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FINANCING FOR COMPETITIVENESS: SOME (MISSED) OPPORTUNITIES AND REGULATORY CONSTRAINTS

Finansiranjem do konkurentnosti: neke (propuštene)
prilike i regulatorna ograničenja

Abstract

Given the challenges in the public finance and in the banking sector, the traditional funding sources will hardly be more available and affordable. This paper considers the alternative and less explored forms and institutional funding frameworks: development bank, debt to equity swap, factoring, negotiated financial restructuring, venture capital. Along with solving the major challenges in terms of stabilization and development, it is necessary to adjust the regulation in the given areas in order to enable more favorable finance for companies, thus encouraging economic growth.

Key words: *financing, development bank, debt to equity swap, factoring, negotiated financial restructuring, venture capital*

Sažetak

S obzirom na izazove u javnim finansijama i bankarskom sektoru, teško je da će tradicionalni izvori finansiranja biti dostupniji i povoljniji. U radu razmatramo alternativne i manje istražene oblike i institucionalne okvire finansiranja: development bank, debt to equity swap, factoring, sporazumno finansijsko restrukturiranje, venture capital. Uporedo sa rešavanjem krupnih stabilizacionih i razvojnih izazova, potrebno je da se prilagodbom regulative u navedenim oblastima omogući povoljnije finansiranje preduzeća i time podstakne privredni rast.

Ključne reči: *finansiranje, razvojna banka, konverzija potraživanja u kapital, faktoring, sporazumno finansijsko restrukturiranje, fondovi rizičnog kapitala*

Introduction

Funding sources – their structure and price – are the major constraint to economic development. Financing is always at the top of the list of business constraints (see, for example, [8, p. 45]). In the period 2009-2011 the Government of the Republic of Serbia implemented a series of measures to mitigate the negative effects of economic crisis. The main objectives of the said measures were related to discontinuation of the economic activity decline, maintaining of the number of employees, stimulating exports and instigating demand for durable consumer goods. The programs subsidizing part of the interest on loans to maintain liquidity, finance export operations and companies' investment activities, as well as household loans, were aimed at enhancing the capacity of the commercial banks' loan activity. Over the past three years, commercial banks granted over EUR 2.5 billion to private sector through subsidized loans, of which 85% were corporate loans to maintain liquidity and finance the purchase of working capital. In addition, through the business agenda of the RS Development Fund (by means of schemes of loans and guarantees) and the Serbia *Investment and Export Promotion Agency (SIEPA)* the policy makers sought to make to the corporate sector available additional financial resources for investment and export projects.

The measures of the Government of the Republic of Serbia had a positive effect on mitigating effects of crisis on economic activity. However, the problem of the

companies' low liquidity and low creditworthiness has not been solved. The data on the number of companies, the accounts of which were blocked in the process of enforced collection and the constant problem of a high level of non-performing loans (NPL), confirm the said assertion. In addition, banks' high aversion to risk affects realization of low growth rates of loan activities from month to month.

In the same period, the financial sector faced a series of problems, from increased losses due to rapid growth of loans risk, to lack of funding sources and the high price thereof. In order to avoid a complete crash, the banks focused on rebuilding financial assets and capital base. Serbia's banking sector has remained outside of these flows due to the strict regulatory business requirements, primarily related to capitalization of banks. However, faced with growing level of problem loans, i.e. the growth of loan risk but of other risks as well, and with the lack of cheap placement sources, commercial banks opted for the change in the business model towards tightening the conditions for the private sector financing. The aforementioned process in practice often reflected through more demanding requirements in terms of collateral for newly approved loans. Practically, reducing the banks' lending activities pro-cyclically affected deepening of the liquidity problem the corporate sector faced with.

In addition, the entry into force of the new regulatory framework – Basel III standard – does not contribute to finding solutions to the problem of the companies' access to cheap funding sources. The banks have to meet the requirements regarding the capital levels which practically means that, in the next few months, the banks' focus on the European financial market will not be on the side of the lending activity. Given that the banking systems in the SEE countries are majority owned by the parent companies of foreign banks, the corporate sector will still have limited access to funding sources.

The question arises as to whether something will change in the following period. Given the challenges in the public finance and in the banking sector, the traditional funding sources will hardly be more available and affordable. This paper considers the alternative and less explored forms and institutional funding frameworks: development bank, debt to equity swap, factoring, negotiated financial

restructuring, venture capital. Along with solving the major challenges in terms of stabilization and development, it is necessary to adjust the regulation in the given areas in order to enable more favorable finance for companies, thus encouraging economic growth.

Public finance

The existence of fiscal space is a necessary prerequisite to implement the measures without risk to the sustainability of public finance, in order to stimulate aggregate demand thus accelerating economic growth or supporting yet uncertain exit from the crisis. If such space exists, it is desirable to consume a fraction of it in times of crisis. Unlike most countries that reduced their deficits, strengthened their fiscal position and increased fiscal space during 2011 and 2012, Serbia failed to do so. On the contrary, Serbia's fiscal adjustment went into the opposite, negative direction. Deficit increased from 2.6% of GDP in 2008 to about 6% of GDP in 2012. Due to deficit growth and increased volume of issuing guarantees (as well as due to the dinar depreciation, etc.), public debt increased from 29.2% of GDP in 2008 to over 55% of GDP in 2012. Such level of public debt in Serbia, which is relatively high for transitional countries, is hardly sustainable and, if taking into account the fact that the legally defined limit of 45% of GDP was exceeded, it is certain that the measures (short-term and long-term) for forcing the debt back into allowable and sustainable framework, will have to be taken without delay. In comparison with the EU countries Serbia is ranked among negative recorders in terms of fiscal adjustment. An average fiscal adjustment (deficit reduction) in the EU countries amounted to about 3% of GDP during 2011 and 2012 (in transitional countries 3.4% of GDP and in developed countries 2.7% of GDP, see [6, p. 61]). Fiscal adjustment in Serbia, in the same period, increased by about 1.5% of GDP (0.3% in 2011 and 1.2% in 2012), i.e. the conducted fiscal adjustment amounted to negative 1.5% of GDP. The negative balance of fiscal adjustment over the past two years was recorded by only two countries, members of the European Union – Denmark and Estonia. Denmark increased fiscal deficit by 3.2% of GDP, Estonia by 2.5% of GDP, while all the other EU countries reduced

