RIINVEST
INSTITUTI PËR HULUMTIME ZHVILLIMORE
INSTITUTE FOR DEVELOPMENT RESEARCH

SME FINANCING AND DEVELOPMENT

Prepared by the Riinvest Institute for Development Research within the USAID-Supported Project "Promoting Economic Development Through Civil Society" and Implemented with the Center for International Private Enterprise (CIPE)

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SMALL AND MEDIUM SIZE (SME) ENTERPRISE FINANCING AND DEVELOPMENT

I. Executive Summary

(1) The SME sector is playing a very important role in Kosova's economic development. It is the major source of job creation and income generation and has shown rapid post-war revitalization. Employment in private enterprises is increasing, and structural changes within enterprises can also be observed, with a fall in the proportion of trade companies and an increase in the share of production firms. It is also estimated that during the post-war period the contribution of private business in GDP has increased to more than 65%.

(2) In the past two years the international administration, donor community and many other actors have intensively addressed different issues related to small and medium size enterprises, and a favorable climate for SME development has been created. However, despite efforts to establish new legislation and market economy institutions as part of Kosova's reconstruction, lacking are clearer steps to support small and medium size enterprises which recognize the important contribution that SMEs make to the economy. This includes the absence of an overall SME development strategy and a national SME Policy, and related implementing mechanisms such as an institution that would coordinate government support to this sector.

(3) Steps taken by the international administration to build a market economy have included the licensing of the first commercial banks and non-bank financial institutions, which are beginning to engage in SME and business financing and development. The activity of the Micro Enterprise Bank (MEB) was very important because this was the first bank to issue loans in post-war Kosova, and has thus become a cornerstone in building a system for business financing. Three other banks have commenced operations during the first 6 months of 2001, which has helped lead to better conditions for SME financing and the creation of a more competitive banking market.

(4) Despite their continuing development, Kosova SMEs face a number of barriers to development, the most serious of which are the lack of a fully developed legal framework, unfair competition, and the lack of access to external sources of finance. Almost 2/3 of enterprises surveyed by Riinvest in late 2000 state that the lack of access to external sources of finance is a barrier causing serious problems.

(5) There appears to be a significant discrepancy between the demand for and supply of credit. According to the Riinvest enterprise survey, planned investment per enterprise is 562,000 DM (much greater than investment carried out to date), while the average demand for credit per enterprise is 347,696 DM, or 61% of the planned investment per enterprise. The highest demand for credit comes from the trade (53.9 %) and production (39.5 %) sectors. Over the period 2001 – 2003 banking and non-banking financial institutions estimate that they will provide

about 760 million DM in credit, with over half of this total to be supplied in the year 2003.

(6) There is also a strong but largely unmet demand for longer term credit. Nearly 90% of enterprises surveyed expressed the preference for credit in excess of one year, while the repayment period for the vast majority of banks and non bank financial institutions is less than one year. Thus, even with a significant adjustment downward to offset what might be over optimistic business estimates of expansion plans and credit needs, it is clear that a credit gap exists in the Kosovar economy.

(7) There are a limited number of financial instruments currently being offered on the Kosova market. Financial instruments like leasing, factoring, and loan guarantee programs, commonly available to small business in other transitional countries, are not being offered. While the focus in this initial phase of building a market economy and financial institution sector is understandably on more traditional credit instruments, consideration should be given at some point to the introduction of other kinds of financial instruments to ensure greater SME access to finance.

(8) Initial indications appear to show a good repayment culture within the Kosovar business community. If this continues, it will bode well for SMEs becoming serious clients of financial institutions and for banks and business to work effectively together.

(9) Gaps in the legal/regulatory framework are contributing significantly to the lack of access by business to external finance. This includes, in particular: (i) the as yet unapproved mortgage and bankruptcy regulations; (ii) the absence of implementing mechanisms (registries) to record movable and immovable assets pledged as collateral (which would make it easier for banks to ascertain the encumbrance status of a particular asset); and (iii) the lack of effective enforcement mechanisms for mortgages, including an extra-judicial foreclosure proceeding.

(10) SME financing terms and conditions *vis-a-vis* other neighboring and transition countries are similar (lending rates are currently between 12 – 18% annually, repayment periods of between 1 – 3 years, and a maximum available loan amount of 400,000 DM. However, Kosova is a country that has only recently emerged from a devastating war and is facing major damage to property (including commercial property) and infrastructure. Current terms and conditions provided by banking and non-banking financial institutions are considered more favorable for expanding of existing businesses as opposed to start-ups. Given the vitality shown by the Kosova private sector since 1999 in rejuvenating the economy, the question arises as to whether typical approaches to SME finance as applied in other transition countries are adequate in the face of such large and urgent reconstruction needs.

(11) Signs point to the beginning of competition in the banking sector. Loan volumes are higher, lending rates have fallen, the costs of specific banking services appear to be declining, and in general experience continues to be gained within this very new set of financial institutions. However, the dominance of very short term deposit bases within the commercial banks makes it difficult to contemplate significantly greater term lending in the foreseeable future.

(12) During the emergency phase of development, the international community provided financial support for rehabilitation and renewing of businesses largely in the form of grants. In the current phase of reconstruction, banks and non-bank financial institutions are using loans and micro credit schemes as a support for SME development. In the future phase, depending on development dynamics in the financial markets and privatization, other types of instruments can be expected to be introduced, including leasing, guarantees, and venture capital.

(13) SMEs' capacity to absorb credit appears limited, and management and other skills within firms are generally considered weak. However, the donor-supported business support programs currently operating cover just a very small portion of the enterprise sector.

II.Recommendations

Policy

- UNMIK and the upcoming new Kosovar government to lead the development of a SME Strategy for Kosova that reflects the important role and contribution of small and medium size firms to the Kosova economy. This strategy could include (i) an assessment of needed financial support for the sector, and the identification of international and other sources that could be attracted to fund, for example, market-based SME Credit Lines and/or other arrangements involving local institutions; and (ii) a coordinated approach to technical assistance that identifies gaps between SME skill needs and technical assistance currently being provided. Consideration should also be given to the establishment of an institutional implementing mechanism for this strategy.
- UNMIK to support a broadening of the range of SME finance initiatives currently available, including consideration of new relationships with donors and other entities that result in SME financing alternatives to reduce gaps between credit supply and demand. In particular, a strategy for improving the management of, and investment in, key infrastructure sectors is needed to alleviate the extra burden faced by Kosova enterprises in often having to finance major amounts of infrastructure as part of their business development and investment.
- UNMIK to stimulate increased competition within the banking system and nonbank financial institutions that will lead to further improvement in loan and financing conditions. This to including the prudent extension of additional banking licenses, and equal conditions, where appropriate, for banks' participation in economic development and their access to potential public deposits.

- Create possibilities for promoting and supporting export activity, including opportunities for Kosovar SMEs to cooperate with foreign partners including joint ventures.

Regulatory Framework

- Approval by UNMIK, in the near future (possibly during the next month) of the following regulations:

  - Mortgage regulation;
  - Bankruptcy regulation;
  - Accounting regulation.

- Adoption of an extra-judicial enforcement mechanism for mortgages that would permit the sale of mortgaged property under certain limited circumstances, and would represent an efficient, effective and fair way for the creditor to recover the mortgaged property in the event of debtor default.
- Immediate establishment and commencement of operations of the pledge and mortgage registries, and the official business registration registry.
- Address the underlying problems causing uncertainty in land ownership, continuing efforts to create a multipurpose cadastre including a juridical component linked to the mortgage registration system, and building up an inventory of land ownership records.
- Address the potential judicial capacity shortages in appointing and training judges and administrators to ensure successful implementation of the bankruptcy regulation.
- Add definitions of specific financial products such as leasing, guarantees and factoring to the set of regulations governing the bank and financial institution sector.
- Consider a reassessment, once banks build a stronger track record in lending activity, of clauses in the pledge regulation that may be inhibiting certain types of commercial transactions.
- Operationalize as soon as possible, through the issuance of instructions, the implementation of approved commercial regulations.
- Development of the legal and regulatory framework in a more transparent way, including greater opportunities for the business community to participate in the process.

Banking Community

- Educate banks about the importance of sharing borrower information in a regular and systematic fashion. Promote the advantages of membership in the Kosova Credit Information Service to all banks and financial institutions.

- Support the establishment of a Kosova Bankers Association to unite the interests of the banking sector, and use this vehicle to adopt best practices and standards in product development and service provision within the industry.
- Target an information campaign to the banking community about the role of the pledge registry. Successful introduction of the registry with the small number of existing banks would facilitate faster acceptance over time as the entire banking system expands.
- Introduce an information campaign to banks and businesses about the different pledge options available, including the inventory pledge which is not widely used.
- Promote to banks, through information and education, the use of the mortgage registry.
- Support greater and more consistent information sharing between the BPK and other government and non-government audiences, including more regular reporting by the BPK of credit and deposit flows.

Business Community

- Continue training to business on the new accounting requirements as a critical factor in increasing their readiness to work with financial institutions.
- Carry out a public education campaign about bankruptcy as a concept of business reorganization and not business failure.
- Business associations to act as a conduit of information to their members about banking and financial sector credit opportunities, terms and conditions.
- Continue and significantly expand international technical assistance support for the business sector to build their skills and capacities.

Donor Community

- Consideration of greater support for SME credit lines and other credit lines aimed at specific segments of the business community, and which could involve on-lending arrangements with local banks.
- Increased technical assistance support for business skill development, including a greater assistance at the regional level.
- Undertake further research to address the potential for offering leasing and factoring services and loan guarantee programs on the Kosova market, and which for each would address market potential, needed regulatory framework, and information and training.

III. Background

The Riinvest Institute for Development Research in Prishtina, in cooperation with the Washington-based Center for International Private Enterprise (CIPE), is implementing a project entitled "Promoting Economic Development through Civil Society" which is supported by USAID. The objective of this project is to strengthen economic policy and the business environment in Kosova through the greater involvement by the local business community in the policy debate. To date the project has addressed the issues of taxation policy and privatization, and the results have been presented at two International Roundtable Forums. The third topic, and the subject of this report, is the issue of SME access to finance.

IV. Purpose of the Report

The purpose of this report is to analyse the access by SMEs to sources of finance and provide policy and other recommendations to strengthen this access.

The report has addressed the following specific issues:

- The role and importance of SMEs in the economy, and the institutional environment supporting SME development;
- The current state of business finance, and access to external financial sources as a barrier to business development;
- Key legal and regulatory issues impacting the access to external finance by the business community;
- SME needs for financial support;
- The activities of banking and non-banking financial institutions currently operating in Kosova, including their lending activity to the private sector and the specific features of this lending activity;
- The managerial capacities of firms in Kosova and the technical assistance being provided to strengthen this capacity;
- Providing recommendations to improve the system of SME finance in Kosova.

