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Research Report

Assessment of financing needs of SMEs in the Western Balkans countries. Country report: Bosnia and Herzegovina

Regional Studies and Roundtables

Provided in Cooperation with:

European Investment Bank (EIB), Luxembourg

Suggested Citation: Hauser, Peter; Dolgaya, Tatyana; Revenko, Sorin; Kortenbusch, Michael (2016) : Assessment of financing needs of SMEs in the Western Balkans countries. Country report: Bosnia and Herzegovina, Regional Studies and Roundtables, European Investment Bank (EIB), Luxembourg

This Version is available at:

<https://hdl.handle.net/10419/163419>

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Bosnia and Herzegovina

Assessment of financing needs of SMEs in the Western Balkans countries

August 2016

Assessment of financing needs of SMEs in the Western Balkans countries

Country report: Bosnia and Herzegovina



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Acknowledgements

We would like to acknowledge the support of BFC – Business and Financing Consulting for all their work in conducting the country scoping missions and reports. Without their work, this study would not have been possible. We would also like to thank all of those who participated in interviews, including regulators, donors, providers and other stakeholders across the all involved countries. Finally, the European Investment Bank and Western Balkans Enterprise Development and Innovation Facility (EDIF) would like to extend special thanks to the authors; Peter Hauser, Tatyana Dolgaya, Sorin Revenko, Michael Kortenbusch and to the editors for their contributions; Luca Gattini and Dragan Soljan.

This document has been produced with the financial support of Western Balkans Enterprise Development and Innovation Facility (EDIF), and managed by the European Investment Bank.

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List of Acronyms

AML	Anti-money Laundering
BAM	Bosnian Mark
BEEPS	Business Environment and Enterprise Performance Survey
BFC	Business & Finance Consulting
BiH	Bosnia and Herzegovina
CAR	Capital Adequacy Ratio
CBBH	Central Bank of Bosnia and Herzegovina
CPI	Consumer Price Index
EBRD	European Bank for Reconstruction and Development
EDIF	Enterprise Development & Innovation Facility
EFSE	European Fund For Southeast Europe
EIB	European Investment Bank
ENEF	Enterprise Expansion Fund
EU	European Union
EUR	Euro currency
FBiH	Federation of Bosnia and Herzegovina
FDI	Foreign Direct Investment
FI	Financial Institution
GDP	Gross Domestic Product
IFC	International Finance Corporation
IFIS	International Financial Institutions
ILO	International Labour Organization
KfW	German Development Bank
LC	Letter of Credit
MCO	Micro-credit Organizations
MFI	Micro-finance Institution
MSME	Micro, Small and Medium Enterprises
NACE	Statistical classification of economic activities in the European Community
NPL	Non-performing Loan
OECD	Organization for Economic Co-operation and Development
PAR	Portfolio at Risk
PE	Private Equity
RS	Republika Srpska
SERDA	Sarajevo Economic Region Development Agency
SIDA	Swedish International Development Cooperation Agency
SME	Small and Medium Enterprises
SOE	State-owned Enterprises
TA	Technical Assistance
USAID	United States Agency for International Development
USD	United States Dollars
VAT	Value Added Tax
VC	Venture Capital
WBES	World Bank Enterprise Survey

End of period exchange rates used in this report

	Sep 30, 2015	2014	2013	2012	2011
EUR/BAM	1.9558	1.9558	1.9558	1.9558	1.9558

About this report

This report is one of a series of reports produced by Business & Finance Consulting GmbH (BFC) for European Investment Bank (EIB) as part of the project “Assessment of financing needs of SMEs in Western Balkans countries.” The series of reports includes individual reports on Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro, and Serbia as well as a synthesis report which considers the results of all six reports. The purpose of the project is to assess the financing needs of SMEs in the Western Balkans and identify market failures that prevent SME access to finance.

The project was carried out from October 2015 to April 2016 by a team of three experts from BFC. Onsite visits were conducted for each country in order to meet with representatives from financial institutions, development institutions, government organizations, and other relevant experts with insights into the SME sector.

The visit to Bosnia and Herzegovina took place from December 3-11, 2015, during which time meetings were held with representatives from 24 organizations (including 9 local financial institutions, 7 international development institutions, 3 government organizations, 3 SMEs, and two organizations offering incubator-like services).

The authors take full responsibility for the contents of this report. The opinions expressed do not necessarily reflect the view of the European Investment Bank.

1. Executive summary

Economy: Bosnia's economy is characterized by slow GDP growth, a small number of large corporations, high unemployment (particularly among young people), a very large trading deficit, a sizeable gray economy, and the huge role of the state in overall expenditure. The deflationary environment for consumer prices may be harming some SMEs as consumers choose to save more and spend less. Overall, the slow economic growth combined with political gridlock has resulted in stagnation of SME development, although an improved economic climate in 2015 and early 2016 bodes well for the future.

Demand: There are about 186,000 SMEs in Bosnia, although this is only a rough estimate since the government does not track the number of sole proprietorships, the most common form of business registration. The contribution of SMEs to the economy in terms of value added and employment is generally in line with EU averages. However, there is a large, informal sector so official statistics probably understate the contribution of SMEs to a significant extent (although the size of the informal sector is shrinking over time). The largest share of enterprises are engaged in the services sector, with the trading sector the second most popular type of activity. SMEs commonly identify high tax rates, competition from the informal sector, political instability, and corruption as key constraints to their development. Demand for credit among SMEs has been generally stable in that past five years but is increasing recently in line with improved economic growth.

Supply: Bosnia has a large number of banks and MFIs for a country of its size, leading to intense competition for SMEs clients. However, the benefits of high competition for SMEs are partly offset by conservative lending policies and practices resulting from the high level of NPLs in the banking system. Aside from the NPLs, most of which are a legacy of the 2008-2010 financial crisis, the banking and MFI sectors are relatively healthy, but the leasing sector has shrunk considerably in recent years. Equity financing is very difficult for SMEs to obtain as there are no private equity or venture capital funds, and the low turnover of the stock market makes it an unappealing option. For the most part, the regulatory and supervisory framework is adequate, although the leasing sector is disadvantaged by VAT regulations and the MFI sector is limited by a maximum loan size cap. Credit growth has been very slow in recent years but showed signs of improvement in late 2015 and early 2016. The total supply of MSME loans as of mid-2015 was EUR 2.13 billion, equivalent to 23.6% of total bank and MFI loans and 15.3% of 2014 GDP.

Gaps: There is small to moderate gap in terms of SME access to finance in Bosnia. In terms of loan funding, high competition among lenders means that good SMEs do not lack for options, but poor loan portfolio quality among banks, a legacy of the crisis period of 2008-2010, has led to conservative credit practices, so borrowers with less than ideal characteristics may have difficulty getting credit on acceptable terms. The leasing supply has contracted in recent years, leading to a gap for this product, although demand is at a low level. There are no institutions providing equity finance at present, so there is also a gap for equity products. Startup enterprises have particular difficulty getting funding, as do enterprises that are too big to be served by MFIs but small enough to be of limited interest to banks. As a result of strong deposit growth and low credit growth in recent years, access to funding does not represent a constraint for most financial intermediaries.

2. Macroeconomic environment

Key findings:

- *GDP growth has been very slow in the past five years but has picked up in 2015, increasing 3.2% over the first three quarters. Another year of solid growth is anticipated for 2016*
- *High unemployment, especially among young people, is a key economic and social problem*
- *Participation of SMEs in agriculture is usually at the micro level, in the form of family farms; some SMEs have been pushed out of the trading sector by the appearance of large, international retailers*
- *The slightly deflationary environment has not had a significant impact on SMEs, but a decline in real estate prices reduces the value of collateral which could be offered for loans*
- *Bosnia runs a very large trade deficit, equivalent to 28% of GDP. SMEs are not very active in the export market and benefit very little from FDI inflows.*
- *The government has an enormous influence on the economy with an expenditure equivalent to 46% of GDP and a huge state apparatus of ministries and agencies*
- *Political tension between the Federation of BiH and Republika Srpska harms business confidence and discourages SMEs from making long-term investments*

Key macroeconomic indicators for the country are presented in Annex 1. Unless otherwise noted, all data in this section is from the Agency of Statistics of Bosnia and Herzegovina.

2.1 Economic development and growth

Bosnia experienced weak economic growth from 2011 to 2014, with real GDP growth of less than 1% in all but one of those years¹. The situation is much improved in 2015, however, with growth of 3.2% in the first three quarters. For the most part, both SMEs and large enterprises have participated equally in the ups and downs of the economy, and the recently improved conditions should translate into better performance in the SME sector.

The nominal GDP of Bosnia was EUR 13.9 billion in 2014 with a population of 3.8 million. With a nominal GDP per capita of just EUR 3,642, Bosnia lags behind neighbors Montenegro (EUR 5,561) and Serbia (EUR 4,524). High unemployment is a key contributing factor to low average income and poverty. At 27.9% in 2014, Bosnia's unemployment rate is one of the highest in Europe. A high volume of remittances – equaling about 20% of GDP – may reduce the incentives for some unemployed to find work. Youth unemployment is particularly troublesome – the unemployment rate for persons aged 15-30 stood at 54.3% in 2012, the highest in Europe and among the highest in the world.² Encouraging and enabling young people to participate in the economy through entrepreneurship, particularly in fields such as technology, science, engineering and agriculture, has the potential to boost GDP growth and living standards.

