PROMOTING ECONOMIC DEVELOPMENT THROUGH CIVIL SOCIETY – PHASE II

A FOLLOW-UP REPORT ON DEVELOPMENTS IN SME FINANCE

This Report is prepared by the Riinvest Institute for Development Research as part of the second phase of the project "Promoting Economic Development Through Civil Society", supported by the United States Agency for International Development (USAID).

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1. INTRODUCTION

This report is prepared as part of the second phase of the project "Promoting Economic Development Through Civil Society", implemented by the Riinvest Institute for Development Research with the support of the United States Agency for International Development (USAID) Mission in Kosova. During the first phase of this project Riinvest prepared a comprehensive Research Report, which focused on an analysis of SME Finance and Development in Kosova, and which was presented in the third session of the International Roundtable Forum (IRTF), organized by Riinvest on September 29, 2001. Given that the finance system was still in its initial phase of development, the Roundtable encouraged an active debate in which all the key players involved in SME finance participated. The debate produced a consensus on the future directions of SME finance and proposed a number of recommendations in favor of advancing the economic policies and developing the required legal framework that would contribute towards the improvement of finance opportunities for Kosovar businesses.

The main recommendations were: further commitment and coordination of efforts between all banks and financial institutions, the business community, donors, UNMIK and governmental organizations in order to eliminate barriers, especially to complete the legal framework and implement, as soon as possible, guarantee instruments and, through their enforcement, increase credit supply and improve finance conditions.

This short report aims to assess the achievements and progress made in SME finance and also to address the challenges faced by banks in SME finance in Kosova. The experience over the last two years provides sufficient insight on how to improve and advance finance in accordance with the SME need for credit support.

During the preparation of this report, Riinvest had discussions with all commercial banks to obtain a more realistic diagnosis of SME finance, and to learn about their work experience, estimate of credit potential, relations with clients, barriers to increasing lending capacities and attitudes toward improving the actual credit system. In addition, discussions were conducted with the following institutions and players involved in SME finance:

- Banking and Payment Authority (BPK),
- Business Community (Bankers Association of Kosova, Association "ESNAF" from Prizren, Business Association of Mitrovica, Alliance of Kosovar Businesses),
- Banks' clients (some loan users).

It should be emphasized that in preparing this brief report, data published in the following reports have been used: Transition Report 2000, EBRD; Expanding Financial Intermediation and Managing Risk, *Southeast Europe Financial Sector Conference,* Zagreb, Croatia, 2002; Monthly Statistics Bulletin, BPK, December, 2002; Monthly Macroeconomic Monitor Kosovo, MEF, December, 2002; SME Development in Kosova, *Annual Survey Report,* Riinvest 2001, 2002. Riinvest's surveys have been intensively

used, in particular the survey of 607 private SMEs (carried out in December, 2002 and in previous years).
This report contains an overview on: the development of the credit system, SME attitudes concerning their finance and relevant factors for improving SME finance.

Box 1: Extract from the main recommendations of IRTF (September 29, 2001):

- Development of a strategy for SMEs in Kosova would ensure the coordinated approach of economic policy mechanisms, including improvements in the possibilities for SME finance;
- Reducing the gap between credit supply and demand through alternative forms of finance, increasing the credit supply and stimulating competitiveness in the credit market will lead to further improvement in loan conditions (interest rate, volume of loans, repayment period);
- Create conditions for the implementation of finance mechanisms such as leasing, factoring and other possibilities within the package that regulates the banking system and other financial organizations;
- Immediate approval of the Mortgage Law and its implementation along with other guarantee instruments and the creation of an information system on the history of clients' credibility;
- Educate banks about the importance of sharing borrower information in a regular and systematic fashion, promoting the advantages of membership of the Kosova Credit Information Service (KCIS);
- Support the establishment of a Kosova Bankers Association to unite the interests of the banking sector, including the adoption of best practice and standards;
- Consideration of specific SME credit lines in cooperation with local banks and international financial organizations/donors aimed at increasing credit supply for SMEs and improving loan conditions.

2. THE DEVELOPMENT OF A CREDIT SYSTEM

2.1. Dynamics of credit increase

After the war, banking in Kosova in general, and a credit system in particular, needed to be established. For a period of seven months until the first bank started operation (MEB, January 2000) there were no banks in Kosova. Between March and November 2001, six other banks were established. In 2002, the development of banks was manifested through spreading their networks within the territory of Kosova, and the number of branches increased significantly in all municipalities in Kosova (Table 1). The activities of these banks are based on regulations that correspond to international standards and are monitored by the Banking and Payment Authority of Kosova (BPK).

