



Kosovo

Assessment of financing needs of SMEs in the Western Balkans countries

August 2016

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Country report: Kosovo



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Acknowledgements

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

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

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Table of contents

About this report	5
1 Executive summary	6
1.1 Macroeconomic Overview	6
1.2 Demand for Finance	6
1.3 Supply of Finance	6
1.4 Financing Gaps	6
2 Macroeconomic environment	8
2.1 Economic development and growth	8
2.2 The structure of the economy.....	8
2.3 Inflation and asset prices.....	9
2.4 Balance of payments	9
2.5 The fiscal and political situation.....	10
3 Demand analysis	11
3.1 Size and growth of the segment.....	11
3.2 Characteristics of SMEs	12
3.3 Performance.....	13
3.4 Institutional and regulatory issues	14
3.5 Innovation	15
3.6 Demand for finance.....	17
4 Supply analysis	20
4.1 Number and type of intermediaries.....	20
4.2 Type of funding instruments	20
4.3 Characteristics of funding recipients.....	22
4.4 Institutional and regulatory issues	23
4.5 Funding of intermediaries	23
4.6 Supply estimate	25
5 Gaps in private sector financing	26
5.1 Gaps by instrument	26
5.2 Gaps by type of SME.....	27
5.3 Gaps in funding of intermediaries.....	27
5.4 Potential and capability of IFIs to fill gaps.....	27
5.5 Recommendations	28
Annex 1: Macroeconomic indicators	30
Annex 2: Financial sector indicators	31
Annex 3: Largest lending institutions.....	32
Annex 4: World Bank Doing Business Indicators 2016.....	33

List of Acronyms

BFC	Business & Finance Consulting
CAR	Capital Adequacy Ratio
CIA	Central Intelligence Agency
CPI	Consumer Price Index
DCA	Development Credit Authority
DEED	Diaspora Engagement for Economic Development
DFI	Development Finance Institution
EBRD	European Bank for Reconstruction and Development
EFSE	European Fund For Southeast Europe
EIB	European Investment Bank
ENEF	Enterprise Expansion Fund
EU	European Union
EUR	Euro currency
FAO	Food and Agriculture Organization of the United Nations
FDI	Foreign Direct Investment
FI	Financial Institution
GDP	Gross Domestic Product
GIZ	Deutsche Gesellschaft für Internationale Zusammenarbeit
IFC	International Finance Corporation
IFI	International Financial Institutions
ISO	International Organization for Standardization
KfW	German Development Bank
KOSEP	Kosovo Energy Efficiency Lending Program
KOSME	Kosovo SME Promotion Programme
KRK	Kreditimi Rural I Kosoves
MFI	Micro-finance Institution
MSME	Micro, Small and Medium Enterprises
NPL	Non-performing Loan
OECD	Organization for Economic Co-operation and Development
PPP	Purchasing Power Parity
SME	Small and Medium Enterprises
SOB	State-owned Bank
UNDP	United Nations Development Program
USAID	United States Agency for International Development
USD	United States Dollars
WB	World Bank

Kosovo uses the euro as its currency.

About this report

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

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

The visit to Kosovo took place from December 1st through December 8th, 2015, during which time meetings were held with representatives from 21 organizations including banks, SMEs, microfinance institutions, multinational donors, startup ecosystem members, and government agencies.

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1 Executive summary

Kosovo's private sector is based almost entirely on SMEs, which provide job growth in an economy that otherwise suffers from high unemployment and depends on external funding. While ample bank loans are available to small and medium enterprises at increasingly falling rates, micro-enterprises are underserved due to insufficient funding for MFIs. High collateral requirements are a major barrier to access to finance, and the emergence of guarantee funds provides a timely solution to this problem. Equity finance and leasing are essentially unavailable, creating a gap in financing for riskier investments.

1.1 Macroeconomic Overview

Though Kosovo's economy posted consistently positive economic growth over the past decade, it remains small, dependent on public investment, remittances, and donor funding, and is characterized by very high unemployment. With a GDP per capita of about EUR 3,000 and just over a quarter of the population employed, Kosovo has a major need for SME development in order to provide jobs and increase local production to correct its -35.3% trade deficit. SMEs, which account for the vast majority of the private sector economy and are the predominant source of job growth, are concentrated in the trade and service sectors, with the agricultural sector quickly gaining speed due to government and donor support. The development of more capital-intensive sectors such as manufacturing has been slowed by political uncertainty, with SMEs expressing hesitance to invest in fixed assets and take on longer-term loans. The August 2015 signing of a series of landmark agreements with Serbia is an important step toward stabilizing the political situation, which should eventually lead to a more favorable investment climate.

1.2 Demand for Finance

Though Kosovo's SME sector consists of traditional, non-innovative enterprises, it has performed well in terms of its ability to generate jobs, with over 80% of employment provided by SMEs. This is especially the case for micro-enterprises, which have steadily increased in number, due in part to the ongoing formalization of unregistered enterprises. Given its growth dynamics, the SME sector exhibits a healthy demand for loans, with all the enterprises interviewed for this study showing a high degree of comfort with borrowing in order to grow their businesses and actively negotiating for better loan terms with banks. The sophistication of SMEs in areas such as business planning, financial record keeping, and growth management, on the other hand, is lacking, creating a barrier for lending with lower collateral requirements and equity finance. Because most of Kosovo's SMEs wish to retain their family-owned business structures, demand for equity finance is low. Demand for other financial products is tempered by low awareness, and low availability in the market, especially in the case of leasing.

1.3 Supply of Finance

The supply of loan financing to small and medium enterprises is sufficient, with the country's ten banks aggressively competing for their business, lowering interest rates and loosening lending standards in the process. Trade finance services are also generally available through banks, with a special focus on guarantee products. Because the largest banks in the country have recently decided to stop serving the microenterprise segment, micro-loans are now mostly supplied by the small microfinance sector. While banks have ample liquidity due to high levels of deposit funding, MFIs struggle to meet the growing demand due to limited funding sources. The supply of formal equity funding for SMEs is essentially nonexistent, with the only fund established in the country (the UNDP supported Diaspora Engagement for Enterprise Development fund) being inactive due to a lack of capitalization. The leasing sector is underdeveloped, with no leasing services provided to SMEs.

1.4 Financing Gaps

The most apparent private sector financing gaps in Kosovo include those for loans to micro-enterprises and for equity finance. While small and medium loan finance availability is sufficient, high collateral requirements present a major barrier for access to finance by SMEs. To resolve this issue, the government and several multi-national donors are in the process of setting up a EUR 12–15 million national credit

guarantee fund to provide partial security in lieu of collateral. An agriculture-focused guarantee facility provided by USAID has been successful in reducing collateral requirements for farmers and spurring lending to the sector, and room for additional donor guarantee funds exists.

2 Macroeconomic environment

Key findings:

- *Kosovo's high unemployment makes the SME sector very important for job creation*
- *GDP growth has largely been driven by remittances, donor funding, and public spending rather than private sector activity*
- *Trade and services account for almost 65% of private sector activity, with relatively low contributions from manufacturing and agriculture*
- *Because large enterprises are very few in number (less than 50), the structure of the SME sector mirrors that of the private sector overall*
- *Kosovo is heavily reliant on imports, including food imports, and SME development is important for eventual import substitution*
- *The August 2015 signing of a series of landmark agreements with Serbia has paved the way for Kosovo's EU accession negotiations*

Key macroeconomic indicators for the country are presented in Annex 1.

2.1 Economic development and growth

Kosovo's economy is small, and characterized by limited economic activity and very high unemployment. With a GDP of EUR 5.5 billion as of 2014 and a population of 1.8 million people, the nominal per capita GDP amounts to just EUR 3,065 for the year (though income inequality is relatively low with a Gini coefficient of 30 as of 2005/2006). This is partially the result of the country's very low level of employment, with just 26.9% of the working age population employed in 2014 (comprised of labor force participation of 41.6% and unemployment of 35.3%) according to the Kosovo Agency of Statistics. At about half of Albania's employment levels, Kosovo fares the worst in the region in this metric. Development of the SME sector is therefore viewed as a key solution to Kosovo's unemployment problem.

Very high youth unemployment, estimated at 55.9% of the population aged 15 to 24¹ as of 2013, is also a key impediment to Kosovo's development. The unemployment is driven by the poor quality education system coupled with generally few quality employment opportunities for youth. Many of the younger workers unable to find employment end up working in low-skilled, low productivity positions, often in the informal sector.²

Kosovo's GDP growth rates of 2.7–3.3% over the past five years have fared better than other countries in the region, most of which have experienced some contraction in the same time period. Nonetheless, GDP growth figures may present a somewhat distorted picture. Onsite interviews revealed a general opinion that much of the growth figures are driven by the shift of many of Kosovo's businesses toward the formal economy, with companies obtaining formal registration and declaring more of their incomes. Additionally, much of the growth can be attributed to remittances, foreign aid, and public investment as opposed to private sector activity (including SMEs). Remittances alone grew by 11.7% during 2014 alone and represented 12.6% of GDP that year.