2.2 The structure of the economy

The service sector (excluding public administration) accounted for 40.6% of GDP in 2014 and is the most common sector in which SMEs operate. The contribution of the trading sector to GDP is not particularly high at 15.9% of the total. As large, international retail chains expand their presence in the country, opportunities for SMEs in the trading sector are dwindling, driving many entrepreneurs to the already large service sector or to salaried jobs.

¹ 2013 saw 2,5% growth following a contraction of 0,9% in 2012.

² Erol Mujanovic. *Youth Unemployment in Bosnia and Herzegovina*. Friedrich-Ebert-Stiftung, 2013.

Manufacturing represents 12.9% of GDP, but most of this is reportedly accounted for by large enterprises. Within the manufacturing sector, wood processing is the most common activity in which SMEs engage.³ Although most wood processing businesses tend to focus on activities with low value added, like cutting, there is a strong potential for higher value added activities such as the manufacture of paper products.

Agriculture represented 7.0% of GDP in 2014, down significantly from 8.0% in 2010. Agricultural output is mostly generated by widely differing types of enterprises – large corporations on one hand and micro-sized family farms on the other. The emergence of a class of agricultural SMEs, led by experienced businesspeople, could be one possible path to the revitalization of the agriculture sector.

Although there are a significant number of state-owned enterprises that make major contributions to Bosnia's GDP (the exact number and contributions are unknown), they are not thought to constitute direct competition to the SME sector. Many of the SOEs are large enterprises operating in areas such as telecommunications, water supply, and electricity distribution; smaller SOEs that could be classified as SMEs themselves are reportedly not strong performers on average.

2.3 Inflation and asset prices

Bosnia has experienced a slightly deflationary economy in the past three years (2013-2015), with a negative CPI of between -0.1% and -0.9%. Declines in clothing and food prices were mostly responsible for the lower overall CPI. This deflation has probably had a modestly negative effect on SMEs, with some consumers preferring to save rather than spend, as evidenced by the increase in bank deposits by the population in the last 2-3 years. However, the negative impact on revenues from weak consumer spending is mitigated for many SMEs by decreased input prices.

The country's real estate index is down 15% at Q4 2014 compared to Q1 2010 and has steadily declined since early 2009⁴. On the one hand, this has made it more affordable for some SMEs to acquire real estate, but for SMEs that already own real estate, it has reduced the value of collateral which they can offer, making it more difficult to borrow. With the improvement in economic conditions in 2015, real estate prices have reportedly stabilized and could head upward in 2016.

2.4 Balance of payments

Bosnia consistently runs a large trade deficit, equivalent to 27.6% of GDP in 2014. The country's exports represent about 32% of GDP, one of the lowest ratios in Europe. Local financial experts confirm that, among SMEs, it is rare to find exporting firms, whereas importers from overseas are common. A disproportionately high share of Bosnia's exports is generated by large enterprises. The trade deficit is financed largely by remittances, which accounted for 11.4% of GDP in 2014, and official development assistance, which accounted for 3.1% of GDP in 2013.

The largest export sectors are metals (19.1%), machinery and appliances (11.3%), minerals (8.4%), chemical products (7.6%), footwear and headwear (7.4%), and wood and wood products (7.3%). Of these, SMEs tend to be most active in the wood products sector, with large enterprises tending to dominate the other sectors. Overall exports of all categories were up 4.2% in the first 9 months of 2015 compared to the same period of 2014.

³ 43% of Bosnia's surface area is forested

⁴ CBBH financial stability report

The government's long-term success at maintaining a fixed exchange rate with the Euro has had a positive impact overall, especially for the importers who make up a large share of SMEs. The country has maintained its exchange rate at 1.95583 Convertible Marks for one Euro since 1997.

Net FDI inflows represented 2.7% of GDP in 2014, increasing from 1.9% in 2014 but still below the level of neighbors such as Montenegro (10.8% of GDP) and Serbia (3.7%). Concerns about the country's political situation (see below) among foreign investors are a key factor holding back the growth of FDI. Since most FDI is reportedly targeted towards large enterprises, it is likely that there is little direct benefit to the SME sector. Although FDI outflows are close to 0% of GDP, according to anecdotal accounts, many Bosnian individuals and businesses are using their savings to buy property overseas rather than investing it in the local economy – a lost opportunity for SMEs.

In January 2016, the EU suspended Bosnia's trade preferences that allowed Bosnian firms to export to the EU without paying tariffs. This should lead to a deterioration of export performance in 2016 and is expected to be particularly painful for the agriculture sector.

2.5 The fiscal and political situation

The government's influence on the Bosnian economy is unusually large in comparison with its neighbors. Government expenditure was equivalent to 45.9% of GDP in 2014, one of the highest rates in the world. The equivalent of 17.1% of GDP is spent on social benefit payments while 12.0% goes to compensation of government employees. Bosnia has consistently run a budget deficit of around 2% of GDP in recent years, but its public foreign debt remains low at 30.1% of GDP in 2014. If the government and state-owned enterprises were to reduce their massive workforce gradually, some portion of those former employees would turn to entrepreneurship, boosting the SME sector. In order to support its high spending, the government has set the tax rate on employee salaries at 37%, frequently cited by SMEs as one of the biggest constraints to their development.

Bosnia consists of two entities that have a high degree of autonomy: the Federation of Bosnia and Herzegovina and the Republika Srpska. Both entities have their own parliament and judicial system. The state apparatus is exceptionally large – for example, there are more than 150 ministers for a country with a population of just 3.8 million. Although the central bank is at the national level, most other financial sector supervisory and regulatory bodies are at the entity level, including the agencies which supervise and regulate banks, micro-credit organizations, the stock markets, and insurance companies.

The political relationship between the two entities is contentious. In 2015, the President of RS called for a referendum on the authority of the national court over RS. He further threatened to hold a referendum on independence in 2018 if various issues, including the national court's jurisdiction, are not resolved in favor of RS. The two entities often disagree on legislation, making it difficult to pass new laws. Both local businesspersons and foreign investors are cautious about making long-term investments in the country over fears about the long-term viability of the dual-entity structure. In spite of these problems, beneficial reforms are adopted from time to time, and the business climate is improving overall, although not at an optimal pace.

3. Demand analysis

Key findings:

- There are about 32,000 active legal entities that are SMEs in Bosnia along with roughly 154,000 sole proprietors; the numbers have remained generally stable in recent years
- The contribution of SMEs to the economy – 66% of employment and 62% of value added – is in line with EU averages
- Informality is a key characteristic of the SME sector, either in the form of unregistered enterprises or enterprises that do not report all of their income for tax purposes
- SMEs in Bosnia usually identify political instability, corruption, poor access to finance, high tax rates, and competition from the informal sector as the main constraints to doing business. The World Bank's Doing Business indicators suggest that Bosnia is weakest in starting a business, dealing with construction permits, and taxation
- Demand for loans from SMEs is estimated at EUR 2.0 billion per year, with just over half of enterprises needing a loan annually

3.1 Size and growth of the segment

3.1.1 Number of SMEs

The main source of data about the number of legal entities is the *Units of the Statistical Business Register* report from the Agency for Statistics of Bosnia and Herzegovina. According to this source, there were a total of 34,586 active enterprises in June 2015 (the term “active” meaning that they are submitting the required financial reports to the authorities). Of the 32,760 active enterprises that submitted relevant data⁵, 32,441 (or 99.0%) were MSMEs with 0–249 employees. The breakdown of active enterprises submitting employment data by number of employees is given in the following table.

Table 1. Number of active legal entities grouped by number of employees, June 2015

# of employees	#	%
0–9	24,557	75.0%
10–19	3,219	9.8%
20–49	2,687	8.2%
50–249	1,978	6.0%
250 and more	319	1.0%
TOTAL	32,760	100.0%
Total MSMEs (0–249)	32,441	99.0%

Source: Agency for Statistics of BiH, June 2015

Since these statistics include only legal entities, they miss the even larger segment of sole proprietors, which are considered natural persons rather than legal entities. Although the government does not publish statistics on sole proprietors, the *Labor Force Survey* of 2014, also by the Agency of Statistics, estimates that there are 153,900 self-employed persons, meaning they manage or own an enterprise. Self-employed individuals could either be registered as sole proprietors or could be unregistered. For the purposes of this study, BFC assumes that all of these self-employed persons are sole proprietors since entrepreneurs who are unregistered (and thus operating illegally) would be hesitant to reveal their unregistered status to government employees conducting the labor force survey. Assuming that all the self-employed persons are SMEs, the total number of SMEs would then

⁵ Of the 34,586 active enterprises, 1,826 are recently registered and thus have not yet submitted financials. Hence the “32,760 active enterprises that submitted relevant data”.

be 186,341 (32,441 + 153,900), and the share of SMEs in total enterprises would be 99.8%, the same as the EU average.⁶

It should be noted that there is little consistency among banks in their definition of SMEs. Some use turnover, some credit exposure, and some number of employees as key criteria. The institutions using number of employees commonly follow EU guidelines, but ones using turnover rarely apply the EU definition of EUR 50 million for some it may be as low as EUR 1.5 million.

3.1.2 Importance of the SME sector to the economy

SMEs accounted for 66% of employment, 72% of turnover, and 62% of value added in 2014, according to the Structural Business Statistics report of the Agency for Statistics. These figures are roughly in line with EU averages where SMEs account for 67% of employment and 58% of value added.⁷ The following table shows a more detailed breakdown of the contribution of SMEs to the economy by enterprise size.