Table 1: Indicators of banking sector development

Indicators	2000	2001	2002
Number of commercial banks	1	7	7
Number of branches (affiliations)	5	25	42
Number of sub branches	-	5	63
Non-bank financial organizations		16	16

Source: Macroeconomic Monitor Kosovo, Quarterly Outlook, MEF/CFA, 2002

Box 2: Extract from the main conclusions of IRTF (September 29, 2001):

- SME finance system is in its initial phase of development and is facing the following barriers: (i) lack of legal framework, (ii) lack of competition, and (iii) inadequate financial sources;
- SME's high level of credit demand implies that there is a disproportion between credit supply and demand, although the SMEs intention for future development is also sometimes based on an unrealistic approach to their needs;
- Domestic banks and financial institutions provide mainly short-term loans for one year or less. Businesses have ambitions for comprehensive investments relating to long-term finance.

The activity of the banks is primarily focused on payment transfers within the country and abroad and the collection of deposits for loans, mainly from businesses.
In addition to the banks, there are 16 non-bank financial organizations, operating mostly on the basis of micro credit schemes (excluding the Interim Credit Unit (ICU) of the World Bank).

Table 2: Amount of loans outstanding (in € mil.)

Years	Banks	Non-bank financial organizations	Total
2000	3.3	2.7	6.0
2001	25.2	21.4	46.6
2002	85.7	33.4	119.1
% increase (2002/2001)	240.0	56.1	155.6

Source: Monthly Statistics Bulletin, BPK, December, 2002.

There was an apparent increase in the volume of loans granted. The total amount of loans made by the banks has more than tripled. On the other hand, loans by non-bank financial organizations increased by approximately 58%. In 2002 banks dominated the loan market with nearly 70% of the total amount of loans granted. However, when the dynamic of the volume of loans is estimated, it should be noted that credit activity in the previous year was very low. Otherwise, credit activity has moved in accordance with the forecasts of other credit organizations (Survey with Banks and Non-bank Financial Organizations in Kosova, 2001).
Nevertheless, this volume of loans cannot be considered as adequate compared to the needs of businesses, their demands and the experiences of other countries, especially the need of society to generate new jobs. Therefore, increasing the volume and credit supply should be one of the main concerns in terms of economic policy in Kosova. The share of

loans to GDP in Kosova is still very low (see Table 3). While in 2001 the share of loans outstanding to GDP in Kosova was 2.7%, that increased to around 6% in 2002. The table below shows that this share is higher in Albania (6.8%), and far higher in Croatia (35%), Czech Republic (46%), etc. It is interesting that for the Euro Zone countries loans granted in their economies are higher than GDP.

Table 3: Share of total loans to GDP (%)

Countries	1999	2001
Kosova	n/a	2.7
Albania	3.9	6.8
Croatia	38.2	35.6
Slovenia	36	41.3
Czech Republic	60	46
Poland	27.6	30.3
Euro Zone countries	101.2	107.3

Source: Fundamental Trends in Financial Sector/Banking Sector Trends Through 2001, *Southeast Europe Financial Sector Conference,* Zagreb, Croatia, 2002.

Despite the difficulties in access to finance, businesses in Kosova are not using other finance mechanisms, such as leasing and franchising.[1] An attempt to introduce new investment practices has been made by the Kosova Reconstruction Equity Fund (KREF), supported by EBRD, with capital of $4.5 million. It is expected that with the further development of financial and capital markets, the importance of these financial instruments in the development of this sector will be increased.

2.2. Structure of loans

According to the findings from the survey conducted with seven commercial banks in Kosova, five of them had granted loans for the expansion and modernization of existing businesses (Kasabank, BpB, BRK, ABK, Banka Ekonomike) and, at the same time three out of these five banks have lent funds for the establishment of new businesses (BRK, ABK, Banka Ekonomike).

Table 4: Distribution of loans by sector (in %)

Sectors	2000	2001	2002
Trade	66.0	55.5	56.5
Production	16.9	12.4	15.2
Services	17.0	15.8	18.5
Agriculture	-	0.2	1.7
Other	-	16.4	8.1
Total	100.0	100	100.0

Source: Monthly Statistics Bulletin, BPK, December, 2002.

[1] Franchising is a process when a company gives the exclusive right to an individual or a firm the name of the firm to sell the products and services of that firm.

Table 5: Distribution of loans by ownership of enterprises

Ownership	2000	2001	2002
Private	100.0	96.0	94.7
Socially owned	-	0.4	5.3
Publicly owned	-	-	-
Total	100.0	100.0	100.0

Source: Monthly Statistics Bulletin, BPK, December, 2002.

Attempts to change the structure of loans in favor of production have not been encouraging. Trade absorbed about 56% of total loans in 2001 and 2002. Production recorded a slight increase, while the share of agriculture is still worryingly low (only 1.7% in 2002). Despite some attempts made by ABU-Agri Business Unit there is still no any appropriate financing system that would take into consideration specifics of agriculture. From the perspective of the distribution of loans by banks, there are also differences from bank to bank. For instance, three banks have mostly lent to trade enterprises: Kasabank (83%), Banka Ekonomike (63.0%) and New Bank of Kosova (59.0%). On the other hand, three other banks dominate in lending to production enterprises: Bank for Private Business (72.0%), American Bank of Kosova (70.0%) and MEB (51.0%). The sectoral distribution of loans is mainly determined by the existing unfavorable loan conditions. These conditions are especially insurmountable for more serious investments in the domestic SME production sector, which require a longer term to pay back the loans and a lower interest rate. It is important to note that socially owned enterprises have increased their share in the market for loans (5.3% in 2002), but publicly owned enterprises are not present in this market.

