUNDS FLOW: ISSUES AND CHALLENGES IN SLOVENIA: A TRANSITIONING ECONOMY[1]

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Abstract

Many companies residing in countries transitioning to a free market are experiencing difficulties in obtaining capital. Slovenia is a transitioning economy and banks lend on assets instead of cash flows and often have a relatively high risk free rate which provides little incentive for them to provide funds to even moderately risky firms. The existing debtor laws favor the borrower and assets can be transferred to family members in order to avoid collection. There are no effective procedures to collect on a failed loan.

This project involved defining a unique solution to this problem in Slovenia. The Slovenian government is developing a program to provide a guarantee for a part of the loan funded through the banks. Furthermore, a program is being developed for insurance companies to guarantee part of the government's position. The insurance companies would provide a means to collect on defaulted loans and provide additional assurances for the lender. There were conflicting objectives from the various government ministries involved and the project involved defining and balancing the various concerns of the ministries involved. The Minister of the Economy is trying to get more funds to the firms while the Minister of Finance wants assurances that the tax revenues will not be wasted. The insurance company involved was concerned with evaluating the credit worthiness of the borrowing firms, developing collection procedures and getting a return on for their risk. All these efforts were aimed at providing further capital to small and medium sized firms.

Key words: Investment capital, transitioning economies, emerging economies, legislation, small business, loan default, loan insurance, insurance, credit, rule-of-law, credit analysis, medium businesses, SBA, market subsidy, government subsidy, country expertise, investment.

JEL classification: F21, G18, H81, O23.

Introduction

Transitioning countries have had difficulties in providing funds to small and medium sized firms. Several countries have passed legislation with the specific purpose of increasing investment flows to small and medium sized firms (Commission of European Communities, 2000, 2002, Small Business Venture Capital Act, 1996, European Charter, 2000). However large numbers of loan defaults of significant size are problematic and impact both government and private investor's willingness and ability to provide such funds. This article presents a unique solution to this problem in Slovenia through the use of insurance companies to guarantee part of the funds and to provide a means to collect on defaulted loans.

Slovenia has gone through several programs of providing loans to Small and Medium sized firms. Past experiences led to the development of a new law that will provide more funding

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than was available in the past. There are four distinct stakeholder groups involved in the latest effort to promote entrepreneurship. The firms, the banks, the Ministry of the Economy, and the Ministry of Finance all have unique but mutual interests in ensuring the success of the new program. In the U.S. the U.S. Small Business Administration has had considerable experience in providing assistance and funds toward new and existing businesses. A comparison of their policies and procedures to those being provided in the new law may provide some insight into issues that may evolve and assist in securing success of the program in transitioning economies.

Lack of Investment Flows

There are several reasons for limited investment flows in Slovenia and other transitioning economies. They are as follows:

- banks lend on assets and not on cash flows;
- the risk free rate is relatively high;
- bankruptcy laws favor the borrower;
- no effective procedures for the collection of bad debts exist.

Slovenia has developed several strategies for increasing the flow of capital funds to firms with limited success to date (SEF, 2002, 2003, 2004). Banks in Slovenia lend on assets and not on cash flows. First, banks can get a fairly high return on relatively low risk assets so the question for them then becomes "Why to take on additional risk for a minimal additional return?" Companies may need to purchase buildings or equipment and if they are able to accomplish this task they can then secure funds from banks against these assets. But first, they need capital to secure these assets in a classic "chicken-and-egg" dilemma. Another issue with this practice is that firms do not need to buy earning assets to secure their loans. Thus, firms can develop a significant amount of "non-earning" assets as part of their portfolios. Finally, banks need to receive a return commensurate with the risk they bear. Banks receive a return based on the spread between the amount that they pay for money and the rate that they charge for loans. Making loans based on already existing assets instead of cash flows reduces the risk of the loans provided. There is also a little incentive to lend on riskier loans if secure investments are available that provide a substantial return in excess of the rate that they pay for funds (the spread). The risk free rate is relatively high; accordingly there is little need for a bank to seek increased risk by investing in a business for a marginally higher return. Additionally, Slovene bankruptcy laws favor the borrower. There is an apparent attitude that the government provides the funds and therefore, the government and not others will bear the loss of the defaulted loans. Exacerbating this situation is a common practice of management in trouble to transfer assets to a family member or trusted friend effectively rendering any judgment against the individual manager/debtor useless. Further, there are no effective procedures for collecting on defaulted loans so the borrower is in a win-win situation and the lenders understand this very well. These aspects have restricted the flow of investment funds in the past and will continue to do so in the future unless procedures are adopted and implemented that encourage loan security for lenders.