Table 2. Share of SMEs in employment, turnover and value added (2014)

Enterprise size (# of employees)	% of persons employed	Turnover	Value added
Small (0–49)	39.9%	43.0%	37.2%
Medium (50–249)	26.5%	28.7%	24.4%
Large (250+)	33.7%	28.3%	38.4%
TOTAL	100.0%	100.0%	100.0%
SME total for BiH	66.3%	71.7%	61.6%

Source: Agency for Statistics of BiH, Structural Business Statistics 2014

Since these statistics only account for legal entities and exclude sole proprietorships (which are considered natural persons under the law), the inclusion of this latter type of enterprise would almost certainly boost the contribution of the SME sector. In addition, classifying the enterprises by turnover rather than number of employees would also be likely to boost the contribution of SMEs since many enterprises with more than 250 employees earn less than the EU threshold of EUR 50 million in turnover, evidenced by the fact that the average reported turnover of enterprises with more than 250 employees in Bosnia is only EUR 41 million.

3.1.2 Growth in number of SMEs

The number of active SMEs registered as legal entities (excluding sole proprietorships) has generally remained stable in recent years, falling by 0.7% from June 2011 to June 2015. A somewhat sharp decrease of 5.6% in 2012/2013 was followed by a rise of 4.4% in 2013/2014.

Table 3.

	June 30, 2015	June 30, 2014	June 30, 2013	June 30, 2012
# of SMEs	32,441	32,334	30,981	32,835
Growth rate	0.3%	4.4%	-5.6%	0.5%

The simplification of business registration procedures and pressure from tax authorities is encouraging previously unregistered businesses to join the formal economy, which provides a boost to the numbers. On the other hand, struggling businesses that never managed to fully recover from the crisis period continue to fail (although at a slower rate now than in previous years), offsetting the gains from formalization of the economy. Most of the local experts interviewed for this study anticipate positive, but modest growth in the number of SMEs for the next several years.

⁶ European Commission. *Annual report on European SMEs 2014/2015*. November 2015.

⁷ European Commission. *Annual report on European SMEs 2014/2015*. November 2015.

3.2 Characteristics of SMEs

3.2.1 Business activity

According to official statistics, which apply the EU NACE categories of business activities, enterprises engaged in trade account for 30.5% of the total number of enterprises; manufacturing, 13.5%; construction, 6.1%; and agriculture, 2.4%. After including the small share of enterprises in mining and electricity generation (1.2% of the total), the remaining 46.2% can be attributed to the services sector. The following table presents the official statistics by NACE category at mid-2015.

Table 4. Number of SMEs by activity (% of total, June 2015)

Activity	Share
Trade	30.5%
Manufacturing	13.5%
Professional, scientific and technical activities	8.3%
Other service activities	8.2%
Construction	6.1%
Storage and transportation	5.7%
Education	4.2%
Arts, entertainment and recreation	4.0%
Information and communication	3.0%
Human health and social work	2.7%
Agriculture, forestry and fishing	2.4%
Others	11.3%
TOTAL	100.0%

Source: Agency for Statistics of BiH, June 2015

As these statistics do not include sole proprietorships, the largest group of registered enterprises, it is likely that the statistics overstate the share of manufacturing and construction enterprises since sole proprietorships are more likely to be engaged in trade and services. The low share of agricultural enterprises in the official statistics is attributable to the fact that most agricultural production is accounted for by unregistered family farms.

Although the share of enterprises engaged in trade is at a reasonably high 30.5%, their share is declining over time as large retail chains, often representing foreign brands, expand their presence in the country. In mid-2011, the number of SMEs engaged in trade represented 34.0% of the total. From mid-2011 to mid-2015, the proportion of SMEs in manufacturing fell from 14.5% to 13.5%. Wood processing, metalworking, and the manufacture of furniture and auto parts were the most commonly-mentioned examples of manufacturing for SMEs in Bosnia.

3.2.2 Regional distribution

65.0% of all active legal entities are registered in the Federation, 31.1% in Republika Srpska, and 3.9% in Brcko District⁸. There is a reasonably good distribution of business activity throughout the country. Although the entity-level capitals of Sarajevo and Banja Luka are the main centers, they do not dominate business activity by as large a margin as the capitals of some other countries in the region. This distribution of business activity is consistent with the population, which is spread across a large number of urban centers in various parts of the country. Other main cities include Tuzla, Zenica, Bijelina, Mostar, Prijedor, and Brcko.

⁸ Brcko District is a self-governing municipality which is not part of RS or FBiH

3.2.3 Gender

The rate of female participation in businesses as owners or managers is low in Bosnia. According to the 2014 *Labour Force Survey* of the Statistics Agency, 9% of men are self-employed, indicating that they are engaged in entrepreneurial activity, versus only 3.3% of women. A 2008 study found that about 25% of entrepreneurs in Bosnia are female.⁹ Although female entrepreneurship is held back by traditional cultural norms, many women find themselves with no other options due to limited employment opportunities. The participation of women in business is reportedly increasing slowly over time, aided by a variety of support programs from the government and international organizations.

3.3 Performance

Most interviewees reported that the growth and profitability of SMEs in 2015 was moderate, on average, and slightly improved from 2014 when economic conditions were less favorable.

Data from the *Structural Business Statistics* report of the Statistics Agency show that, in 2014, the SME sector generally outperformed the large enterprise sector in terms of growth. The average number of employees, turnover and value added of SMEs increased by 4.5%, 6.2% and 7.1%, respectively in 2014, versus 1.0%, -2.7% and -1.7% for large enterprises. SMEs generated acceptable profitability in 2014 – the gross operating rate (operating profit to turnover) was 10.1% for small enterprises and 9.0% for medium enterprises, lagging behind the 12.2% rate for large enterprises. SMEs generate more turnover per employee than large enterprises but less value added per employee. The following table summarizes the statistical results for 2013 and 2014.

Table 5. Performance metrics of enterprises

	2014	2013
Gross operating rate (% of turnover)		
Small	10.1%	10.2%
Medium	9.0%	8.4%
Large	12.2%	12.0%
Turnover per employee (BAM)		
Small	143,476	140,950
Medium	144,296	142,416
Large	111,979	116,273
Value added per employee (BAM)		
Small	27,595	27,075
Medium	27,258	26,343
Large	33,688	34,614

Source: Agency for Statistics of BiH, *Structural Business Statistics 2014*, *Structural Business Statistics 2013*

These data should be interpreted with caution due to the prevalence of misstating revenues and profits by SMEs for the purposes of tax avoidance.

3.4 Institutional and regulatory issues

The business environment in Bosnia is characterized by a number of weaknesses that are highlighted by survey data and international institution studies. Constraints that are repeatedly rated as serious

⁹ Shwetlena Sabarwal and Katherine Terrell. *Does Gender Matter for Firm Performance? Evidence from Eastern Europe and Central Asia*. Institute for the Study of Labor, October 2008.

across a variety of these surveys and studies are political instability, corruption, poor access to finance, high tax rates, and competition from the informal sector.

The World Bank's Doing Business indicators¹⁰ highlight Bosnia's particularly poor performance in the areas of starting a business (2016 rank: 175), dealing with construction permits (171) and paying taxes (154). These rankings are much worse than Bosnia's overall rank of 79. Trading across borders (28), resolving insolvency (38) and getting credit (42) are the strongest aspects of the business environment according to the World Bank. Bosnia's rank improved slightly in 2016 from its 2015 rank of 82. The full set of World Bank indicators, as well as other indicators mentioned in the remainder of this section, can be found in Annex 2.

EBRD's BEEPS surveys¹¹ (carried out most recently in 2012 and 2013) identify the top constraints to doing business as political instability, access to finance, competition from the informal sector, and corruption. The high perceived political instability is mainly a function of tension and gridlock between FBiH and RS. As indicators of corruption, 6.5% of respondents reported that tax officials requested informal payments (second-highest in the Southeastern Europe region), while 14% reported that informal payments were requested to obtain a business license (highest in the region). In contrast to the Doing Business indicators, business licensing (which is comparable to starting a business in Doing Business) in BEEPS is not rated as a major constraint.

The World Bank Enterprise Surveys (WBES) are generally consistent with the results of BEEPS. Political instability and access to finance are identified as the top two constraints¹², and corruption is fourth just as in BEEPS. The only difference is that tax rates are the third most important constraint in WBES compared to informal sector competition in BEEPS. WBES results differ somewhat by the size of the firm. Both small (5–19 employees) and medium (20–99 employees) enterprises identify political instability as the top constraint, but small firms identify access to finance and tax rates as second and third rated constraints while medium firms identify labor regulations and access to finance as second and third.

Transparency International ranked Bosnia 76 out of 168 countries (a lower rank is better) in its Corruption Perceptions Index for 2015, versus 80 out of 175 in 2014.

At the national level, SME policy is the responsibility of the Sector for Economic Development and Entrepreneurship of the Ministry for Foreign Trade and Economic Relations. According to an insider interviewed for this study, disagreements between representatives of the two entities (FBiH and RS) have made it difficult to introduce new policies in recent years. There is currently no written government strategy for development of the SME sector and no law on SMEs.