V. Activities Undertaken in the Preparation of the Report

The following activities were undertaken by Riinvest staff in preparing this report:

(i) Review of findings of other Riinvest projects realized to date, including:

- “Economic activities and Democratic Development for Kosova ”;
- “Post War Reconstruction of Kosova – Strategy and Policies”;
- Survey with 300 private enterprises 1997, 1999 and 2000;
- Survey with 3500 family economies and businesses;
- Survey on SME Credit Needs Assessment, Riinvest/EAR/World Bank.

(ii) Discussions and interviews with banks, including the Micro Enterprise Bank (MEB), New Bank of Kosova, Bank for Private Business, and Economic Bank, to become familiar with their current and planned future credit activity, their operations, and to discuss the most serious legal and other barriers which may be restricting this credit activity, with emphasis on the pledge and mortgage registries and the mortgage regulation.

(iii) Meetings with non bank financial institutions, including ICU, USAID KBFF, Mercy Corps’ Agency for Finace in Kosova(AFK), and Besëlidhja Micro Finance, to discuss their credit terms and conditions, future planned credit activity, the repayment discipline in the business community, their participation in the Kosova Credit Information Service, and the importance of financial sector competition and financial market development for long-term SME financing.

(iv) Meetings with officials of various UNMIK departments, including:

- Department of Trade and Industry (DTI), to primarily discuss key regulatory pillars impacting business access to finance, and their current approval and implementation status;
- Banking and Payment Authority of Kosova (BPK), to discuss the impact of the overriding framework regulating the activity of banks and nonbank financial institutions, credit activity of the financial institution sector, and sharing of economic information between key pillars of UNMIK.
- Central Fiscal Authority (CFA) and experts housed within it, to discuss the status of key selected regulations within the commercial law framework;

(v) Participation in seminars and other events related to land and property rights reform, and the development of a multipurpose cadastral system which will include information on property and real estate.

(vi) Riinvest Survey Design and Administration – Findings from Riinvest’s survey of 300 small and medium size enterprises, carried out in late 2000, were used extensively in this report. An additional survey was designed and administered directly to the four operating banks as well as to nonbank financial institutions. The purpose of this survey was to obtain quantitative information about their current and planned credit activity, and their opinions about opportunities and barriers to SME lending. The following banks were included in the survey:

- MEB;
- New Bank of Kosova;
- Bank for Private Business; and
- Economic Bank.

Nonbank financial institutions surveyed included:

- ICU;
- USAID KBFF;
- FINCA;
- ABU/EAR;
- Grameen Trust;
- Mercy Corps'AFK;
- ICMC-KEP;
- Danish Refugee Council;
- German Invest Fund;
- Beselidhja;
- World Vision; and
- ADIE.

The questionnaire to financial institutions covered the following issues:

  - Credit activity (number of applications received and approved);
  - Amount of loans approved by sector;
  - Most common reasons for refusing a loan application;
  - Gender structure of loan recipients;
  - Terms and conditions for the loans used (amount of loans approved, interest rate, payback period);
  - Documentation requirements; and
  - Planned future loan volume.

While all institutions responded to the questions to as great an extent as possible, responses from some nonbank financial institutions were not always complete. This was reasonable given the initial crediting phase of some of these institutions.

VI. Small and Medium Size Enterprises in the Kosova Economy

(A) General Overview

Pre- War

The history of private enterprise in Kosova started before 1989, but significant growth in their number took place between 1990 – 1993 followed by a period of declining start-up rate. The motivation of SME development can be attributed to a large extent to push factors most important of which was the massive layoffs in the socially owned sector. On the eve of the military conflict in Kosova, it is estimated that 16,500 private enterprises were registered, with most of them family-run and small businesses. Taking into account the destructive effect of the institutional environment at the time, only some 50 – 55% of private SMEs were actively carrying out business activity.

The main features of these enterprises were:

- Domination of trade enterprises in the overall structure (65%);
- Lack of tradition and business culture to manage private capital;
- Lack of institutional support for SME financing and development;
- Undeveloped managerial structures, lack of modern business partnerships (predominance of family business relationships, lack of formal business education);
- Lack of strategic/business plans;
- High degree of political and commercial risk.

Post-War

In the aftermath of the war, most private SMEs were consolidated and many new business entities were founded and provisionally registered. According to the Business Directory of the Statistical Office of Kosova on business registration, as of May 2001 there were 29,564 business entities registered in Kosova. This total includes:

- 14,656 small and medium size enterprises (of which 14,177 are private small and medium size firms, and the remaining 400 or so either socially owned or state owned firms);
- 14,908 sole proprietorships.[1]

Riinvest estimates that about 11,000 (or 78.0%) of private enterprises are registered and actively carrying out business activity.

While definitions of small and medium size enterprises can vary by country, the most common definition is based on number of employees. We have applied the employee size classes as used in the European Union for purposes of this analysis:

[1] Riinvest's survey of 300 private sector firms, carried out at the end of 2000, included firms registered as enterprises. The survey did not include sole proprietorships.

Micro enterprises:	Less than 10 employees
Small enterprises:	10-49 employees
Medium size enterprises:	50-249 employees

Table 1: The Number and Proportion of Registered Enterprises in Kosova by Type of Ownership

Type of Ownership	# of Enterprises	%
1. Enterprises with a single owner	13,284	90.4
2. Partnerships	550	3.8
3. Joint Stock Companies	80	0.5
4. Cooperatives	72	0.5
5. Private Limited Liability Companies	299	2.0
6. Public Utilities	24	0.2
7. State Owned Enterprises	98	0.7
8. Socially Owned Enterprises	285	1.9
Total	14,656	100.0

Source: Business Directory, Statistical Overview, Statistical Office of Kosova, Prishtina, 2001.

Riinvest's survey of 300 enterprises in 2000 showed that a majority of enterprises (56.7%) are classified as micro enterprises employing less than 10 people, while 38.3% are small enterprises employing 10 – 49 people. A further 5.0 % belong to the category of medium sized enterprises employing 50 – 249 people. Small and medium sized enterprises have the largest shares of total investment, fixed assets, and employment.

Graph 1: The Structure of Enterprises by Number of Employees

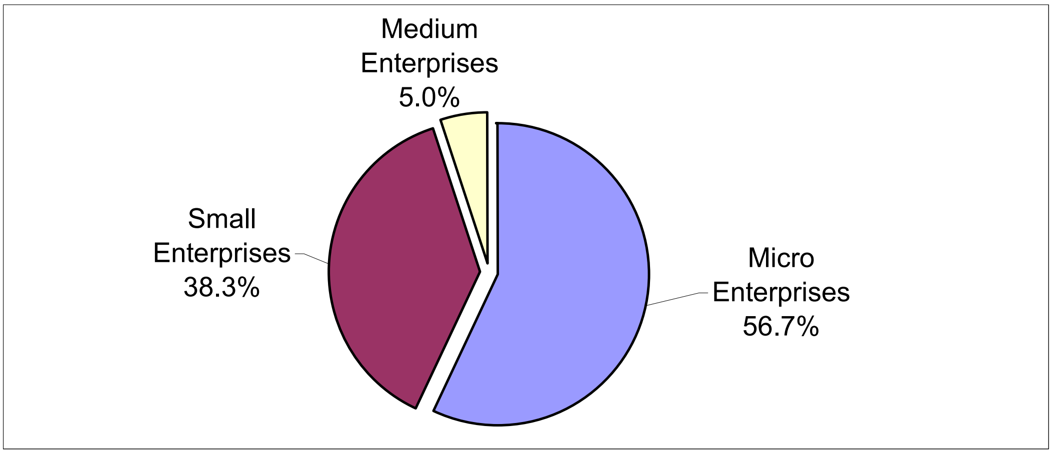

Table 2: The Role of Enterprises in Kosova's Economy, by Firm Size (%)

Enterprises by size	Share of total enterprise population	Share in total enterprise investment	Share in total enterprise fixed assets	Share in total enterprise employment
Micro	57%	25%	16%	19%
Small	38%	55%	60%	55%
Medium	5%	20%	24%	26%
Total	100%	100%	100%	100%

Source: Riinvest survey data, 2000.

According to the Riinvest survey of 300 private enterprises, the average number of employees per enterprise is 13.42, and that the private sector is experiencing an ongoing increase in employment. During the period 1997-2000, employment in the private sector increased by 41%, with an increase of 15% in 2000 alone. Looking at firm size, small enterprises have the largest share (34.4%), followed by medium sized enterprises (20.3%).

Despite the political and institutional barriers during the last decade, private SMEs have increased their share in all macroeconomic figures. Riinvest surveys and analysis showed that the private sector in 1997 contributed 50-55% to economic activity**.** The private sector share in some economic branches was very high: agriculture (96.4%), construction (75.6%), trade (67.3%) and handicrafts (73.3%), while industry was represented by only 13%.[2]

[2] Economic Activities and Democratic Development of Kosova, Riinvest, 1998.

Table 3: Sector Structure of Private Enterprises in Kosova by Economic Activity and Employment

Sector	% of Total Enterprises	% of Total Employment
Trade	53.0	32.0
Industry	11.0	33.0
Transport	11.0	8.0
Construction	7.0	13.0
Agriculture	1.1	4.0
Services (hostelry and tourism, financial intermediation, rent)	13.0	9.0
Others	3.9	1.0
Total	100.0	100.0

Source: Business Directory, Statistical Office of Kosova, 2000.

Since the end of the military conflict, private SMEs have shown a significant vitality in renewing economic activity, and contributing to the economic reconstruction of Kosova and income generation. Riinvest surveys show a change in the structure of economic activity of private enterprises after the war. A fall in the proportion of trade companies is evident, while the share of production companies and some services is increasing. The number of people employed at production enterprises has increased (33.0%), construction (13%) and services (9.0%). It is estimated that during the post-war period the share of private enterprises to GDP has gone up to more than 65%. Some estimations in 2000, indicates that private investments were about 400 million DM, or 13% of GDP.[3]

These developments are extremely encouraging, all the more so in a situation without a fully developed institutional support environment and legal framework, no national strategy for SME development, insufficient organization of the business community, and a very young and undeveloped financial institution sector.

(B) Enterprise Performance

(i) Average Monthly Turnover

Turnover among the sample of enterprises surveyed by Riinvest [4] in late 2000 has increased almost 40% since 1997 despite a decline in turnover in 2000 by 25%. This decline between 1999 and 2000 could be explained by the simultaneous occurrence of two or more of the following:

[3] Macroeconomic Report, CFA, Prishtina, 2001.
[4] Riinvest has carried out its survey of 300 private sector enterprises three times since 1997, using largely the same sample of firms.

- The excess demand for products of an emergency nature during the period June-December 1999;
- An increase in the number of enterprises, and hence greater competition;
- The reluctance of entrepreneurs to reveal their actual turnover due to the introduction of taxes in 2000.

