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Finance, Competitiveness & Innovation
Financial Sector Advisory Center (FinSAC)

Drivers and Implications of Private Sector Debt in the CESEE

Optimal private debt levels: deleveraging and rebalancing finance

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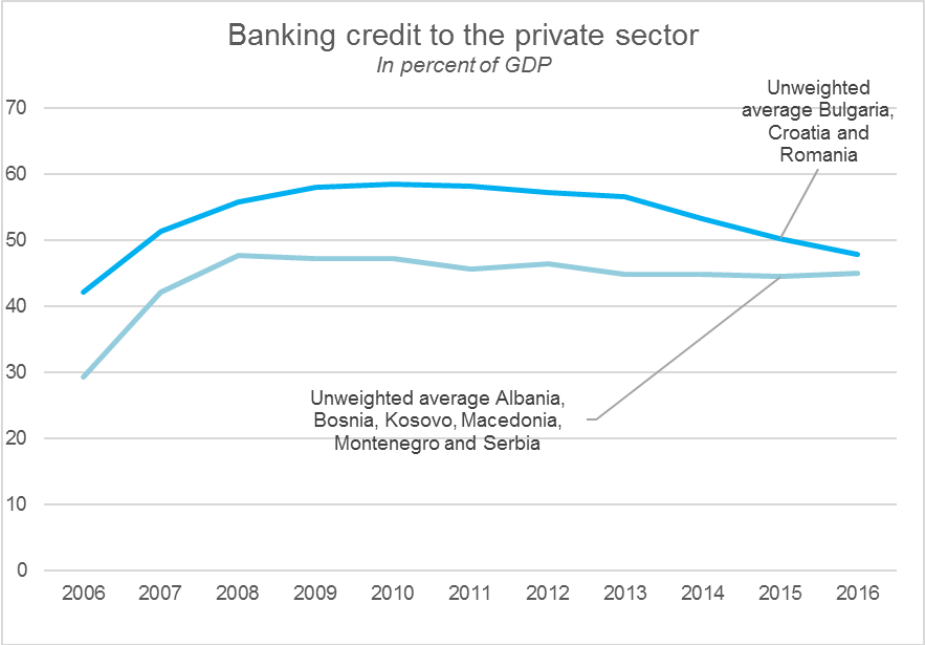
Macro developments

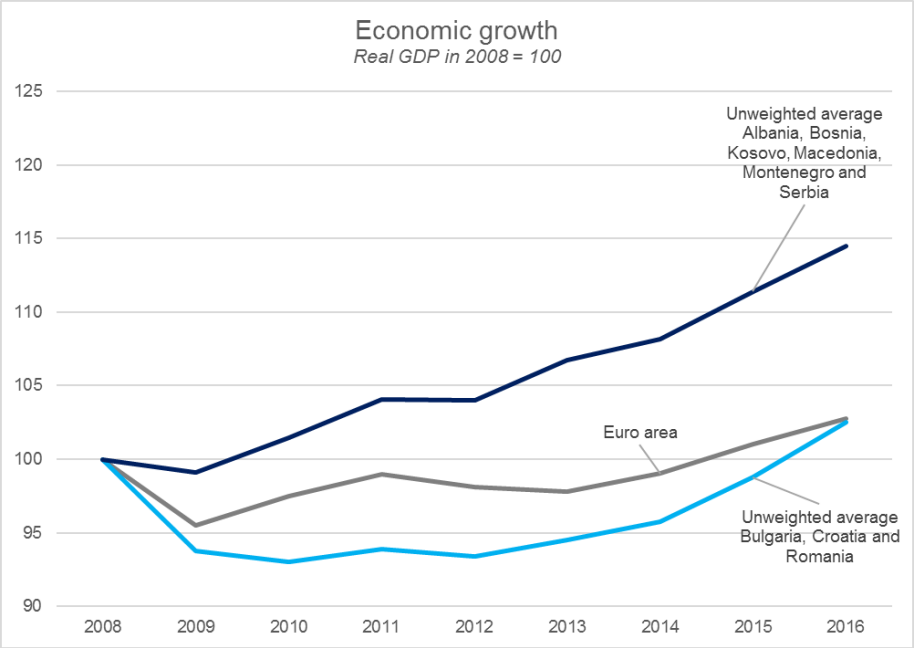
- How has private sector debt evolved in the aftermath of the Global Financial Crisis?
- Particularly in South East Europe, macro developments have not been very conducive to a rapid recovery
  - Financial systems in the region have been affected by a combination of high NPLs, low bank profitability and weak credit growth
    - While most countries in Central Europe were relatively quick to recover, others – particularly in South East Europe – were less fortunate
    - Boom-bust cycle is particularly pronounced in South East Europe
  - Banks' capacity to support the development of private sector companies affected by banking sector weaknesses
    - Banks sought to repair balance sheets through a decrease or restraint in the growth of risk-weighted assets
    - Structural changes in banks' funding models– transition from parent-bank funding to domestic deposits
  - Banking sector weaknesses have also weighed on economic performance
    - In some countries, income convergence vis-à-vis EU averages has come to a virtual halt
    - Weak economic performance then led to renewed stress on the banking sector