their deficits. However, Estonia and Denmark differ from Serbia in terms of all other parameters. Estonia's public debt in 2012 will amount to only 5.7% of GDP and deficit will be 2.1% of GDP while Denmark will record public debt of 51.3% of GDP and deficit of 5.9% of GDP. Denmark is not comparable with Serbia due to the fact that the public debt sustainability limit in developed countries is at the higher level than in transitional countries.

Fiscal multiplier in Serbia is not at the level high enough to show the obvious positive influence of fiscal expansion on economic growth. Increase in public spending over the first six months of 2012, which resulted in a pronounced increase in GDP, speaks in favor of the said. Since the experiment of fiscal expansion proved to be unsuccessful, further increase in public spending (or tax reduction) would almost certainly have a negative influence on fiscal sustainability, with neutral effect on economic growth (see more about the said in [11, p. 18]).

The above data (a relatively high and growing level of public debt, high and growing deficit, i.e. complete absence of fiscal adjustment) suggest that the fiscal space in Serbia is completely used. Also, when taking into account that fiscal multiplier in Serbia is not high enough, it turns out that there is no justification for increased spending which, anyhow, would not result in GDP growth but which would only increase the deficit and cause the public debt growth far above the limits permitted by fiscal rules. The absence of any program of measures additionally increases the risk of the public debt crisis outbreak, while the mere announcement of the adoption of fiscal consolidation measures (when the use thereof is certain) would send a good signal and would result in a positive financial market feedback, i.e. with creditors who decide whether re(financing) of Serbia's public debt would continue and what would be the conditions thereof. Exceeded legal limit of public debt in Serbia, of 45% of GDP, is set between the optimal level and the public debt sustainability level, so the only conclusion based on the said would be that the fiscal space in Serbia is spent and that it is necessary to immediately start implementing the fiscal consolidation measures.

In the context of the previous conclusion, some proposals on extensive government borrowing should be

considered in order to enable financing of development projects. In a more radical version of this idea, a radical shift in conducting monetary policy is even suggested instead of borrowing. This is about the requirement that the central bank would finance investments by purchasing bonds from the development bank (which would be owned by the state). The amount rumored is EUR 1 billion. The argument is that such emission would not seemed to be inflationary like when it goes for consumption since it creates the value to be used to redeem the debt. This should solve the problem of missing or costly loans and capital outflows in the balance of foreign direct investment. However, what guarantees the profitability of such investment and who eventually covers the debt? The government, i.e. the taxpayers. Second, if the investment is profitable it does not rule out income in the course of construction and expenses, including the personal income, i.e. the portion of funds which flow into consumption in the course of construction, are paid. Third, a great portion of such emission will turn to demand for funds from foreign exchange reserves. In other words, foreign currency will be sold for dinars from the emission, which will strengthen the pressure on the exchange rate and, thus, on inflation – precisely to the extent to which the inflationary pressure of emission is reduced by the dinar neutralization through the foreign exchange reserves sale. In other words, the overall emission for these loans (the central bank will not thus reverse the emission to support the banks' liquidity, but such investment emission is an inflation allowance) will spill over into inflation. In a very short term, inflation would push economic activity forward – and recessionary tendencies would subsequently follow.

Development Bank

The steps towards the establishment of the development bank have been made by the previous Serbian government and the Proposal of the Law on the Development Bank of Serbia (DBS) was adopted at the government session in December 2011. The form in which the Proposal of the Law will be delivered to the new Parliament is unknown, but the following notes should certainly be taken into account.

The advantages of establishing the DBS are numerous. In less developed countries like Serbia, development banks play a significant role in financing small and medium-sized enterprises and in corporate lending. In order to fulfill their mission, development banks adapt their services to specific needs of interested businesses entities, providing them with a diverse range of services and products that meet the corporate sector's needs. Given that, due to their specific objectives, development banks are not guided by the principle of profit maximization in their business operations, investors' risk is reduced. Also, the security that investors see in the Republic guarantees for the DBS obligations is an advantage, which, on the other hand, can burden public finance in Serbia. Since they will not collect deposits as the commercial banks do (which could otherwise jeopardize the stability of national financial system), development banks do not compete with commercial banks in their activities, but rather complement the banking sector. Corporate lending in crisis, where the money supply is low, debts are high and loans offered by commercial banks expensive, will be facilitated to some extent due to greater and easier availability of funds, and partly to favorable lending conditions. Neutral and non-discriminatory manner of the DBS operations and provision of services to all parties under equal conditions, can significantly affect the evident market failure in terms of financing the corporate sector, although financing of the economy by the commercial banks is generally of smaller volume and of lower intensity than the corporate sectors' necessities. It is possible to finance cheaper and to service the priority projects of development and export-oriented nature in an easier manner, as well as the projects of no interest to be financed by the commercial banks (for example, infrastructure projects which are expensive and the repayment terms are long). In this way, Serbia can reduce the need for taking loans from international financial institutions, particularly in the area of infrastructure development which is of particular importance if one takes into account the current level of indebtedness. The potential advantage of the development bank is that Serbia will also have access to different sources of funding by the EU (such as the European Regional Development Fund and European Agricultural Fund for Rural Development),

whose importance, as a funding instrument, increasingly grows. If the development bank's operations prove effective, the future may bring an increase in the financial range of the development bank in the form of integrated resource management of development funding from abroad, public-private partnership with commercial banks and the DBS entrance to capital markets through emission of high-range securities and of other financial instruments.