(ii) Employment

Over the period 1997 – 2000, employment within the sampled group of enterprises has increased 12 - 15% per year on average. There appears to be an improvement in the education level, with a greater proportion of employees with high school and university education. The gender structure has also improved slightly, with the share of females employed reaching 23%. However, the number of females employed in private enterprises is still extremely limited.

(iii) Changes in Managerial Structure

In sampled enterprises, there appears to be an increasing formal separation between the functions of ownership and management; in 2000, about 46.7% of private enterprises were run by the manager, which is a significant improvement in comparison with 1997 (22.4 %).

(iv) Average Salary

Average salary per month within the sample of enterprises is 603 DM per employee. This is much greater than the average salary level within socially owned enterprises (210 DM), and the public sector (300 DM). Salaries rose in sampled enterprises by 25.3% in 2000 compared to 1999.

(v) **Exports and Imports**

According to Riinvest survey findings in 2000, only 15% of sampled enterprises were exporters, while 68.3% were importers. Survey findings showed that the average value of exports per enterprise was 25,000 DM, and if that sum is applicable to the overall number of active enterprises, it would result in a total export value for these enterprises of about 27 million DM, or just 7% of the total average export before 1989. The structure of exports is comprised mainly by: construction material (24.4%), food items (15.6%), and household equipment (8.9%). The same categories in different percentages dominate in imports as well: food items (28.4%), construction material (26.0%), machinery/equipment (16.7%), and household equipment (8.4%).

VII. Business Environment and Barriers to Doing Business

UNMIK, Kosovar institutions and the international community all share the view that the development of Kosova should be based on development of the private sector. UNMIK are moving forward in creating a commercial law framework and institutional structure to facilitate economic reconstruction and development, and the transformation of socially owned enterprises. Key UNMIK departments and central authorities participating in this institutional development include:

A. Institutional and Policy Environment

- Department of Trade and Industry (DTI);
- Department of Reconstruction;
- Central and Fiscal Authority (CFA); and
- Banking and Payments Authority of Kosova (BPK).

Key elements of the commercial law framework include approval of the following regulations:

- Regulation on establishing and licensing of banks;
- Regulation on provisional business registration;
- Regulation on enterprises;
- Regulation on foreign investment;
- Regulation on collateral (pledges).

The structure of these institutions and legislative capacities is important for building a system to support sustainable SME financing and development in Kosova, and which includes banking and non-banking institutions, technical assistance programs, foreign investment, and access to finance and micro credits.

However, missing amidst this set of regulatory and policy initiatives is a set of more specific actions by the government to support small and medium size enterprises. This includes, first and foremost, the absence of a SME development strategy in Kosova, and/or a national SME Policy that could include:

- A basic and commonly acceptable and applied definition of SMEs;
- An institutional implementing mechanism within the government to more effectively coordinate government and international support to this sector;
- The allocation of specific financial resources, or at least a role in attracting international donor resources, for the establishment of financial support vehicles such as a SME credit line aimed either at all SMEs or specific subgroups.

The development of a SME Strategy or Policy (or even a SME Law) is a common feature within governments in transitional countries, especially in this region, and in almost every case represented a shift in government attitudes toward the sector reflecting their greater understanding of the sector's role and importance in economic development.

Economic Policy

Economic policy plays a key role in creating a favorable environment for SME development, and like in all transitional countries is strongly linked to SME access to external finance. Some of the most important economic policy frameworks – taxation and privatization, for example - have not yet been fully formed. Strong sentiments have been expressed over the financial burden faced by the business community as a result of the high levels of business taxes collected at the border (a combined total of 26.5% of border tax paid on imports, including on all raw material and capital imports), which may be restricting the development of the Kosovar production and manufacturing sectors and hence limiting their ability to enter into long term credit relationships with banks. Considerable pressure is being placed on the international administration to continue efforts to develop more sustainable policy frameworks in these areas.

B. Donor's Roles in Business Development

A number of bilateral and international organizations are supporting the SME development (financial and technical assistance). These organizations include:

- ***USAID***
  - Kosova Business Support, which provides direct technical assistance to firms and local organizations;
    - Kosova Business Finance Fund, which provides direct financial assistance to firms and which will soon be transformed into the Kosovar-American Bank;
  - Riinvest/CIPE, which strengthens cooperation between the business community and government;
  - IFDC, which provides technical and policy support to the agricultural sector including support in applying for financing, training and trade missions, and development of business plans;
- FINCA, a micro finance institution with both a Village Banking and a Small Enterprise lending program.
- World Bank (Farm Revitalization, ICU, Technical Assistance Programs);
- European Commission (ICU, EURECNA);
- European Agency for Reconstruction, in cooperation with DTI to establish local enterprise agencies in three regional centers;
- European Bank (AREF Equity Investment Fund);
- Banking Institutions (MEB, New bank of Kosova, Bank for Private Business, Economic Bank);
- Non-bank financial institutions (15 licensed to date);
- State organizations and agencies (DFID, GTZ, SDC);
- Humanitarian Organizations.

In the first Donors Conference in 1999, the International Community pledged that during the period between 1999 – 2003, it would provide 250 million Euro for SME development, or 10% of the total amount to be allocated for Kosova reconstruction. In post-war period, a number of donors were involved in supporting SME development through grants and without financial intermediation (Economic and Social Reform for Peace and Reconciliation, World Bank, 2000). During this period, efforts of the International Community to support SME development focused on:

(i) Establishing a system for credit support, and

(ii) Providing technical assistance for existing and new businesses in Kosova.

Table 4: Donors' Role in SME Development in Kosova (in millions of EURO)

Type of Investment	First phase (to end of 2000)	Second phase (2001 – 2003)	Total
I. Credit lines for SMEs	30.0	20.0	50.0
II. Credit lines from the banking system	-	35.0	35.0
III. Business consulting services	15.0	10.0	25.0
IV. Enterprise capital funds	20.0	15.0	35.0
V. Program for supporting of reconstruction	10.0	5.0	15.0
VI. Political security for foreign investment	25.0	20.0	45.0
(I-VI) Total	100.0	105.0	205.0
Technical assistance	20.0	5.0	25.0
Grand Total	120.0	110.0	230.0

Source: *A Programme for Renewal and Reconstruction in Kosova, European Commission / World Bank, 2000.*

In the emergency phase, SME support has been provided through grants. This form of SME support was accepted by UNMIK, because a sustainable system for SME financing was missing at that time. In order to have a clear policy for SME finance and development, UNMIK has promoted the following basic regulations and criteria:

- Lending activity should be carried out in terms of the new monitoring structure on banking activities;
- Credit support should be given only to SMEs that have prepared a business plan;
- Borrowing criteria should not hamper competition to the credit offered by private financial institutions.

C. Main Barriers to Doing Business

Riinvest research has focused to a considerable extent on identifying internal and external barriers to business development. According to the Riinvest enterprise survey of 2000, barriers of the greatest intensity on the functioning of enterprises were:

(i) The lack of legislation;

(ii) Unfair competition;

(iii) Lack of external financial sources;

(iv) High taxes; and

(v) Strong competition.

Table 5: Ranking of Business Barriers Among Enterprises

Barrier	**1**	**2**	**3**	**4**	**Intensity Indicator**
Lack of legislation	208	57	14	15	85
Unfair competition	166	63	36	28	75
Lack of external financial sources	112	78	43	60	**61**
High taxes	96	53	51	93	51
Strong competition	73	69	76	74	49
Lack of information on business	76	72	45	96	48
Availability of raw materials and equipment	53	59	53	126	38
Insufficient capacity	46	54	67	120	36
Delay of payments	37	63	53	135	34
Lack of demand	21	51	72	145	27
Administrative procedures	21	51	68	149	27
Trade export barriers	37	35	28	163	26
Payment arrangements with other companies	20	45	53	167	24
Parity between exchange rate-inflation	21	25	36	202	17
Employees knowledge	11	16	53	210	14
Management skills	12	22	25	232	12

Source: Riinvest survey data, 2000.

(1 =causes very big problems, 2 = causes problems, 3=causes small problems , 4 = Does not cause any problems)

Calculation of the indicator: *respondents ranked the factor on a 0 – 3 , 4 grade scale. Individual values were multiplied by the number of respondents and divided by the possible maximum value of the indicator. This yielded a* *percentage value of maximum 100 (all the respondents attributing maximum importance to the factor), and minimum 0 (all respondents attributing minimum importance to the factor).*[5]

Lack of legislation is a very big problem for nearly 70% of the enterprises. This is a unique feature in international comparisons, since businesses typically complain about high taxes and administrative burdens. It is very important to note the desire of Kosovar enterprises to have a stable legal and regulatory environment. Establishing the legal and regulatory framework of a market economy was difficult in other transition countries as well, but Kosova has been in an unprecedented situation of a legislation vacuum, caused by the inoperative function of the old laws at a time when new laws have not yet been created. In any case, while other countries inherited some elements from the old laws, in Kosova a new institutional framework is needed, but the creation of the new legislation system is moving slowly. The UNMIK administration has taken very important steps towards developing the legal framework, but still has not approved some key regulations such as: (i) Regulation on Accounting; (ii) a Law on Privatization, and (iii) Regulation on Bankruptcy, which together will help facilitate the creation of an adequate environment for SME business activity.

Beyond the regulation itself, also lacking in several areas are the implementing mechanisms that would make the regulations operational. This issue is addressed in greater detail in Section IX.

More than 55% of surveyed enterprises consider unfair competition as a very serious problem. This can be related to the lack of laws, the informal sector, tax evasion and the lack of adequate law enforcement. The mentioning of unfair competition as a barrier is very high among production enterprises.

It should also be noted that Kosovar enterprises appear not to be taking seriously various internal issues, which can greatly influence the development of managerial capacities, the attraction of financial support, and the effective use of credit. Observing the table, we see that managerial skills (12) and employees' skills (14) are considered as the least intense barriers to development, which is very much in line with observations in other countries. It may mean that there is not yet a strong competitive environment in place where a good competitive position can be achieved through effective managerial skills. Or it may mean that other barriers are perceived as more urgent. We consider that managerial skills and employee's knowledge are essential factors for an enterprise's success, and ignoring these issues may have negative consequences for firms' ability to access finance and effectively utilize the funds acquired.

D. Financing as a Barrier to SME Development

Lack of external financial sources is the third most intense problem for sampled enterprises. The problem of lack of business financing, in spite of the development of a support system during this period, clearly remains a serious issue. Approximately 63% of surveyed enterprises consider that the lack of

[5] In the same way has been calculated the intensity indicator in the "State of Small and Medium Sized Enterprises in Hungary in 1999 ", Institute for Small Business Development, Budapest.

external financial sources is a barrier causing serious problems, while only 20% think that this does not present any problem.

Table 6: Intensity Indicator for Lack of External Financial Sources as a Barrier to SMEs, by Firm Size

Barrier	Micro	Small	Medium	Total
Lack of External Financial Sources	62	61	44	61

Source: Riinvest survey data, 2000.