There have been attempts to stimulate investment through training and development. These enlightenment theories have attempted to provide further investment through education (Sheikh, 2002) but the problems as described persist. Other paths may be more fruitful in gaining the desired loan security result for loans. This paper examines one potential procedure that seems to have good promise as a problem solver for transitioning economy growth through secure loans.

Comparative Issues

A comparison between The U.S. Small Business Administration Policies and the existing policies will provide insight into changes that would further support the flow of funds.

Rule of Law

The rule of law is a significant factor in determining the amount of investment funds available in a particular country. If lenders have a good chance of collecting their investment then more funds will be made available to firms. The performance of loans is directly related to the rule of law. The United States has a very litigious culture. However, that culture allows for a relatively high collection rate for debt. There are penalties for individuals who seek refuge by declaring bankruptcy. The bankrupt individual is often socially stigmatized and will find it quite difficult or impossible to obtain any loans for at least a seven year period. Further, they will have their credit rating restricted for many years after the bankruptcy is granted. It is much easier to avoid payment of debts in Slovenia and there is not much of a social stigma involved in a bankruptcy. Unlike Slovenia, American debtor assets can NOT be legally transferred to others to avoid payment of debts. When the rule of law favors the debtor over the lender then investment funds will not be as readily available. Given the favorable legal position of the debtor over the lender in Slovenia other measures will necessarily need to be taken to ensure the performance of the loan. However, one should not expect large amounts of investment funds to be made available when few assurances are available to the lender.

Lenders can be protected through a careful analysis of the business plan and a comprehensive analysis of the health of the firm. However, in Slovenia and other transitioning economies often obligations such as war taxes are hidden and not included in the statements of an organization thereby providing a much more positive picture to a lender than reality justifies. In the U.S. such omissions would certainly be cause for legal action and foreclosure or fines from the borrower to the lender. In Slovenia insurance seems promising as a way to transfer risk away from the lender as well as specific government programs and help make funds available to groups requiring additional assistance to develop their economic potential.

Insurance

The lender bears all the loan risks in the U.S. but there are several safeguards that are taken prior to a loan being made including insurance. Common insurance products dealing with U.S. loans include title insurance, bonded inspections and often, required “key-man” life insurance attached to a loan. This covenant requires that the borrower pay premiums on a life insurance policy large enough to cover the loan should something happen to the owner or a key member of the organization who is vital to the success of the business. This is different from the insurance provided by the borrower in Slovenia. There the risk of loan default is actually transferred from the lender to the insurance company for a fee.

Insurance reduces lender risk but increases the costs of the loan. Providing protective covenants on the loan can also reduce the risk but this may run counter to the objectives of providing low cost high risk loans.

For Slovenian loans made under this plan the insurance premium will be a function of the maturity, purpose, amount and credit rating of the business. The premium would be determined on a case by case analysis but this will add to the decision complexity for the loan granting committee. It seems that the idea of loan insurance is promising as an idea but the resultant costs of adding the insurance fee realistically limit loan availability for entrepreneurial activities which could substantially enhance economic growth potential. However, analysis of some techniques used in the U.S. for generating small business loans may assist in helping the transitioning countries in their loan dilemma.