On the other hand, the establishment of an additional financial institution in Serbia has its weaknesses [3, p. 44]. First of all, it will be necessary to spend some budget funds to make the Law applicable and to efficiently monitor the implementation thereof by the Ministry of Finance and the State Audit Institution, which will require additional human and financial resources. Significant funds are needed for instigating the operations of the DBS, as only the previously envisaged minimum amount of the founding capital required, which will be provided from the republic budget, is EUR 400 million. Also, certain period of time is needed for the formal establishment of the development bank, but also for the effective commencement of its operations (including internal audit operations within the DBS). Finally, given that, in case nothing substantially changes, it is already planned that three members of the supervisory board (consisting of seven prospective members) will be ministers, the room is left for political influence over the bank's operations. Thus, the question of the supervision efficiency arises since supervision over the development bank's operations, where the Minister of Finance is Chairman of the Supervisory Board, is conducted by the Ministry of Finance. Such a solution is even present nowadays in case of the Development Fund but it has often been the subject of numerous complaints about the Fund's operations. A quality system and a good practice of corporate governance over the development bank are essential to resist the pressures and increase economic and financial efficiency of such public financial institution. The system of indirect fund placements itself, adopted by the development bank, has disadvantages. First of all, the risk undertaken by the development bank is not negligible. In addition, the development bank has influence neither over the choice of the commercial bank by commercial entities nor over the total amount of borrowed funds.

Opportunities that arise before the establishment of the development bank could be crucial to justification of establishing such a financial institution under the conditions of diffuse effects of the global economic crisis. First of all, the development bank could affect the decrease in the Republic of Serbia and the corporate sector's borrowing from abroad. Next, the long-term financing of projects which are of no interest to commercial banks, primarily long-term business ventures with high positive effects, and systematic support to small and medium-sized enterprises and export promotion, could all together have positive effects on overall economic development of Serbia through increase in international competitiveness, reduction of regional disparities in terms of development and business internationalization of Serbian companies. One of the major opportunities is to increase the efficiency and rationality of budgetary spending, to consolidate the existing ways of financially encouraging the corporate sector, as well as of transparency and control in corporate lending, which would consequently decrease the level of corruption in development activities. Also, entrance of the state development bank to Serbian financial market can contribute to decreased interest rates on corporate loans in our banking sector because the interest rates offered by the development bank should not be burdened to the extent and in a manner in which the interest rates offered by commercial banks are burdened. However, as was stated by the representatives of the public sector, not just the interest rate is a key element of the development bank's operations because loan maturity and grace period should also be taken into account. Granting of guarantees (which have been modestly granted thus far through the public guarantee schemes) through the development bank, which can lead to interest rates decrease, should also be taken into account. In any case, interest rates will be defined by the development bank's arrangements with commercial banks, including the creation of individual banking products. The development bank is also a chance to depoliticize the procedures of granting loans to the corporate sector and the said reduction of corruption, since there will be no direct lending to entrepreneurs. But, on the other hand, one should not forget that the Proposal of the Law leaves room for the development fund to authorize direct funding

to end users in the name and on behalf of the Republic of Serbia, with the consent of the bank's Supervisory Board. This retention of direct lending opportunities can have very beneficial effects on the development of micro, small and medium-sized enterprises and entrepreneurs, as well as on the development of underdeveloped areas provided that the effective supervision over the spending of these funds (including not only the office but also the field monitoring) is of key importance. If the development bank's operations are conducted professionally and if it is completely protected from possible political, lobbying and party interference and pressure (which could be verified, for example, by public choice of management, operations of the bank's management and overall transparency of bank's operations), the chances for the development bank to completely fulfill its mission and justify the purpose of its existence increase.

The development bank's operations will not fall under the official banking supervision. Indirect lending of funds for subsidies and loans does not guarantee depolitization and professionalism of the development bank's management. The development bank's operations can lead to displacement of the private capital if its business activities are to compete with commercial banks' operations. Given the nature of the public sector, the following question arises: what if, in practice, the development bank fails to represent an independent institution and its operations fail to be sufficiently transparent? In this sense, one of the threats lies in the development bank's possibility to frequently ask for additional funds from the Republic for capital increase without reliable indicators of the effects of previous investment. The performance of the development bank's activities exclusively through commercial banks can call into question the possibility of reducing the effective interest rate on corporate loans, if the commercial banks are to perceive the development bank as a guarantee fund (a similar situation, only in reverse, exists in relationship of the commercial banks and the Deposit Insurance Agency which guarantees the deposit payments). Such a solution may also affect the creation of the privileged position of some banks, therefore the privileged position of certain business entities while neglecting others.

Debt to equity swap

Given the situation in our economy and worldwide, debt to equity swap has its application both in commercial and in tax debts [2, p. 15]). Conversion of claims into capital stock (debt-to-equity swap) is a replacement of debtor's claims against the company into debtor's percentage share in the company's equity. In economic terms, it is transformation of borrowed capital into equity, in financial terms - a refinancing and in legal terms *datio in solutum*, implying thereby accounting changes as well. Swap is applied when a company finds itself in business and financial difficulties, with negative cash flows, without the ability to continue to pay its debts, but with promising prospects providing that operations would continue (bearing in mind its market share, product, brand, goodwill, etc.), to which the creditors convert their claims into the company share, thus restoring the company's liquidity and healthy cash flows and acquiring ownership and management rights in the company and the income thereof. Swap can also be performed by transforming the convertible bonds into the company's equity. Moreover, tax debt can also be converted. Through debt to equity swap the creditors try to manage risks by choosing safer and more cost-effective way when their analyses show that it is better for the company to continue its operations as a *going concern* rather than to wait for the outcome of bankruptcy proceedings. However, swap can also be carried out in bankruptcy, within reorganization. Different financial thresholds and indicators of financial ratios can be set as "trigger" of swap. Debts are extinguished through swap since the obligation is thus fulfilled. In this way, company's equity is increased, company's obligations are reduced in the amount converted into capital and reorganization of capital structure is made by reducing the percentage share in the capital of the existing company members (the so-called capital dilution), who often become minority members while the creditors are majority members of the company. Observed by effects, debt to equity swap is similar to venture capital for specific purposes.