Macro developments

Credit growth has been weak across the region, as illustrated by the stabilization or decrease in the credit-to-GDP ratio



Despite recent improvements, economic growth has been sluggish

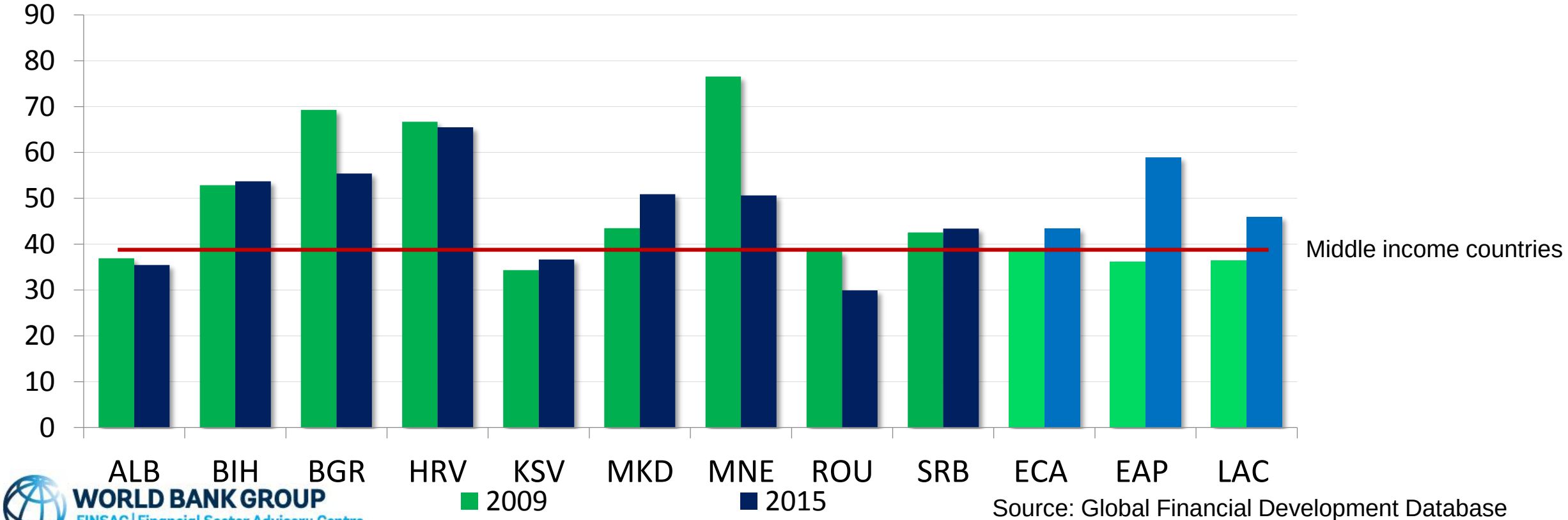


Source: World Development Indicators (WDI)

A closer look at private sector credit

- Deleveraging to various extent in Albania, Bulgaria, Croatia, Montenegro and Romania, lackluster credit growth in other countries
- Despite cross-country variance, current levels of private sector credit/GDP are broadly in line with levels observed in other middle income countries
- No extreme outliers on both sides of the distribution

Credit to private non-financial companies/GDP



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Source: Global Financial Development Database
* ECA, EAP, and LAC include only developing countries

A closer look at private sector credit

However, do these aggregate figures tell the full story?