2.2 The structure of the economy

While the government does not publish statistics on the components of the economy by economic sector, the CIA Factbook estimated that services (including trade) accounted for 64.5% of GDP, with indus-

¹ World Bank (2014), *Results of the Kosovo 2013 Labor Force Survey*
<https://www.worldbank.org/content/dam/Worldbank/Brief/Europe%20and%20Central%20Asia/KOS-Labour-Force-Survey-2013-Eng.pdf>

² World Bank (2015), *Kosovo Country Snapshot*
<http://www.worldbank.org/content/dam/Worldbank/document/eca/Kosovo-Snapshot.pdf>

try (manufacturing) making up just 22.6% and agriculture 12.9% as of 2009. These figures are supported by the breakdown of Kosovo's enterprises: based on a 2013 economic activity survey conducted by the Kosovo Agency of Statistics, only 12.9% of enterprises were involved in manufacturing, and services made up the vast majority of the businesses on the list (agriculture was not covered by the survey). Economic sector breakdowns of bank loan portfolios, as discussed later in this report, also support this picture.

SMEs account for the vast majority of Kosovo's private sector economy, with less than 50 enterprises having enough employees (over 250) to qualify as large³. Thus, the economic activity structure of SMEs mirrors that of the private sector economy in general, with trade and services being by far the most popular. SME participation in the agricultural sector has recently increased due to government support of the sector, including grants, infrastructure investments and better financing terms.

2.3 Inflation and asset prices

Since peaking at 7.3% in 2011, inflation rates have steadily declined, ending 2014 with consumer price growth of a very low 0.4%. Greater price increases have been observed for several import categories important to SMEs, including cattle and cattle products (5.1%), machinery and electrical appliances (0.8%), and wood and wood products (0.7%) in 2014⁴. Kosovo's reliance on imports closely ties the national inflation rates to global prices for food and other goods. While the stabilization of consumer prices is a positive for Kosovo's SME sector, given that the sector is reliant on the domestic consumer market, the continued increases in imported input costs can bring down SME profitability and growth capacity.

The real estate market has generally performed well in Kosovo, supported by significant demand from the diaspora. Nonetheless, difficulties with disposing of real estate collateral, especially in smaller communities, persist for banks due to the stigma associated with buying neighbors' properties. This creates a barrier for access to finance for SMEs desiring to pledge properties in smaller communities, as banks tend to discount the value of such collateral.

Because Kosovo does not have its own currency and instead uses the Euro, exchange rates are not an issue.

2.4 Balance of payments

Kosovo relies heavily on imports, and its export base is quite small, resulting in a large trade deficit for the country. The negative current account balance (-8% of GDP in 2014) is driven directly by the trade imbalance (-35.3% in 2014), which is partially offset by the heavy inflow of remittances into the country. Foreign direct investment (FDI) in SMEs is low, amounting to just 2.7% of GDP in 2014, down from 5.3% the previous year. SMEs do not benefit from much FDI, with the vast majority of companies being domestically owned.

Exports in Kosovo are low, stagnating at no more than 20% of GDP between the period of 2010 and 2014. The country's main exports are metal and mineral products, whereas prepared foods and textiles are examples of exports more relevant to the SME sector. Kosovo has made strides toward meeting EU safety standards for food exports, but this process is still in progress, with SMEs having a disadvantage in accessing markets due to an inability to adopt quality standards and underdeveloped value chains for aggregation and selling of agricultural products at scale.

³ There is no national standard defining turnover limits by enterprise size, and bank definitions of segments by loan size vary drastically.

⁴ Independent Balkan News Agency *Consumer Prices in Kosovo Continue to Rise* <http://balkaneu.com/consumer-prices-kosovo-continues-rise/>

2.5 The fiscal and political situation

At the end of 2014 Kosovo had a fiscal deficit of 2.4% of GDP, a slight improvement from a 2.9% deficit in 2013. Though Kosovo adopted a fiscal rule aimed at keeping the fiscal deficit to roughly 2.2% of GDP, several election-time promises of increasing public sector wages, motorway construction, and social benefits for political and war prisoners, along with low tax revenues, have kept Kosovo away from achieving its fiscal targets.⁵ Fiscal constraints pose a limitation to government support programs for SMEs.

As a potential candidate for EU membership, Kosovo has worked to improve its political and legal systems, striving to bring them to European standards, and the country has recently deepened its coordination with the European Commission on economic policies and governance issues. Nonetheless, the rule of law and judicial independence remain as major challenges in Kosovo, with continued problems arising from corruption and organized crime. The lack of full international support for Kosovo's 2008 declaration of independence (only 51% of UN member states recognize its autonomy) continues to be an obstacle to the country's integration and socio-economic development as it keeps Kosovo from attaining UN membership. In August 2015 Kosovo signed a series of landmark agreements with Serbia on energy, telecommunications, treatment of Serb majority municipalities, and freedom of movement, paving the way for EU negotiations with Kosovo⁶.

⁵ The World Bank (2015) *Kosovo Country Snapshot* <http://worldbank.org/content/dam/Worldbank/document/eca/Kosovo-Snapshot.pdf>

⁶ European Union External Action (2015) *Statement by High Representative/Vice President Federica Mogherini Following the Meeting of the EU-facilitated Dialogue* http://eeas.europa.eu/statements-eeas/2015/150825_02_en.htm

3 Demand analysis

Key findings:

- SMEs, defined as enterprises with fewer than 250 employees, account for the vast majority of Kosovo's enterprises.
- Micro enterprises with 2-9 employees are the largest generator of jobs in the SME sector.
- Over half of SMEs are involved in the trade sector, and the manufacturing and information technology sectors are underdeveloped.
- Many smaller SMEs are unregistered, but their gradual formalization has consistently added to the number of registered enterprises in the country.
- SME performance has been uneven due to changing market conditions, with SME non-performing loans exceeding that of the banking sector on average.
- Demand for SME finance consists primarily of loans, with demand for equity tempered by the family owned nature of enterprises.

3.1 Size and growth of the segment

SMEs, defined as businesses with fewer than 250 employees, represent the vast majority of Kosovo's enterprises. As of year-end 2013, only 47 enterprises in the country had more than 250 employees, representing just 0.1% of the country's 46,032 enterprises based on national tax administration data compiled by the Kosovo SME Promotion Programme (KOSME)⁷. This is inline with the dynamics for European SMEs overall, which represent 99.8% of enterprises⁸. Over half of the SMEs are sole proprietorships (56.4%), another 38.7% are micro enterprises with 2–9 employees, 4.2% are small enterprises with 10–49 employees, and only 0.7% are medium enterprises with 50–249 employees.

Table 1. Number of SMEs by size, 2013

Size	Definition	Number of enterprises
Sole proprietors	1 person	25,938
Micro	2–9 employees	17,797
Small	10–49 employees	1,940
Medium	50–249 employees	310
TOTAL	n/a	45,985

Source: KOSME Report on SMEs in Kosovo 2014

The SME sector is very important to Kosovo as it accounts for the majority of Kosovo's private sector and is the primary source of its growth potential. The sector provided a high 80.7% of employment as of 2013 with micro enterprises (2–9 employees) providing 31.9% of jobs as of the same year⁹. This is well above the average of 67% for European SMEs¹⁰.

Official statistics show the number of SMEs growing steadily over the past several years, with just short of 10,000 new enterprises being added each year between 2012 and 2015¹¹, but much of this growth can be attributed to the registration of previously unregistered enterprises, the number of which is not known but was estimated to be potentially as high as the number of registered sole proprietorships.

⁷ KOSME (2014) Report on SMEs in Kosovo 2014

http://eciks.org/repository/docs/Report_on_State_of_SMEs_in_Kosovo_2014_99378.pdf

⁸ European Commission (2015) Report on European SMEs 2014/2015

<http://ec.europa.eu/DocsRoom/documents/13942/attachments/1/translations/en/renditions/native>

⁹ KOSME (2014) Report on SMEs in Kosovo 2014

http://eciks.org/repository/docs/Report_on_State_of_SMEs_in_Kosovo_2014_99378.pdf

¹⁰ European Commission (2015) Report on European SMEs 2014/2015

<http://ec.europa.eu/DocsRoom/documents/13942/attachments/1/translations/en/renditions/native>

¹¹ Republic of Kosovo (2016) Statistical Repertoire of Enterprises in Kosovo Q42015 <http://ask.rks-qov.net/ENG/bussines-statistics/publications>

3.2 Characteristics of SMEs

Over half of Kosovo's enterprises are involved in wholesale and retail trade, based on 2014 data published by the Kosovo Agency of Statistics. This appears to be due to the popularity of trade activities among small proprietors, as suggested by the fact that only 37.3% of employment is provided by the sector. Manufacturing, on the other hand, accounts for 15.3% of employment and only 12.7% of the enterprises, suggesting that larger SMEs are involved in the sector. Accommodation and food services and construction round out the most important economic sectors for SMEs. It should be noted that national statistics do not cover the agricultural sector, which distorts the data reported.