2.3. Loan terms and conditions

The improvement of loan terms and conditions slowed down in 2002. Interest rates did fall from 14-22% to 10-14%, but they still remain high. According to the survey with banks, short-term loans (less than one year) characterized the loan market in 90% of cases. Only ICU (Interim Credit Unit) as an interim credit organization of the World Bank delivered medium-term loans, with a repayment period of up to three years.

Table 6: Interest rate for the loans delivered

Interest rate	Number of banks
Minimum	
10-12%	2
12-15%	5
Maximum	
14-18%	2
18-24%	5

Source: Riinvest survey of banks and nonbank financial organizations, 2001.

The survey data for the commercial banks indicates that the minimum interest rate at BpB and MEB is 11.5% and 10.0% respectively. The minimum rate in the five other banks is between 12-15%. In the meantime, the maximum interest rate varies from 14-18% at Kasabank and BpB, BRK and ABK have set it at 18%, whereas MEB charges the highest maximum rate.

Microfinance organizations in Kosova also charge high interest rates for their loans. On average, their charge is estimated to be 24%[2]. The lack of a period of grace is a specific difficulty in the repayment of loans, which puts at risk businesses with high production costs by jeopardizing their cash flow.

Box 3. Bad loans

Even in developed economies, banks face various risks during their work with clients. The greatest influence on their activity comes from changes in the stock exchange, and competition. In general, it can be said that loans from foreign banks are also at risk from the possibility that their clients will go bankrupt. Foreign banks have difficulties in recovering the loans they have made, although these loans are declared as 'bad loans'.

Banking practices demonstrate a different share of these loans to the total number of loans granted. Bad loans are present in the banking practices of other countries. The presence of these loans in Kosova would be a disincentive to improving the credit and finance system for SMEs.

Share of bad loans in total loans (%)

Countries	2000	2001
Kosova	-	1.0-1.7 (*)
Albania	42.6	n/a
Bosnia and Herzegovina	15.7	9.1
Croatia	9.5	7.2
Macedonia	26.9	33.5
Slovenia	8.5	8.2
Bulgaria	10.9	7.0
Czech Republic	19.3	11.8
Estonia	1.5	1.3
Hungary	3.1	n/a
Poland	15.9	18.3
USA (estimation)	2.0	2.0

(*) has to do with the estimation of banks for 2002

In the current circumstances of an institutional vacuum and the non-functioning of guarantee instruments, domestic borrowers have demonstrated a high level of business ethics. Even without a history of the practice of repaying loans, so far bad loans appear to be on a relatively low scale in several domestic banks. In regional and international comparisons the share of bad loans from 1% to 1.7% of overall loans still remains very low and cannot endanger the credibility of the Kosovar banks and their clients.

Source: Fundamental Trends in Financial Sector/Banking Sector Trends Through 2001, *Southeast Europe Financial Sector Conference*, Zagreb, Croatia, 2002.

[2] Monthly Macroeconomic Monitor of Kosova, MEF

3. SME ATTITUDES ON FINANCING THEIR DEVELOPMENT

During December 2002, Riinvest conducted a survey with 607 private SMEs and is preparing the annual report concerning their development trends and evolution of institutional and business environment. The sample consisted of a panel group of 200 enterprises that were continuously observed from year to year, then a group of 300 enterprises randomly selected and stratified by sector, size and location, and 100 sole proprietors, randomly selected too. In this part of the Report we present some of the preliminary results about investment activity and their financing needs.

3.1. Attitudes of private entrepreneurs to loan terms and conditions

Responses received from the surveyed private entrepreneurs revealed that over half of them (55%) considered the general loan terms and conditions to be unfavorable. This situation has eased compared to the previous year but is still unfavorable and contributes to the reluctance of entrepreneurs to make capital investments. In shaping this opinion, entrepreneurs were largely influenced by the three factors that determine loan terms and conditions: (i) lack of a period of grace; (ii) high interest rates; and (iii) short-term repayment period.

Table 7: Opinion of entrepreneurs concerning loan terms and conditions (%)

Opinion	2002
Favorable	44.5
Unfavorable	52.4
n/a	3.1
Total	100.0

Source: Riinvest survey data, December, 2002.

An overwhelming majority of the surveyed enterprises prefer lower interest rates and longer repayment periods as a precondition to their involvement in capital investments, especially in production.