Leasing

One option utilized to increase the flow of investment funds is leasing. Loans would be tied to specific assets and require more work on the part of the borrower and lender as a separate agreement is needed for each asset. Recent changes in the tax law have helped in making leasing more attractive. Leasing allows greater flexibility for the firm and is very useful when there is uncertainty in the demand for your product. They are also advantageous to firms seeking maximum leverage. Operating leases can provide for both the financing and maintenance of the asset. There are various types of leases but the differences lie in the length of the lease, the ability to cancel the lease and if maintenance is included in the lease. Sale leaseback’s allows the sellers to get the money immediately for the asset and further allows them to utilize the asset.

The value of leases depends on the current tax laws and the residual value of the lease. Residual values of leases are also impacted heavily by inflation. Investment tax credits, depreciation rules and tax rates influence the usefulness of leases. The fact that ownership lies with the lender is only one of the considerations that impacts the decision to lease. As tax law, depreciation rules and inflation change the value of utilizing leases will change.

Special Purpose Programs

The SBA has several programs that might be of interest and applicable to transitioning economic systems like Slovenia in order to support special interest groups. A brief description of these programs can provide insight into ideas which have the potential to assist the flow of investment funds. These programs include the SBA Express Program and The Community Express Program.

In the SBA Express Program the government guarantees 50% of the loan up to $250,000. The banks use their own paperwork and only send the SBA the eligibility paperwork to verify that it is a small business. This requires a good working relationship and trust between the SBA and the banks.

The Community Express Program is similar to SBA Express. Banks must register separately for both the Community Express Program and the SBA Express Program. In the Community Express Program the SBA guarantees 85% of the loan. This program is specifically designed for veterans, minorities, women, and people living in low to moderate income areas. The SBA provides special assistance to several groups. It has, for example, an excellent "Women in Business Program". Lectures for women's groups, funding and special consultations are provided for women wanting to start a business. This program has been very successful in the past.

Default Procedures Compared

The Slovene Enterprise Fund documentation in 2003, provides for a two year grace period for borrowers in default of a loan. The U.S. S.B.A. allows only a **90** day grace period. The U.S. Small Business Administration takes a pro-active role once a loan is in default. There are two volunteer organizations available to the SBA to consult with firms that are not current on their loans. The Active Corps of Executives (ACE) and the Service Corps of Retired Executives (SCORE) provide volunteer business counseling services to firms.

The smaller 90 day grace period of the SBA assures prompt examination of problem areas and prompts action as necessary. The volunteers suggest that honesty is the best policy in dealing with the bankers. Recognition of a problem early provides for a greater likelihood that the firm can be helped into becoming profitable. Earlier recognition of the problem and a pro-active position to assist those Slovene and other transitioning countries' firms that are in trouble, early rather than later would reduce the number of non-performing loans and help the economy thrive through improved velocity of loan funds availability.

Fees

The objective of the SBA fee system is to cover administrative costs as well as loan default costs. The amount collected in fees has a direct effect on the subsidy rate which is the amount taxpayers pay to keep the program going. The fees reflect the government goals toward a particular loan program. Fees for "risk of loss" are only one of the factors considered. As an example, the SBA's Community Express Program charges 1% of the loan value, guarantees are relatively high at 85%, and the total loan can be for up to $250,000. This program is aimed at economic development so the fees are low. Larger losses are expected but a policy decision was made to accept greater losses in that area to allow greater numbers of the targeted groups to participate in the countries' economic development and progress.

On the other hand, fees in the 7(a) program (another SBA loan program) can be as high as 3% with a flexible guarantee for a loan up to $1,000,000. These loans are not expected to have a high loss rate and the default rate is closely monitored by the SBA so it does not get out of line. The fees are determined by policy study and analysis and they shift the burden of financing from the taxpayers to lenders and borrowers.

In Slovenia or other transitioning economies, the government can develop a fee rating in accordance with the sectors that the government wants to stimulate. Industries can be excluded or included in the program as differential country advantages are perceived to have highest success potential. The fee structure can be made flexible and larger fee loans could also be utilized to subsidize lower fee loans.