In Serbia, the Company Law stipulates that one of the forms of increasing equity of a limited liability company is capital increase by conversion (swap) of company's

debt into equity. The Law makes no distinction regarding the type of the debt - it is only important that the debt is convertible (it does not necessary have to be the original pecuniary claim, because the non-pecuniary claim against the company may also be denominated in cash, becoming thus pecuniary claim). The previous Company Law did not (explicitly) anticipate debt equity swap, so there were doubts and discussions on probabilities of its implementation. The new Law solves the dilemma. The limited liability company's equity increases according to the company's assembly decision, while the company's equity is considered increased as from the day the equity increase is registered. Given that the share in capital of one or more company members is reduced by swap, the Articles of Association may provide that the share in the company may be transferred to a person who is not a member of the company only in accordance with the company's prior approval. The Law stipulates that the limited liability company's equity may be increased, *inter alia*, by new shares, implying also debt to equity swap. However, as for the public limited liability company, equity increase can not be conducted by debt to equity swap.

The Law of Contracts and Torts stipulates that obligation shall be terminated should the creditor, by agreement with the debtor, accept something else instead of what was owed to him, that, in such a case the debtor shall be liable as a seller for substantive and legal defects in the object delivered instead of what was owed by him and that a creditor, instead of claiming on the ground of the debtor's liability for substantive and legal defects in the object, may request from the debtor - but not more than a guarantor - the fulfillment of the original claim and the corresponding damages.

Bankruptcy law provides that one of the measures for implementation of the reorganization plan is conversion of claims into debtor's equity. Implementation of this measure can not be done contrary to the provisions of the Law on Protection of Competition. It is necessary that the decision on this measure is adopted by the Competition Commission, acting with particular urgency and in summary proceedings. Implementation of measures envisaged by the reorganization plan, in particular changes in the capital structure of bankruptcy debtor, cannot be done

contrary to the laws governing the protection of socially-owned capital in companies operating with the majority of socially-owned capital or governing the protection of assets recorded as a social property in cooperatives, and the procedure provides for the Privatization Agency's prior approval of a reorganization plan.

The Law on Negotiated Financial Restructuring of Companies stipulates that the financial restructuring shall be terminated by the contract on financial restructuring, which specifically includes, inter alia, conversion of claims into equity. Within two working days after concluding the contract the debtor has to deliver the contract to the Business Register for registration note on the contract existence.

The Law on Tax Procedure and Tax Administration stipulates that the tax liability could be settled, inter alia, by conversion of claims based on taxes into permanent taxpayer's equity stake of the Republic, in a manner and under conditions prescribed by the Government. The day of tax liabilities settlement through conversion of the tax claims into permanent taxpayer's equity stake of the Republic shall be the day when the Government passed an act of conversion.

Reducing liabilities of the company, due to conducted debt to equity swap, improves its financial standing. It encourages the restoration, creation and strengthening of business partnerships, new investment in the company by the existing and new investors, extensive purchase of products by consumers and higher production, better business cooperation with suppliers, higher price of securities emitted by the company, the collection of new funding in the form of loans or in the capital markets, while providing creditors with income and the settlement of the original debt. To achieve the desired financial effects of the conversion, it is important for the creditor to have a clear strategy for managing and using newly acquired share in other company's equity.

On the other hand, if the conversion is carried out too often and/or towards unsuitable companies and/or inappropriately, there is a real danger that "a chronic patient will die due to aspirin therapy," and that banks will lose their status of credit institutions with sound money and securities convertible in the market into

effective equity. For the creditor-companies conversion can often be a forced move, especially in conditions under which our economy currently operates featured by debtor-creditor chains, illiquidity and insolvency. This can lead to "mortification" of funds, especially if there is no clear strategy for managing and using of newly acquired share in other company's equity. One of the dangers arising from the debt to equity swap is the possibility of competition infringement (significant restriction, prevention or distortion of competition), especially in terms of concentration of market participants.

Factoring

International experience shows that factoring is one of the best ways to provide faster, safer and often an advance collection of receivables in the corporate sector. Generally, factoring is a financial instrument and the legal operations by which a factor (a company or a bank) finances business entities by discount purchase of due or future claims against a debtor, arising from the sales of goods or services in a domestic or foreign, i.e. international market, with the submission of invoice. The seller of receivables receives the money before the maturity date or upon the maturity of receivables, while receivables collection risk is transferred to the factor. Factoring is also defined by *the distinction between real and unreal factoring*. In case of real factoring, the factor purchases the client's claims at a discount before maturity or upon the maturity of claims, with factors' right of recourse towards the client (the seller of claims) or without this right. Unreal factoring implies that the client (transferor of claims) transfers the claims to the factor, at their maturity or before the due date for the purpose of collection, while factor undertakes the obligation to collect accounts receivable with the commission and with the collection of costs and, eventually, to guarantee to the client the collection thereof. In both cases, the factor may perform other services (e.g., payment transactions, accounting, market research, etc.).