- “Private sector credit” is a broad category, that encompasses the full range from Micro, Small and Medium-Sized Enterprises (MSMEs) to large corporates
- Aggregate levels may disguise considerable heterogeneity
- It is helpful to differentiate between companies based on size
- In some countries (e.g. Albania), banks have written off significant amounts of NPLs without loan forgiveness for the borrower
- The following slides summarize general lessons emerging from World Bank engagements with client countries across Europe and Central Asia region
- More in-depth analysis is impeded by data availability constraints

A closer look at private sector credit

- **Large corporates – an unfinished corporate restructuring agenda**
  - Large corporates typically account for the lion's share of the credit stock and, usually, the bulk of the stock of NPLs
    - E.g. Albania, where top-30 corporate borrowers account for about half the stock of NPLs
  - In many cases, the problems of overleveraged large corporates have not been effectively addressed
  - In principle, when faced with a distressed corporate borrower, banks should:
    - Determine the viability of the distressed corporate borrower upfront
    - If the borrower is considered unviable, ensure that the borrower exits (i.e. seize collateral and liquidate)
    - If the borrower is distressed but potentially viable, forbearance measures are conditional upon the borrower committing to operational restructuring aimed at turning the company around

A closer look at private sector credit

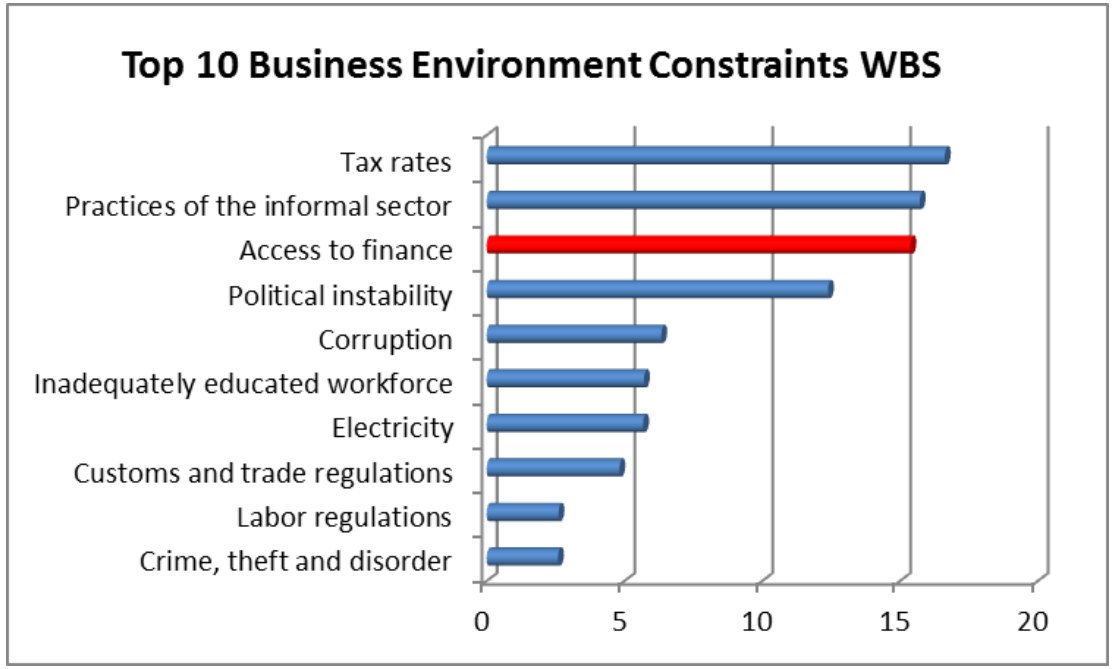
- **Large corporates – an unfinished corporate restructuring agenda**
  - What do we see in practice?
    - Banks are reluctant to make a clear distinction between unviable and distressed but potentially viable borrowers
    - Both often benefit from repeated rounds of financial restructuring, in part thanks to low interest rates
      - "Zombie" companies are left to linger around, with continued demand for credit
      - Little adjustment of distressed but potentially viable corporates (e.g. redundancies, divestiture of enviable divisions): → high likelihood that these companies eventually become zombie companies
      - In some countries, there are particular challenges related to State-Owned Enterprises (SOEs) and/or intransparent ownership linkages between lender and borrower
  - Consequently:
    - A significant portion of banks' loan portfolio is locked up in sectors with limited growth potential
    - Lack of vigor in corporate restructuring impedes the rebalancing of finance