Default rate

The default rates on SBA loans are not made public. However, a representative of the Small Business Administration has suggested that the 15% default rate is not out of line. The SBA success rate has varied in the past from 33% to 85%. The SBA, however, expects different default rates on different programs. The Community Express Program for example, may have higher default rates than the 7(a) loan program but will continue as a policy decision. A 15% loss on Community Express for example may be offset by a much smaller loss on the 7(a) program. The two programs cancel each other out as far as a subsidiary dollar rate concern of the SBA. Perhaps a good goal for a transitioning economy on which to concentrate is the subsidiary support dollar rate which is the amount needed from taxpayers to keep the program going. This would perhaps solve some concerns about wasting taxpayer dollars as this amount could be budgeted and loans adjusted accordingly.

The SBA monitors the default rates of various banks and if the default rate for a particular bank becomes excessive they are removed from the program. However, they realize that the default rate on, for example, the SBA Community Express Program will be higher than other programs and make a conscious effort to keep this source of funding available even though the default rate may be higher. Banks making loans under the Community Express Program would be expected to have higher default rates. These same principals could be applied to default rates in any country developing an investment market. In a transition economy it seems logical that it may be beneficial to work with only a few banks and perhaps best to work with only one bank until the program is functioning as needed. Working with one bank or only a few, might provide a better working relationship, ensure that the loans are in line with the goals of the government, provide for a smooth flow of paperwork, and allow the system participants to quickly learn which loans are acceptable. Other banks could participate by purchasing the loans accepted by the government. This would also spread the risk among other financial institutions while allowing them to participate in the economic development of the country.

The default rate is a subjective element that can be controlled by the government (If there are no defaults there is no economic development). There realistically will be defaults if an objective is to stimulate small business. However, this default rate can be controlled and public funds appropriately spent for small business and economic development with appropriate care in oversight procedures such as those utilized by the United States SBA programs.

Credit Analysis

In Slovenia the risk position of the borrower under the previous program was 30% but this was decreased to 25% under the latest economic stimulus program. This may be in line with the government objective to increase risk in its portfolio but this should also be expected to increase the default rate. The U.S. SBA goes through an extensive credit analysis of the loan applicant. There are several agencies in the U.S. that provide ratios that can be utilized to assess the creditworthiness of firms. There are also firms in Slovenia that provide credit ratings for specific companies. The proposal of the application for small and medium sized firms loan application specifies the point scale for the evaluation of the loan proposals (Map, 2001). Up to 4 points are assigned to a proposal for profitability and up to 12 points are assessed for 50% to 60% participation by the borrower. A maximum of 16 points out of 100 are assessed for the creditworthiness of the borrower. The amount of investment provided by the borrower and the profitability of the endeavor are just two of many elements that can be assessed in determining the financial health and subsequent loan-worthiness of the firm. Other measures can be from the SBA procedures developed to assess the financial stability and health of the organization. These measures could then be combined into the point granting system to develop a more complete picture of a firm and thereby lower the risk in the loan decision. Other countries seeking to increase the flow of funds can adjust their risk factor by allocating a different point scheme.

It is necessary to realize that the judgment to grant a loan has subjective elements. The point system provides a means to quantify some of these subjective elements. If high risk firms could be identified early and assistance provided to help them should difficulties arise it would logically seem to increase the likelihood of success.

Guarantee Rates

The United States SBA has different guarantee rates for different programs. Under the Low Doc program the SBA would absorb 85% of the costs and the banks 15% of the collection costs. Under other programs the SBA would provide 75% and the banks 25% of the collection costs. Thus the SBA would provide greater funding for those programs that they feel will best stimulate a particular sector of the economy.

