Kosovo Credit Guarantee Fund:

Models of Management and Effectiveness

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List of Acronyms

DCA	Development Credit Authority
KCGF	Kosovo Credit Guarantee Fund
KfW	Kreditanstalt für Wiederaufbau
MAFRD	Ministry of Agriculture, Forestry and Rural Development
MTI	Ministry of Trade and Industry
SECO	State Secretariat for Economic Affairs
USAID	United States Agency for International Development
VI	Vienna Initiative

Executive Summary

High interest rates for loans and access to finance are among leading problems for Kosovar businesses. Aiming to improve the situation, the Government of Kosovo, specifically the Ministry of Trade and Industry (MTI) in cooperation with international donors has initiated the establishment of Kosovar for Credit Guarantee Fund (KCGF). This Fund goal is to increase bank lending toward businesses, by guaranteeing up to 50% of the outstanding principal of businesses toward banks. According to MTI's projections, it will create new loans in the amount of 360 million Euro, which will in turn create up to 20,000 new jobs.

Other countries' experiences suggest that these types of funds, in general, did not have an impact in the growth of non-performing loans; however, there have been cases where positive effect on investment was absent. In general, developed countries with more stable financial and banking systems, have been more successful in the creation and growth of new businesses and as a result, in the creation of jobs. In Kosovo, a similar fund has been created, namely the Development Credit Authority, and has been partially successful due to limited financial capacities to issue guarantees for loans compared to the need for loans. Also, despite of the fact that the main goal has been to reduce interest rates for 10%, this fund has managed to reduce them for only 3-5%.

Compared to other financing methods, experiences from other countries suggest that similar guaranteeing funds are more preferable than subsidies. This is so because loans are administered from commercial banks, and they are more efficient and effective in allocating funds compared to public agencies.

Considering financial capacities of KCGF, GAP Institute considers that there will not be a significant impact in increasing the lending activity of banks toward businesses. GAP Institute recommends that along with the implementation of this fund, Government of Kosovo should work in improving the doing business environment in Kosovo, especially in regards to rule of law, reducing the informality and strengthening the banking system. GAP Institute also recommends to include the private sector, especially commercial banks, as share-holders in the fund.

1. Introduction

Small and medium businesses, especially start-ups, have many difficulties in accessing funds through banks. Interest rates on loans, that were 10.6% in June 2014[1] and around 10% in 2015[2], are considered as high for these businesses. This interest rate is one of the highest in the region[3]. Over 50% of the loan portfolio is allocated to trade sector. While the agriculture sector, part of the production sector, consumes only 3.6% of loans[4]. The ratio of loans to overall deposits in Kosovo's banks is 78.1%[5]. This indicates that commercial banks have unused liquidity. Moreover, businesses have listed high interest rates and difficulties accessing funds as two of the biggest challenges.[6]

To address this problem, the Ministry of Trade and Industry (MTI) unveiled plans to establish the Kosovo Credit Guarantee Fund (KCGF). The amount of this fund will be around 19 million Euro, 18 million of which will come as a donation from USAID, KfW and SECO and 1 million from the Ministry. KCGF will cover up to 50% of the collateral or risk for the approved loans, and consequently eventual losses. Through KCGF, the Ministry aims to reduce difficulties that businesses face in accessing financial instruments, a problem that prevents businesses from expanding. Based on Ministries' projections, for the first six years, KCGF will make possible 360 million euro new loans that have potential to create 20 thousand new jobs[7].

The aim of this analysis is to identify some of the challenges that are associated with implementing KCGF, based on experiences of managing similar funds in Kosovo and beyond, and provide recommendations for its management.