Table 2. Number of Enterprises by Economic Sector¹²

Sector	2014	2013	2012	2011	2010
Trade	50.6%	55.4%	49.1%	47.8%	48.2%
Manufacturing	12.7%	12.9%	11.0%	10.2%	10.0%
Accommodation and Food Services	10.5%	10.8%	8.9%	8.3%	8.2%
Construction	6.7%	7.2%	7.3%	6.5%	6.2%
Transportation and Storage	3.7%	4.0%	2.8%	2.8%	2.8%
Information and Communication	2.2%	2.2%	8.5%	8.9%	9.1%
Other	13.6%	7.6%	12.4%	15.4%	15.5%
TOTAL	100.0%	100.0%	100.0%	100.0%	100.0%

Source: Kosovo Agency of Statistics, Results of Structural Business Survey 2014¹³

Note: the changes in breakdown by sector between 2012 and 2013 appear to be due to statistical methodology changes.

Kosovo's business owners tend to be rather young, with a notable 18% of businesses owned by persons under 30 as of 2014 based on the results of a national survey. Another 32% of businesses are owned by individuals from 30-39 years of age, while only 20% is owned by persons over 50.¹⁴

Agricultural enterprises. A 2014 agricultural census counted a total of 129,220 active agricultural land holdings in Kosovo; however, the requirements for being counted as a part of the census were rather loose (for example, owning one cow or one horse qualified a land holding for inclusion in the census)¹⁵. Estimates of the breakdown of agricultural land by landholding size as of 2005 showed that only 3.5%¹⁶ of land holdings amount to five acres or more. Using this as a proxy for commercially oriented farms, the number of agricultural SMEs can be estimated at 4,500, or 9.8% of total enterprises.

Much of the SME activity is concentrated in the capital city of Pristina (23.9% of new enterprises in the fourth quarter of 2015), but the cities of Peja (7.4%), Prizren (7.1%), and Ferizaj (6.5%) also generate a lot of new enterprises. Sole proprietors typically register as individual businesses, while Limited Liability Company is by far the most popular registration type for non-sole proprietors. Foreign ownership

¹² The table covers all enterprises in Kosovo, but is representative of the SME sector due to the very small number of large companies in the country. The total number of enterprises reported by the agency dropped sharply in 2013 and 2014 as compared to the prior years, but this is likely due to an adjustment to exclude inactive enterprises from the count. Based on national statistics on the number of employees by economic sector, it can be inferred that many of the large enterprises operate in the electricity, gas, steam and air conditioning sector (5.8% of employment and 0.1% of the enterprises).

¹³ Note: agriculture, forestry, fishing, finance, education, health, household activities, and public administration were excluded from the reported statistics.

¹⁴ ¹⁴ KOSME (2014) Report on SMEs in Kosovo 2014,

http://www.eciks.org/repository/docs/Report_on_State_of_SMEs_in_Kosovo_2014_99378.pdf

¹⁵ Kosovo Agency of Statistics (2014), Agriculture Census 2014, Preliminary Results

<file:///Users/tatyanadolgaya/Downloads/RezultatetParaprakeRB-ENG.pdf>

¹⁶ Arcotras for the European Commission (2016), Kosovo Report

http://ec.europa.eu/agriculture/analysis/external/applicant/kosovo_en.pdf

among SMEs is uncommon, with less than 5% of the new enterprises in the fourth quarter of 2015 having any foreign ownership¹⁷.

3.3 Performance

The SME sector, as a whole, has performed well as evidenced by its capacity to generate jobs, especially by the micro-enterprise segment (2–9 employees). The performance of individual enterprises within the sector, however, has been uneven, with many companies entering and exiting the sector each year. Roughly 2,000 new enterprises have been registered during each quarter since 2010, with a few hundred terminating their activities each quarter¹⁸ (others are reported to remain passive without official termination). High non-performing loan rates (estimated at 18–19%) also point toward turbulence within the sector, but it should be noted that some of these are left over from the 2008–2010 financial crisis.

Driven by the disproportionately high turnover of medium-sized enterprises, the trade sector accounted for 59.0% of the turnover for all enterprises, but also made up almost 70% of the expenses, showing that it is generally less profitable than the other sectors. Manufacturing and construction, on the other hand, appear to have better profit margins.¹⁹

3.3.1 Formalization and Business Practices

The true financial position of individual SMEs and the sector as a whole can be difficult to determine due to the large size of the shadow economy. Tax evasion is reported to be rampant. All banks interviewed complained about poor and inaccurate financial record keeping by SMEs, reporting that many businesses keep separate sets of books for bank and tax purposes, do not adhere to business plans, and misappropriate funds. One SME interviewed for this study reported being rejected for a bank loan due to insufficient written investment plans (an MFI later accepted this client).

The predominance of family-owned businesses among SMEs creates a bias for taking care of all needs in-house. Even those that outgrow family structures hold on to control and do not hire professional managers. For example, the use of outside accountants is unpopular. There is a general consensus among stakeholders that SMEs are in need of training on quality standards, marketing, staff development, business planning, and accounting. The formalization of SMEs would constitute a big step toward making them attractive to equity investors and improving their access to loans.

On the positive side, banks reported that SMEs have become more sophisticated in their capacity to negotiate for better loan terms, putting competing banks against each other and thereby helping drive down interest rates. Some of the SMEs interviewed for this study also discussed negotiating with banks for better conditions.

3.3.2 Loan Non-performance Drivers

Financial institutions generally reported experiencing more loan quality problems with SMEs than with other loan types, reporting NPLs as high as 12% for current (not legacy) SME loans. Banks reported SME NPLs being driven in part by the inability of the enterprises to manage growth, with problems such as difficulties with collecting receivables and unsuccessful client retention hurting business performance at a larger scale. Slow payments by the government to its private sector contractors also drive NPLs, as EUR 500–600 in monthly payment flow to businesses is frequently delayed according to one of the banks interviewed. Aside from the issues mentioned above, the performance of SMEs has improved since the time of the international financial crisis, when much of the legacy SME NPL portfolios were

¹⁷ Republic of Kosovo (2016) *Statistical Repertoire of Enterprises in Kosovo Q42015* <http://ask.rks-qov.net/ENG/bussines-statistics/publications>

¹⁸ IBID

¹⁹ Kosovo Agency of Statistics (2016) *Results of Structural Business Survey 2014*¹⁹ <file:///Users/tatyanadolgaya/Downloads/Results%20of%20the%20Structural%20Business%20Survey%202014.pdf>

created in Kosovo's banks.

3.3.3 Trade and Food Production Sector Performance

Kosovo's active urbanization trend has had the effect of increasing demand for packaged food and changing the landscape for food vendors. On one hand, this trend has facilitated the growth and financial performance of SMEs such as a meat processing plant interviewed for this study, but on the other hand it has hurt the performance of smaller enterprises. The emergence of supermarket chains has had the effect of putting smaller stores out of business, and has also shifted the power dynamics among food purchasers and suppliers, with late payment for goods by the supermarket chains negatively affecting the suppliers.

3.4 Institutional and regulatory issues²⁰

Though improved through continuous donor efforts, Kosovo's institutional and regulatory frameworks continue to present some challenges for SMEs. Kosovo is ranked an overall 66th on the World Bank's doing business scale for 2016, down from 64th the prior year. The OECD ranked Kosovo's regulatory framework for SME policy making at 2.5 out of 5, which is far below the other countries in the region except Bosnia and Herzegovina. The Policy Index said that while Kosovo has made progress in supporting SMEs through policy framework and skill development, reliance on donors is too high. This assessment is generally still applicable for 2015.

3.4.1 Resolving Insolvency

Kosovo's overall Doing Business ranking is brought down by the country's continued difficulty with resolving insolvency (ranked 163rd). In its Policy Framework assessment for 2012, the OECD noted that Kosovo's bankruptcy laws were still in their early stages. The inefficiency of the court system was repeatedly brought up as an impediment to doing business during interviews conducted for this study, though the recent introduction of a private bailiff system is proving to be a valuable workaround for this problem, with banks beginning to actively use the system in 2015.

3.4.2 Starting a Business

On the positive side, starting a business in Kosovo is relatively easy based on the World Bank's Doing Business assessment for 2016. The country ranks 47th for ease of starting a business, with 5 procedures and 11 business days required to start a business on average. The ranking has slightly deteriorated from the prior year, but is generally representative of the government's efforts to make improvements in this area.

3.4.3 Property Rights

Lacking residential property rights is a major impediment to access to finance and SME development in Kosovo, especially for startups and other enterprises lacking other real estate collateral. This is largely because many of the apartments built after the country's war with Serbia were completed in haste, did not receive occupancy certificates, and were sold without official titles to the properties. The prevalence of unlicensed developers during the post-war real estate boom exacerbated the issue. Poor official records of roads leading to pre-war buildings also create problems.

3.4.4 Infrastructure Issues

Lacking infrastructure is an impediment to SME development in Kosovo. Many of Kosovo's roads, especially in more remote regions, are in need of rehabilitation. Stakeholders interviewed for this study partially attributed the underdeveloped state of the manufacturing sector to infrastructure problems. Infra-

²⁰ Sources for the section: OECD (2012) *SME Policy Index Western Balkans and Turkey* <http://oecd.org/globalrelations/SMEWBalkansTurkey.pdf>; World Bank (2016) *Doing Business* <http://doingbusiness.org/data/exploreconomies/kosovo/>; stakeholder interviews

structure-related costs are also an issue – for example, the high cost of electricity per capita brings Kosovo's Doing Business ranking for getting electricity to a very low 124th.