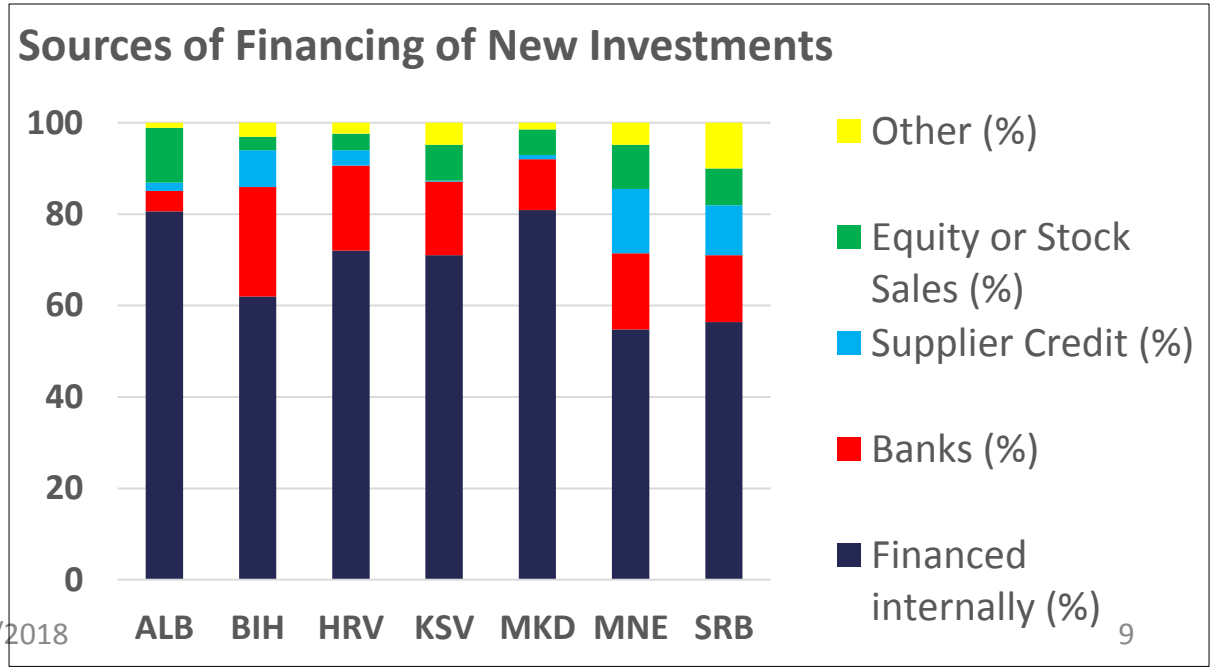
A closer look at private sector credit

- **Small and Medium-Sized Enterprises (SMEs)**
- At the same time, business surveys in the region suggest that there is a large segment of the real economy that is facing finance constraints
- This particularly affects SMEs
- SMEs usually find themselves at a disadvantage vis-à-vis large firms in accessing bank credit due to information asymmetries and agency problems:
  - Limited credit history
  - Limited capacity to produce audited financial statements
  - Difficulty of predicting profits for high risk-return companies
- As a consequence, SMEs are constrained by a combination of limited availability of credit, high interest rates and short maturities