3.5 Innovation

The level of innovation in Bosnia is low among SMEs, but a high-tech startup scene consisting of innovative companies is just starting to emerge, in many cases supported by incubators, business centers and similar organizations. The first incubators to appear in Bosnia were founded by municipal governments, and now there are number of government-supported incubators and business centers in the country's largest cities. Most of these organizations offer free or inexpensive office space and

¹⁰ Source: <http://doingbusiness.org/data/exploreconomies/bosnia-and-herzegovina>

¹¹ Source: <http://ebrd-beeps.com/countries/bosnia-and-herzegovina/>

¹² The identification of access to finance as a top constraint appears to contradict the good ranking for getting credit in the Doing Business report. The Doing Business ranking considers only the regulatory and institutional framework but not product conditions and service quality that might be more important to SMEs surveyed for the Enterprise Surveys, which may explain the contradictory results.

training programs to enterprises, often in cooperation with international development institutions such as SIDA and USAID. More recently, private individuals have founded support networks and incubators as well. A list of incubators and similar organizations can be found in Annex 5.

Bosnia's biggest challenge is in terms of human resources. First, the educational system must provide young people with stronger skills in fields that tend to be associated with innovation such as engineering and computer science. Second, young people with relevant skills must be persuaded to stay in Bosnia rather than go abroad. The continuation of ongoing reforms related to the business environment will be helpful in this regard as would a reduction in political tensions. The emergence of a venture capital finance industry would also encourage potential entrepreneurs, armed with the knowledge that there are funding options available, to start companies.

Example of an innovative SME: Atlantbh (<http://atlantbh.com>)

Atlantbh is a software development company that provides a variety of software solutions, including custom enterprise software, big data solutions, and software testing. It has developed a number of applications available for the iOS and Android operating systems such as a Sarajevo city guide and a photo storage and editing tool. Its clients are both local and international firms, and it has a particular focus on geographical and location-based systems.

3.6 Demand for finance

3.6.1 Overview

Demand for financing from SMEs has been stable in recent years, in line with economic growth with a slight increase in 2015 following a flat 2014. There are no sectors of the economy or business activities that are demonstrating any particularly high or low demand growth. Expectations for 2016 are cautiously optimistic with low, but positive demand growth expected.

3.6.2 Estimate of demand

The demand for loans from registered MSMEs is estimated at about EUR 3.3 billion, which is equivalent to 23.7% of 2014 GDP. The main steps in the calculation are shown in the following table.

Table 6. Calculation of demand for loans from MSMEs

Step in Calculation	Legal entities	Source
A. Number of MSMEs	186,341	Agency for Statistics
B. Average loan size demanded (EUR)	34,409	BFC survey of banks
C. % of enterprises needing a loan	51.5%	World Bank Enterprise Surveys
D. Total demand (EUR millions)	3,302	= A * B * C

The number of enterprises is taken from government sources while the average loan size demanded for legal entities is calculated from a BFC survey of six banks. The average loan size disbursed by the financial institutions is used as a proxy for the loan size demanded under the assumption that financial institutions are not being overly conservative in setting loan amounts. It is likely that this estimate overstates the demand for credit because most of the MSMEs by number are sole proprietors which generally need smaller loan amounts, but banks prefer working with legal entities which need higher loan amounts. As a result, the average loan size disbursed by banks, which is used here for loan size demanded, is probably too high.

There are no reliable data which could be used to estimate the demand for non-loan products such as equity, leases and letters of credit.

3.6.3 By type of SME

Demand is relatively consistent across a variety of business sectors and types of firms. However, several lending institutions report that the service sector is demonstrating higher demand growth than the trading sector as the entry of international retail chains reduces opportunities for small traders.

3.6.4 By instrument

Although it is normal in any economy for loans to account for the vast majority of funding demanded, the demand in Bosnia for non-loan products such as leases, letters of credit, and equity funding is particularly low.

The low level of demand for leases is partly attributable to the cost disadvantage relative to loans. Leasing companies must apply VAT to their finance charges at a 20% rate while interest on loans is not subject to VAT. In addition, leasing companies have a much smaller branch footprint than banks, so potential customers located near smaller cities might have to travel a great distance to reach a leasing provider. Low financial literacy is also a contributor since some SMEs are not sufficiently familiar with the terms and conditions of leasing to appreciate its advantages. Low financial literacy and lack of awareness are key explanatory factors in the low demand for letters of credit and equity financing as well. Equity financing is also held back by a reluctance to cooperate with outsiders as owners or partners in a business – many entrepreneurs will not seek equity funding outside of their own family.

Demand for loans is highly concentrated in working capital purposes and consumer spending rather than investments in fixed assets. Although the pain of the 2008–2010 financial crisis is fading for many entrepreneurs, concerns about the country's political stability may be continuing to suppress the demand for long-term, fixed asset financing. The perception that such financing is not available from financial institutions with acceptable conditions may also be restraining enterprises from requesting these financial products.

4. Supply analysis

Key findings:

- There are a large number of financial institutions in Bosnia given the size of the country, and nearly all the institutions are working with SMEs to some extent, creating a highly competitive environment
- The banking sector is highly competitive, but a history of high NPLs from earlier years has led to a conservative approach to lending and low credit growth
- There are no venture capital funds focused on the country, although there are a number of promising startups supported, in many cases, by incubators or business centers
- The leasing sector has contracted in size in recent years and lost money in 2014, but most leases are being issued to SMEs
- The country's two stock markets are not a meaningful source of financing for SMEs due to a low level of activity
- Regulation and supervision of the financial sector is reasonably good, although strict documentation requirements for small loans, tax disadvantages on leases, and low maximum loan amounts for MFIs constrain the supply of funds
- The total supply of loans to SMEs is estimated to be about EUR 1.2 billion or 24% of total bank and MFI loans. Leasing companies contribute roughly another EUR 157 million.

4.1 Number and type of intermediaries

Given the small size of the country, there are a relatively large number of financial intermediaries working with the MSME sector. However, most are heavily concentrated in the provision of credit products with almost no intermediaries providing equity financing.

Table 7. Number of financial institutions

	Q3 2015	2014	2013
Banks	27	27	27
Leasing companies	8	7	8
Micro-credit organizations	19	19	19
Stock markets	2	2	2

Source: Central Bank of Bosnia and Hercegovina, interviews with local experts

Banks: There are 27 banks in BiH, 18 registered in FBiH and 9 registered in RS. Some of these are effectively the same bank registered separately in both entities. For example, NLB, Unicredit, Hypo-Alpe-Adria, and Sberbank are licensed in both entities. Due to the small number of large enterprises in BiH, all of the banks work with SMEs to some degree, although some banks tend to focus on the larger end of the SME market. The overall number of banks has remained stable in recent years.

Leasing companies: Eight leasing companies are licensed, seven in FBiH and 1 in RS. However, only five of these are actively issuing leases as of late 2015, with the others simply trying to recover their existing portfolios. The leasing sector grew in 2015 with the addition of Porsche Leasing, which received a license in the second quarter. In 2014, the number of players declined as one leasing company withdrew its license. Aside from Porsche, another four companies are subsidiaries of local banks that, in turn, have foreign parent banks: Raiffeisen, NLB, Sparkasse and Unicredit. The seven companies registered in FBiH have a total of 17 branches, so their geographic reach is limited. All of the five active leasing companies are working with SMEs.

Micro-credit organizations: There are 19 micro-credit organizations (MCOs) in BiH, 15 of which are registered as micro-credit foundations and four as micro-credit companies. This distinction in registration status is important because it affects the maximum loan size which MCOs can offer (explained in section 4.4 below). Seven of the MCOs are registered in RS, with the other 12 registered in FBiH. All of the MCOs are lending to the MSME sector, specifically to microenterprises, although some have a substantial portfolio of consumer loans as well.

Equity funds: There were no known investments by venture capital or private equity funds until quite recently, when the Western Balkans Enterprise Development and Innovation Facility made an investment in early 2016.

Stock exchanges: Bosnia has two stock exchanges: the Sarajevo Stock Exchange (SSE) and Banja Luka Stock Exchange (BLSE). Most of the turnover on the exchanges is from government bonds. As explained in more detail in section 4.2.4 below, the stock exchanges are not a meaningful source of financing for SMEs.

Government: There are no known government programs directly providing funding to SMEs, although there are programs that provide funding to financial intermediaries for onlending to SMEs. These are described in section 4.5.1.

Guarantee funds: There are no national or entity-level guarantee funds that have been established or supported by the government, but there are a number of guarantee funds that have been established by municipal governments. These funds tend to be small in size and their exact number is unknown, although there are at least four known to be active at the time of this writing.¹³ These funds provide guarantees directly to SMEs rather than guaranteeing a bank portfolio. The canton of Sarajevo is in the process of establishing a guarantee fund at the time of this writing, which would be the first in the country at the cantonal level. There are also portfolio guarantees available from international institutions, EDIF and USAID/SIDA being the most active.¹⁴

As the following table shows, banks account for 87.3% of financial sector assets, with leasing companies and MCOs contributing 2.0% and 2.5%, respectively. The share of leasing companies and MCOs has been declining recent years, quite rapidly in the case of leasing, while bank and insurance companies shares have grown.

Table 8. Asset share by type of intermediary

	2014	2013	2012
Banks	87.3%	87.1%	86.3%
Leasing companies	2.0%	2.4%	2.9%
MCOs	2.5%	2.6%	2.8%
Investment funds¹⁵	3.0%	3.0%	3.2%
Insurance companies	5.2%	4.9%	4.8%
TOTAL	100.0%	100.0%	100.0%

¹³ One example is the guarantee fund of SERDA, the Sarajevo Regional Development Agency. The fund was established in 2006, the first in Bosnia. The total fund size is EUR 500,000, and it has provided about 250 guarantees over the past five years, covering 50% of the losses of one participating bank. The fund does its own analysis and preliminary approval of potential clients before the bank starts to review the application. Beneficiaries pay nothing for the guarantee.