The main purpose of this specific financial mechanism is to enable the entrepreneurs quickly provide funding. This is particularly important for micro, small and medium-sized enterprises that have a limited range of financial

sources. The typical factoring service includes examining of the customer-debtor solvency, taking the risk of charging 100% of the amount and financing (an advance) up to 80% of the invoice amount or assigned receivables, where 20% is fee deduction or discount interest (commission ranging from 0,5% to 1.5-2%, even more than the invoice value, while interest is at the level of banks interest rates for short-term loans and it is valid from the moment the funds are used, until the enforced collection from a debtor-buyer). The risk taken by the factoring company or by the bank is associated with the customer-debtor. The risk that exists on a seller's- creditor's side consists of an inadequate delivery of the contracted goods, based on which the customer-debtor may refuse to pay either the whole amount or the portion thereof. In this case, another factoring feature becomes pronounced, significantly distinguishing it from the typical financial institution. The factor pays special attention to the type of goods and the manner of its delivery. To this end, the nature of the goods is essential, as well as is the contract with buyers, the history of operations, the mode of production, etc. The factor provides for the possibility of reclamation and the magnitude thereof thus determining the amount of an advance payment and the factoring type.

Although factoring procedures vary in Serbia, the following steps can be highlighted as their characteristics: 1) application for factoring, 2) determining the solvency of the customer-debtor, 3) the conclusion of contract on factoring, 4) informing the customer-debtor about the retrieved receivables 5) the presentation of commercial documents (invoices, shipping documents, JCI, etc.), 6) advance payments, 7) debt collection, 8) payment of commissions and interest.

Since the factoring contract is often concluded for an extended period, it demonstrates the effect of medium-term loans, as well as favorable effects on the company's balance sheets. Factoring is largely a sound substitute for loans, and commercial entities with solid claims can get their money through such arrangement without applying for additional loans with banks. The flow of money is constant, which is why factoring is especially interesting for companies in expansion, particularly to micro, small and medium-sized companies, and to

those who survived the initial years of crisis (usually, the first three). When the company's saving, achieved by factoring, is calculated in the price of factoring service, the company's creditworthiness increases. The factor client obtains additional liquidity through the purchase of claims, accelerates circulation of money and shortens the cycle of working assets. This can also be achieved by taking short-term loans from banks. However, such loans are obtained under complex procedures, with high interest rates, with provision of collateral, with the possession of clean credit history and with the so-called credit limits on companies. Factoring contract allows the client to constantly sell, and its customers to buy on credit without credit procedures, credit costs and collaterals. As a rule, factoring implies the provision of services based on the assessment of the company's debtors, instead of the company itself, as well as a short application procedure and a quick inflow of cash. Factoring provides financing based on assets (receivables), as opposed to loans, when the liabilities of loan user increases. It is also competitive to short-term liquidity loans since it is intended for solving similar problems. It is used by companies that have entered into commercial contracts and longer cooperation with the customers-debtors, the companies that are in need of additional working capital but cannot or do not want to raise it in the usual way, i.e. by means of credit indebtedness.

In Serbia, the Law on Contracts and Torts regulates the assignment of claims under the contract (cession), stipulating that claims can be transferred by the contract, as well as the transfer of accessory rights with a claim, notification of debtor, multiple assignment, relationship between a recipient and a debtor, relationship between an assignor and an assignee presenting a document on debt, guaranteeing the existence of a claim, guaranteeing collectibility and special particular cases of the assignment of claims - assignment instead of fulfillment or for collection and assignment for the purpose of granting guarantees. These and the related provisions set general legal basis for factoring [1, p. 15]. The Law on Banks stipulates that the bank is allowed, in accordance with the law, to perform, inter alia, the activities on purchase, sales and collection of receivables (factoring, forfeiting, etc.); this solution is consistent with the fact that factoring is one of the

typical banking operations. The Law on Foreign Exchange Operations, as well as implementing by-laws, introduced the possibility to fund foreign trade operations through the purchase of receivables and debts by banks and other legal entities – residents. In this way, the legal framework is set for international factoring in the area of payments, collection and cash transfers between residents and non-residents. The Law on payment operations stipulates that legal entities and natural persons engaged in activities can settle mutual financial obligations by contracting the change of creditors or debtors in certain obligations (assignments, cession, collateral promise, debt assumption, debt assignment, etc.), by offset (compensation) and in some other ways, in accordance with the law.

In order to encourage and promote exports and develop economic relations of the Republic of Serbia with foreign countries, AOFI was founded under the Law on Export Credit and Insurance Agency. Activity of the Agency, which operates as a closed joint stock company wholly owned by the Republic of Serbia, is, inter alia, factoring. In addition to AOFI, according to data from the Companies Register, 17 factoring companies operate in Serbia, of which 16 in the form of a limited liability company (Ltd.), and one in the form of the foreign legal entity branch. According to the Belgrade Chamber of Commerce data, four banks have departments or sectors dealing with factoring. Despite this fact, factoring activity is poorly represented in Serbia. Thus, according to a research conducted in 2011 by the Serbian Association of Employers, only 1.8% of businesses in Serbia use factoring (of these, more than a half of small enterprises perform factoring operations through banks).

Although making a significant improvement, the provisions of the aforementioned regulations are not sufficient to achieve the analyzed benefits of factoring and, in our conditions, do not constitute the necessary legal framework for factoring operations in the Republic of Serbia which are, at present, mainly carried out in accordance with the rules of business practice without a special law as a source of regulation in this field. Adoption of a special law on factoring is not necessary for factoring to be operational. But, on the other hand, specific legislation is desirable, because it harmonizes the action in practice and sets precise rules for this particular type

of contract (a contract *sui generis*). In addition, a publicly available register of factoring (which is established only by law) would ensure that transferred receivables and participants in this activity are transparent and open, thus providing a higher level of security. Legal status and regulation of trade aspects of factoring and of the factoring institutions contribute to a greater recognition of the financial instrument and remove the negative image (some perceive factoring as “racketeering”). Adoption of the law, which includes clearly regulated legal status, supervision over the operations and capital of factoring companies, is of particular importance to foreign trade and exports since foreign partners will also have greater confidence in the factoring company which would further result in its higher turnover. The law should regulate the supervision of factoring, which is by its nature a financial activity, while factoring companies are also entities in the financial sector. It should also be considered that, unlike the bank which applies the general banking regulations (structural and prudential regulation) when performing factoring operations, the factoring companies engage their own funds rather than accumulated funds from savings. Precise regulation and effective implementation of supervision prevent the abuse that can arise in this field.