Table 7: Intensity Indicator for Lack of External Financial Sources as a Barrier to SMEs, by Sector

Barrier	Production	Trade	Services	Total
Lack of External Financial Sources	61	59	67	61

Source: Riinvest survey data, 2000.

The impact of lack of external financial sources differs somewhat by firm size and sector, with this perceived as a barrier more acutely by micro and small enterprises, and more so by production and service firms.

VIII. SME Financing, Reactivation and Consolidation During the Emergency Phase

The majority of surveyed enterprises (77%), declared that they undertook investment activity during the emergency phase of development. These investments were made to:

- repair war damages (29%);
- expand existing capacity (20%);
- both of the above (43%).

Investment was primarily concentrated in production (35.8%) and trade (54.4%). By size, the greatest investment activity took place within small enterprises (55%) and micro enterprises (25%). In 73% of surveyed enterprises, investment were in the range between 20,000 – 500,000 DM per enterprise. According to this survey, Kosovar entrepreneurs will orient their new investments in production and industry (31.4%), food industry (15.7%), trade (35.4 %), transport (5.6 %) and professional training (4.3 %).

Table 8: Investment Made by Sector (DM)

Sector	Amount of investment made in 2000 (DM)	Share of amount invested (%)	Number of firms having made investments in 2000	% of firms having made investments in 2000
Production	17,677,000	35.8	76	79.2
Trade	26,865,000	54.4	130	78.3
Services	4,850,500	9.8	25	65.8
Total	49,392,500	100.0	231	77.0

Source: Riinvest survey data, 2000.

Table 9: Investment Made by Firm Size

Size class	Amount of investment made in 2000 (DM)	Share of amount invested (%)	Number of firms having made Investments in 2000	% of firms having made investments in 2000	Share of employm ent
Micro-enterprises	14,125,500	28.6	119	70	19%
Small enterprises	25,807,000	52.2	97	84	55%
Medium enterprises	9,460,000	19.2	15	100	26%
Total	49,392,500	100.0	231	77 [6]	100 %

Source: Riinvest survey data, 2000.

The total value of investment of the 231 surveyed enterprises that made investments was over 49 million DM. From this an average investment per enterprise can be calculated as 164,642 DM.

The military conflict has mostly destroyed private facilities, equipment and stocks of SMEs. As Riinvest survey findings from 1999 show, about 92% of private SMEs suffered from war consequences (damages to business facilities, equipment, inventory, lack of financial assets). The average damage per enterprise was estimated at 268,000 DM. Even in these very unfavorable circumstances, SMEs showed a high vitality in renewing of their economic activity (functioning of domestic market, imports, emergency needs). Mobilization of internal sources was the only solution that substituted international financial support during emergency phase. An indication of the difficulties in attracting external sources of finance can be seen by survey data

[6] From all surveyed enterprises 231 or 77% of them had investments .

below which shows that more than 77% of surveyed enterprise's investments were financed by their own sources during the year 2000, and the very limited participation loan and credit schemes, and other formal sources.

Table 10: Sources of Investment

Investment Source	%
1. Own (internal) sources	77.1
2. Borrowing by family and friends	16.8
3. By credits from foreign banks	2.4
4. By credits from the banks within Kosova	2.4
5. Donations	1.4
Total	100.0

Source: Riinvest survey data, 2000.

Surveyed enterprises plan to continue their current businesses in 53% of cases, while 7.3% stated their intention to start a new businesses, and 35.7% declared both. These orientations are important in establishing an effective system of SME financing.

IX. Legal and Regulatory Issues Impacting Business Access to Finance

A clear and predictable legal and regulatory environment, as well as an appropriate commercial law framework, are critical to Kosova's economic and business development, and to facilitate access by business to external sources of finance. The fundamental purpose of a commercial law framework is to provide commercial parties reasonable predictability as to the legal consequences of their actions, and to the extent possible, certainty as to some types of information. Investors and entrepreneurs do require that, if something goes wrong in the course of a commercial law relationship or undertaking, the legal system provides a remedy that is predictable, and that the legal system provides a forum for adjudication of disputes that is perceived to be fair. As regards access to external finance, banks, investors, and entrepreneurs all require that information regarding property interests, creditors' claims, and business entities be publicly available and reliable. These standards will provide greater confidence and security for banks in entering into financial transactions with commercial enterprises.

As is common in all other transition countries, the key laws or regulations most directly impacting access to external sources of finance include the following:

- collateral (for both movables and immovables), and the establishment of collateral registries;
- bankruptcy;
- property;
- regulations over financial institutions themselves;
- business registration; and
- accounting.

With the exception of the property/land ownership issue, much of the overall regulatory framework impacting SME finance is either in place or is fast being put into place. However, major gaps remain. UNMIK approvals are still needed for certain regulations (in particular mortgage and bankruptcy), and implementation mechanisms have in several key areas not yet been established (pledge and mortgage registries, and business registration). It is crucial that progress continue in all of these areas – in particular, that the aforementioned registries are up and running as soon as possible, and that key regulatory approvals are secured from UNMIK before the November 2001 elections.

(A)Pledge Regulation

The Regulation on Pledges was approved in February 2001 and intends to provide a simple and uniform structure for pledges on movable assets. It represents a major step forward in establishing the regulatory framework for trade and collateral-based lending. Still, further work may be needed to further fine tune some of the provisions of the Regulation. For example, there may be a discussion as to whether the Regulation may be limiting certain types of commercial transactions, including equipment financing. The regulation stipulates that sellers of goods on credit, for example equipment, will have to notify earlier pledge holders of their claims each time they complete a credit sale, prior to giving delivery of the collateral to the pledgor. This could be a burden on the seller who will need to search the pledge records each time a sale is made, and which literally could be on a regular basis depending on the type and frequency of individual credit transactions made. Only in the case of inventory financing, which typically involves future advances, do we feel this is justifiable.

The regulation also calls for the termination of a pledge in situations when the asset becomes part of something else. The regulation also would terminate a pledge when the collateral is changed or incorporated with another thing or right such that it ceases to exist in identifiable or separable form. A farmer may have difficulty obtaining a loan, for example, if he were to pledge his future crops as collateral and then the harvested grain is comingled in a silo before the loan is paid off.

(B)Pledge Registry

A key component of a pledge regulation is the creation of a public notice filing system, or registry, to allow potential lenders and sellers to determine, conclusively and at little cost, the status of the potential borrower's title in the property that is being offering for collateral. Financial institutions cannot be expected to engage in active lending programs without such a mechanism in place. Despite approval of the pledge regulation in February 2001, a pledge registry in Kosova is not yet functional and it appears that the private sector, and not the government, will run it. The Department of Trade and Industry estimates that a centralized pledge registry, creation of which is being supported by USAID, should be up and running in a matter of weeks, with training of the implementing entity being a top short term priority. Banks are urgently calling for the establishment of this registry, without which borrowers can pledge the same moveable asset to different banks simultaneously.

Once established, it will be important that users of this registry are comfortable with it. Successful introduction of the registry with the small number of existing banks would facilitate faster acceptance over time as the entire banking system expands. An information campaign targeted at the banking community about the role of the pledge registry could be considered, as well as informing about the different pledge options available, including the inventory pledge which at present is not widely used.

Greater use of the inventory pledge will be helped by approval by the UN Joint Administrative Council of the Regulation on Accounting, which, among other things, will mandate the development of internationally recognized accounting standards, and introduce a uniform standard for calculating inventory.

(C) Mortgage Regulation

The mortgage regulation, currently in draft form, deals with immovables. We are concerned that the Regulation will not pass the formal UN approval process before the elections in November, the reason being that some UN Departments regard the enactment of such regulation as a part of the broader legal framework for property rights reform. We are concerned that it may take long time before such broader legal framework for property rights be approved in Kosova. Thus it is critical that a market-oriented Regulation on Mortgages is enacted as soon as possible; such regulation can always become a part of a future broader legal framework, once such is developed. The business community can play a critical role in pressuring the UN office to approval such a mortgage regulation.

(D) Mortgage Registration

A mortgage registry would record immovable property such as buildings and structures pledged as collateral, and allow users to check the encumbrance status of a particular asset. There is currently a process in Kosova for registering mortgages, and some banks do accept mortgages as collateral. However, the current process for registering mortgages remains in the local court and does not reach the municipal cadastral office (MCO). The MCO does not therefore provide for the registration of all property interests of which a mortgagee's rights are one.

Development of a complete mortgage registry will build greater certainty into the lending process. Several banks are referring to the lack of a complete mortgage registration system as the number one gap in the legal/regulatory environment related to credit, stating that all collateral-based lending they are doing at the present moment carries with it significant risks in the absence of a real property rights register. To resolve the above situation, a Working Group of legal and cadastral representatives from the Kosovo Cadastral Agency (KCA), the Department of Trade and Industry (DTI) and Public Services has been formed and is drafting an Administrative Direction which will unify the existing registration processes for various interests in real property, and will implement the provisions of existing law which require the use of a "land book." This unified registry will be placed at the MCO and will permit registration of all property rights, including mortgage rights. The task of the working group is to define how the MCO should process all real estate interests, which will include mortgage interests. Expectations are that this complete registration system will be in operation sometime in the Spring of 2002. This initiative is part of a larger effort to create a multipurpose cadastre and land information system, which will include juridical, fiscal and physical cadastres. Creation of this cadastre is related to the reform of land management and administration.

An Effective Enforcement Mechanism for Mortgages

There are two problems with using immovable property as collateral in Kosovo at present. One is that registration of mortgages on immovable property is uncertain, in that proper procedure for registering mortgages may not be followed. Even if the proper procedure is followed, there is no unified registry in which all interests affecting a given real estate object are entered. So first of all, the proposed registration procedure for mortgages and other interests in real estate must be improved (see the discussion above).

Second, the enforcement of mortgages is cumbersome at best. To enforce a mortgage, the creditor must initiate a court proceeding and wait for the eventual outcome before being able to realize a sale of the property in order to satisfy the debt. For all practical purposes, the length and complexity of this procedure makes it unlikely that the creditor would be able to obtain relief through foreclosure.

A solution to the lack of effective enforcement mechanisms would be to design an extra-judicial mechanism capable of providing an efficient, effective but fair way for the creditor to recover the mortgaged property in the event of the debtor's default. This is the purpose of the DTI's proposal for a Regulation on Granting and Exercising a Business Authorization to Sell Immovable Property Over Which a Mortgage Right Exists.

The suggested regulation permits the irrevocable business authorization to sell mortgaged property only under the following limited circumstances:

- the debtor/mortgagor is a corporation or enterprise;
- the mortgaged property is not residential;
- the lender/mortgagee is a financial institution licensed by BPK;
- the conditions of default which will trigger the sale of the mortgaged property are clearly specified in the mortgage agreement;
- proper procedures are followed for notification to the debtor and conduct of the sale.