3.4.5 Support Programs and Women's Entrepreneurship

Kosovo ranks the lowest among its peer countries for support services for SMEs and startups on the SME Policy Index as of 2012, 1.8 out of possible 5 points, as well as for innovation policy, 1.3 out of a possible 5. Current SME support programs, including capacity building, quality improvement, and modernization initiatives, primarily come from donors such as the World Bank, EBRD, and GIZ; government initiatives in this area are lacking. Support of women's entrepreneurship in Kosovo is ranked poorly (1.7 out of possible 5) on the OECD's Policy Index for 2012 because the issue is viewed from a social poverty reduction standpoint as opposed to a way to improve competitiveness (as is the case for other countries in the region).

3.4.6 Formalization and Business Registration

Many of Kosovo's businesses, especially smaller businesses in rural areas, remain unregistered and do not operate in a formalized manner. In addition to the registration issue, the lack of formalization among SMEs (record keeping, business planning, management professionalism) was frequently mentioned as a major impediment to their development in addition to being a barrier for access to credit.

3.4.7 Taxation

Kosovo's business tax rates are relatively low (15.2% vs. Europe and Central Asia's average of 34.8% according to the 2016 Doing Business report). Nonetheless, tax avoidance is rampant, with businesses frequently keeping separate sets of books for tax authorities and for lenders according to banks interviewed for this study. The number of required payments per year, at 32 on average, is more burdensome than Europe and Central Asia (19.2) as of 2016.

3.4.8 Support for Access to Markets and Trade

Internationalization of SMEs in Kosovo ranked last among others in the region on the 2012 OECD Policy Index due to the country's limited export base and ad hoc nature of export promotion. Kosovo has been working toward aligning its quality standards and regulations with the European Union in order to gain access to this export market, but the limited size of its manufacturing and agricultural sectors is an impediment to growing exports.

SME associations and value chains are currently weak, although some strides have recently been made in building coal production value chains. One bank also reported seeing potential in the development of electronics value chains.

3.4.9 Environmental Issues

Kosovo's ranking for SMEs in the green economy is low compared all other countries in the region except Bosnia and Herzegovina (OECD Policy Index 2012), with environmental issues and SME development generally treated as separate issues. One of the SMEs interviewed reported having trouble gaining access to support under EBRD's KOSEP energy efficiency lending program for a potential production equipment upgrade due to the company's insufficient size.

3.5 Innovation

Innovation among SMEs in Kosovo appears to be minimal, with most emerging businesses being built by using existing models. Trade and services prevail among SMEs, with relatively low activity in manufacturing and information technology. Agriculture, which is ubiquitously seen as a source for growth in the

country, has perhaps the greatest potential for innovation in areas such as organic farming and high value crop production for export markets.

Export-oriented crop production has potential in Kosovo because of the country's significant amount of arable land (53%), large rural population (about 60%)²¹, and high levels of unemployment (and therefore the availability of low-wage labor). Several enterprises involved in the aggregation of berries and medicinal plants, for example, have been successful in reaching export markets. Following the introduction of government grants for the sector, a trend of non-agricultural SMEs entering agricultural production has emerged. Banks expressed an appetite for lending to such enterprises, as their risks tend to be diversified.

Other sectors frequently named as having potential for development in Kosovo include wood processing and furniture, food production, and production of other consumables such as clothing, medicinal goods, and hygiene products. Though few in number, SMEs involved in juice production, production of wet towels and wipes, and the denim and leather shoe industries, have been successful with exports. Given the availability of local coal reserves, there is also potential for energy sector development according to the Central Bank.

Government support for innovation among SMEs is minimal, save for its efforts in promoting modernization of the agricultural sector and a small upcoming SME grant program through the Ministry of Trade and Industry²². In recent years the government has significantly increased financial support to agriculture, including production subsidies and investment in infrastructure such as irrigation, with 3% of the government budget dedicated to agriculture support in the 2009-2014 Program of the Government of the Republic of Kosovo. Subsidies have included direct payments, investment grants, and capital investments, and further such government support is anticipated. One of the SMEs interviewed for this study received grants from the government for the construction of greenhouses, allowing the farmer to enter the lucrative seedling production business and employ an increasing number of seasonal workers instead of focusing on growing crops such as strawberries in the open field. This particular grant scheme required 50% co-financing by the farmer.

Other support programs for SMEs appear to be limited to capacity building efforts from multinational donors, with no startup incubators, angel investors, or other such support mechanisms identified. EBRD, one of the major capacity-building providers, has been working to help SMEs improve quality standards in order to reach export markets. For example, a meat processing plant interviewed for the purpose of this study obtained several ISO certifications with the support of an EBRD advisory project. The goal of the project was to allow the company to meet food standards in the EU and other Balkan countries in order to facilitate exports. USAID is another donor supporting SME capacity development, as described in the example below.

²¹ FAO (2012) *Kosovo, Best Practices in Green Jobs Creation*
http://fao.org/fileadmin/user_upload/Europe/documents/Events_2012/3rdRD/07-Bunjaku_Kosovo_Presentation_Praq_30.05.2012.pdf

²² Co-financed by the EU Office in Kosovo, the program will offer EUR 60,000 to 200,000 grants to 20-25 export-oriented SMEs and EUR 10,000 to 20,000 grants to 20-25 export-oriented micro-businesses.

Box 1. Example of innovative SME

Shehu NTP is a manufacturer of stairs based in Pristina. Owned and run by three family members, the company has 20 employees, has been in business for 12 years, and achieved an annual turnover of roughly EUR 600,000. Shehu has continuously invested in production equipment in order to achieve partial automation for greater operating efficiency, and obtained a USD 40,000 grant from USAID for one of its recent equipment upgrades. Even though Shehu regularly imports wood from Bosnia, Croatia, and Serbia, it does not use trade finance products, preferring to pay in advance and receive a pre-payment discount instead. Because Shehu has access to a low cost of overdraft line from a local bank, the savings from the advance payment discount outweigh the interest expense from the line.

Following the trend of green building, Shehu recently entered into an equity partnership with two private entities from Albania and Switzerland in order to produce stairs for green homes in those markets. A separate company was formed to accommodate this new venture. This is an uncommon example of a family-owned Kosovo company accepting outside investment in order to innovate and grow.

3.6 Demand for finance**3.6.1 Overview**

SMEs generally exhibit healthy demand for finance in the form of loans. According to the 2013 World Bank Enterprise Survey for Kosovo, 66.8% of firms have loans or lines of credit, which is almost double the average for Eastern Europe and Central Asia. All SMEs interviewed for this study were active borrowers, and appeared comfortable with using loans in order to grow their businesses. Demand for equity, on the other hand, appears low due to the dominance of family owned businesses and the lack of an equity finance culture. Demand for leasing is tempered by its lack of availability, as SMEs are generally not aware of the benefits of such products.

As a result of Kosovo's falling interest rate environment, demand for SME loans has increased, with the growing agricultural sector showing an increase in demand due to the advent of support programs in the country. Because micro-enterprises are the least served segment among SMEs, they are the largest source of unmet demand for finance. Banks actively compete for the business of more established small and medium enterprises, encouraging their demand for loans through improving lending conditions.

3.6.2 Estimate of demand

Total demand for SME finance in Kosovo is estimated at EUR 730.9 million, as shown in table below. This represents 13.2% of GDP and 36.2% of the loans in the banking system.

Table 3. Calculation of demand for loans from MSEs

Step in Calculation	Value	Source
A. Number of SMEs	45,985	Kosovo Enterprise Promotion Programme
B. Average loan size demanded (EUR)	30,507.3	BFC survey of local lenders
C. % of enterprises needing a loan	52.2	World Bank Enterprise Surveys ²³
D. Total demand (EUR)	730,869,978.5	= A * B * C

The total SME finance demand was estimated by collecting data on the average SME loan size from local banks and MFIs, multiplying the overall average figure by the number of SMEs in Kosovo, and discounting the result by the proportion of enterprises not needing a loan based on 2013 World Bank Enterprise Survey data. Because a disproportionately high number of MFIs are represented in the average loan size figure (MFIs accounted for two of the five enterprises reporting average loan size data), the average loan size demanded could be understated. The model also assumes that just one loan is needed per en-

²³ The World Bank surveys report the % of enterprises not needing a loan, from which the percent of enterprises needing a loan is inferred as 100% minus the % not needing a loan.

terprise, which is not the case in practice (many SMEs have working capital loans, several investment loans, and borrow from multiple institutions). The accuracy of the estimate is also undermined by the lack of representation of unregistered enterprises, which reduces the total number of enterprises in the country. Because these could number as high as 20,000, the demand figure could be substantially underestimated.

3.6.3 By type of SME

By virtue of its size, demand for loan finance appears to be the highest in the trade sector, though most of these loans are for working capital purposes given the low capital requirement nature of the businesses. Demand for agricultural loans, bolstered by the advent of government and donor support programs, has been growing in recent years, and can be expected to continue to do so as more agricultural startups emerge (following the trend of non-agricultural SMEs diversifying into the sector).