[1] Central Bank of Kosovo "Financial Stability Report" No. 6, December 2014
[2] Central Bank of Kosovo "Monthly Statistics Bulletin" No.166, June 2015
[3] World Development Indicator, Real Interest Rates. Burimi: http://bit.ly/1Pc1M8S
[4] Central Bank of Kosovo "Financial Stability Report" No. 6, December 2014
[5] Central Bank of Kosovo "Financial Stability Report" No. 6, December 2014, p. 47
[6] Riinvest Institute"Performanca, Barrierat, dhe Besueshmëria e Bizneseve në Kosovë", 2013, Source: http://bit.ly/1Mk41Ir
[7] Ministry of Trade and Industry "Concept Document on the field of Establishing a Kosovo Credit Guarantee Fund"

2. How will KCGF function

On 17 June 2015, MTI published the concept-document on KCGF, where it provides the reasons and some options to establish such a fund. According to MTI, the main purpose of KCGF is to facilitate access to finance for small and medium businesses, start-ups, businesses run by women, as well as the agricultural sector. By serving as a connecting bridge between these businesses and commercial banks, KCGF aims to stimulate the Kosovo economy, by increasing investments and employment level, and to improve the trade balance of Kosovo. According to MTI's projections, KCGF will make possible issuing 360 million euro in new loans which have potential to create up to 20 thousand new jobs.

Two options to establish KCGF are presented in the concept-document, without taking into account the initial option not to have such a credit guarantee mechanism. According to the second option, KCGF would be established based on a new law that would be voted in the Parliament. This fund would be established as an independent entity from the Government, with full autonomy, with the support of the Ministry, USAID, KfW and SECO as donors. KCGF would later become financially self-sustainable through fees that would be paid by banks that issue loans with the guarantee of the fund. The procedures to obtain the guarantee would be integrated into the internal bank procedures[8]. According to projections of the Ministry, KCGF is expected to generate up to 280 thousand in profit during the first six years[9].

According to the third option, the Government together with the private sector would assist in establishing a joint stock company or a non-governmental organization. In principle, the function would be the same as with the second option. But, according to MTI, the private sector did not show any interest to undertake such an initiative, for this reason the Ministry recommends the second option[10].

The draft law on KCGF represents the basis and legal requests of the functioning of KCGF. Through this draft law the structure and

[8]Ministry of Trade and Industry, Interview with Ilir Salihun, 15 July 2015
[9]Ministry of Trade and Industry, Interview with Ilir Salihun, 15 July 2015
[10]Ministry of Trade and Industry "Concept Document on the field of Establishing a Kosovo Credit Guarantee Fund"

procedures of granting the guarantee of KCFG are clarified. KCGF would be managed by the Managing Director, whose work would be supervised by the Managing Board. One of the obligations of the KCGF would be to approve or reject requests from banks to reimburse guaranteed loans that were not returned. A condition for the approval of the request would be to fulfill the criteria specified under Article 6 of this draft law. Banks would take the decision to place a client under the guarantee of KCFG, while KCFG would have an oversight role in this process[11].

3. Experience with Development Credit Authority

A similar fund to KCFG already exists in Kosovo. On 26 September 2012, an agreement was signed between the Ministry of Agriculture, Forestry and Rural Development (MAFRD), USAID and six commercial banks in Kosovo (Raiffeisen Bank, TEB, ProCredit Bank, BKT, NLB and Banka Ekonomike) to establish the Development Credit Authority (DCA) which aimed at facilitating access to finance for farmers and agribusinesses. This project will be completed in 2020.

DCA has access to 21 million Euro provided by USAID and 2.5 million provided by MAFRD. DCA covers 50% of the loan in all cases and targets agribusinesses and commercial farmers with potential to grow[12]. Based on the agreement, loans that are covered by DCA need to be from 5,500 euro to 180 thousand euro. Therefore, any loan between these amounts is qualified to be covered by DCA, always if some preconditions are met by individual banks. For example, ProCredit Bank requires from borrowers to be registered businesses to be covered by DCA.[13]

Banks that cooperate with USAID and MAFRD in this project had to pay a fee after the allocation of funds as well as a fee on provided loans that were placed under the guarantee of DCA during a year. The higher the risk for a non-performing loan, the higher the fee.[14]

[11] Ministry of Trade and Industry "Draft-Law on Establishment of Kosovo Credit Guarantee Fund"
[12] USAID, Interview with a USAID official, 9 July 2015
[13] ProCredit Bank Kosova, Interview with Shpend Xharra and Armend Hoxha, 3 July 2015.
[14] USAID, Interview with a USAID official, 9 July 2015

The decision to place certain loans under the guarantee of DCA were taken by the banks themselves. However, these banks report to USAID every six months for each granted loan under the guarantee by DCA. At the same time, USAID reserves the right to refuse to guarantee a loan that the bank placed under the guarantee of DCA in case it sees that applicable standards according to the agreement were not met.