This draft regulation, if adopted, will permit the creation of a non-revocable business authorization to sell mortgaged property in the event of specific defaults on the part of the mortgagor. With this increased ability to foreclose on mortgaged property in the event of default, licensed financial institutions will have greater incentive to make loans secured by mortgages, thus expanding economic activity in Kosovo.

The concept of an extra-judicial foreclosure proceeding based on the agreement of the parties is one which has been used in other jurisdictions, such as Kazakhstan, the Philippines and the Czech Republic. It is critical to the success of the proposed legislation in the areas of registration and enforcement of mortgages that the business community exercises strong pressure on the UN administration about prioritizing the above reforms.

(E) Land Title and Ownership

Another regulatory barrier inhibiting access to credit in Kosova is the uncertainty and complexity surrounding land ownership and property rights. The importance of secure property rights cannot be overemphasized. Land serves as collateral for credit or as a source of security. If land could be collateralized it would open up a whole new asset base on which to use as pledged security for lending. Such secure property rights to land provide the basis for land transactions and improve the transferability of property. Currently land rights in Kosova are unclear. There are gaps and inconsistencies exist in the legal framework including the lack of a basic definition of real property; there is a lack of clarity about the concept of ownership; land records proving ownership are far from complete; additional ownership claims may emerge at any moment; communication and information sharing between key actors, especially at the local level, is flawed; and the cadastral system is in need of a major overhaul. Action is needed in each of these areas.

Complicating things further is the existence of the concept of "social ownership". Social ownership remains a vague and undefined concept; only with difficulty can it be assigned attributes of ownership. For an SOE in the form of a joint stock company to be able to attract outside capital, it is critical that they be given full and clear title to the land, and that UNMIK provide leadership in clarifying this.

(F)Bankruptcy

Although a critical pillar in a market economy, the concept of bankruptcy is misunderstood, too often interpreted as an indication of business failure instead of as a mechanism to enable the re-use of dying assets. Effective bankruptcy regulation and procedures will be a key, for example, to the privatization of SOEs as some SOEs will be transformed through liquidation (forced by law into bankruptcy, with assets transferred to successor company, ensuring transfer of the SOE into privately held capital). Financial institutions will be extremely reluctant to lend to enterprises without clear bankruptcy procedures in place. It will therefore be important that efforts are made to promote bankruptcy as a concept of business reorganization.

A draft bankruptcy regulation for Kosova has been developed. The draft makes a number of efforts to protect the rights of secured creditors against unsecured creditors. It is expected at some point in the near future to be submitted to UN Office of the Legal Advisor, and hopefully passed before the November 2001 elections.

(G) Regulations on Banks and Financial Institutions

A problem with bankruptcy law in many transitional economies has been the difficulty in ensuring an adequate pool of trained judges and bankruptcy trustees to adequately handle the number of bankruptcy cases at a given time. Hence it is even more important that UNMIK approve the bankruptcy regulation as soon as possible to allow for practical issues related to its implementation to be addressed.

We have few concerns about the current set of regulations governing the Banking and Payments System of Kosova (BPK), individual banks and financial institutions. Feedback from the banks themselves and other sources mirrored our conclusions. A brief analysis is as follows.

Regulation 1999/21 On Bank Licensing, Supervision and Regulation

We think that Regulation 1999/21 provides a broad and fairly liberal framework for banks to extend credit and other products to business. We understand that the BPK will in the near future review this Regulation based on the nearly two years of experience gained with its application. We encourage that as many institutions as possible participate in this review process, and that the revisions include specific definitions for "leasing", "factoring", and "guarantees". There is some interest by financial institutions in more carefully considering the leasing market, and the BPK can help clarify what this is. The term "guarantee" could mean several things; the type of guarantee most closely associated with small business finance is a loan guarantee program in which a portion of the repayment risk is covered by a stand-alone guarantee fund that would pay out to cover a previously agreed upon portion of the loan in case of default. This would allow banks and financial institutions to more aggressively lend money to higher risk entities. Such programs operate in most EU and Eastern and Central Europe countries, and while opinions about their overall impact are divided, experience shows that in certain countries they can act as catalysts in stimulating access to finance by very small enterprises in local communities.

Regulation 1999/20 on the Banking and Payments Authority of Kosova

This regulation refers repeatedly to the power of the BPK to develop various kinds of information for other audiences, and receive information in return. However, no specific obligations have been imposed on the BPK (or on other administrative entities) to develop and share this information. Guidelines have also not been provided as to the types of information to be shared, as well as their frequency. Steps are being taken by the BPK to help fill these information gaps, with publishing of their first annual report (for the year 2000) expected very soon, and which will contain a wealth of important economic and financial information. The BPK is also nearing completion of its semi-annual report for the first half of the year 2001, and plan the development of a monthly bulletin of banking statistics to review credit and deposit flows, and payments. In addition, development by other authorities of a SIC classification system and its use by the BPK could, for example, yield more detailed insights into credit patterns and other financial trends in the economy.

*Rules of the Banking and Payments Authority of Kosova****Our general conclusion is that the BPK: (i) is not unduly restricting the ability of banks and non bank financial institutions to extend credit and other financial products to the business community; and (ii) is putting into place effective oversight mechanisms for non bank financial institutions.[7] Our suggestions for the BPK, as part of the monitoring of bank and nonbank financial institutions, are:***

(i) to monitor the policies to be developed by banks which describe the bases on which uncollectable loans are recognized as losses and written off;

(ii) to consider establishing, at some point, maximum loan classifications and minimum required provisioning for loans issued by nonbank financial institutions to persons which have prior poor repayment histories for similar loans; and

(iii) considers establishing, once a lending track record has been established, methodologies for classifying and setting minimum provisions for loans appropriate to the types of loans made by non bank financial institutions.

Kosova Credit Information Service (KCIS)

(H) The Financial Institution Sector in Kosova – Standards, Practices and Information Sharing

The Kosova Credit Information Service (KCIS), established in May 2000, is an important contribution to the development and exchange of information within the financial sector. Spearheaded by the Micro Enterprise Bank (MEB), the KCIS is to provide subscribers and other financial institutions with vital and reliable information on potential borrowers' credit history, repayment behavior, outstanding credit(s), and also such secondary information as criminal records and company history/performance, all in a timely fashion. There are currently 7 members of the KCIS: (i) Micro Enterprise Bank; (ii) FINCA; (iii) International Catholic Migration Commission; (iv) Mercy Corps'AFK; (v) World Relief; (vi) Kosova Business Finance Fund (KBFF); and (vii) ADIE. Charman of the KCIS reports some due diligence success in identifying unscrupulous borrowers, but says that more systematic efforts are needed by members to make the KCIS work effectively, which includes more regular queries to the KCIS before considering loan applications. He also reports considerable outside interest in the KCIS and would like to increase membership.

Attitudes of the 3 Kosovar banks towards the KCIS are mixed. One bank is enthusiastic and would like to become a member, citing the opportunity to use this service in the identification of unsavory or blacklisted borrowers. Another bank claims not to need this service as it knows all companies in Kosova. While we understand to a degree the reluctance by some institutions in sharing

[7] Prudent oversight mechanisms for non bank financial institutions should always be given adequate attention, largely to prevent a situation from arising, as it has in other countries, where unsavory decisions by one, or a small number of NBFI players, have unfairly tarnished the reputation of the entire industry.

confidential borrower information to a circle of other institutions, this facility, if implemented with the appropriate safeguards, can greatly assist in increasing bank awareness of the borrowing community, improve the lending practices and performance of all financial institutions, and strengthen communication between the banks and financial institutions themselves.

Banks and Financial Institutions – Communication, Representation, Standards

The Micro Enterprise Bank (MEB) is by far the most prominent bank in Kosova. It is playing an active role in the establishment of the pledge and mortgage registries, has spearheaded the creation of a credit information service bureau, and is being recognized by the government to play a key intermediary role in the implementation of other reforms (for example, as a deposit point for VAT). USAID's newly created Kosova Business Finance Fund (KBFF) is also likely to take the lead in offering new types of credit instruments. The KBFF has expressed interested in cooperating with other banks in loan syndication arrangements, cooperating with non bank financial institutions s clients of the latter evolve to become clients of larger loan programs, and considers it worthwhile to investigate the development of leasing service. Their planned eventual transition into a Kosova-American bank will cement their presence on the Kosova stage.

This attention being placed on the MEB and KBFF has resulted to some degree in a marginalization of the other Kosovar banks, including their ability to act as intermediaries in government economic reform efforts. Should this imbalance be addressed? To ensure that the banking system will be able to effectively play its part in addressing Kosovar economic reconstruction, needed are high professional standards and practices throughout the banking system, which will also serve as a key foundation for the system's expansion. A mechanism to facilitate this might be the creation of a ***Kosova Bankers Association*** that will: (i) ensure more consistent awareness and use among banks of bank products and services, and legal and institutional vehicles established to safeguard their interests; (ii) better ensure adoption of best practices in the banking profession which will feed into their ability to offer a larger range of specific lending instruments to business; (iii) increase the banking system's exposure to international-standard training programs; (iv) ensure the banking sector speaks with one voice in advocating to the public sector and other groups; and (v) create a stronger image of the Kosova banking sector in the region and elsewhere, and help attract international support. The idea to establish a Kosova Bankers Association has generated considerable support among Kosovar banks and the KBFF.

X. Planned Investment, Credit Demand and Supply

In order to assess SME credit needs, findings from the Riinvest survey with 300 private enterprises conducted in late 2000 have again been used. Some important conclusions can be drawn concerning the real needs for SME financing and also for setting up of an effective financing system.

(A) Planned Investment

About 90% of surveyed enterprises declared that they require credits to realize their investment plans.

Table 11: Amount of Current and Planned Investment (DM)

Description	Investment to Date	Planned Investment
Total investment	49,392,500	168,658,000
Average per enterprise	164,642	562,000
Mode	50,000 – 100,000	200,000-500,000

Source: Riinvest survey data, 2000.

From the table above we see much greater investment plans in the future, with planned investment exceeding investment to date by 2.5 times.

Table 12: Planned Investment by Amount and Percentage

Amount in DM	%
Up to 10,000	1.3
10,000 – 20,000	2.3
20,000 – 50,000	10.0
50,000 – 100,000	16.3
100,000 – 200,000	14.7
200,000 – 500,000	26.7
500,000 – 1,000,000	12.3
Over 1,000,000	9.3
N/A	7.0
Total	100.0

Source: Riinvest survey data, 2000.

The greatest magnitude of planned investment is between 50,000 – 500,000 DM (58%), with just 13% of surveyed enterprises planning to invest less than 50,000 DM (13%). About 9% of firms plan to invest more than 1 million DM.