Enterprises of all sizes exhibit healthy demand for finance. Banks recognized that although they do not focus on the microenterprise sector, demand for micro-loans is high, and MFIs reported that they struggle to meet the demand due to their limited size and funding availability. Demand for finance among small and medium enterprises remains healthy due to continued improvements in lending conditions, especially interest rates.

The geography of SME loan demand appears to mirror that of SMEs in the country, with concentrated demand in the capitol city of Pristina, as well as other major cities such as Prizren and Peja. Given Kosovo's limited size (10,908 square kilometers) and dense population (159 inhabitants per square kilometer), servicing SMEs countrywide is not a major issue.

Both the ownership and management of enterprises by women is rather low in Kosovo compared to Eastern Europe and Central Asia, with just 5.6% of enterprises having majority female ownership in Kosovo compared to 12.2% for the region, and 7.2% having female top managers compared to 18.7% for the region according to the 2013 World Bank Enterprise Survey for Kosovo. This dynamic limits the demand for finance by women-owned and controlled enterprises in the country.

3.6.4 By instrument

Demand for SME loans in Kosovo is somewhat above the average for Eastern Europe and Central Asia according to the World Bank Enterprise Survey for 2013, which showed only 47.8% of enterprises not needing a loan compared to 51.1% for Eastern Europe and Central Asia on average. The Central Bank opined that demand for credit among SMEs has increased as a result of the recent decline in interest rates. Working capital loans are generally more in demand, while demand for investment loans is lower due to unstable political and economic conditions.

Due to the predominance of family owned enterprises in Kosovo, demand for equity finance is limited by the general preference of owners to retain control of their companies. None of the SMEs interviewed for this study expressed an interest in equity finance, preferring to keep the companies family-owned (an enterprise with over 40 employees maintained this position). All of the SMEs interviewed had family members employed in the businesses.

Demand for leasing and trade finance products is low due to the lack of awareness of the products among SMEs. None of the SMEs interviewed for this study had any experience with leasing, and expressed the belief that leasing products are only available for vehicles and are not applicable to their businesses.

Demand for trade finance is similarly low, and the SMEs that have heard of trade finance chose to forego it in favor of prepaying for inputs to obtain discounts from suppliers.

4 Supply analysis

Key findings:

- *Loans are the predominant funding instrument for SMEs in Kosovo.*
- *The supply of leasing and formal equity funding is virtually nonexistent for SMEs.*
- *Loan funding is skewed toward small and medium enterprises, with the dominant banks choosing to move away from the micro segment.*
- *Due to high levels of deposit funding, banks have ample liquidity, but MFIs need funding in order to serve the micro-enterprise market.*
- *Bank interest rates have declined sharply due to competition among banks for SME business.*
- *Collateral requirements are the major barrier for access to loans, in part due to issues with property rights.*
- *A national SME credit guarantee fund is currently being created, and is expected to alleviate the issue of collateral as a barrier to borrowing.*

4.1 Number and type of intermediaries

SME finance in Kosovo is provided by ten banks, 18 microfinance institutions (MFIs), and one organization offering purchase order finance (Crimson Capital Fund). Kosovo's one active leasing company, Raiffeisen Leasing, does not actively serve the SME sector, based on stakeholder opinions gathered through interviews conducted for this study. A national credit guarantee fund covering business loans, the law for which was approved by the Kosovo government in December 2015, is in the process of being established.

Because MFIs account for only 4% of the loans provided by the system, and over half of MFI loans are made to households, banks should be viewed as the main provider of financing to SMEs. Since SMEs represent the vast majority of enterprises in Kosovo, all ten banks pursue the sector, and continue to view it as an area of growth in spite of heavy competition for SMEs and declining interest rates.

With just over EUR 5 million in assets, the Crimson Capital Fund does not represent a substantial portion of the SME finance market, and there appear to be no intermediaries actively offering equity finance. SME finance support provided by the federal government is minimal and concentrated on the agricultural sector, but municipalities do occasionally provide targeted SME finance support. The 2015–2018 Program of the Government of the Republic of Kosovo sets forth the goals of subsidizing both agricultural loans and financing for startups, establishing the government's intention to increase its support for the SME sector.²⁴

4.2 Type of funding instruments

4.2.1 Loans

Loans are the primary funding instrument for SMEs, with the vast majority of the loan volume coming from local banks. Shorter-term working capital loans are the most popular, while investment loans are viewed as less in demand due to uncertain political and economic conditions. Lending activity, especially SME loans, has grown during the recent past in Kosovo, especially during 2015, as noted by the central bank's semi-annual Bank Lending Survey as of October 2015. This has been in large part driven by the improvement of lending conditions increasing demand, as described below.²⁵

²⁴ Republic of Kosovo (2015), *Program of the Government of the Republic of Kosovo* http://kryeministri-ks.net/repository/docs/Government_Programme_2015-2018_eng_10_mars.pdf

²⁵ Central Bank of the Republic of Kosovo (2015), *Financial Stability Report Number 8* <http://bgk-kos.org/repository/docs/2015/Central%20Bank%20of%20the%20Republic%20of%20Kosovo-FSR.%20No.%208.pdf>

SME interest rates have declined rapidly in recent years, reaching below 8% at the end of 2015 from over 13% on average in 2013 for banks, driving an increase in lending. Given this trend, rates can be viewed as reasonable. Tenors also appear to be sufficient, often stretching beyond 7 years for SMEs. Due to their relatively high cost of funds and operating costs, the interest rates of MFIs are much higher than that of banks, at 12% and upward as of January 2016.

Collateral requirements represent the greatest barrier to borrowing for SMEs as banks continue to employ conservative collateral practices. World Bank Enterprise Surveys revealed collateral requirements of 299.3% of loan value for 2013, although the figures quoted by banks during interviews were lower. Lenders generally do not take assets such as receivables and inventory as collateral, only accepting moveable and immovable assets with few exceptions. This is especially true for MFIs. As a competitive measure, some banks have adopted the practice of taking blanket pledges of collateral for up to ten years as a part of so-called “framework agreements”. While this allows for faster processing of new loans, it keeps customers from accessing loans from other banks. Kosovo’s issues with property registration further exacerbate the lack of collateral issue.

4.2.2 Leases

Leasing, especially as it applies to SMEs, is not developed in Kosovo. Raiffeisen Leasing and Factor Leasing are the only leasing providers in the country, and the companies offer very limited financing to SMEs. Crimson Capital Fund, a non-bank financial institution offering purchase order finance, intends to provide leasing to SMEs but is currently not offering the product due to a lack of liquidity (the firm is considering raising funds for this specific purpose). A lack of an aftermarket for equipment driven by the very small size of the manufacturing sector in the country and a lack of awareness of leasing among SMEs are key reasons for the undeveloped state of the leasing industry.

4.2.3 Letters of credit and trade finance guarantees

Trade finance products, especially guarantees, are primarily available to medium-sized businesses. For example, over 80% of ProCredit’s trade finance volume can be attributed to medium enterprises, and most of the trade finance volume at BKT is done in connection with larger energy efficiency and hydro-power projects. Other institutions interviewed for this study reported rather low trade finance volumes for SMEs, attributing the lack of focus on these products to lacking demand.

Based on surveys of three banks conducted for this study, letter of credit volumes to SMEs are negligible, representing 0.1% of the institutions’ loan portfolios or less as of June 2015. Guarantee volumes, at 1–6% of total loan portfolios, are more substantial.

4.2.4 Risk capital

Equity finance is an important gap in Kosovo, with no apparent examples of institutional equity investments made in the country beyond the regional Enterprise Expansion Fund's and EBRD's provision of EUR 6.5 million to Viva Fresh, a local grocery chain in June 2015. No such further investments were in EBRD’s pipeline at the time of the interview, and other multinational donors have not made any such investments in Kosovo in the recent past. World Bank Enterprise surveys reported that 7.9% of enterprise investments were financed through equity for 2013, suggesting the availability of non-institutional (private individual) equity funding.

The Kosovo Diaspora Investment Fund, established through the UNDP DEED (Diaspora Engagement for Economic Development) project, was meant to encourage the Kosovo diaspora to invest in the private sector. It was established in September 2014 as a legal entity, but has failed to attract any funds for investment. The intention of the fund was to tap the diaspora business networks in about twenty countries worldwide, with four to five investors needed to raise the desired EUR 1 million in capital for the fund. A fund manager was never chosen for the fund, and a pipeline was not established, which potentially contributed to the difficulty with attracting investors.

4.3 Characteristics of funding recipients

The supply of loan finance to small and medium enterprises is generally wide, save for the supply of unsecured loans. The supply of loans to micro enterprises (2–9 employees), on the other hand, is limited. Banks have recently increased their minimum business loan amounts, effectively exiting the micro segment and transferring the business to MFIs. Though MFIs focus on the micro-business segment, they operate on a small scale due to funding constraints (MFIs do not have access to deposits). The cost of funds for MFIs from microfinance investment vehicles and other sources amounts to 6–8%, which is on par with the rates currently offered to end borrowers by banks. Given this interest rate environment, some banks have begun to make loans to MFIs to meet their funding requirements.

The availability of equity finance appears to be minimal for all segments in Kosovo, with all stakeholders interviewed opining that formalized equity finance is scarce in the country.