Negotiated financial restructuring

The Law on Negotiated Financial Restructuring of Companies (as from May 2011) should make it possible to fill the gap in practice between the market mechanism and bankruptcy, as two models to solve the debtor-creditor relations [7, p. 38]. The first mechanism mentioned implies negotiated (out-of-court, non-bankruptcy proceedings) restructuring, i.e. the situation in which creditors and lenders are left to solve the problem themselves (case by case approach), while the bankruptcy proceedings is performed under the auspices of the court and ends up with bankruptcy or with reorganization of debtors. The Law creates the systemic conditions for a mixed approach: out-of-court proceedings with mediation of and incentives from the state in resolving debtor-creditor relations.

The Law provides for regulation of the companies' debts to banks and to other creditors before initiation of

the bankruptcy proceedings. This is a good solution since bankruptcy cannot be excluded or derogated as an option. Financial discipline will be stronger if the debtors believe that, in case it is initiated, the bankruptcy proceedings will be completed efficiently and in accordance with the law. This is the only mechanism that can financially motivate vulnerable companies to consider and accept alternative ways of dealing with illiquidity and insolvency.

Financial restructuring is defined as reordering of debtor-creditor relationship between the company in financial difficulties and the creditors. It is important to emphasize that financial difficulties can also imply threatening insolvency or big indebtedness, not just factual illiquidity, i.e. inability to meet the outstanding liabilities. In addition, the Law does not specify the meaning of threatening insolvency or big indebtedness. The question arises as to whether this opens the way for inclusion in the process of financial restructuring (including the enjoyment of the benefits based on the law) of the companies that should not be included therein. For example, banks cannot reach agreement on financial restructuring with invulnerable companies just to benefit from the privileges and allocate lower reserve requirements. Or, on the other hand, invulnerable company can initiate the agreement on negotiated financial restructuring in order to take advantage of the benefits based on the law and pay lower taxes.

It is important to emphasize that financial restructuring is voluntary and will be implemented by written consent of the creditors and debtors. Therefore, neither creditor nor debtor is required to agree to restructuring of obligations under the provisions of the Law, unless they are willing to do so. They can also reach the mutual agreement out of court, or the creditor can initiate bankruptcy proceedings if the legal requirements for debtor's bankruptcy are met. More creditors can participate in the restructuring process, whereby they agree on the method for negotiating with the debtor.

Not all debtors are guaranteed the possibility of concluding a negotiated financial restructuring. In addition to the present principle of free will – thus no creditor is under obligation – legal provisions also stipulate the principle of sustainability of the debtor's business

activities, under which the financial restructuring is carried out if the recovery and the sustainable business activity of the company are possible. This part is left to the creditors' (arbitrary) estimate in which cases it is a possible recovery. We believe that this is a good decision. Otherwise, it would be necessary to determine the criteria for debtor's eligibility (for example, the outstanding amount, period of financial difficulties, etc.), which would prevent the participants in the process (primarily banks) to independently estimate who should be provided with an opportunity for financial restructuring in terms of this Law. The fact that should be taken into account, having in mind the principle of sustainability of the debtor's business activities, is to determine the benefits for participants in this process.

The process of negotiated financial restructuring envisages the mandatory participation of, first, institutional mediator and, second, at least two domestic or foreign banks on foreign creditor's side. Institutional mediator is the Serbian Chamber of Commerce (PKS), which provides assistance in establishing cooperation between debtors and creditors and support during negotiations. PKS' role is to assist in identifying the contract for negotiated financial restructuring and debt standstill agreement. PKS shall charge a fee for the amount of which prior approval is given by the Minister in charge of economy. Selection of the PKS as an institutional mediator is good, because this institution should be the liaison between debtor and creditor, and between enterprises and banks.

As for the participation of banks, the legislator has foreseen the mandatory participation of at least two domestic and foreign banks as creditors, and, as seen from the explanation that accompanies the Proposal of the Law, this provision is intended to prevent abuse and undue use of incentives derived from the Law. Given the fact that domestic companies are also indebted abroad, allowing non-resident banks to participate in restructuring is a good solution. But the provision, relating to at least two banks from the process of negotiated financial restructuring, which eliminates all companies that fail to meet this requirement, i.e. those who have no financial difficulties with the two banks, is at issue. There is no limit on foreign assets and creditors, in terms to predict

that the restructuring process can be entered into only if a certain percentage of total claims / debts are covered by the agreement on financial restructuring. Since there are no such or similar provisions, administrative barriers are lowered, the greater freedom is provided as well as greater number of potential customers included in the process of resolving debtor-creditor relations.

The Law on Negotiated Financial Restructuring of Companies cannot prescribe the *incentives* for creditors and debtors. The Law only indicates the possibility of introducing special incentives for financial restructuring. Tax incentives would include write-off tax relief and rescheduling of debt on the basis of public revenue (which implies amendments to the respective laws). Moreover, the NBS determines appropriate incentives by regulations within its jurisdiction, primarily the decrease in the banks' provisions on the basis of negotiated financial restructuring of companies.

Finally, the extent to which the Law will be attractive to creditors and debtors will depend on the incentives determined by the government and the NBS. Given the risk that insolvent (instead of illiquid) debtors could be drawn into the process, economic authorities have to precisely evaluate and differentiate the approach to the problem in order to direct the negotiated financial restructuring towards those who could benefit from the assistance as well as to avoid the maintenance of "zombie-companies" and the decrease in obligatory bank reserves with no effect on the real sector. Decrease should also be avoided in banks' provisions due to conclusion of contract under the provisions of this Law, for uncollectible receivables, i.e. for the companies with long-standing problems, doomed to bankruptcy.