Table 13: Planned Investment by Sector and Firm Size (%)

Sector	Micro	Small	Medium	TOTAL	%
Industry (production)	7.6	42.3	31.4	32.5	33.0
Construction	5.5	4.0	2.3	4.1	4.0
Agriculture	0.8	0.5	0.0	0.5	0.0
Trade	68.2	52.5	64.4	58.0	58.0
Transport	10.9	0.6	0.0	2.9	3.0
Hotels and Tourism	3.4	0.2	0.0	0.9	1.0
Tourist agencies	3.2	0.0	1.9	1.1	1.0
Services	0.3	0.0	0.0	0.1	0.0
Total	100.0	100.0	100.0	100.0	100.0

Source: Riinvest survey data, 2000.

By sector, planned investment is highest in trade (58%) and industry (33%), with all other sectors taken together representing only 8%. By firm size and sector together, the largest proportion is recorded in small (42.2%) and medium (31.4%) enterprises. In other sectors like construction, trade and transport, micro enterprises have the greatest proportion.

(B) Credit Demand and Supply

Table 14: Number of Firms, Employees, Volume of Fixed Assets and Credit Demand by Sector (DM)

Sector	Credit Demand	Credit Demand per firm	Credit Demand per employee
Production	41,169,000	428,843.8	21,331.1
Trade	56,265,000	338,945.8	32,674.2
Services	6,875,000	180,921.1	26,341.0
Total	104,309,000	347,696.7	26,657.0

Source: Riinvest survey data, 2000.

The findings above are shown in the table below from another perspective.

Table 15: Distribution of Firms, Employees, Fixed Assets and Credit Demand by Sector (%)

Sector	% of firms	% of employees	% of fixed assets	% of credit demand
Production	32.0	49.3	54.4	39.5
Trade	55.3	44.0	41.3	53.9
Services	12.7	6.7	4.2	6.6
Total	100.0	100.0	100.0	100.0

Source: Riinvest survey data, 2000.

Total credit demand for the sample of 300 surveyed enterprises are estimated at 104 million DM, or 347,967 DM per enterprise. The average credit demand in the production sector is 428,843 DM, or 22.4% higher than the total average, while the average credit demand in the service sector is 180,921 DM or 49% below the average. The share of production in overall credit demand is 39.5% (proportionally higher than its 32% share in the number of firms), while trade has a 53.9% share.

Table 16: Number of Firms, Employees, Volume of Fixed Assets and Credit Demand by Region (%)

Region	% of firms	% of employment	% of fixed assets	Credit demand
Prishtina	24.7	30.9	35.4	33.8
Prizren	16.3	17.1	8.5	10.2
Peja	16.3	18.0	28.3	14.8
Ferizaj	9.0	8.7	6.2	9.1
Gjakova	11.0	6.3	5.6	5.7
Gjilan	12.7	13.2	8.1	14.4
Mitrovica	10.0	5.9	7.9	12.0
Total	100.0	100.0	100.0	100.0

Source: Riinvest survey data, 2000.

The table above shows differences in credit demand by region. Firms in Prishtina and Mitrovica indicate the highest average credit demand, while firms in Gjakova and Prizren indicate lower average credit demand than the sample average. However, the average credit demand per employee is much higher in Mitrovica than in all other regions, and lowest in Prizren. The average credit demand in comparison to fixed assets is highest in Gjilan, Mitrovica and Ferizaj.

Table 17: Distribution of Credit Demand by Sector (%)

	Production	Trade	Services	Total
<10,000	0.0	0.0	0.5	0.1
10,001 – 20,000	0.0	0.0	0.3	0.0
20,001 – 50,000	1.2	1.2	3.2	1.3
50,001 – 100,000	1.8	6.0	9.0	4.5
100,001 – 200,000	4.4	8.6	14.5	7.3
200,001 – 500,000	36.7	31.1	21.5	32.7
500,001 – 1,000,000	27.8	23.2	50.9	26.8
>1,000,000	28.2	29.9	0.0	27.2
Total	100.0	100.0	100.0	100.0

Source: Riinvest survey data, 2000.

A low proportion of firms in all sectors report a credit demand less than 100,000 DM. By sector, the credit range of between 200,000 – 500,000 DM is most popular for the entire sample, in particular within the production and trade sectors. Over ¼ of all sampled enterprises report credit demand of higher amounts (500,000 – 1,000,000 DM), a category in which over half of service firms can be found.

Supply of Credit from Banks and Non Bank Financial Institutions (millions of DM)

Over the period 2001-2003, banking and non-banking institutions estimate the granting of credit to all businesses in Kosova in the amount of 760.2 million DM, with a significant acceleration expected over time. Banks are expected to contribute about 47%. The credit estimates are broken down as follows:

- 136.7 million DM, or 18%, in the year 2001;
- 214.2 million DM, or 28%, in 2002;
- 409.3 million DM, or 54%, in 2003.

Table 18: Current and Planned Credit Activity by Banks and Non Bank Financial Institutions, 2001 – 2003 (mln DM)*

Banking Institutions	**2001**	**2002**	**2003**	**2001 – 2003**
1. MEB – Micro Enterprises Bank	20.0	40.0	60.0	120.0
2. Bank for Private Business	6.5	8.5	10.0	25.0
3. New Bank of Kosova	15.0	40.0	100.0	155.0
4. Economic Bank	16.4	17.8	20.4	54.6
Total Banks	**57.9**	**106.3**	**190.4**	**354.6**
Non Bank Financial Institutions				
5. ICU	15.0	10.0	40.0	65.0
6. FINCA	8.5	8.5	8.5	25.5
7. Mercy Corps AFK	2.2	3.0	4.0	9.2
8. ICMC-KEP	10.9			10.9
9. USAID KBFF	10.0	46.0	100.0	156.0
10.CORDAID	0.4			0.4
11. Grameen Trust	1.4			1.4
12. ABU/EAR	24.0	36.0	60.0	120.0
13.Danish Refugee Council	0.2			0.2
14. ADIE	1.0			1.0
15. German Invest Fund	3.0	3.0	4.0	10.0
16.Besëlidhja Mikrofinance	3.0	3.0	5.0	11.0
Total NBFIs	**79.6**	**109.5**	**221.5**	**410.6**
Total Supply of Credit	**137.5**	**215.8**	**411.9**	**765.2**

Source: Findings from the survey with banking and non-banking institutions, Riinvest, 2001).

* Credit activity totals are for enterprises as well as individuals and families.

In other words, over the period 2001 – 2003 and with the current financial institution structure in place, the private sector will have at its disposal on average approximately 253 million DM per year. Deposits and savings of citizens and business could be a very important source for increasing the banks' financial potential to support SME development, whereas non-banking institutions see their future commitment to SME development based more on contribution of the donor community and less in the generation of profit from their operations. For the period 2001-2003, when realization of the reconstruction phase of Kosova will be over, the greatest credit support, according to banks' own estimates, is expected to come from USAID KBFF (156 million DM), New Bank of Kosova (155 million), MEB (120 million), ABU/EAR (120 million) and ICU (64 million).

Relationship Between Supply and Demand of Banking and Non Bank Financial Institutions

The following table illustrates the very clear discrepancy between credit demand and supply.

Table 19: Credit Demand vs. Supply

Description	**Amount in DM**
Average investment made per enterprise in 2000	164,642
Planned average investment per enterprise	562,000
Declared credit demand per enterprise	347,696
Total credit demand for actively operating enterprises (extrapolated to cover 11,000 enterprises)	3.5 billion DM
Most frequent range of credit need of enterprises (Mode)	200,000 – 500,000 DM
Estimated credit supply to all business entities from financial institutions (credits and micro credits):	
2001	136.7 million DM
2002	214.2 million DM
2003	409.3 million DM
Total estimated supply 2001 – 2003	**760.2 million DM**

Source: Riinvest survey data, 2000, and the questionnaire for banking and non-banking institutions, Riinvest, 2001)

We are aware that estimates of credit demand by enterprises, influenced to a significant degree by post-war reconstruction needs, seem to be high. A comparison with transitional countries at a more advanced stage of development may provide further insight. Using as a comparative yardstick the proportion of total bank credit to GDP, we find a ratio of 10% in both Poland[8] and Hungary. Using the same rate of 10% of the Kosova GDP estimate of 3 billion DM, this suggests that total bank credit on the balance sheet of Kosovar firms could be up to approximately 300 million DM. While this figure is obviously several times lower than the estimates from enterprises and comes much closer to the estimated credit supply figures above, we still see a significant gap; credit supply estimates in Kosova for the year 2001 are 136.7 million DM including non bank financial institutions (with 57.9 million DM planned from banks), and total credit issued to date by the banks at just under 30 million DM. All of these figures include enterprise credit as well as credit to individuals and families. Assuming a growth rate in Kosova GDP of 10% per year and using the above credit supply estimates (including the ambitious estimates from the New Bank of Kosova), we would calculate total credit to GDP in Kosova as 4.1% in 2001, 6.5% in 2002, and 11.1% in 2003, with the ratios for bank credit alone being 1.9%, 3.2% and 5.2% respectively .[9] It is clear, from this perspective, that there is currently an enterprise credit gap and will probably be in the medium term as well, and which should be addressed by policy makers.

XI. Activities of Banks and Non bank Financial Institutions

A new banking system has been created in Kosova as part of the development of market institutions after a 10 year development gap. Legislation has also being developed to guide the creation of financial institutions and a banking system. Currently in Kosova, a total of 4 banks and 15 non bank financial institutions are operating. This group of institutions has granted a total of 79.9 million DM in credit for the period 2000-2001 for business development (an additional 3 million DEM has been invested by an equity investment fund called AREFKOS). This can be broken down as follows:

Table 20: Credit Support for Private Sector, 2000 – June 30, 2001 (mln DM)

Type of Institution	Amount of Credit (mln DM)	Share of total (%)
Banks	28.7	36.0
Non Bank Financial Institutions	51.2	64.0
Total	79.9	100.0

Source: Riinvest survey of banks and non bank financial institutions, 2001)Most of the credit issued in the reconstruction phase has been aimed at reactivating existing businesses, and not for the development of new businesses.

[8] Total bank credit of 48.5 billion PLN and total GDP of 469 billion PLN in 1998. However, bank credit typically represent only half of total enterprise debt in Poland, with supplier credit also contributing significantly. Total enterprise debt in Poland is therefore closer to 20% of GDP. Another useful statistic is total bank credit in comparison to total SME assets (15.4% in Poland).