Startup finance is limited, with most lenders requiring at least six months of financial statements for loan eligibility. Banks did report a willingness to finance new ventures of existing enterprises. For example, agricultural startups have become popular among Kosovo's established businesses given the increased government and donor support for the sector, and banks have provided financing for these startups.

Though most banks reported an interest in lending to the manufacturing sector, the Central Bank reported that about half of loans to enterprises of all sizes are to the trade and service sectors, reflecting the distribution of enterprises in Kosovo overall. This breakdown is further supported by the data reported by financial institutions surveyed for this study, which showed 31.3% of SME loans being allocated to trade, and 26.7% to services as of June 2015, as shown in the table below. Supply of agricultural finance has improved significantly due to demand spurred by government and donor support of the sector, with banks beginning to devote specific personnel to the sector and introducing seasonal agricultural loans. Agricultural loans accounted for 20.7% of the SME loans at the institutions surveyed.

Table 4. SME lending by economic sector, June 2015

Sector	Proportion of SME loans
Agriculture	20.7%
Manufacturing	11.3%
Services	26.7%
Trade	31.3%
Other	10.0%
TOTAL	100%

Source: BFC survey of four banks and MFIs

Access to finance by SMEs led by women is supported by donors. For example, EBRD extended a EUR 3 million credit line to TEB bank to support women-led enterprises along with a first-loss cover against poor credit quality.

In part due to Kosovo's small size, access to SME finance in areas removed from Pristina does not appear to be an issue, with the major banks offering wide branch networks and placing SME lending specialists in all or most branches, with some banks dedicating specific areas of branches to SME services.

4.4 Institutional and regulatory issues

4.4.1 Issues for Banks

The lack of collateral is a major impediment to access to loans, with banks reporting the lack of collateral as the top factor constraining the supply of SME loans. The issue is further exacerbated by the following:

- Due to the legal system's shortcomings, collateral enforcement is difficult, and drives higher collateral requirements according to the Central Bank. While lacking functionality of the judicial system remains as an impediment to resolving problem credits, the recent introduction of private arbitrators has allowed banks to begin to liquidate collateral more quickly, and should improve access to finance in the near future. Banks reported that resolutions typically take about a month through private arbitration. Because the number of private arbitrators in the market is currently limited, they are not able to fully meet demand from lenders. The system also only works when the disputed collateral is properly registered.
- Loans against accounts receivable are not currently feasible because receivables cannot be legally registered as collateral.

A national SME credit guarantee fund, supported by USAID and KfW, will soon be established in Kosovo. The law to establish the fund was passed in December 2015. The fund is expected to help ease collateral requirements for SMEs (with the guarantee taking the place of higher collateral coverage), and will have EUR 12–15 million in capital to start.

The facility is expected to drive roughly EUR 70–80 million in new loan volume. Loans guaranteed by the fund are expected to amount to EUR 10,000–20,000, with loans to medium size businesses reaching up to EUR 100,000. Companies with less than EUR 500,000 in turnover and fewer than 250 employees will be eligible to participate. Specific loan products eligible for guarantee coverage are to be designed in cooperation with partner financial institutions. A separate agency for handling the scheme is envisioned, but detailed plans have not been put into place. Banks reported that the guarantee scheme should allow them to relax collateral requirements once it is in place.

The guarantee fund will expand on the success of USAID credit guarantee programs, which offer 50% risk sharing for loans covered by the guarantees. The most recent facility covered agricultural loans, and USAID reported that the agricultural facility has been successful in encouraging banks to increase lending to the sector. The facility was also reported to decrease collateral coverage requirements for agricultural enterprises by 25% and interest rates by 2%. A total of six banks participated in this facility, and a new USD 12–15 million facility is in the works.

4.4.2 Issues for MFIs

MFIs can only provide loans up to EUR 25,000 according to Kosovo's Law on Banks, Microfinance Institutions and Non-Bank Financial Institutions. This leaves MFIs unable to service larger clients, including SMEs that grew while being MFI clients.

4.4.3 Issues for Leasing Companies

Leasing activities are covered by the Leasing Law (for non-real estate leases) and the Obligations Law (for real estate leases). EBRD's 2013 assessment of the laws of Kosovo did not identify deficiencies in the regulatory system for leasing.²⁶

4.5 Funding of intermediaries

Kosovo's banks enjoy ample liquidity, mostly due to the high level of deposit funding available to the sector. Deposits funded almost 80% of bank assets as of year-end 2015, with shareholder equity being

²⁶ EBRD (2013) *Commercial Laws of Kosovo, an Assessment by the EBRD*

the second largest funding source at 11.6% of assets. Over 70% of bank deposits come from households, highlighting the stability of this funding source, and most banks have access to additional funds from parent organizations. Deposit funding has remained strong despite the decline of interest rates (the weighted average rate for deposits was 1.2% at the end of 2015)²⁷. For these reasons, funding is not a constraint for SME access to bank loans.

MFIs, which do not have access to deposits, are more constrained by funding in their ability to provide loans to SMEs. MFI funding typically comes in the form of borrowings from international microfinance investment vehicles, local banks, and multinational donor organizations, and is thus available at roughly the same rates as the end-user bank loans in Kosovo (around 6–7% following the recent bank interest rate drops). The availability of less costly funding to MFIs would allow them to better serve the SMEs whose size and risk profiles are less attractive to banks. During meetings MFIs reported having the capacity to absorb more funds at market rates due to the exit of the market-leading ProCredit bank from the microfinance market.

The only local equity funding intermediary, the UNDP supported DEED fund, has suffered from a lack of funding due to its inability to attract investment from Kosovo's diaspora as planned. An influx of investment into the fund could spur some equity financing of SMEs, although the fund would need to attract a management company and develop an investment strategy prior to working with SMEs.

Crimson Capital, the purchase order financing company, utilizes all of its funding and believes that much more of such financing could be absorbed by Kosovo's SME market were it to become available.

4.5.1 Government

Due to budgetary constraints, the government largely relies on development finance institutions (DFIs) to provide the funding for financially supporting SME development programs. The Rural Development Grant Program, intended to improve agricultural production infrastructure in order to increase the productivity of agricultural enterprises is a rare example of direct government support to enterprises. The program has facilitated the construction of new greenhouses and the planting of new orchards, among other improvements, attracting donor funding to match the budgetary outlays.

The upcoming Credit Guarantee Fund, as described in section 5.4 above, will be one of the most concrete government efforts to support SMEs in Kosovo to date.

4.5.2 Development finance institutions

DFIs provide funding to SMEs by using banks and MFIs as intermediaries, and direct investment and lending to enterprises has not occurred in recent years²⁸. Institutions such as EIB, EFSE, EBRD, and USAID provide credit lines to banks and MFIs for special purpose on-lending, covering agriculture, women-owned enterprises, energy efficiency, and SMEs in general.

MFIs utilize DFI funding from sources such as the EFSE fund rather actively. The EBRD has been heavily involved in supporting the SME sector, providing energy efficiency loans through MFI partners via its KOSEP program (EUR 15 million, almost fully utilized by year-end 2015), as well as loans and technical assistance to female-owned and run businesses through TEB bank.

4.5.3 Parent banks

Among Kosovo's ten banks, eight are subsidiaries of foreign holding companies and only two are domestically owned, and over 90% of bank assets belonged to banks with foreign ownership as of year-

²⁷ Central Bank of Kosovo (February 2016), *Financial System Monthly Information December 2015* http://bqk-kos.org/repository/docs/2015/12_FINAL%20Monthly%20Info%20December%202015.pdf

²⁸ EBRD made a single equity investment into a large local grocery chain in 2015, but the size of this company and of the investment was large.

end 2015²⁹. Thus, the majority of the country's banks have access to funding from foreign parent companies with excess liquidity. Given the wide availability of deposit funding, borrowings from parent companies are not widely used, and their use has declined as deposits have grown in importance. Parent company funding accounted for a minimal 1.5% of the assets of Kosovo's five largest banks as of year-end 2015, and has not changed compared to 2013 (1.6%) based on data presented in the 2014 audited financial statements for the five institutions (the list of institutions is presented in Annex 3).

4.5.4 Local commercial sources

Banks use borrowings from other local commercial banks, but these also do not represent a significant portion of assets (1.7% as of June 2015). These tend to be short term funds (30 days or less) sourced from parent companies by the lending institutions.³⁰

MFIs have recently begun obtaining funding from local commercial banks at interest rates similar to those available from international commercial sources (around 6%) following the decline in lending rates in Kosovo.

4.5.5 Other sources

MFIs actively obtain loans from commercial microfinance investment vehicles at rates of around 6%. Nongovernmental organizations, such as World Vision, also play a role in providing funding to SMEs in Kosovo through MFI on-lending, though their contribution to the overall supply of funding is small. The Kosovo Crimson Finance Fund, with USD 5.4 million in funding, is provided entirely by the privately owned Crimson Capital.

4.6 Supply estimate

The supply of finance to SMEs is estimated at EUR 901.1 million. This is based on year-end 2015 data published by the Central Bank³¹, as well as portfolio breakdown data provided by three banks and two microfinance institutions. Central bank figures are as of year-end 2015, and bank figures (affecting the estimated proportion of SME loans to total loans) are as of June 30, 2015. The most recent available figures were used in all cases.