Stakeholder Interests

In Slovenia, there are four major stakeholder groups involved with increasing flows to firms to improve and grow the economy. These groups are: 1) the borrowing firms; 2) the Ministry of the Economy; 3) the Banks organizing the loans; and 4) the Ministry of Finance. Each of these groups has a distinct interest in the program. Considering these stakeholder positions may help in providing a scheme that will satisfy all concerned parties.

Firms

The firms are seeking low cost loans that would not be available to them through normal investment channels. The program can provide funds for small and medium sized firms and also for risky startup enterprises. Startup firms often have little personal capital available for startup and because the existing debtor laws protect the borrower, these individuals may have little or nothing to lose if they should fail in their endeavor. However, these conditions also make it difficult to secure any funding.

Banks

Banks are in business to obtain funds at one rate and to lend them at a higher rate. The banks bear risk and are compensated for bearing that risk. Traditional financial theory holds that higher returns are expected when higher risks are involved. The higher the guarantee provided by the government is the lower the risk exposure of the bank is. The government guarantee lowers the effective cost of the loan. The risk of the loan could also be transferred to an insurance company. This is not possible in the U.S. as no such direct loan insurance is available as discussed. In the U.S. the banks and the government assume the full risk of the transaction. However, in transitioning economies the involvement of insurance companies can potentially provide a unique solution to at least partially ease the loan guarantee problem. If direct insurance for loans is available this also provides an excellent opportunity to assess the actual costs of the risk of the investment as well as a collection improvement potential for defaulted loans.

Ministry of the Economy

The role of the Ministry of the Economy is to improve economic development. Loans provided are meant to increase funds available to startup, small and medium sized enterprises. Further objectives include: increased productivity, technological development, internationalization, improvement of competitive capacity, promotion of foreign direct investment and new domestic direct investment. Its mission should also include maximizing the benefits affiliated with the expenditure of public funds.

Ministry of Finance

The role of the Ministry of Finance is to ensure the welfare of public funds. Since its mission is to ensure the proper use of public funds a high rate of loan defaults would be a major concern.

They would also be concerned about maximizing the benefits from the expenditure of public funds and the loan insurance may significantly assist goal achievement for this and other ministries.

A New Role for Insurance companies

In transitioning countries it is extremely important that investment flows be established for the proper development of the country and governments have been seeking ways to increase these flows (Gruevski, 2002; Strategic, 2002; Brice, 2004). There have been some limited attempts to include insurance companies in the investment process (American Banker, 2003). The possibility of an insurance company participating in bearing the risk of the loan poses an interesting scenario. The insurance company, for example, would provide 50% of the coverage provided by the government. The insurance company would also seek to recover the funds that they paid to the government. This would increase the costs to the borrower if they default on the loan. In the long run the efforts by the insurance company to collect on bad debts would make it more difficult for borrowers to renege on their obligations and would also make investment funds available for firms in the future. At present in Slovenia and other transitioning countries, there are no effective procedures for collecting on defaulted loans. The insurance companies can and would develop default collection procedures which would further assist in the flow of funds. This would also strongly instill in the minds of the lender and borrower that once a loan is made, prompt and effective efforts will be made to collect that loan should it go into default thereby increasing needed responsibility on the part of the borrower and giving risk relief to the loan provider. According to Dusan Mramor, former Minister of Finance, there is little public debate on the issue of guarantees provided by insurance companies but he assumed that everyone would be supportive of the practice as it would help to increase the flow of investment funds.

Table 1

Comparison of Differences

LOAN SUMMARY				
	ASSETS	**CASH FLOW**	**TRANSFER ASSETS**	**INSURANCE GUARANTEE**
SLOVENIA	Yes Even non performing assets $\boxed{\text{Lo}}$	No $\boxed{\text{Lo}}$	Yes $\boxed{\text{Hi}}$	Yes $\boxed{\text{Lo}}$
US	Yes Income Producing assets $\boxed{\text{M}}$	Yes $\boxed{\text{Hi}}$	No $\boxed{\text{Lo}}$	No $\boxed{\text{Hi}}$