¹⁴ The USAID/SIDA guarantee fund has cooperated with Raiffeisen, Volksbank (now Sberbank), Nova Banka, ProCredit and Sparkasse.

¹⁵ These funds are invested in the stock market and do not directly contribute to the financing of SMEs.

4.2 Type of funding instruments

4.2.1 Loans

Overall, loan growth has been slow in recent years, in line with slow economic growth and also influenced by the legacy of high NPLs in banks. Lending to households has been growing faster than SME lending, partly due to greater demand growth from households but also due to higher than average NPL rates in SME portfolios. Although most of the bad loans were disbursed during the crisis period years ago, it has made banks more cautious about lending to SMEs. In the first 9 months of 2015, loan growth was a modest 1.9%. During that period, loans to households grew 3.5% but loans to businesses decreased. Overall credit growth was a modest 2.9% in 2014 with household loans increasing by 5.2% and business loans decreasing by 2.2%. Many banks are anticipating higher credit growth rates in 2016 as economic performance continues to improve.

The NPL ratio of banks stood at 14.0% at the end of 2014. Although this was a notable improvement from 15.1% in 2013, much of the improvement in NPLs in 2014 was related to the sale of EUR 168 million of NPLs by Hypo Alpe Adria Bank to a special purpose entity. Most banks interviewed for this study reported a slight improvement in portfolio quality in 2015. For MFIs the situation is quite different as portfolio quality is excellent. As of September 30, 2015, MFIs in FBiH had a PAR 30¹⁶ of 1.1%, and MFIs in RS were slightly higher at 1.5%. Nevertheless, loan portfolio growth among MFIs has been weak, with a decline of 2.6% in 2014 following a 1.6% decline in 2013.

The high NPL ratio has led to conservative lending policies as banks and MFIs focus on risk management rather than expansion. Banks and MFIs tend to have flexible collateral policies on paper, granting much discretion to credit committees to determine the type and amount of security to be taken. In practice, however, credit committees are usually strict, demanding real estate collateral for all but small loan sizes and requesting that the value of collateral exceed the loan amount by a large margin, usually 150% or more. One bank reported that the market value of collateral must be triple the loan amount for SME loans. Respondents to the World Bank Enterprise surveys indicated that the average collateral value required for a loan was 190% of the loan amount; although this is high, it is below the average of 207% for the Eastern Europe and Central Asia region.

Conservatism is also manifested in the approach to setting loan amounts which are often lower than the amount requested by clients. To a large extent, the practice of reducing loan amounts is related to the client practice of understating their revenues for tax purposes. Most banks will not consider unreported income in their financial analysis. One bank reported that it takes the unusual approach of requiring new SME clients to have their unofficial financial records audited in order to receive a loan if the client does not qualify based on their official income alone. Loan maturity is generally less of a constraint than the amount; relatively long maturities of five years can be obtained for fixed asset purchases and two to three years for working capital loans.

4.2.2 Leases

The supply of leases has been declining rapidly in recent years as several leasing companies have stopped issuing new leases and several of the still-active companies have reduced the volume of their disbursements. Total assets of leasing companies were EUR 262 million at the end of 2014, down 28.5% from the end of 2012. The sector suffered an aggregate loss of EUR 7.3 million in 2014 which the Central Bank attributed to “inadequate business practices” leading to poor quality of receivables.¹⁷ As with the banks, the poor portfolio quality is, to a large extent, attributable to relatively old loans dating from the crisis period. As time passes and portfolio quality improves, the shrinking of

¹⁶ The Portfolio at Risk (PAR) 30 ratio is the share of loans that are more than 30 days overdue.

¹⁷ CBBH Financial stability report

leasing sector assets should stabilize and reverse. In the first six months of 2015, the seven leasing companies in FBiH earned a small combined profit and their total assets increased by 0.4%.

The vast majority (93%) of leases are issued to legal entities rather than individuals – this is mainly the result of tax issues (further described in section 4.4 below). Finance leases account for 88.8% of the total value of all leases. In the first half of 2015, 65% of the value of new leases issued in FBiH was for vehicle financing while the other 35% was for equipment.¹⁸ Weighted effective interest rates to legal entities were 7.8% in the first half of 2015 and have been steadily declining over the past two years.

4.2.3 Letters of credit and trade finance guarantees

All banks in Bosnia offer trade finance guarantees to SMEs, and many offer letters of credit as well. Guarantees are a relatively popular product among SMEs, but the supply of letters of credit is quite low. Bankers argue that the low supply of letters of credit to SMEs is a consequence of low demand (as discussed in section 3 of this report) and does not reflect an unwillingness of financial institutions to provide these products on reasonable terms.

Banks reported EUR 803 million in outstanding guarantees to companies at the end of 2014¹⁹, equivalent to 22.9% of total loans to companies, but only EUR 26.5 million in letters of credit. Among the six banks that provided data, the value of outstanding guarantees on behalf of SMEs totaled EUR 99.9 million, equivalent to 12.9% of their SME loan portfolio, whereas the total value of outstanding letters of credit for SMEs was just EUR 2.2 million (three of six banks having no LCs).

A law on factoring was adopted in 2014, so this product has the potential to boost SME liquidity as it becomes more common. By the end of 2014, banks had a factoring portfolio of about EUR 511,000 on their balance sheets.

4.2.4 Risk capital

The supply of risk capital to SMEs in Bosnia from formal institutions is extremely low. There are no PE or VC funds located in or targeting Bosnia and no angel investor networks or similar platforms for entrepreneurs to connect with individual investors. SMEs do have access to equity capital but only through informal channels – typically family and friends. The limited supply of equity financing is particularly disappointing in light of the presence of an ecosystem for startups in the form of incubators, business centers, and similar support organizations described in section 3.5.

The country's two stock markets have not proven to be a meaningful source of equity financing for SMEs. The combined turnover in equities on both stock markets in 2014 was EUR 326 million, equivalent to 2.3% of GDP. All or nearly all the turnover is reportedly generated by large enterprises.

4.3 Characteristics of funding recipients

4.3.1 Sector

On the basis of six banks that provided data as of mid-2015, the largest share of SME loans, 39.8%, is going to the trade sector followed by the manufacturing sector at 25.1% and services at 14.8%. Agricultural lending is very low at 3.8%.

¹⁸ Banking Agency of the Federation of Bosnia and Herzegovina. *Information on the Leasing Sector in the Federation of Bosnia and Herzegovina*. June 2015.

¹⁹ CBBH Financial stability report

Table 9. SME lending of 6 banks by sector as of June 2015 compared to share of GDP

Sector	6 banks	Share of GDP
Trade	39.8%	16.9%
Manufacturing/production	25.1%	12.9%
Services	14.8%	40.6%
Agriculture	3.8%	7.0%
Other	16.6%	22.6%
TOTAL	100%	100%

Source: BFC survey, Agency of Statistics

The results differ significantly from the share of each sector in GDP. Trading and manufacturing enterprises receive a disproportionately high amount of funding while services and agriculture receive less. Several banks reported that they intentionally favor the manufacturing sector over the service sector as manufacturing enterprises are seen as having better growth potential, having more assets which could be pledged as collateral, and being more “important” for the economy, in a subjective sense. The availability of funding lines specifically for the manufacturing sector (such as from Odraz – see section 4.5 below) may also give a boost to the figures. The trading sector’s high share of total lending partly represents the high demand for working capital loans in that sector and the relative simplicity for banks to conduct that type of business analysis.

The majority of agricultural enterprises are unregistered, so most banks will not consider them as potential clients. However, the MFI sector has proved to be capable of filling this gap. Within the total loan portfolio of MFIs, the share of agricultural loans was 36.8% at the end of 2014.²⁰

4.3.2 Region

Although there are no figures on the distribution of SME loans by region, the geographic scope of lending appears to be broad. Banks had a total of 900 organizational units (branches and sub-branches) at Q3 2015, a high number for a country with a population of 3.8 million. Intense competition has encouraged banks to set up operations in all parts of the country. All major cities and towns can claim at least a few bank branches. Due to the country’s compact size, even potential clients in rural areas usually do not have to travel especially far to reach a branch.

The situation is similar for MFIs, which also have extensive branch networks country-wide and are even more focused on reaching rural areas than banks. At Q3 2015, the 17 MFIs had a total of 358 organizational units.

4.3.3 Purpose

Working capital is the main purpose of bank funding to SMEs, accounting for about half of the total among the six banks which provided data. Although it is common for working capital loans to occupy the first position in any country, the share of lending in Bosnia for fixed assets is quite substantial at about 40%.

Table 10. SME lending by purpose for six banks

Sector	Share
Working capital	49.6%
Fixed assets	40.2%
Other	10.3%
TOTAL	100%

²⁰ Central Bank, Financial Stability Report 2014.

Source: BFC survey

Two of the six reporting banks indicated that they intentionally favor loans for the purchase of fixed assets, arguing that purchases of fixed assets are more indicative of a healthy, growth-oriented business.

4.3.4 By registration status

Most banks do not lend to unregistered businesses operating in the informal sector. Two banks interviewed for this study stated they do occasionally lend to unregistered businesses, but only under the condition that the enterprise will register shortly after receiving the loan. By contrast, most MFIs are actively lending to unregistered businesses. A branch manager of one MFI stated that about 85% of his branch's clients are unregistered, although the average share of lending to unregistered clients in the MFI sector as a whole is almost certainly much lower than that.