Box 4: CITADELA, Klina

Citadela is a company from the Klina municipality which deals with the production of construction material. Earlier, the owners of Citadela were involved in trade. For two years they were the main contractors for the European Agency for Reconstruction (EAR), supplying construction material to the municipalities of Klina and Istog. At the same time they took the initiative to build a factory to produce construction material. Their initiative was based on several sources of finance. The main source (55%) was their own capital. They also received considerable support from a Slovenian partner. The latter allowed them to pay for the equipment purchased in installments. Citadela also received a short-term (one year) loan from the Bank for Private Business (BpB) of €125,000. The share of this loan in the total investments made by the owners of Citadela is 15%. The owners point out that the loan terms and conditions were unfavorable given the short repayment time, high interest rate (14% per year) and the lack of a period of grace. 'If the capital generated from the beneficial activity in the past had not been available, we would not have been able to afford the loan terms and conditions. We would have been able to pay back the loan to BpB even if our initiative had failed', says one of the owners of Citadela. This can be proved by the fact that the loan was received in April, while production started in August 2002. If the interest rate was lower and medium-term finance was available, the owners of Citadela claim they could increase the number of products and the number of workers. But, with the current conditions in the financial market, it seems impossible to obtain and make efficient use of loans.

3.2. Difficulties in access to external financial sources

One of the most intense barriers to business about which managers and entrepreneurs complained, is the difficulty in accessing external financial sources. According to their responses, lack of access to external finance was ranked as the third most intense barrier in 2000, out of 14 barriers to business in Kosova, and fifth in 2001 and 2002, after unfair competition, incomplete legislation and high taxes. The fall of this barrier in the ranking in 2001 and 2002 from third into fifth place can be explained by the increase in credit supply during the last two years and the slight improvement in loan terms. However, about 67% of the surveyed enterprises considered this to be a high or medium intense barrier, while 33% declared it to be low or inexistent.

The findings indicated that access to external finance is more severe amongst micro enterprises, because 68% of them ranked it as a high or medium intense barrier. Slightly more than half of medium sized enterprises ranked this barrier in the same way. By sectors, it seems that production is experiencing the greatest difficulty, although the banks in their credit policies have production as their priority. But despite this, the volume of credits, the repayment period, and the interest rate charged make these loans less acceptable for production enterprises. By location, the respondents from Ferizaj, Peja and Gjilani complain more about the difficulty in access to external financial sources. This can be explained by the fact that in these locations entrepreneurs are more oriented toward investment, therefore difficulties in implementing and carrying out their plans are greater.

Table 8: Difficulty in access to finance as a barrier (% of respondents)

Type of enterprises	High or medium intense	Low intense or inexistent
Production	72	28
Services	59	41
Trade	68	32
Micro enterprises	68	32
Small enterprises	65	35
Medium enterprises	53	47

Source: Riinvest survey data, December 2002.

3.3. Investment activity of SMEs

The investment activity of SMEs and other private businesses remains intensive, although there is a decline in the percentage of enterprises having investments, but with an increase in the average volume of investment per enterprise.
In 2002, about 59% of the surveyed enterprises declared they had investment activities, which shows a decline from previous years (62% in 2001, and 70% in 1999-2000).
By sector, it looks as though production had the highest share. In this respect, production enterprises share in total investments made was 47%, compared with their share of 27% in the sample (see Table 9). The same applies to small and medium sized enterprises, whose share in the sample is only 23%, but who carried out 75% of total investments. On

the contrary, the investment activity of micro enterprises is unsatisfactory, because this group had only 25% of total investments, but make up 77% of the enterprises included in the sample.

Table 9: Structure of investments made in 2002 (by sector and size)

Type of enterprises	% in volume of investments	% in the sample
Production	47	27
Services	12	27
Trade	41	46
Micro enterprises	25	77
Small enterprises	39	20
Medium enterprises	36	3

Source: Riinvest survey data, December 2002.

There is an increase in the average investments per enterprise (of those that had investments) over the last three years. The average increased from €84,000 in 2000 to around €107,000 in 2002, an increase of 27%. The reason for this could be found in the increased volume of loans and greater credit activity by banks.
Sources of investment have improved significantly in 2002, but only in terms of greater access to bank loans. Borrowing from family and friends, credit from abroad and donations decreased, balanced by an increase in own sources of funds and credit from the banks within Kosova (Table 10).

Table 10: Sources of investments (%)

Source	2000	2001	2002
Own (internal) means	77.1	68.5	79.4
Borrowing from family and friends	16.8	5.0	3.93
By credit from foreign banks	2.4	19.4	1.6
By credit from the banks within Kosova	2.4	0.6	13.6
Donations	1.3	6.5	0.3

Source: Riinvest SME survey data, various years.