[9] A study carried out by Mr. Patrick Tardy, with the help of Riinvest, for the European Agency for Reconstruction and the World Bank in March 2000, entitled “Kosova: Pilot Line of Credit for Small and Medium Enterprises”, produced similar estimates by enterprises about investment plans and credit needs. Based on past investment made and on a reasonable replacement rate of current fixed assets, the average yearly investment worked out by Mr. Tardy to be between 400,000 – 600,000 DEM per firm, which was translated into an average loan size of between 200,000 – 400,000 DM. As we are in this report, the authors of the previous report were cautious with the assessment of investment needs provided by enterprises, and concluded that while there is little doubt about the extent of need and demand, the capacity of Kosovar SMEs to properly assess their financing needs, to absorb loans and credit, and to manage their finance needed to be tested, with a strong recommendation for more systematic technical support and training, and a further increase in credit supply.

In order to establish an effective banking and financial system, BPK approved the was of great importance for the coordination and technical realization of supporting donors that were engaged in reconstruction and financial support for SMEs.

(A) Bank Activity

At the beginning of the year 2000, the first bank with international capital in Kosova, MEB bank, received its license. In the meantime 3 more local banks received temporary licenses from the BPK. Final licenses were given by the end of this year to: New Bank of Kosova, Private Bank of Business and Economic Bank. Each of these banks, with 3 million DM in deposits, were granted the right to undertake various types of activities, including the taking of deposits and savings, and to issue credits.

MEB is the dominant bank on the market, and for over one year was the only bank carrying out financial transactions, deposits and savings, as well as providing other banking services. MEB activity was very important since it represented the first signs of a modern banking system in Kosova based on international practice. And, as a very important momentum for the post-war economy, MEB started to issues loans after a very long period in Kosova without such activity.

Table 21: Activity Indicators of Licensed Banks (July, 2001)

Banks	**Deposits in Million DM**	**Total loans (mln DM)**	**Relation of loans to deposits (%)**	**Number of clients (accounts)**
I. MEB	243.2	24.2	9.9	38,582
II. New Bank of Kosova	9.7	2.8	28.7	1,321
III. Private Bank of Business	2.4	1.3	54.2	404
IV. Economic Bank	0.8	0.4	-	86
Total	255.3	28.7	11.2	40,393

(Source: Interviews with bank representatives, 2001)

The above table indicates a disproportion between deposits and lending activities within banking institutions. In July 2001, approximately 40,300 depositors had deposited in banks about 255 million DM, while the total of loans granted stood at 28.7 million DM, or 11.2% of total deposits. A more favorable ratio between deposits and loans is evident at the Private Bank of Business and New Bank of Kosova, while MEB falls behind in this regard.

Out of the structure of domestic deposits in 2000, 30% were from individuals, and 70% legal businesses. In the year 2000 (July) resident deposits increased to 261.4 million DM, while participation of individuals was 35.2 % and of legal businesses 64.8%. (Source: BPK). We laud the degree to which Kosovar individuals and firms have placed this magnitude of financial resources in the banking system so quickly after the war, and we recognize the opportunity this provides for financial support of private enterprises, in particular SMEs.

The Structure of Deposits

The above analysis must be tempered by a review of the deposit structure within the banking system in Kosova. Regardless of the source of deposits, the vast majority of bank deposits are either demand deposits (can be withdrawn at any moment) or deposits with a very short term maturity. Given that a generally accepted and prudent bank policy is to ensure a close matching of asset and liability maturities, it is unrealistic to expect banks to grant a high proportion of medium and long term investment credit in a situation when much of the capital supporting that credit activity can be withdrawn from the bank virtually at a moment's notice. Liquidity is an extremely important reflection of a banking system's soundness, particularly a newly established system, and perhaps the most important indicator in determining the level of public confidence in that system. Therefore, the development over time of medium- and longer-term deposit options within the banking system, and their acceptance by the general public, are critical prerequisites in facilitating expanded credit activity with longer repayment periods.

Table 22: Number of Loan Applications and Loans Approved (to June, 2001)

Banks	**Applications**	**Approved loans**	**% of approved loans**
MEB Bank	2,663	1,663	62.4
New Bank of Kosova	105	76	72.4
Private Bank of Business	87	48	55.2
Economic Bank	2	2	100
Total	2,857	1,789	62.6

(Source: Questionnaire for banks and other non-banking organizations, Riinvest, 2001)

Competition Within the Banking Sector

Competition in the banking system and the development of a banking market may be slowly emerging. For more than 6 months after the war there were no functional banks in Kosova. Then for more than one year just one bank (MEB) operated, while in the last 6 months alone three other banks have commenced activity. Competition appears to have lowered the price of some bank services, for example the fee (from 1.5 % down to 0.5 %) for transferring larger amounts of money. Loan rates also seem to be falling. Rates stood at 18 % -24 % per year at the end of 2000, while current loan rates are in the range of 12 –18%. It is expected that loan rates will decrease further with the emergence of new banks and other financial institutions such as USAID KBFF entering the market. Competition will make banks fight for their clients and offer a wider and more attractive range of loan, deposit and other services.

An effective financial system in Kosova, along with new banks will have positive effects and will make possible a more favorable environment for financing private enterprises. Macroeconomic stability will have as well its positive effects in mobilizing deposits and savings toward development programs of private businesses. This stability is very much achievable taking into consideration that Kosova uses the German Mark, and by the beginning of 2002, the Euro. Banks in the future should be more concentrated on expanding their financial distribution activities into development functions. This will be achieved is there is a stabile partnership among banks and businesses. These relationships suggest the need for equal conditions in the financial market for new banks, where they will attempt to strengthen their position by applying principles of international management, personnel training and installing contemporary software systems. With such standards in place, they should be given a fair opportunity to act as the intermediary for government business and the holder of deposits of international organizations.

Quality of the Loan Portfolio

Perhaps the most impressive element of the banking system to date has to do with the relationship between the banks and their business clients – namely, the strong repayment discipline evident among Kosovar businesspeople at this fairly early stage. According to MEB, out of 3,000 loans it has granted, only three loans have turned out to be problematic. Other banks have not yet experienced this problem, and banks and selected non bank financial institutions have reported being favorably impressed with their high loan repayment ratios. While it may be too early to make definitive conclusions, it does suggest that some of the risks of lending to the business sector in this market may have been overestimated, and that SMEs are in fact serious clients for long-term cooperation with banks and other non bank financial institutions.

(B) Non Bank Financial Institution (NBFI) Activity

BPK regulations provide legislative capacities to license non-bank financial institutions (NBFIs). These organizations are acting as intermediaries between financial sources and businesses by providing loans and micro loans. To date, the BPK has registered 15 non banking institutions, including some humanitarian institutions. Most of the non-banking organizations are from abroad and are being led by international experts, while financed by donor resources. With the exception of the ICU and USAID KBFF, most are applying micro credit schemes for certain businesses in particular regions.

Table 23: Non Bank Financial Institution Activity (July, 2001)

Institution	Loan amount to date in millions of DM	Number of loans/micro-loans	Loan amount (DM)
1. ICU	14.3	55	60.000 – 400.000
2. FINCA	8.5	1,351(*)	2.000 – 75.000
3. Mercy Corps'AFK	3.6	159	5.000 – 50.000
4. ICMC-KEP	10.9	4.828 (*)	800 – 10.000
5. USAID KBFF	0.110	16	Up to 400.000
6.CORDAID	0.4	20	
7. Grameen Trust	1.4	1.300 (*)	1.200 – 2.000
8. ABU/EAR	5.0	10	> 200.000
9. Danish Refugee Council		24	1.000 – 3.000
10. ADIE	1.0	848	Up to 2.000
11. German Invest Fund	3.0	25	
12.Besëlidhja Micro finance	3.0	859	Up to 4.500
Total	51.2		

(*) Lending to individuals. Regarding FINCA, the information above includes their Village Banking lending program that as of August 31, 2001 disbursed nearly 3 million DM through 1,021 loans.

(Source: Questionnaire for banks and other non-banking financial institutions, 2001, Riinvest)

Some of these institutions are offering very important support for SMEs and in general for business development in Kosova. Leading institutions are ICU, USAID KBFF and ICMC-KEP. Except ICU and USAID KBFF (which offer larger amounts of loans), other financial institutions are offering just micro loans (800 to 10,000 DM) for small family and individual businesses. This support has been important keeping in mind the high participation of micro enterprises in the structure of private enterprises (56.7 %).

(C) Equity Investment Fund

AREFKOS is functioning as a unique form of investment in Kosova. This fund was established by the European Bank for Reconstruction and Development and represents an innovative support for businesses in Kosova. This form creates partnership relations with SMEs based on commercial principles. The fund in reality is a new practice that is being applied in Kosova and is a predecessor of other investment funds that are to be created. The European Bank has established a special fund to finance businesses based on principles of participation in the shared assets of Kosovar enterprises. This form differs from loan support and probably will have an encouraging influence on foreign investors to invest in Kosova.

XII. Terms and Conditions for SME Financing

Terms and conditions for financing were first defined right after the war, at a time when there was neither a stable financial system nor competition. As a consequence of such conditions, terms and conditions for financing were established in a somewhat restrictive manner, in terms of loan limits, loan rates, rates on financial transfers, collateral requirements, repayment period, and grace period. New Kosovar banks, as they attempt to strengthen their position in the Kosovar economy, will face these challenges:

- Regaining the trust of citizens and businesses;
- Applying new techniques of financial management;
- Obtaining appropriate skills to operate in the future financial market of Kosova;
- Involvement in servicing the resources of the donor community for financing the development of SMEs.

Table 24: Terms and Conditions of Financing Businesses by Banks in Kosova

Name of Bank	Legal Status	Loan Amount	Sectors that receive financial support	Security	Interest Rate	Repayment Period
MEB Bank	Joint stock company	To 100, 000 DM	Trade/Production	Movables	1.7 % monthly	Up to 24 months
New Bank of Kosova	Joint stock company	To 450,000 DM	All private sectors	200% of loan value	1.2 - 1.5 % monthly	4 – 9 months
Private Bank of Business	Joint stock company	To 100,000 DM	All private sectors	More than 200 % of loan value	14 % yearly	1 –12 months
Economic Bank	Joint stock company	To 300,000 DM	All private sectors	More than 200% of loan value	1.6 % monthly	6 – 12 months

Table 25: Conditions for financing businesses by non-banking institutions

Non-bank organization	Sectors supported	Security	Interest rate	Repayment Period
1. ICU	Production	Mortgage	15 % annually	3 months – 3 years
2. USAID KBFF	Production	Guarantees	13 – 15% annually	Up to 3 years
3. FINCA	Production / Tourism / trade	Mortgage, equipment or inventory	1.5 – 2.0% monthly	4 – 12 months
4. Mercy Corps'AFK	Industry/ agriculture/ services	Collateral Guarantees	24% annually	6-24 months
5. ICMC-KEP	Production	-	1.25% monthly	9 months
6.CORDAID				
7. Grameen Trust	Victimized women		6% annually	1 year
8. ABU/EAR	Agriculture	Immovables (150% of value of loan)	8 – 12 % annually	1 – 10 years
9. Danish Refugee Council				
10. ADIE	Rural areas	Collateral	15%	Up to 18 months
11. German Invest Fund	Production businesses/ trade	Simple application and membership	17 – 18% annually	
12.Besëlidhja Micro finance	Production businesses and trade		12% annually	
	All economic sectors		1.5% monthly	Up to 6 months

(*) Has to do with individuals

Source: Questionnaire for banks and other non-banking financial institutions, Riinvest, 2001)

A short summary of loaning conditions shows that BPB, USAID KBF, ICU and German Investment Fund have set yearly interest rates of between 13-15 %. Other banking institutions have set monthly interest rates of 1.7 % (MEB), 1.2-1.5% (New Bank of Kosova) or 1.6 % Economic Bank). Other financial institutions charge monthly interest rates; operating with monthly interest rates shows that we are dealing with short-term financial support, as opposed to essential financing of SME development. Exceptions to this are the ICU and USAID's KBFF, which will soon operate as the Kosovar-American Bank.