A few banks expressed hesitation about working with sole proprietorships, which is a registered business but considered as a natural person rather than a legal entity according to law. Sole proprietorships have simplified financial reporting obligations compared to legal entities, so it is often more difficult for banks to perform a financial analysis for these clients. MFIs are much more comfortable working with sole proprietors.

4.4 Institutional and regulatory issues

Banks are generally satisfied with the institutional and regulatory environment in Bosnia. The constraint that was mentioned most commonly by banks was related to strict requirements for documentation that must be collected (and often notarized) from clients in connection with loan applications. Although these documentation requirements are appropriate for medium and large enterprises, they are particularly burdensome for micro and small enterprises, which need a faster and less bureaucratic approach. The separate licensing and supervision systems for FBiH and RS complicate the process of operating on a national scale, although that issue is not specific to SMEs. Other constraints mentioned by banks were strict requirements related to liquidity, AML and related party lending; however, none of these are considered major barriers to SME lending.

The MFI sector, which is supervised in each entity by the respective banking agency, is limited in terms of maximum exposure to one client. MFIs that are licensed as non-profit foundations face a maximum loan size of EUR 5,113 (BAM 10,000) while MFIs licensed as for-profit, micro-credit companies can offer up to EUR 25,565 (BAM 50,000). These limits ensure that MFIs cannot upscale from the microenterprise to the SME sector. MFIs cannot accept deposits (a common restriction to MFIs in most countries in the region), limiting their funding options. Regulation and supervision has reportedly become tougher in recent years as a result of the failure of a number of prominent MFIs. One of the entity banking agencies, for example, is reported to be increasingly less tolerant of the practice of including unofficial (i.e. unreported for tax purposes) income in the calculation of an applicant's repayment capacity.

For the leasing sector, the main regulatory issue is related to the treatment of VAT, which must be taken on leasing finance charges but not on interest on loans, making leasing relatively more expensive. This is not a problem for legal entities since they can deduct VAT paid; as a result, most leases are disbursed to legal entities. However, sole proprietorships – the most common form of business registration – are considered natural persons and, thus, are subject to the VAT disadvantage. Although a new leasing law is expected to be implemented in 2016, the tax disadvantage is not expected to be remedied by it.

4.5 Funding of intermediaries

4.5.1 Government

The government, whether at the federal, entity or cantonal level, is an important provider of funding to local banks. The following table shows the level of government financing to seven selected banks that report their sources of borrowing in their audit reports²¹.

Table 11. Government and quasi-government loan financing to 7 selected banks, end of 2014²²

	Amount (EUR 000s)	%
Investment-Development Bank of RS	101,060	68.4%
Odras – Foundation for Sustainable Development	23,752	16.1%
Ministry of Finance	22,743	15.4%
Ministry of Industry of Canton Sarajevo	119	0.1%
TOTAL	147,673	100%

Source: Banks' audit reports

For these selected banks, government funding increased by 5.0% in 2014.

The Investment-Development Bank of RS is included here as a government funding source since it is 100% owned by the government of RS and its credit lines to commercial banks are partly funded by credit lines from the government.

Odras is a non-profit organization established by the government for the purpose of promoting economic development. Its main areas of focus are lending to SMEs via commercial banks, infrastructure development, and projects related to the EU transition. Its funding comes both from the government and development institutions such as World Bank and EBRD. After a participating bank has reviewed and preliminarily approved an application, Odras checks that the application meets its eligibility criteria before the loan can be disbursed. Odras does not support the trading sector – its main target segment is the production sector. Interest rates to end borrowers are around 4–5% + LIBOR, while participating banks pay a 1.0% fixed rate. Minimum loan sizes are about EUR 25,000, and the maximum size is EUR 2.5 million.

4.5.2 Development finance institutions

Development finance institutions are also major contributors to bank funding, led by EIB, which accounted for more than half of loan borrowing to the seven banks which reported data. EBRD and EFSE are also very active in lending to local banks.

Table 12. Outstanding borrowings of selected banks from international institutions, end of 2014

	Amount (EUR 000s)	%
EIB	33,042	51.7%
EBRD	14,324	22.4%
EFSE	12,250	19.1%
Kuwait Fund for Arabian Economic Development	2,726	4.3%
IFAD	1,632	2.6%
TOTAL	63,973	100.0%

Source: Banks' audit reports

Funding from development institutions increased slightly (3.4%) in 2014.

²¹ The seven banks were chosen because they report their borrowings individually for each lender in their audit reports, so the following breakdown could be made. These seven include many but not all of the country's largest banks and are generally believed to offer good insight into the situation of the banking sector as a whole.

²² There may be some overlap between funding from the government and development finance institutions.

In terms of equity investments, EBRD has a stake in Hypo Alpe Adria Bank, and the Islamic Development Bank is an investor in Bosna Bank. The IFC was an investor in UniCredit but sold its stake in 2015.

4.5.3 Parent banks

An analysis of the 2014 financial statements of nine banks owned by foreign parent banks reveals that total parent bank financing (including both deposits and loans) declined by 17% in 2014. Five of these nine banks experienced a decline in parent bank financing while four saw increases. Parent bank financing was equivalent to 7.2% of these banks' total assets in 2014. This decline does not necessarily represent reduced capacity or willingness of the parent banks to support their subsidiaries since most of the banks experienced increasing deposit levels from customers.

For the seven banks that reported details of borrowings, loans from parent banks totaled EUR 135 million, somewhat less than the EUR 148 million from government sources but much more than the EUR 64 million from development institutions.

4.6 Supply estimate

The total supply of MSME loans as of mid-2015 was EUR 2.13 billion, equivalent to 23.6% of total bank and MFI loans and 15.3% of 2014 GDP. The estimate of the proportion of MSME loans for banks is based on the weighted average of a survey of six banks. For MFIs, the ratio is calculated from data in the quarterly reports of the respective banking agencies of FBiH and RS.²³

Table 13. Estimate of MSME loan supply at June 30, 2015

	Banks	MFIs	Total
A. % of FIs offering MSME loans	100%	100%	n/a
B. MSME loans to total loans	22.4%	63.3%*	23.6%
C. Total loans (EUR millions)	8,773.8	260.2*	9,034.0
D. MSME loan supply estimate (=A*B*C)	1,965.3	164.7	2,130.0

Source: BFC Survey, Central Bank of Bosnia and Herzegovina, Banking Agencies of FBiH and RS

* Data is from September 30, 2015

A very high share of leases is granted to SMEs since leasing to individuals is hampered by VAT regulations. Based on data from one of the largest leasing companies, BFC estimates that roughly 85% of all leasing contracts are granted to SMEs, with the remainder going to large enterprises and individuals. The total lease portfolio was EUR 184.7 million on September 30, 2015, so the SME lease portfolio would be around EUR 157.0 million. Combining this with the loan supply estimate, total outstanding funding to SMEs would be EUR 2,287.0, or 16.4% of GDP.

The supply of venture capital funding is assumed to be close to zero since there are no VC funds operating in the country yet and no substantial activity from angel investors, aside from perhaps a handful of small investments.

²³ Any loans not clearly identified as business loans to the trade, services, agriculture or manufacturing sector are not included in this calculation

5. Gaps in private sector financing

Key findings:

- Bosnia faces a small to moderate gap in loan financing, mainly affecting SMEs with less than ideal risk profiles
- There is a substantial gap for leasing products since supply has greatly decreased in recent years
- The gap for equity is high in relative terms since there are no formal institutions providing equity funding, although demand is still at a low level
- Enterprises that are too big for MFIs to serve but too small to be of interest to banks have more difficulty getting loans, and startup enterprises also face a significant gap
- Funding of financial institutions generally does not act as a barrier to SME access to finance; deposit growth has been strong in recent periods, and access to borrowings from international lenders is good

5.1 Gaps by instrument

Summary of gaps by instrument



5.1.1 Loans

Bosnia faces a small to moderate gap for SME loan financing. Local experts interviewed for this study expressed different opinions about the severity of the financing gap. Some argued that high competition and the small number of large corporations was driving financial institutions to provide services to any creditworthy SME, resulting in little or no credit gap. Others argued that excessive conservatism in lending policies, a legacy of the crisis period, is leading banks to set conditions that are very difficult for many SMEs to meet, leading to rejections or greatly reduced loan amounts. There is some truth in both of these arguments. The best-performing SMEs have a wide range of choice and can negotiate reasonably attractive terms for their loans. However, SMEs with less than ideal characteristics – insufficient collateral, a short operating history, weak accounting systems, etc. – may struggle to obtain a loan that meets their needs. On the basis of the World Bank’s Enterprise Surveys, however, outright rejections are uncommon – only 3.8% of respondents indicated that their most recent loan was rejected, well below the 8.5% average for Eastern Europe and Central Asia.

At the low end of the market, the smallest of the microenterprises generally have good access to credit. The microfinance sector is large, competitive, and has much less baggage in the form of NPLs than banks. However, most MFIs only disburse loans in amounts of up to approximately EUR 5,000, so their outreach is limited. There are only a few MFIs that can disburse up to EUR 25,000.