While in 2000 local banks contributed only 19% of overall borrowings, this share has recently risen to 80%, which means that domestic banks are becoming the major player in SME finance through credit. Table 11 clearly shows that banks' involvement in SME finance is higher than it was two years ago. In this way the banks increased their share in overall credit from 20% in 2000 to over 80% in 2002. As a result of these changes in the structure of credit, borrowing from family and friends dropped sharply from 57.4% to 12.8%.

Table 11: Sources of credit for SMEs

Year	2000	2001	2002
Banks	19.7	57.8	81.7
Non-bank financial organizations	6.6	15.6	4.3
Friends	57.4	26.6	12.8
n/a	16.4	-	1.2
Total	100.0	100.0	100.0

Source: Riinvest survey of banks and nonbank financial organizations, 2001, SME survey data, various years.

3.4. Investment plans and credit demand

Ambitions for investment and development are still present amongst SMEs in Kosova. Around 92% of the surveyed enterprises claimed they were planning new investment activities. 86% of those that intended to invest argued that they would need credit.
However, predictions concerning investment became 'more realistic' when the volume of investments expected to be made is taken into account. This should be interpreted as a fall in excess optimism after the war. As can be seen from Table 12, the average investment per enterprise made in 2002 is close to the average planned investments.

Table 12: Amount of current and planned investments (in €)

Description	Current investments	Planned investments
Total investments	39,003,140	63,612,650
Average investment per enterprise	107,446	114,001

Source: Riinvest survey data, December 2002.

Planned investments per enterprise have declined from €181,000 in 2001 to €114,000 in 2002, or by 24%. The share of credit in the planned investments is 70%, which in reality would make it difficult for the plans to be feasible. But, per enterprise the average amount of planned credit has dropped from an unrealistic expectation of around €174,000 in 2000, to over €98,000 in 2002 (Table 13).

Table 13: Investments made and credit demand (in €)

Years	Average investment made per enterprise	Planned average investment per enterprise	Declared credit demand for enterprise
2000	84,001	286,735	173,849
2001	95,655	181,399	110,680
2002	109,640	141,001	98,164

Source: Riinvest survey data, 2000, 2001, 2002.

It seems that the biggest obstacles for enterprises to attain their investment plans are more related to the sources of finance rather than to other factors, such as the lack of business plans, and economic and political insecurity (see Table 14). Economic and political insecurity, which was considered to be the main limiting factor, is now replaced by the lack of financial sources.

Table 14: Limiting factors to attain investment plans (in %)

Obstacle	2001	2002
Lack of business plan and ideas	15.3	8.6
Political and economic insecurity	45.8	31.4
Lack of financial sources	39.0	60.0
Total	100.0	100.0

Source: Riinvest survey data, 2001, 2002.

4. SOME RELEVANT FACTORS FOR IMPROVING CREDIT SUPPLY

The ratio of credit supply by banks and non-bank financial organizations on the one hand versus credit demand of SMEs on the other hand, is several times lower. The volume of loans provided to finance the needs of businesses depends on mobilization of the financial potential of the population, businesses, banks and other financial institutions. In the current phase of banking development, improvement in terms and conditions depends upon the impact of the following factors: (i) deposits and their structure; (ii) encouraging long-term savings; (iii) activation of special credit lines and the development of borrowing policies from financial institutions abroad; (iv) legislation/guarantee instruments and their enforcement; (v) increasing the absorptive capacities of enterprises; and (vi) increasing the capacities of banks and financial institutions for credit management.

4.1. Deposits and their structure as a determinant to increasing credit supply

Deposits and long-term savings will essentially affect the banks' activity in the credit market, which in turn will have a significant impact on the creation of a sustainable system for SME finance through the increase of credit supply, and more acceptable terms and conditions for credit for enterprises.

Table 15: Increase in and structure of deposits (in € mil.)

Years	Deposits	Termed deposits	Termed deposits/Deposits
2000	88.5	-	-
2001	468.8	126.3	26.9
2002	419.8	131.3	31.3

Source: Monthly Statistics Bulletin, BPK, December 2002.

The period 2001-2002 was characterized by important changes in the banking and credit system in Kosova. In addition to the establishment of new banks, by the end of 2001 Kosova was included in the Euro Zone. That brought a stabilization of deposits at €400-420 million. However, to establish a sustainable system for SME finance, an increase in overall deposits alone is not sufficient. Their structure, in particular the share of termed deposits and long-term savings has special importance. Termed deposits have increased and represented 31.1% of total deposits in 2002, but that is insufficient to increase the credit supply. Also, in 2002 termed deposits increased by 3.9% compared to the previous year, which again is insufficient to bring about changes in the finance policy for enterprises.

Table 16: Share of deposits to GDP

Countries	2000	2001
Kosova	-	26.8
Albania	41.9	51.0
Croatia	41.9	57.4
Slovenia	46.5	54.1
Czech Republic	66.6	71.6
Poland	37.7	41.0
Euro Zone	79.1	80.3

Source: Fundamental Trends in Financial Sector/Banking Sector Trends Through 2001, *Southeast Europe Financial Sector Conference,* Zagreb, Croatia, 2002

From the perspective of international comparisons, the share of deposits to GDP in Kosova is far lower than in other countries in transition. While in 2001 this share was 26.8 %, in 2002 it dropped to 21.1 %. In other countries this share has a positive correlation to the level of economic development and financial and capital market development.