Table 5. Estimate of SME loan supply at (date) (currency figures in EUR millions)

	Banks	Non-bank FIs	Total
A. % of FIs offering SME loans	100	100	n/a
B. SME loans to total loans (survey)	40.3%	72.4%	n/a
C. Total loans (EUR millions)	2,019.4	87.4*	2,106.8
D. SME loan supply estimate (=A*B*C)	813.7	87.4	901.1

*Includes loans from MFIs and the Crimson Capital Fund

The supply of leasing to SMEs is estimated at a very low EUR 10.4 million as of June 2015, calculated by applying the proportion of leasing allocated to enterprises (46.5%) to the total amount of leasing in the market (EUR 22.4 million).³²

The supply of equity finance to SMEs in Kosovo can be estimated as virtually zero as the only equity investment made in 2015 was to one of the largest businesses in the market.

²⁹ Central Bank of Kosovo (February 2016), *Financial System Monthly Information December 2015* http://bqk-kos.org/repository/docs/2015/12_FINAL%20Monthly%20Info%20December%202015.pdf

³⁰ IBID

³¹ IBID

³² Central Bank of Kosovo (2015), *Financial Stability Report Number 7* <http://bqk-kos.org/repository/docs/2015/BQK-ENG-FSR%207.pdf>

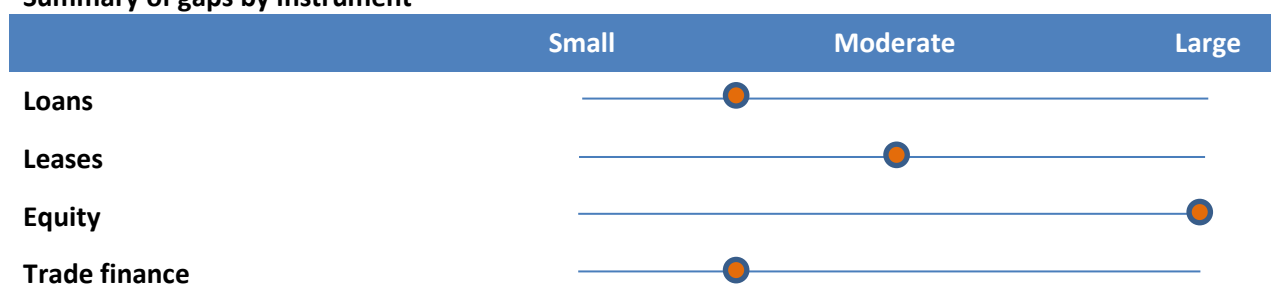
5 Gaps in private sector financing

Key findings:

- Bank loans are widely available to small and medium, but not micro enterprises due to a lack of interest in this segment.
- Equity finance in all forms (private equity, venture capital, angel investment) is lacking.
- Clients without sufficient real estate or moveable asset collateral generally lack access to finance, but this issue is beginning to be solved through guarantee funds.
- Though innovation activity in Kosovo is very limited, funding for startups is a major gap.
- Financial education for SMEs would be needed to create demand for currently unavailable products such as leasing and equity funding.

5.1 Gaps by instrument

Summary of gaps by instrument



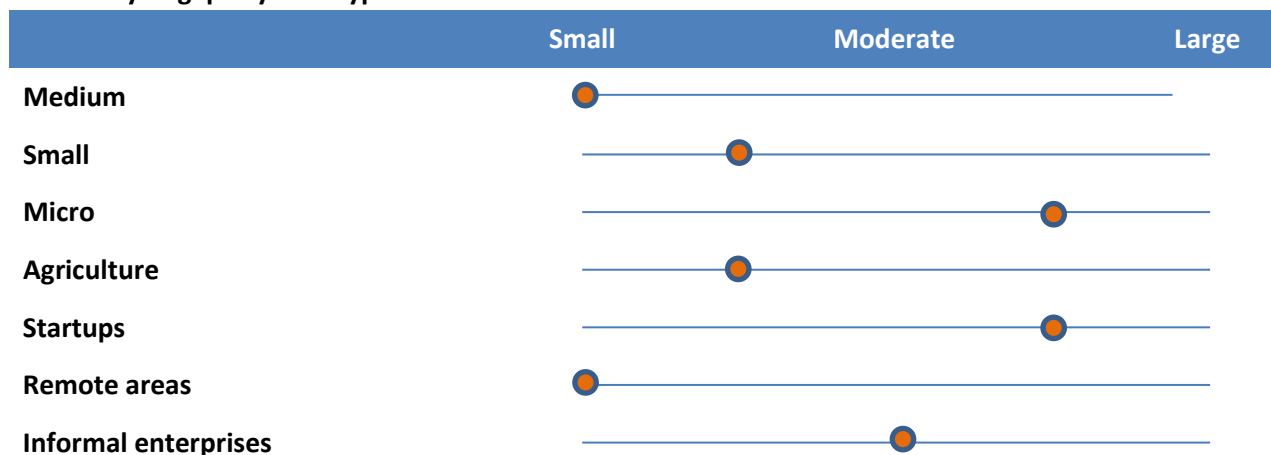
With the notable exception of microloans, the availability of SME loans is sufficient. Interest rates have declined and are now reasonable, and available maturities are sufficient to finance investments. High collateral requirements are the most important barrier to SME borrowing, making credit guarantees to support loans in lieu of collateral a much needed product in the market.

There is a major gap in equity finance in Kosovo, with no institutions making equity investments in the country beyond the few intermittent investments by multinational donors. Demand for equity finance is low due to the prevalence of family-owned businesses and the lack of innovative companies, and much financial education and awareness building would be needed to create the demand. Nonetheless, the infusion of risk capital into the market would be instrumental in encouraging more innovative businesses to develop in the country.

Because the leasing sector is relatively undeveloped, and leasing products are not available to SMEs, awareness of the product is low and limited to vehicle leases, causing SMEs to believe that leasing is not applicable to them. As is the case with equity finance, awareness building would be needed in order to increase demand for leasing if the products became available to SMEs. Because demand for trade finance is similarly limited by awareness, and trade finance products are available from several banks in Kosovo, demand for trade finance products does not appear to exceed supply.

5.2 Gaps by type of SME

Summary of gaps by SME type



There is sufficient supply of loans to small and medium enterprises given the high liquidity of banks, but loan funding for microenterprises is insufficient. The largest banks have deemed the sector unprofitable and have exited the microloan business, leaving MFIs to struggle to meet the demand with limited funding sources. Smaller SMEs interviewed for this study reported that banks were not interested in their business (loans of EUR 10,000 and below), and that they chose to work with MFIs for this reason; however, the MFI sector is not large enough to adequately meet the demand in the market.

A previous gap in agricultural finance is in the process of being filled, with banks developing specific agricultural lending capacities following the growth of government and donor support to the sector.

Because banks do not lend to enterprises with less than six months of financial statements, and equity finance is generally unavailable, there is a significant funding gap for startups. Support structures for startups such as incubators are also missing, and the lack of innovative enterprises in Kosovo may be the direct result of these shortfalls.

5.3 Gaps in funding of intermediaries

Banks have access to more than sufficient liquidity, but have a need for guarantee facilities in order to lend with less conservative collateral requirements. Continued guarantee programs from USAID and the upcoming national guarantee fund will take care of some of these gaps, but there could be space for additional credit guarantees, especially for targeted areas such as startups.

Given the increased demand for microloans from MFIs following the departure of banks from the sector, the insufficient funding of MFIs at rates that would allow on lending to clients under acceptable conditions represents an important intermediary financing gap.

The only equity fund existing in the country (DEED) is not active and lacks a fund manager, but it also suffers from a lack of capitalization as it has not attracted any investments thus far from its target group, the Kosovo diaspora.

5.4 Potential and capability of IFIs to fill gaps

Given the limited support available from the government, IFIs play an important role in SME finance development in Kosovo, as follows:

- **EBRD**, along with the Enterprise Expansion Fund (**ENEF**), is a rare equity investor, providing EUR 6.5 million in funding to Viva Fresh, a large local grocery chain, for expansion and moderniza-

tion. Unfortunately, EBRD reported no other potential investments in the ENEF pipeline for Kosovo. Additional support for SME finance from EBRD has come through its support of ProCredit Bank and the Deposit Insurance Fund of Kosovo.