5.1.2 Leases

There is a large gap in terms of leasing in Bosnia, primarily resulting from a sharp contraction in supply. As mentioned above, assets of leasing companies fell by 28% from year-end 2012 to year-end 2014. Since demand was probably stable over that time, it can be concluded that there is a sizable

leasing gap at present, even if some of the decline in assets was the result of leasing companies clearing out old, defaulted loans from their books.

It should be kept in mind that many SMEs can substitute loan financing for leasing to acquire needed assets, so the gap is not necessarily very harmful for the SME segment as a whole. However, SMEs that do not have sufficient collateral for loans will be negatively impacted by the contraction in supply from leasing companies.

5.1.3 Equity investment

There is a large funding gap for equity products, mainly as a result of the absence of specialized investment vehicles such as venture capital funds. Only 2.9% of respondents in the World Bank Enterprise Surveys financed their recent investments through equity, well below the 6.0% average for Eastern Europe and Central Asia. Entrepreneurs’ access to equity finance is limited to their network of personal connections such as friends and family members. There are numerous incubators and business centers that are supporting startup enterprises and a small, but promising IT sector, so the lack of equity finance is particularly troubling. A few of these enterprises manage to obtain bank loans, but equity financing would usually be a more appropriate instrument. For medium-sized enterprises, listing on one of the country’s two stock exchanges is possible, but very low turnover among all but the largest and most well-known companies assures that very few SMEs consider this option.

5.1.4 Trade finance

The gap for unfunded trade finance products – guarantees and letters of credit – is reportedly low. Although the overall volume of such products to SMEs is low relative to loans, the supply is generally in line with demand. SMEs do not have difficulty obtaining guarantee products, as these are readily available from banks. Although only some banks offer letters of credit to SMEs, there is very little demand, much less than for guarantees.

5.2 Gaps by type of SME

Summary of gaps by SME type



5.2.1 Size

There are some differences in access to finance based on enterprise size. In particular, there is an above-average gap for a particular group of micro and small enterprises – those that are too large to be served by MFIs and too small to be of high interest to banks. Most MFIs are limited to a maximum loan amount of about EUR 5,000, although there are two leading MFIs that can make loans up to

EUR 25,000. Banks do make loans in amounts less than EUR 25,000, but low profit per loan in absolute terms makes these loans less of a priority. Overall, businesses needing relatively small loan amounts but higher than the EUR 5,000 limit of most MFIs have reduced options and generally receive poorer customer service than enterprises requesting larger amounts. Despite the small loan amounts, many banks apply the same collateral and documentation requirements that they apply to much larger loans.

For the purposes of the rating system shown in the figure above, the enterprises that are too big for most MFIs but too small for the banks are classified as small enterprises, resulting in a moderate gap for small enterprises. The smallest of the microenterprises, who usually need up to EUR 5,000, have virtually no constraints in access to finance since MFIs actively lend to informal enterprises, startups, farmers, and any other segment, usually with no collateral.

5.2.2 Sector

The funding gap for the agriculture sector is low-to-moderate overall in Bosnia but differs based on the size of the enterprise. As mentioned in section 3 above, agricultural production tends to be dominated by micro-sized family farms at one end and relatively large corporations at the other. Family farms are very actively served by the MFI sector while larger corporations are well served by banks. There is, however, a small sub-segment of agricultural enterprises that may have difficulty getting loans – small commercial farms, often led by professional businesspeople who were successful in other sectors before turning to agriculture. Such commercial farms are too big for MFIs but, in many cases, are considered too risky and too expensive to serve by the banks. Since the number of these small commercial farms is low in Bosnia, this gap does not yet constitute a major impediment. However, the knowledge that funding options are limited may discourage some potential investors from engaging in agriculture in the first place. A greater willingness and capability of banks to work with agricultural enterprises could provide a boost to the sector through the creation of more commercial farms.

5.2.3 Regions

Due to Bosnia's compact size and high population density, there are no parts of the country that are especially remote. Even customers in rural areas are usually not very far away from an urban center with bank branches. Therefore, the access to finance for customers in all parts of the country is judged to be relatively good.

5.2.4 Startups

Startups face a moderate to high gap in access to credit and have no access to equity financing through formal institutions. Most financial institutions have minimum business age restrictions that make it impossible for startups to get credit. A few banks and MFIs will grant loans to startups but usually only in small amounts and only to owners who have very low risk profiles.

5.2.5 Other types of SMEs

Unregistered SMEs can obtain loans from MFIs without difficulty, but those needing larger amounts than MFIs can provide would be unlikely to access funding since banks rarely lend to unregistered firms. However, the number of such unregistered SMEs needing more than just micro loans is small and decreasing over time. By contrast, the number of registered SMEs that under-report their income for the purpose of tax avoidance is very large. These SMEs have reduced access to finance since most banks only consider official income when setting loan amounts. Of course, these SMEs are making an intentional decision to under-report their income, so it is within their power to get better access to finance by operating on a fully official basis.

SMEs with no real estate collateral or an insufficient amount of collateral have greatly reduced opportunities to obtain a loan unless they are applying for small amounts.

5.3 Gaps in funding of intermediaries

Funding of financial intermediaries does not act as a barrier to SME access to finance at present. Deposit growth has outpaced credit growth in recent years, so most banks report a reduced need for external funding. A few of the smaller, locally owned banks experience funding difficulties from time to time. However, as their share of the market is small and there are so many institutions in Bosnia, their occasional difficulties do not have a noticeable impact on access to finance in the market as a whole. MFIs cannot accept deposits, so they are more reliant on borrowing from international institutions. Although overall credit growth in the MFI sector was negative in 2013 and 2014, several MFIs are in a position to expand and have been successful in obtaining loan funding. The expected increase in credit growth in 2016 should gradually lead to a higher demand for external funding for both banks and MFIs.

5.4 Potential and capability of IFIs to fill gaps

International institutions are very active in Bosnia in a variety of developmental capacities, providing funding and technical assistance across a wide spectrum of topics. Most of these institutions include support to the SME sector as part of their mandate. Nevertheless, the challenges in Bosnia are numerous, so opportunities for new projects are present. The following short profiles summarize the activities of selected institutions with whom the consulting team met in Bosnia.

5.4.1 World Bank and IFC

The World Bank's main project in Bosnia related to SMEs is the Enhancing SME Access to Finance Project, which provides loans to SMEs via the Ministry of Finance and commercial banks. With most of the committed funding of USD 70 million already disbursed, the project has been utilized by 13 local partner banks and reached 320 SME beneficiaries by late 2015. The project will end in June 2016. An upcoming bank advisory program should indirectly benefit SMEs through training focused on risk management provided to all banks, in cooperation with the bank association.

IFC provided technical assistance to a local bank for the development of its trade finance operations, which may contribute to enhanced SME access to trade finance. The World Bank is also providing TA related to the establishment of a national guarantee fund. The World Bank is an active lender to the financial sector and has recently made loans to MF Banka and Raiffeisen Bank. A loan to another bank for renewable energy financing is also planned for 2016.

5.4.2 EBRD

EBRD provides credit lines to local banks for on-lending to SMEs. Aside from general SME sector loans, EBRD has specialized credit lines for energy efficiency (utilized by two banks) and women in business (one partner bank). Loans are also provided to three active partner MFIs at the time of writing; these loans are not sector-specific and are not accompanied by technical assistance. EBRD has a 20% equity stake in Hypo Alpe Adria's parent bank. EBRD also has two projects related to trade finance, but its Trade Finance Program has seen a decline in utilization in recent years because international banks are increasingly not asking for a guarantee or are getting a guarantee from the foreign parent bank.

EBRD does not currently work with leasing companies but is considering providing loans with a parent bank guarantee. EBRD has not made any direct equity investments in SMEs but is managing the

ENEF fund, which will start to operate in 2016. EBRD is also considering providing support to local accelerators.

5.4.3 KfW

KfW is active in the financial sector and has MSME credit lines with four local banks. Although these lines are intended for all types of MSMEs, KfW prefers to fund the manufacturing sector with less support to consumption and trade loans. KfW considers the energy sector – especially energy efficiency – its main priority. It has one credit line for energy efficiency open with a local bank and previously had a specialized credit line for housing finance. KfW also works with the MFI sector and has outstanding loans to two MFIs, which were related to flood relief following the 2014 floods. KfW operated a guarantee fund for about 15 years that provided guarantees on behalf of BiH banks to borrow internationally. That fund is expected to close in 2016. KfW's technical assistance to the financial sector is primarily directed towards energy efficiency training for bank staff.

5.4.4 SIDA

Together with USAID, SIDA founded the Development Credit Authority guarantee fund which provides 50% portfolio guarantees to local financial institutions. The average loan size extended to sub-borrowers covered by the scheme is about EUR 75,000, and there have been no claims since the fund's inception in 2009. The fund has been successful overall: it was fully utilized and the sub-loans reportedly have a high degree of job creation. However, some sub-loans have been over-collateralized with partner banks taking assets as collateral in addition to the guarantee. The total amount of the fund is USD 40 million.

Aside from the guarantee fund, SIDA is advising and giving funding to incubators, business centers, and similar types of support organizations in Bosnia with the goal of increasing entrepreneurial activity and business creation.