The Law strives to allow the debtors to increase the level and efficiency of own operations, thus reducing the risk of fulfillment, i.e. credit risk. This is a clear and reliable logic in cases where illiquidity is a real problem and when there is a high probability of regeneration of the debtor's creditworthiness. This is evident as in the case if three short-term loans are rescheduled by a mid-term or a long-term loan. If the debtor is insolvent, this Law can be misused to further strengthen the privileged position of already favored entities that generate illiquidity

Venture capital

Small and medium-sized enterprises, particularly those dealing with innovative industries, are facing problems of capital raising. There are number of restrictions on financing these enterprises by traditional means, so it is necessary to find new and affordable sources of funding to meet the need for capital of those enterprises that, due to specific activity or actual life stage, have limited alternative sources.

Private sources of funding include financing of various life stages of small and medium-sized enterprises by individual investors or privately-owned companies, usually organized as partnerships or limited liability companies. These sources of funding are usually related to assets of the company founder, his family and friends who are willing to sponsor business ideas, capital, business angels and venture capital funds. The investment goes for the enterprises that are not listed on stock exchange or are unable to raise the funds by public emission of securities. Funding through private sources has a number of forms, both by mode and features of enterprises in need of capital.

Venture capital funds are usually organized as limited liability companies. They comprise the funds of individual investors, partnership firms, pension funds, insurance companies, endowments, foundations or corporations. The said entities invest in small and medium-sized enterprises that are often unrecognized, in the initial (start-up) phase, with great development potential but missing the funds for further growth and expansion. Such companies, as noted, do not have a wide range of financial sources given the initial stages of the life cycle, high level of risk, variables and uncertain cash flows. Bank lending would be too expensive and the capital market at this stage unattainable.

Venture capital is primarily interested in investing in new technologies able to generate high level of income in early stages of growth. The biggest challenge in the operations of these funds is their ability and opportunity to actually find such investments. Funds take on high risk, but expect a high level of return usually within few years (five to seven, up to ten years). The fund invests in a private enterprise with the aim of gaining control in the ownership

and management, bringing its experts, using its network of business contacts and implementing expertise. Their investment mission takes several years, usually up to a mature development stage when a company comes into position to obtain capital under more favorable terms as well as by other means. Thus, venture capital leaves the company when it becomes sufficiently developed and independent as regards greater business restructurings in the form of merger, acquisition or listing on the stock exchange (see more in [9, p. 71]).

Companies in the Republic of Serbia, as well as in other systems, can be financed by external borrowing, or capital increase (debt or equity). However, many companies in the Republic of Serbia (such as: companies in the process of establishment, the newly established companies, micro and small companies, many appropriate collaterals, companies in corporate and financial restructuring, companies in business hardship, etc.) are not able to meet strict conditions under which bank loans are granted, particularly in terms of claims on collaterals, or are not able to repay borrowed funds with high interest rates, given the small capital turnover, or the fact that they cannot collect their commercial receivables in due time or completely. On the other hand, banks are not particularly interested in placing their funds – loans into risky projects and ventures, even though their placements can also be secured with guarantees provided by the Development Fund of the Republic of Serbia, previously merged with the Guarantee Fund. At the same time, banks are limited by prudential regulations (general and special laws, by-laws of the National Bank of Serbia) in terms of interest rates on granted loans, required reserves, collaterals, risk management, exposure and other conditions and elements of such activities, and they are not able to support projects and activities which, due to the level of risk, can bear interest rates higher than allowable, but also higher required reserves and/or prescribe additional requirements and other elements necessary to be met. The Republic of Serbia law does not specifically regulate entrepreneurial venture capital. Therefore, in a legal sense, entrepreneurial venture capital is regulated by general legal rules, but not by special law. Such a situation makes it difficult for entrepreneurial venture funds to operate in Serbia thus

contributing to legal, economic and financial insecurity, disorder and uncertainty.

The only explicit regulation of venture capital, according to legislation of the Republic of Serbia, (but only in terms of the relationship of this legal instrument and state aid) is specified by the subsidiary act - the Regulation on the rules for granting state aid adopted in accordance with the Law on State Aid Control. This Regulation provides a definition of venture capital (in terms of this paper – entrepreneurial venture capital) as follows: “Venture capital is a process of financing in the form of equity capital or similar to equity capital during different stages of establishment and early development of a business entity (initiation, establishment and development)”. Thus, several provisions regulate the technical relationship between state aid and this capital, directly or indirectly, from financial, company, property, fiscal and commercial standpoint.

The Law on Investment Funds, which in a general way exempts private investment funds from property fund investment restrictions (in a more liberal way than investments of a closed-end and certainly open-end investment funds), provides a legal basis for operational activities of the entrepreneurial venture fund in the Republic of Serbia in the form of private investment fund. Observed from domestic and comparative legal perspective, i.e. legal (“external”) and autonomous (“internal”) regulatory standpoint, entrepreneurial venture funds are, as a rule, established and operational as private investment funds (private equity funds).

In a general legal context of venture capital in the Republic of Serbia, the role of the Innovation Activity Fund is very important in terms of an institutional form of public and mixed entrepreneurial capital in the Republic of Serbia, regulated by special law. Also, in this regard, Foreign Trade Law stipulates that foreign trade - trade of goods and services and economic activities of foreign persons in the Republic of Serbia and domestic persons in another country or customs territory includes direct investments and investing by foreign persons in the Republic of Serbia, i.e. domestic persons in another country or customs territory.