Looking at the deposits per capita, we observe a lower level for Kosova amongst the countries in the region (Kosova €162, Romania €189, Bulgaria €305, Macedonia €314 and Albania €519).[3]

The data in the table below indicates that despite general positive trends in banking system development, the confidence of clients in the banking system of Kosova still remains to be tested on the basis of long-term savings.

[3] Fundamental Trends in Financial Sector/Banking Sector Trends Through 2001, *Southeast Europe Financial Sector Conference,* Zagreb, Croatia, 2002.

Table 17: Deposits and credits of banks (in mil. €)

Banks	Deposits	Credits	Deposits (%)	Credits (%)	Deposits/ Credits
MEB	266.7	21.4	66.4	28.0	8.0
BRK	34.9	14.4	8.7	18.7	41.3
BPB	25.1	11.4	6.2	14.8	45.4
BE	11.5	5.4	2.9	7.0	46.9
BAK	41.7	11.7	10.4	15.2	28.0
BKP	8.7	5.8	2.1	7.5	67.0
KSB	11.5	6.6	2.9	8.6	57.4
Total	401.8	76.9	100.0	100.0	19.1

Source: Monthly Macroeconomic Monitor Kosovo, December 2002, MEF.

From the data on ratios between deposits and credits in different banks, considerable disproportions are found:

- These disproportions are present especially in MEB (restrictive approach to lending), BKP and KSB (expansionary approach to lending). The real causes of this situation are not known and they may depend on the management capacities, absorptive capacities, and the guarantee instruments and their enforcement. Anyway, from the table above more intensive credit by some banks could been expected in the existing conditions.
- The share of banks in deposits and credit to support businesses in general has generated different ratios, as shown by MEB (8.0%), while Banka Kreditore has shown a higher share (67.0%), Kasabanka (57.4), Banka Ekonomike (46.9 %) and Bank for Private Business (45.4%). All these banks contributed to the increase in the credit supply, and the share of credit to termed deposits increased from 19.9% in 2001 to 60.0% in 2002.

Box 5:

According to BPK officials, banks by their nature should be conservative and careful while increasing the volume of credit. Even though there are no legal constraints on the determination of the ratio between deposits and credits, BPK officials recommend that this ratio should not exceed 40-60%. In the view of these officials, the vacuum in the legal framework is not a constraint to the increase of the credit supply and, does not put at risk the ratio between the benefits to banks with approved credit.

Interview with David Weatherman, Deputy Managing Director, BPK.

4.2. Encouraging long-term savings and loans

In order to increase the share of loans to deposits, it is necessary to apply an encouraging policy to mobilize the financial potential of the population through long-term savings as a base to increase the long-term lending possibilities of banks, and create better opportunities for SME finance. Encouraging long-term savings in this phase of the development of the banking system would be positively reflected in mobilizing the volume of credit, improving terms and conditions and the performance of banks.

Table 18: Interest rate on termed deposits and credit (%)

		Interest rate on credit	
Banks	**Interest rate on annual deposits**	**Minimum**	**Maximum**
MEB	2.3	10.0	24.0
BRK	3.5	14.4	18.0
BPB	3.5	11.5	14.0
BE	3.5	15.0	-
BAK	-	15.0	18.0
BKP	3.25	14.5	-
KSB	3.5	14.0	-

Source: Survey with commercial banks, Riinvest, 2003.

Figures in Table 18 indicate a relatively low interest rate on termed deposits and savings which varies up to 3.5%. MEB is an exception by offering a lower interest rate (2.3%) as opposed to the other banks. The path from termed deposits to long-term savings is determined first of all by the implementation of a policy for a more stimulating interest rate, to mobilize the financial potential of the population and of businesses. With regard to termed deposits, the financial potential of the population *vis-à-vis* other legal entities has a dominant share (80.0%). The interest rate on deposits and loans charged by banks in Kosova indicate an apparent imbalance. Hence, stimulating deposits by 3.5% interest and charging loans at 10% - 15.0% has resulted in a disproportion from 6.5 to 11.5 index points. Such disproportion in the case of Kosova compared to countries with monetary stability and the Euro Zone is significantly higher. Kosova and Albania have a greater disproportion in the level of net nominal bank interest rate.

Table 19: Net spread on nominal bank rates (percentage points)

Countries	**2000**	**2001**
Kosova		6.5 – 11.5 *
Albania	13.8	12.0
Croatia	8.3	6.4
Slovenia	5.7	5.3
Czech Republic	3.7	4.1
Estonia	3.9	5.4
Hungary	3.0	2.8
Poland	5.8	6.6
USA	2.8	3.2
Euro Zone	3.2	3.3

Source: Fundamental Trends in Financial Sector/Banking Sector Trends Through 2001, Southeast Europe Financial Sector Conference, Zagreb, Croatia, 2002.