Faced with an uncertain and undefined business environment, all licensed banks and other non bank financial institutions have established somewhat restrictive terms and conditions in doing business with enterprises. A relatively high interest rate ranges (monthly) from 1.1% up to 1.7 %, while yearly loan rates range from 14% to 24%. Only ICU and USAID KBFF, as non bank institutions, are providing medium-term loans. In comparison with other banks, ICU is applying a longer loan repayment period (30 months). All other banks apply more restrictive conditions for SMEs to obtain loans. Banks currently are supporting the production sectors (agriculture, industry), construction, transport and services. Banking support is focused only in the private sector, both in existing companies and new ones.

Table 26: Comparison of Credit Demand and Approved Loans, by Sector

Sectors	Credit Demand (% of total)	Approved loans in year 2000 (%)	Approved loans June 30, 2001 (%)
Production	39.5	17.0	21.7
Trade	53.9	66.0	61.3
Services	6.6	17.0	17.0
Total	100	100	100

(Source: Riinvest for credit demand, BPK for approved loans)

The above table shows a disproportion by sector between credit demand and credit approved to date. This is more evident in the production sector, which has a lower participation in approved loans in comparison to its declared demand. This difference in 2000 was minus 22.5 index points, while it slightly improved in 2001. There was also a disproportion between credit demand and approved loans in the trade sector, but in this case the discrepancy was positive; it had a higher participation by 12.1 index points. Private enterprises are primarily the recipients of credit; up to June 2001, out of 21.8 million DM in credit socially owned enterprises participated in this sum with only 670,000 DM.

While other transitional countries have similar loan rates (with the exception of Croatia, which has lower), these countries have developed a more favorable legal environment and physical infrastructure (power, water, telecommunications, roads). Infrastructure shortages are a major and unique constraint on business development in Kosova, in particular electricity and telecommunications. Adding needed infrastructure to business development projects adds significantly to the total cost. In Kosova, UNMIK and local government still have not defined industrial zones for developing small and medium size businesses. Taking into consideration the real needs of business for development, we can conclude that lending may be restrictive because:

- Kosova is using a strong currency (DM) with a very small possibility of inflation and unexpected inflation impact on loan rates;
- Kosova's business development projects, especially those in the production sector, are costlier than those in other countries because Kosovar entrepreneurs have to pay for the cost of infrastructure.

Interest Rate

Loan Conditions Preferred by Business

It is not surprising that the vast majority of surveyed enterprises prefer a loan interest rate less than current market rates. According to the enterprise survey, 88% of surveyed enterprises think that interest rates should be less than 10 %. Only 12 % prefers an interest rate up to 10-15 %.

Repayment Period

The table below indicates a much greater preference for long term credit. Nearly 90% of enterprises in the sample indicate a preferred repayment period of at least 1 year, with over 70% indicating a preferred repayment period of at least 2 years, and 40% a period of more than 3 years. These trends are similar in all sectors, in particular production and trade, with a somewhat less skewed distribution in the service sector. Although it was an option, no one in the sample selected a preferred repayment period less than 3 months.

Table 27: Preferred Loan Repayment Period

Term	Production	Trade	Services	Total
< 3 months	0.0	0.0	0.0	0.0
3-6 months	1.1	2.0	0.0	1.5
6-12 months	6.7	8.6	15.6	8.8
1-2 years	14.6	19.7	28.1	19.0
2-3 years	38.2	27.0	15.6	29.3
> 3 years	39.3	42.8	40.6	41.4
Total	100.0	100.0	100.0	100.0

Source: Riinvest survey data

BPK regulations have created sufficient opportunity to implement a considerable number of financing instruments aimed at SMEs. Yet some of this potential is not being realized, with the absence of instruments such as leasing, factoring and loan guarantee programs that are all typically geared to support smaller firms.

XIII. Financial Instruments for Supporting SME Development

It is understandable as to the limited number of financial instruments currently in place; Kosova never had a history of supporting development of SMEs, it is just emerging from a long period of oppression and a devastating war, the overall framework for a market economy, including the development of the financial institutions sector, is only now being put into place, and only very recently can we observe the beginning of a credit repayment track record. Applying new instruments will take time; in part it will depend greatly on the development of the financial and capital markets, particularly in the case of long term debt financing and the utilization of venture capital. We should stress here the importance of accelerating the privatization process and the creation of a commercial paper market and stock exchange. In the phase of emergency post-war development and reactivation of existing businesses, support has been obtained primarily through grants. After this phase, the donor community reduced its emphasis on grants and has begun to incorporate market elements in supporting business. We encourage this transition to self-sustainable mechanisms.

Table 28: Existing Financial Instruments for SMEs in Kosova

Current Financial Instruments	Contributors
1. Grants	Humanitarian organizations
2. Loans	ICU, MEB Bank, Private Bank of Business, New Bank of Kosova, KBFF, Economic Bank
3. Micro-loans	Non Bank Financial Institutions
4. Equity investment funds	AREFKOS

Table 29: Financial Instruments for SMEs Used in Selected Transitional Countries

Financial Instrument	Kosova	Albania	Bulgaria	Croatia	Romania
1. Grants	+	+			+
2. Loans scheme	+	+	+	+	+
3. Micro loans scheme	+	+	+	+	+
4. Equity investment Funds	+	+		+	
5. Guarantee Instruments			+	+	
6. Bilateral Funds					
7. Leasing				+	+
8. Venture Capital		+		+	+
9. Factoring					+
10. Stock Exchange					+

(Source: Reports on SMEs financing presented at the international conference: "Code of Best SME Finance Practices in South Eastern Europe", Sofia, 2001)

We can see that certain other countries in the region offer a similarly limited range of financial instruments for SMEs, while others offer a wider range. This range of instruments available is closely linked to the development of a market economy infrastructure and financial system; in Poland and Hungary, for example, which are not on the above table, there are available perhaps the widest possible range of financial instruments for SMEs in the entire region. This is due to several factors, including the much more developed financial infrastructure in those countries, the greater competition between financial institutions, the higher standards adopted in the financial sector, the greater range of technical assistance support programs for business, and a growing awareness of the role and importance of SMEs in those economies.[10]

[10] Research recently carried out by CIPE with a series of economic research institutions in several neighboring countries shows in many cases real lending rates in these countries

XIV. Sme Capacity Constraints

Research carried out for this Report highlights the difficulties for Kosovar SMEs in accessing loans and other external financial sources. However, regulatory gaps and demand-supply imbalances notwithstanding, the issue of credit absorption capacity of firms themselves must also be addressed. Are Kosovar businesses ready to be capable and responsible users of external financial resources? Do they possess the required level of strategic, managerial and operational skills to ensure their firms are as competitive and as efficient as possible? According to the Riinvest questionnaire administered to banks and NBFIs, the most frequent reasons for rejecting loan applications were:

- Lack of a business plan, or it poor quality;
- Imprecise description of the business idea;
- Inability to provide adequate collateral or security;
- Lack of information about the business community.

The first two items on the list relate directly to the strategic and managerial ability of enterprise, and suggest a skill and capacity gap within the business community that may be preventing firms from developing more effective relationships with financial institutions. These conclusions have been echoed by leaders of the most prominent providers of direct business technical assistance in Kosova, who, based on experience to date, feel that (i) the absorption capacity of firms is indeed limited; (ii) firms often want a loan to a solve a cash flow problem they do not have; (iii) enterprises are underestimating weaknesses in their own management skills, and (iv) the need for internal capacity building in firms will not be overcome in the short run. As banks develop higher professional standards of their own, it will be imperative that business do the same.

The international community, in some of its programs for technical assistance, is focused on increasing the capacities of private enterprises and establishing a more favorable institutional environment for development of private businesses in Kosova. Two key programs, described below, are USAID's Kosova Business Support program, and the EU's Integrated SME project.

(1) **USAID Kosova Business Support (KBS)**

The main objective of this three-year $11.5 million program is to support a revival of the SME sector, encouraging employment and investment. It is the largest technical assistance program aimed at the business community currently being implemented in Kosova. Key activities include:

(i) Support for institutional development (training of trainers) of local organizations;

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between 10 and 15%, and the general opinion of the respective business communities that such real rates are burdensome.

(ii) Support for businesses in Kosova through the provision of consulting services in private companies (strategy, marketing, operations, accounting systems, turnaround)

The KBS team is composed of local and international experts. They offer to their clients the following services: creating contacts with foreign companies, identifying trade and investment opportunities; conducting business and marketing planning; undertaking operational improvements, and delivering training programs. By participating in this program, Kosovar companies will benefit in many aspects, including the development of their human resources and professional capacities.

The KBS program reports approximately 250 enterprises actively participating in the program (with an average of 20 employees) including new bookkeeping systems having been installed in about 100 firms. While this number will increase over time, our concern is that given an active enterprise population of 11,000, this coverage ratio is still very limited, and that a significant need exists for additional efforts to address the problem of internal enterprise capacity.

(2) EU Integrated SME Development Programme for Kosova

This technical assistance project is being financed by the European Agency for Reconstruction (EAR) and is part of a wider effort to support SME development. Project components are the following:

- ***Component 1***: Improving the enabling business environment for SMEs by facilitating dialogue between the business community and the public sector, reviewing key laws and regulations impacting SME development, and conducting research on issues of relevance for the SME sector;
- ***Component 2***: Assist the recently established Private Sector Development (PSD) Unit within DTI of Pillar IV to become the focus of SME support by helping develop a SME Development Strategy, a database of SME support programs, and designing new SME support programs;
- ***Component 3***: Establish a network of Local Enterprise Agencies in the regions to provide business information, counseling, and training to SMEs.

Other international organizations such as ILO, Swisscontact, UMCOR, AFEF, IOM and GTZ are implementing technical assistance programs in Kosova. However, we are unable to identify a consistent structure of technical assistance for increasing the capacities of SMEs, and support the immediate establishment of such a structure. Obstacles to this may be: (i) the absence of a strategy for SME development in Kosova; and (ii) the limited degree of organization within the business community itself.