A closer look at private sector credit

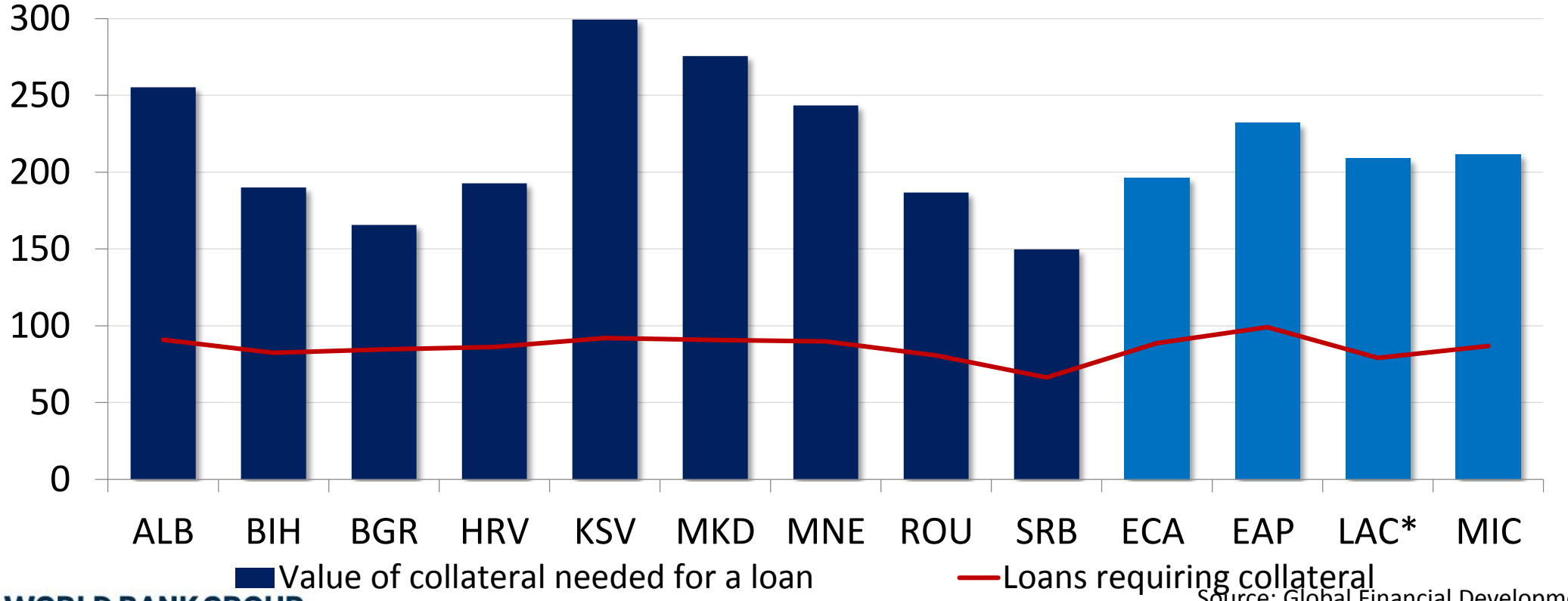
- Access to finance is among the leading business environment constraints in the region, as reported by entrepreneurs
- Entrepreneurs in the region rely primarily on returned earnings as a source of funding, with bank lending following at a considerable distance





A closer look at private credit

- Lending in the region is highly dependent on collateral
- Deficiencies in the insolvency framework lead banks to require an additional cushion to absorb losses when loans end in insolvency (when recovery prospects are low)
- High collateral requirements particularly disadvantage SMEs, particularly start-ups



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Source: Global Financial Development Database
*Data for LAC are for 2010
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Deleveraging and rebalancing finance – putting the pieces together

Banks' credit allocation – is there a paradox?

- A significant portion of banks' credit is locked up in large corporates with limited growth potential
- At the same time, entrepreneurs economy faces real finance constraints, particularly in the less established sectors of the economy

- The above raises questions about the effectiveness of banks' allocative function
- Objectives for public policy
  - A higher level of ambition in addressing the challenges related to distressed large corporates
    - Strengthen insolvency frameworks, reinforce the functioning of the judiciary, create alternatives for formal court-based insolvency proceeding (e.g. out-of-court restructuring)
  - Strengthen the enabling environment for companies that are finance-constrained
    - Credit Reporting Systems, Accounting frameworks, Secured Transactions Frameworks

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Thank you!

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