For the purpose of legal and actual recognition, therefore certainty as well, and for the reasons of promotion

and recognition of entrepreneurial venture funds and clearly defined criteria, the Law on Investment Funds shall stipulate the fund for entrepreneurial venture capital as a special economic category in line with the targeted investment goal (in the same way as it was applied to fund for property value growth, revenue fund, balanced fund, and fund for preservation of property values). This is particularly important for the purpose of prescribing incentives and measures for these funds by blanket and referral norms of other laws, which would rely on the definition and structure of entrepreneurial venture funds under the Law on investment funds. Also, this legal determination is important for participation of the said funds in different types of programmes, tenders and similar activities.

Methods of state, international and market support for development of entrepreneurial venture capital are diverse - from the establishment of a mixed public-private venture capital fund through public-private partnership, through public financing of private entrepreneurial venture funds, to granting guarantees to investors for investing in private venture capital funds. Namely, in partnership with the private sector or individually the state could establish the fund to invest in companies on ownership basis, but also a special fund with resources available to venture capital funds to apply for them. This could provide public support for the development of entrepreneurial venture capital as well as innovative micro, small and medium-sized companies with the potentials for growth and development. It would further encourage healthy competition among interested investors. Significant steps in this direction have been made through the Innovation Activity Fund, whose scope and business activities should be further developed and improved. Development Fund of the Republic of Serbia could adopt this form of financing in its portfolio and programmes, having in mind that there is a legal basis for such activity. As for the guarantees to investors when investing in private venture capital funds, foreign investors can use various legal means of investment protection (based on property and obligatory rights), available in the Serbian market ("market" guarantees), such as: bank guarantees, insurance against commercial risk, a mortgage or lien on movable

assets and rights, guarantees, bills of exchange, various forms of changes in debtor or creditor obligations, etc.. In addition to these collaterals, special forms of investment guarantees are also applied – e.g. foreign investors (investors from countries "exporting capital") secure their investments abroad at the public funds of their own country. Observed from the international aspect, an institution of particular importance for securing foreign investment is the Multilateral Investment Guarantee Agency - MIGA, which could extend the scope of guarantees provided by the Republic of Serbia to venture capital.

Within incentive measures to promote venture capital, it is necessary to consider the possibility of relaxing regulatory requirements prescribed by the laws governing the equity market and investment funds, as well as by the related bylaws and regulations implementing these laws. This may particularly be considered through simplifying regulatory requirements for the primary (initial) public offering of shares and the capital market entrance for the companies in which the entrepreneurial venture capital had already been invested but is now flowing out of the company in a said way, as well as by reducing the regulatory and administrative burdens on entrepreneurial venture funds.

Conclusion

Given the challenges in the public finance and in the banking sector, the traditional funding sources will hardly be more available and affordable. In Serbia, the fiscal space that existed before the crisis was largely or completely used. Also, when taking into account that fiscal multiplier in Serbia is not high enough, it turns out that there is no justification for increased spending which, anyhow, would not result in GDP growth increase but which would only increase the deficit and cause the public debt growth far above the limits permitted by fiscal rules. This paper considers the alternative and less explored forms and institutional funding frameworks: development bank, debt to equity swap, factoring, negotiated financial restructuring, venture capital.

The advantages of establishing the DBS are numerous. In less developed countries like Serbia, development banks

play a significant role in financing small and medium-sized enterprises and in corporate lending. In order to fulfill their mission, development banks adapt their services to specific needs of interested business entities, providing them with a diverse range of services and products that meet the corporate sector's needs. If the development bank's operations are conducted professionally and if it is completely protected from possible political, lobbying and party interference and pressure (which could be verified, for example, by public choice of management, operations of the bank's management and overall transparency of bank's operations), the chances for the development bank to completely fulfill its mission and justify the purpose of its existence increase.

Conversion of claims into capital stock (debt to equity swap) is a replacement of debtor's claims against the company into debtor's percentage share in the company's equity. In Serbia, the Company Law stipulates that one of the forms of increasing equity of a limited liability company is capital increase by conversion (swap) of company's debt into equity... On the other hand, if the conversion is carried out too often and/or towards unsuitable companies and/or inappropriately, there is a real danger that "a chronic patient will die due to aspirin therapy," and that banks will lose their status of credit institutions with sound money and securities convertible in the market into effective equity..

Factoring is a financial instrument and the legal operations by which a factor (a company or a bank) finances business entities by discount purchase of due or future claims against a debtor, arising from the sales of goods or services in a domestic or foreign, i.e. international market, with the submission of invoice. Adoption of a special law on factoring is not necessary for factoring to be operational. But on the other hand, specific legislation is desirable, because it harmonizes the action in practice and sets precise rules for this particular type of contract (a contract *sui generis*), and a publicly available register of factoring (which is established only by law) would ensure transparency of transferred receivables and participants in this activity, thus providing a higher level of security.

The Law on Negotiated Financial Restructuring of Companies (as from May 2011) should make it possible to fill the gap in practice between the market mechanism

and bankruptcy, as two models to solve the debtor-creditor relations. The Law on Negotiated Financial Restructuring of Companies cannot prescribe the incentives for creditors and debtors. The Law only indicates the possibility of introducing special incentives for financial restructuring. Tax incentives would include write-off tax relief and rescheduling of debt on the basis of public revenue. However, with regulations within its jurisdiction the NBS could determine the appropriate incentives, primarily the decrease in the banks' provisions on the basis of negotiated financial restructuring of companies.

For the purpose of legal and actual recognition, and for promotion and affirmation of entrepreneurial venture funds, the Law on Investment Funds shall stipulate the fund for entrepreneurial venture capital as a special economic category in line with the targeted investment goal. This is particularly important for the purpose of prescribing incentives and measures for these funds by blanket and referral norms of other laws, which would rely on the definition and structure of entrepreneurial venture funds under the Law on investment funds.

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