Table 1 summarizes the differences in loan strategies between the U.S. and Slovenia which characterizes the reasons why investment funds flow better in the U.S. The box in the matrix provides an indication of the risk to the lending institution. Banks in Slovenia loan on assets which provides low risk for the bankers. Since they do not lend the total market value of the asset there is low risk for the bankers. U.S. bankers will lend on income producing assets. There is still some risk especially for assets tied to a very specific purpose which would be difficult to sell should the loan go into default. Slovenian banks will not lend on cash flows. Lending on cash flows is much riskier than lending on assets should the loan go into default. In Slovenia it is possible for borrowers to transfer assets to spouses in order to protect those assets should a loan go into default. This decreases the likelihood that a bank would be able to recover assets as part of a settlement making the risk for the Slovenian lender much greater than the U.S. counterpart. Insurance companies in the U.S. do not participate in guaranteeing funds and therefore the U.S. banks have a much higher risk profile.

Suggestions

Several suggestions may be useful in increasing investment flows to small and medium sized firms in transitioning economies. This section will provide a summary of some of those suggestions.

Greater centralization of loan processing

A few well chosen and trained banks processing loans are more effective and efficient than many banks processing loans. This selection allows for better control of loans and the ability to track poor performing loans with the banks that issued them. If other banks want to participate the loans could be sold to them to spread risk and allow wider participation in economic development of the country. Small banks may not have the ability to track loans as well as the larger banks.

Express loan Procedure

Providing a single contact point would assist the borrower in applying for a loan. Loan application paperwork and multiple points of contact can be a real hindrance for firms. Keeping the procedures and paperwork to a minimum will assist and encourage more firms to apply.

Declaration of default

The earlier the loan is recognized in default the greater the likelihood that the firm may improve. Early recognition is a key factor in assessing what needs to be done in order to protect the loan. Counseling and training provided early rather than late would increase the likelihood that the firm can improve its performance.

Rule of Law

The greater protection afforded the lender by the rule of law, the greater the amount of funds will be made available to borrowers. The insurance of government funds may provide for further protection offered lenders as new techniques are developed for collecting non-performing loans. Regardless of whether the government or the insurance company will collect on defaulted loans the rule of law needs to be developed to protect the lender as well as the borrower and to improve borrower acceptance of their repayment responsibility.

Counseling Services

Providing counseling services for firms would assist in the development of new enterprises and also provide help for firms that have difficulty. The struggling business does not need text books but “cook books” that are specific and designed to be short and to the point. These would provide an excellent resource for businesses experiencing specific problems.

Special Interest Programs

Special programs for specific targeted groups can be developed. Either women in business, specific geographic areas, particular industries or certain ethnic groups could be targeted for assistance. The amount of the guarantee and the fee structure can be used to support a particular interest as an integral part of government planning for effective participation in the burgeoning global economy.

Subsidiary Dollar Rate

The subsidiary dollar rate or the amount the taxpayers have to pay to keep the program going may serve as a good indicator as to the economic success of the program. It is possible to target a specific amount of taxpayer contribution for the loan program. This would also ensure that taxpayer dollars are put to the best use.

Credit Analysis

Presently only a limited number of points are assessed for the creditworthiness of the firm. Assessing the financial health of a firm is somewhat subjective but there are other quantitative tools that can be used to assess the creditworthiness of a firm. There is no economic development without risk and some failure. This needs to be balanced against the loss of public funds.

Conclusion

Developing the flow of investment funds for newly transitioning countries can present a significant problem. Past collection policies, the rule of law, insufficient procedures to collect defaulted loans and the lack of a social stigma for bankruptcy all restrict the flow of funds. Insurance companies could provide a unique role in increasing the flow of funds by providing a guarantee for risky loans, but more importantly could provide a procedure and a means to collect on defaulted loans that is not now available. Initially, the success rate would be rather low but as procedures and borrower attitudes are changed the market for funds would be stimulated. It provides a unique solution for firms transitioning to a free market economy.

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