* The figure is for the year 2002.

Countries in the advanced stages of transition like the Czech Republic, Hungary and Estonia have lower disproportion as a result of encouraging long-term savings. The proportions in the USA and the Euro Zone, in which Kosova is included, are also stable and have the function of increasing savings and the credit supply.

4.3. Other financial instruments/possibilities

In the business community there is an attitude that only credit, micro credit schemes and grants can be used for the development of new businesses. With the completion of the emergency phase of development, grants have decreased. This has forced entrepreneurs to rely on credits schemes for their investment projects. Current banking legislation allows for the opportunity to use other financial instruments. Since 2001, KREF have started to operate 'equity investment funds', with capital of € 4.5 million provided by EBRD. Experience has shown that this could be a useful tool for new initiatives.
An important precondition to activating new financial instruments (guarantee instruments, leasing, factoring, and the stock exchange) is the development of the financial market and an increase in the role of foreign investments for business development. Financial market development and the involvement of new institutions would significantly improve the business environment and have a beneficial influence on investment opportunities.

4.4. Borrowing policy and SME credit lines

UNMIK and the Government of Kosova are discussing the creation of opportunities for access to international finance for the projects of infrastructure and businesses in Kosova. In this context the initiatives to include SMEs in the borrowing schemes of international finance organizations would be important. In the past the World Bank and European Agency for Reconstruction (EAR) provided credit support for Kosovar businesses through the establishment of ICU. This model of partnership in credit has proved to be successful. On the basis of this formula, it is possible to provide further support for businesses.

Box 6: An example of a credit partnership (KfW and the Bank for Private Business)

Kreditanstalt für Wiederaufbau (KfW) of Germany, as a representative of and distributor of assistance for the German Government, in cooperation with the European Agency for Reconstruction (€5.0 million), Swiss Government (€1.2 million) and the German Government (€4.9 million) have established and are managing the European Fund for Kosova. The Fund aims to provide financial support to the qualified local banks for refinance (setting up of a new credit line). To date, only BpB as a local bank has been taken as a partner to deliver a new credit line of €1.8 million. On this basis, a memorandum has been signed between KfW and BpB to make use of this credit line and the technical assistance. This credit line has demonstrated the credibility of a local bank to manage the credit, and the real opportunities to increase the supply of long-term credit. This credit is mainly distributed according to the following conditions: (i) support with credit for SMEs and individuals; (ii) annual interest rate of 12% (11% for agriculture), (iii) repayment period of 3 years; (iii) maximum amount of loan of €50,000; and (iv) a period of grace of 3 to 5 months, depending on the sector. This is a model of partnership that other financial organizations and donors could implement with other banks in Kosova in order to strengthen the financial market, increase the credit supply and improve the conditions of providing finance to businesses.

Discussions with the Islamic Bank for Development concerning delivery of credit worth $30.0 – 60.0 million should also be mentioned. In fact, opportunities are being developed to enable SMEs to benefit from these credits. Implementation of these initiatives would be positively reflected in an increase in the credit supply and an improvement in conditions for SME finance and businesses in general, as the credit potential of banks does not allow for long-term credit.

Box 7: Three important events in advancing the finance system:

(i). The signing of a credit line arrangement between KfW (from Germany) and BpB (Bank for Private Business) to implement long-term finance has provided €1.8 million for BpB to support small enterprises in Kosova. This arrangement, although not so important by the volume of the transaction, promotes a useful practice and channel to increase the credit supply for SME finance in particular, and businesses in general;

(ii). The sale of 76% of the shares by ABK (American Bank of Kosova) to a banking group RFB (Raiffeisen BANK), demonstrates the beginning of the establishment of a financial market in Kosova and opportunities to increase credit supply and improve the terms and conditions to support businesses. It is a good example for potential foreign investors. In the future, new initiatives should be encouraged to find new alternative sources for support, including other domestic banks;

(iii). Progress in the completion of the legal framework and building of a sustainable financial environment to support businesses. The Regulation on Immovable Property/Mortgage, the Regulation on the Establishment of the Kosova Trust Agency (KTA), and a draft Regulation on Bankruptcy should be mentioned.

4.5. Legislation and guarantee instruments

Legislation on Banking promoted modern practices and standards. Banking system development is estimated to be one of the most successful stories within the building of market economy institutions in Kosova. With the passing of the Law on Mortgages and Registration of Immovable Property, a basic legal framework to promote a more sustainable financial environment in Kosova is in place. In the current phase of the development of a SME finance system, only pledge instruments are being used. Although it was agreed to establish the office for pledge registration, this has not been implemented, neither within the system of courts, nor within KCIS. Implementation of mortgages is seen by banks as a real opportunity to increase the volume of loans for clients. Some domestic banks, intending to be secure from bad loans, were also implementing 'applicable laws'. A number of banks are also waiting to implement guarantee instruments, based on the regulations passed by the Parliament of Kosova. Some banks estimate that until now borrowing from them was associated with difficulties because of the absence of Mortgage Law. It was difficult to enforce the collateral/property of the borrower when the repayment of credit failed.