5.4.5 EIB Group

EIB is the single largest lender to banks in Bosnia and has a number of credit lines open with the country's largest banks. These usually take the form of senior loans in relatively large amounts for general (not sector-specific) SME lending. A new agreement between EIF and ProCredit Bank as part of the InnovFin program will facilitate the funding of innovative SMEs in Bosnia and other countries in the region by providing a loan portfolio guarantee. Together with EBRD and the European Commission, EIB is also one of the founding partners of the Western Balkans Enterprise Development and Innovation Facility. This facility consists of an early-stage venture capital fund, the Enterprise Innovation Fund (ENIF), a growth-stage fund, the Enterprise Expansion Fund (ENEF, managed by EBRD), a loan guarantee facility, and a support services facility offering technical assistance directly to SMEs and other stakeholders. EDIF made its first equity investment in Bosnia in the first half of 2016. The guarantee facility is working with ProCredit Bank with a guaranteed portfolio amount of EUR 20 million.

The EIB group is also involved in financing projects not related to access to finance, such as the construction of highways and hydroelectric plants.

5.5 Recommendations

Investment from IFIs is needed to mitigate the considerable gaps in access to finance described above. The types of funding and technical assistance that are judged to have the best potential to close these gaps are:

- Increase the volume of guarantee funds available through the creation of new funds or expansion of existing ones. Guarantee funds should be targeted to ease the creation of startup enterprises and provide collateral relief. Guarantees could also be used to spur increased lending to agricultural enterprises, particularly in circumstances where lenders primary concern is the risk of agricultural activities
- Increase the availability of equity funding to SMEs, especially through creation or expansion of venture capital funds. Seed-stage, early stage, and growth stage investments are all needed.
- Substantial TA support is needed to develop the venture capital ecosystem. While there are a number of incubators, mostly established by local governments, the country would benefit from more private incubators and accelerators that have improved capacity to offer training and technical support to their companies. Invest in training programs for entrepreneurs focusing on core skills like accounting, financial management, marketing and human resources management, either as standalone programs or in cooperation with incubators.

The synthesis report that accompanies this country report provides additional details about how such funding and TA support could be structured.

Annex 1: Macroeconomic indicators

Indicator	2015 Q3	2014	2013	2012	2011
GDP (nominal, EUR millions)	10,817*	13,938	13,674	13,392	13,401
Population (millions)		3.827	3.832	3.836	3.840
GDP (nominal) per capita (EUR)		3,642	3,568	3,491	3,490
Real GDP growth rate	3.2% ²⁴	0.8%	2.5%	-0.9%	0.9%
Inflation rate (CPI)	-0.8%	-0.9%	-0.1%	2.1%	3.7%
Exchange rate (EUR, end of period)	1.9558	1.9558	1.9558	1.9558	1.9558
Unemployment rate (ILO definition)		27.9%	27.4%	28.1%	27.6%
Poverty rate (national poverty line)					17.9%
Current account balance (% of GDP)		-7.7%	-5.5%		
Trade balance (% of GDP)	-24.1%	-27.6%	-25.4%	-28.2%	-27.9%
Exports (% of GDP)	31.6%	31.9%	31.3%	30.0%	31.4%
Net FDI (% of GDP)		2.7%	1.9%	2.3%	2.6%
Foreign exchange reserves (% of GDP)	39.1%	28.7%	26.4%	24.8%	24.5%
Public foreign debt (% of GDP)		30.1%	27.7%	27.3%	25.4%
Fiscal balance (% of GDP)		-2.0%	-2.2%	-2.0%	-1.2%

Sources: Agency of Statistics of Bosnia and Herzegovina, World Bank Development Indicators

*first 9 months of 2015

Sectoral distribution of GDP (% of total, top 10 categories)

Sector/activity	2014
Trade; repair of motor vehicles	15.9%
Manufacturing	12.9%
Public administration and defense	10.5%
Agriculture, forestry and fishing	7.0%
Real estate activities	6.1%
Human health and social work activities	5.7%
Education	5.6%
Information and communication	5.6%
Construction	4.7%
Electricity, gas, steam and air conditioning supply	4.7%

Source: Agency of Statistics of Bosnia and Herzegovina

²⁴ Average growth for first 3 quarters of 2015

Annex 2: Business environment indicators

World Bank *Doing Business* Indicators (2016)

Source: <http://doingbusiness.org/data/exploreeconomies/bosnia-and-herzegovina>

Indicator	Rank
Ease of doing business	79
Starting a business	175
Dealing with construction permits	171
Getting electricity	119
Registering property	97
Getting credit	42
Protecting investors	66
Paying taxes	154
Trading across borders	28
Enforcing contracts	66
Resolving insolvency	38

Getting credit indicators

Indicator	Value
Strength of legal rights index (0–12)	7.0
Depth of credit information index (0–8)	6.0
Public credit registry coverage (% of adults)	38.0
Private credit bureau coverage (% of adults)	9.9

OECD SME Policy Index (2012)

Source: OECD, et al. (2012), *SME Policy Index: Western Balkans and Turkey 2012: Progress in the Implementation of the Small Business Act for Europe*, OECD Publishing.

	Indicator	Score
1	Entrepreneurial learning and women's entrepreneurship	1.79
2	Bankruptcy and second chance for SMEs	3.13
3	Regulatory framework for SME policy making	2.16
4	Operational environment for SMEs	2.02
5a	Support services for SMEs and start-ups	2.39
5b	Public procurement	2.67
6	Access to finance for SMEs	3.09
7	Standards and technical regulations	2.63
8a	Enterprise skills	2.31
8b	Innovation policy for SMEs	1.89
9	SMEs in a green economy	1.29
10	Internationalization of SMEs	2.21

World Bank Enterprise Surveys (2013)

% of firms identifying the given constraint as a major constraint

Indicator	%
Political instability	31.4
Access to finance	15.5
Tax rates	8.2
Corruption	8.1
Customs and trade regulations	7.9
Labor regulations	6.8
Practices of the informal sector	4.3
Business licensing and permits	3.9
Courts	3.4
Transportation	2.9
Inadequately educated workforce	2.0
Crime, theft and disorder	1.9
Electricity	1.6
Tax administration	1.3
Access to land	0.9

Annex 3: Financial sector indicators

Banking sector indicators

Indicator	2015 Q3	2014	2013
Structure of the sector			
Number of banks	27	27	27
Number of state-owned banks	1	1	1
5-bank concentration ratio	-	52.3%	-
Number of bank branches	661	-	-
Financial indicators (BAM millions)			
Total assets	24,729.7	24,468.5	23,446.3
Total gross loans	17,169.4	16,887.7	16,405.0
Total net loans	-	15,903	15,728
Total deposits	16,028.0	15,376.1	14,249.9
Total equity	3,684.8	3,422.6	3,362.4
Total regulatory capital	-	2,777	2,995
Total net profit	-	159.1	-38.6
Financial ratios			
Capital adequacy:			
Total CAR	-	16.3%	17.8%
Equity to total assets	14.9%	14.0%	14.3%
Liquidity:			
Loans to deposits	107.1%	109.8%	115.1%
Growth rate of deposits	4.2%	7.9%	-11.8%
Liquid assets to total assets	-	26.8%	26.4%
Profitability:			
Return on average assets	-	0.7%	-0.2%
Return on average equity	-	4.7%	-1.2%
Asset quality:			
Growth rate of loan portfolio	1.7%	2.9%	
NPL ratio	-	14.0%	15.1%
Others:			
Growth rate of total assets	1.1%	4.4%	6.4%
Bank assets to financial sector assets (%)	-	87.3%	87.1%

Annex 4: The largest lending institutions

The 20 largest banks by asset size at year-end 2014

	Bank name	Assets (EUR 000s)
1	UniCredit Bank Mostar	2,033,285
2	Raiffeisen Bank BiH	1,895,912
3	Nova Banka Banja Luka	815,382
4	Intesa Sanpaolo Banka BiH	737,827
5	NLB Razvojna Banka	609,086
6	Unicredit Bank Banja Luka	560,299
7	Sparkasse Bank	530,792
8	Sberbank BiH	514,771
9	Hypo Alpe Adria Bank Mostar	506,834
10	Hypo Alpe-Adria-Bank Banja Luka	482,633
11	NLB Tuzlanska Banka Tuzla	465,360
12	Sberbank Banja Luka	437,907
13	Bosna Bank International Sarajevo	326,288
14	ZiraatBank Sarajevo	279,125
15	ProCredit Bank Sarajevo	198,630
16	Union Banka Sarajevo	193,948
17	Komercijalna banka Banja Luka	136,796
18	Banka Srpske Banja Luka	126,489
19	BOR Banka Sarajevo	123,835
20	Vakufska Banka Sarajevo	120,033

The 8 largest MFIs by asset size at September 30, 2015

	MFI name	Assets (EUR 000s)
1	Mikrofin	96,980
2	Partner	64,880
3	EKI	64,729
4	Mi-Bospo	24,649
5	Sunrise	17,377
6	LOK	15,761
7	MIKRA	11,332
8	Lider	7,135

Annex 5: List of selected incubators and similar organizations

Name	Main sponsor	Location	Web site
BIT Centar	Tuzla municipality	Tuzla	http://bitcentar.com
Business Incubator Zenica	Zenica Development Agency	Zenica	http://zeda.ba/service/biznis-inkubator
Hub 387	Private investors	Sarajevo	http://hub387.com
Incubator Lipnica	Tuzla municipality	Tuzla	http://rpctuzla.ba
Innovation Centre Banja Luka	Banja Luka municipality	Banja Luka	http://icbl.ba
Intera Technology Park		Mostar	http://intera.ba
Networks	Private investors	Sarajevo	http://networks.ba
SERDA Business Incubator	Sarajevo Economic Region Development Agency (SERDA)	Sarajevo	http://serda.ba



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