- **IFC** has not made any direct investments into private enterprises in Kosovo in the recent past, but supports the sector through providing funding to Kreditimi Rural I Kosoves (KRRK), a local microfinance institution. In July 2015 IFC extended a EUR 1.5 million credit line to KRRK for on-lending to micro and small enterprises. IFC also issued a EUR 3.5 million credit line for SME lending to TEB Bank in 2013.
- **KfW** historically played an important role in fostering SME finance in Kosovo by setting up ProCredit Bank (now the largest bank in the country), and supporting the creation of the country's deposit protection fund in 2011. In recent years KfW has curtailed its direct involvement with the SME sector, but participates in large multi-donor initiatives such as the planned national guarantee fund, as described earlier in this report.
- **UNDP** supports SME finance through the DEED diaspora engagement project, which aims to bring investment from the successful Kosovo diaspora to the country's enterprises. As discussed earlier in this report, DEED set up a legal fund for diaspora investments but has thus far been unable to attract any investor funding.
- **USAID** supports SME finance through its Development Credit Authority (DCA) guarantee facility, which provides 50% risk sharing for individual loans to the agricultural sector by local banks, as described earlier in this report. From its start in 2012, a total of USD 22 million in loans was generated through the facility as of January 2016. The USAID has also provided 36 grants to enterprises totaling USD 1.2 million to enterprises for capacity building through its EMPOWER program since 2014.
- **The EIB Group** offers credit lines to banks in Kosovo for general (not sector-specific) SME lending. Together with EBRD and the European Commission, EIB is also one of the founding partners of the Western Balkans Enterprise Development and Innovation Facility. This facility consists of an early-stage venture capital fund, the Enterprise Innovation Fund (ENIF), a growth-stage fund, the Enterprise Expansion Fund (ENEF, managed by EBRD), a loan guarantee facility, and a support services facility offering technical assistance directly to SMEs and other stakeholders. The guarantee facility is working with ProCredit Bank Kosovo with a guaranteed portfolio amount of EUR 20 million. The EIB group is also involved in financing projects not related to access to finance, such as the construction of highways and hydroelectric plants.

Considering the high levels of liquidity available to Kosovo banks, additional bank financing is not needed at this time. MFIs did report a need for funding given the increased demand created by the exit of major banks from the microfinance market in spite of the much higher rates charged by MFIs.

Banks that had access to the USAID's credit guarantee facility reported satisfaction with the program and demand for additional such support. Though the soon-to-be-approved multi-donor government supported guarantee fund will likely meet a lot of the demand for such support, there is likely space for additional targeted guarantee funds, for example for the financing of startups in sectors such as information technology and export-oriented high value crops such as mushrooms, berries, and medicinal herbs.

5.5 Recommendations

Very high unemployment, including youth unemployment, is one of the most important challenges facing Kosovo. The shortages in micro-enterprise funding, equity funding, and startup support programs are a barrier to the creation of additional workplaces in small firms and income opportunities through entrepreneurship. By working to address these issues with access to finance, IFIs could significantly contribute to creating work opportunities for Kosovo's population. Specifically, IFIs could consider the following:

- Offer a preferential microfinance-specific credit line to banks in order to encourage them to re-focus on the micro-enterprise sector. Provide technical assistance to participating banks to help them develop and implement efficient lending models for microenterprises.
- Provide funding to MFIs, either directly or through dedicated credit lines to commercial banks, designed for on lending to MFIs. The credit lines could specifically target youth entrepreneurship, or include an interest rate discount for younger borrowers in order to address the youth unemployment specifically.
- To help reduce unemployment, sponsor loan programs whereby SME borrowers receive financial incentives for adding jobs (for example, interest rate discounts, grace periods, or looser collateral requirements through a credit guarantee scheme). Incentives for hiring younger workers or perhaps offering internship positions could also be considered.
- Given the absence of equity finance in Kosovo, engage with the Diaspora Engagement for Economic Development project to discuss ways in which technical assistance could be leveraged to push forward its stagnant diaspora engagement fund. Assistance with finding a fund manager that could develop an investment pipeline to be used for pitching the fund to diaspora investors is one potential option.
- Following the launch of the new national credit guarantee fund, investigate the need for additional capital for the existing fund in order to further reduce the collateral requirement burden for SME borrowers.

Annex 1: Macroeconomic indicators

Indicator	2015	2014	2013	2012	2011	2010
GDP (nominal, EUR millions)	5,755	5,518 ³³	5,326.6	5,059	4,815	4,402
Population (millions)	n/a	1.8	1.8	1.8	1.8	1.8
GDP (nominal) per capita (EUR)	n/a	3,065	2,959	2,810	2,675	2,446
GDP (PPP) per capita (EUR)	n/a	7,507	6,526	6,473	6,354	5,813
Real GDP growth rate	3.4	2.7	3.4	2.8	4.4	3.3
Inflation rate (CPI)	-0.5	0.4	1.8	2.5	7.3	3.5
Unemployment rate (official)³⁴	n/a	35.3	30.0	30.9	n/a	n/a
Poverty rate (WB, USD 1.90 per day)	n/a	n/a	n/a	n/a	n/a	1.6
Current account balance (% of GDP)	n/a	-8.0	-6.4	-7.5	-13.7	-11.7
Trade balance (% of GDP)	n/a	-31.1	-31.6	-34.1	-37.2	-35.3
Capital account balance (% of GDP)	n/a	-7.5	-5.7	-7.3	-12.8	-11.2
FDI (% of GDP)	5.5	2.7	5.3	4.5	8.0	8.4
Central bank reserves (% of GDP)	n/a	n/a	n/a	n/a	n/a	n/a
Public debt (% of GDP)	n/a	10.6	9.1	8.4	n/a	n/a
Fiscal balance (% of GDP)	-1.9	-2.4	-2.9	-3.0	n/a	n/a

Sources: Central Bank of Kosovo, Kosovo Agency of Statistics, and World Bank Databank (converted from USD using official European Central Bank rates). Cells marked n/a indicate unavailable data.

Sectoral distribution of GDP (% of total)

Sector/activity	2009
Services	64.5%
Industry	22.6%
Agriculture	12.9%
TOTAL	100%

Source: CIA Fact Book estimates, latest available.

Sectoral GDP breakdowns are not published by local authorities.

³³ World Bank GDP figures were used for all years but 2015. These differ slightly from figures reported by the central bank.

³⁴ Unemployment data was not gathered during 2010 and 2011 due to a lack of resources for the statistical bureau

Annex 2: Financial sector indicators

Banking sector indicators

Indicator	2015	2014	2013
Structure of the sector			
Number of banks by type:			
Foreign-owned	n/a	8	7
Domestically-owned	n/a	2	2
Total banks	n/a	10	9
Number of state-owned banks:			
Assets of SOBs to total bank assets	n/a	0	0
5-bank concentration ratio	n/a		
Bank branches per 100,000 adults	n/a	20.9	22.6
Financial indicators (EUR millions)			
Total assets	3,387	3,187	3,049
Total loans	2,019	1,882	1795
Total deposits	2,701	2,538	2,443
Total equity	n/a	323	281
Total regulatory capital	n/a	n/a	n/a
Total net profit	n/a	60	n/a
Financial ratios			
Capital adequacy:			
Total CAR (%)	n/a	17.8	16.7
Equity to total assets	n/a	10.1	9.2
Liquidity:			
Loans to deposits (%)	74.8	74.2	73.4
Growth rate of deposits (%)	6.4	3.6	7.9
Regulatory liquidity ratio ³⁵ (%)	n/a	43.3	48.4
Profitability:			
Return on average assets (%)	n/a	1.9	1.2
Return on average equity (%)	n/a	20.2	12.5
Asset quality:			
Growth rate of loan portfolio	7.2	4.8	n/a
NPL ratio (%)	n/a	8.3	8.7
Others:			
Growth rate of total assets (%)	6.3	4.5	n/a
Bank assets to financial sector assets (%)	69.2	70.3	n/a

Source: Central Bank of the Republic of Kosovo Monthly Report of the Financial System, December 2014 (latest available figures from the CBK)

³⁵ Liquid assets (broad)/short term liabilities

Annex 3: Largest lending institutions

Banks by asset size as of December 31, 2014

	Bank name	Website	Assets (EUR 000s)
1	ProCredit Bank	http://procreditbank-kos.com	883,200
2	Raiffeisen Bank	http://raiffeisen-kosovo.com	788,000
3	NLB Prishtina	http://nlbprishtina-kos.com	493,300
4	TEB SH.A.	http://teb-kos.com	394,900
5	Banka Kombetare Tregtare – Kosove	http://bkt-ks.com	252,500
6	Economic Bank	http://bekonomike.com	183,400
7	Bank for Business	http://bpbbank.com	120,900
8	Komercijalna Banka AD Beograd – Mitrovica Branch	http://kombank.com	57.8
9	Turkiye IS Bankasi	http://isbankkosova.com	36.6
10	Turkiye Cumhuriyeti Ziraat Bankasi	http://ziraatbank-kosova.com	n/a

The largest MFIs by asset size as of September 2013 – September 30, 2015

	MFI name	Website	Assets (EUR 000s)
1	KEP	http://keponline.net	20,400
2	FINCA	http://FINCA-ks.org	16,700
3	AFK	http://afkonline.org	12,600
4	Kreditimi Rural E Kosoves (World Vision)	http://krk-ks.com	9,900
5	Kosovo Grameen Missione Arco-baleno	http://amik.org/english/?page_id=114	6,400

Source: MixMarket data

Annex 4: World Bank Doing Business Indicators 2016

Source: <http://doingbusiness.org/data/exploreconomies/kosovo>

Indicator	Rank
Ease of doing business	66
Starting a business	47
Dealing with construction permits	136
Getting electricity	124
Registering property	32
Getting credit	28
Protecting minority investors	57
Paying taxes	67
Trading across borders	71
Enforcing contracts	48
Resolving insolvency	163

Getting credit indicators

Indicator	Value
Strength of legal rights index (0–12)	8.0
Depth of credit information index (0–8)	6.0
Public registry coverage (% of adults)	95.2
Private bureau coverage	0.0



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