In addition to the lack of long-term savings, one of the reasons for not expanding credit activities and increasing credit supply was the current legal system in Kosova. Most interviewed officials at the banks expressed dissatisfaction with the efficiency of the courts in Kosova in enforcing the mortgage law. The problems raised in these interviews related to the negligence in solving contestable issues and the implementation of collateral, although officials of the American Bank did not share the same view, assessing the work of the judicial system to be satisfactory in their case.

In order to implement the mortgage as a guarantee instrument more successfully, the register of immovable property should be developed as soon as possible. This would have a positive effect on improving and advancing the business environment in Kosova, and hence improving credit terms and conditions.

4.6. Increasing SME absorptive capacities

Based on the research of Riinvest with private businesses, it can be concluded that SMEs are in the process of creating an unrealistic picture in general terms concerning their future development. The ambitions of entrepreneurs still do not contain a real understanding of the amount of capital they need and the external financial sources that they could engage, including their terms. Therefore, their vision is based more on institutional environment expectations from external financial sources, than in increasing internal capacities for better management of financial resources. The increase of these capacities is very important bearing in mind the limited opportunities for credit with more favorable conditions. Short-term repayment and the lack of periods of grace associated with high interest rates cannot be surmounted by Kosovar businesses if better financial management, marketing, and other business operations are missing. In the absence of internal capacities, the consulting services of the business associations' network should be used for analysis and expertise.[4] Entrepreneurs should appreciate the importance of their services as a way to improve their performance. Business associations should play an active role in educating their members on this issue.

4.7. Increasing the capacity for credit management at banks and other financial institutions

The capacity of banks to manage credit also has a significant impact on the credit market. Many material factors will determine the increase of credit supply in this phase of the development of the financial system. In this context, human resources and the building up of management capacities is crucial for the consolidation and advancement of the credit system. Bearing in mind that all the banks in Kosova are new, there is a long-term need to provide efficient training of personnel who would be able to develop credit techniques, investment projects and their evaluation. It is also important to increase the banks' capabilities for operation in the financial market, the implementation of new financial instruments and the support of export and other projects carried out through joint ventures with foreign partners. Some banks (especially MEB) regard the current volume of credit and opportunities to increase the supply of credit to be high risk considering the lack of institutional support and the limited capacities of SMEs to manage potential credit.

[4] There are several projects of technical assistance being implemented in Kosova, focused on building up new management capacities, market and marketing expertise, aiming at facilitating access of SMEs to external financial sources and applying international accounting standards. The most efficient in this domain are: USAID-KBS with more than 400 clients. Other important activities have also been developed by Integrated SME Development (EAR) and Swiss Contact.

Recommendations

In supporting further business development in general and SME finance in particular, and in overcoming the barriers to access to financial sources, the following recommendations are proposed:

(1) We recommend that the Government of Kosova, in cooperation with important local and international stakeholders, designs a strategy for the medium and long-term development of Kosova which would provide policies focused on sustainable business finance and development.

(2) The economic policy measures and joint efforts and activities of the Government, UNMIK, and international financial organizations (GOs and NGOs), should influence the increase of credit supply and the improvement of credit terms and conditions. To achieve this, the following measures should be undertaken:

(a) The creation of opportunities for medium and long-term finance requires that the banks and the Government of Kosova undertake measures to mobilize the financial resources of the population and businesses by encouraging long-term savings in domestic banks with competitive interest rates, at least at the level of neighboring and European Union countries.
(b) It is necessary to support activities to create arrangements between domestic banks, international financial organizations/donors and foreign banks to set up new credit lines for SME finance.
(c) We recommend that UNMIK and the Parliament of Kosova, in cooperation with the United Nations Organization, clarify the procedures and enforcement mechanisms that regulate arrangements for borrowing from international financial sources and seriously consider this, including credit lines for private businesses, as a source of finance.
(d) Create banking practices and guarantees that support the implementation of leasing and franchising.
(e) Security for loans should be increased through the efficient implementation of guarantee instruments, namely pledges and mortgages, and an increase in the efficiency of the courts and the prioritizing of execution procedures for issues in this area. That requires: improving the registry of movable and immovable property; digitalization of cadastre registries; creating the information system that would record clients' credibility and history, which would strengthen business ethics and confidence between the banks and their clients and reduce the presence of bad loans.

(3) Our recommendation for the Chamber of Commerce, Bankers Association, and the Business Associations is that they should encourage the activity of their members to increase absorptive capacities in favor of better management of credit and investment activities.