DCA did not increase non-performing loans, despite the fact that guarantee mechanisms are expected to increase such loans. Out of 193 loans granted under the guarantee of DCA, from 2012 to March 2015 by ProCredit, only five are non-performing[15]. Banka Ekonomike, although it did not use the fund fully, also reports not having non-performing loans[16]. Raiffaisen Bank had a low percentage of non-performing loans, but this percentage it attributes to other factors as well such as private bailiffs, established cooperation with clients and general awareness of clients to return loans[17]. The fact that clients of some banks were not informed that their loan was placed under the DCA agreement also contributed to the low level of non-performing loans.

In general, DCA program was successful, although the fund allocated to DCA was very small compared to the needs of businesses for financing. In comparison, during three years of cooperation with DCA ProCredit granted loans amounting to six million euro, which is the same amount of loans granted by this bank during a quarter in the field of agriculture[18].

Although the impact of the program was positive, it cannot be said that it brought substantial change in Kosovo's economy. In addition, DCA promised to lower the interest rates for 5-10% for clients that are placed under the guarantee of this fund. However, interest rates only dropped for 3-5%[19].

4. Experiences of other countries

Studies show that success of guarantee funds is not certain and depends on the way it functions. In general, developed countries

[15] ProCredit Bank Kosova, Interview with Shpend Xharra and Armend Hoxha, 3 July 2015.
[16] Banka Ekonomike, Interview with Shpend Kusari, 21 JulyKorrik 2015.
[17] Raiffaisen Bank, Interview with Bujar Shkodrën, 22 July 2015.
[18] ProCredit Bank Kosova, Interview with Shpend Xharra and Armend Hoxha, 3 July 2015.
[19] Ministry of Agriculture, Forestry and Rural Development, Interview with Ekrem Gjokaj, 8 July 2015.

with a sound financial and banking system, were more successful in creating and growing new businesses and as a result in creating jobs. In some cases, even developing countries, such as Colombia and Paraguay managed to create successful funds[20].

Funds or guarantee mechanisms for loans, in theory, create the risk of non-payment of loans. The risk in this case is twofold because the bank has an additional safety net therefore it can lower the criteria to issue the loan, but also the borrowing business has less incentive to pay the loan. However, empirical data to support this claim is missing.

This does not happen for several reasons. Initially, such funds only cover a part of the loan. The rest contains enough incentive for banks to conduct enough due diligence of clients. However, to reach such a level, governments had to design credit guarantee funds in such a way that would incentivize all the actors to fulfill their obligations on time. Many studies of history of previous loans of all borrowers were conducted to reach such a division of risk.[21]

If a loan is not returned, governments have legally obliged banks to go through several phases before they request that that loan is covered by the fund. Such mechanisms include additional time to pay the installments and involvement of legal measures to take possession of the collateral, if it was part of the loan contract.[22] This shows that rule of law and its implementation affect the proper functioning of a credit guarantee fund.

Further, the main interest of banks in such cases is not simply granting loans to businesses, but keeping borrowers as clients for a longer timeframe. Usually, the beneficiaries of such funds are small businesses, which do not bring a lot of profit to the banks. For this reason, when granting loans guaranteed by the fund, banks consider the potential of borrowers to grow and generate more profit for the bank before they approve that loan[23].

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[20] Irani Arraiz, Marcela Melendez and Rodolfo Stucchi "Partial credit guarantees and firm performance: evidence from Colombia".

[21] Vienna Initiative "Credit Guarantee Schemes for SME lending in Central, Eastern and South-Eastern Europe".

[22] Ted K. Bradshaw " The Contribution of Small Business Loan Guarantees to Economic Development"

[23] Allan L Ridinga and George Haines "Loan guarantees: Costs of default and benefits to small firms"

Apart from this, data indicates that in cases when credit guarantee mechanisms were initiated, the overall risk of non-performing loans significantly decreased. This happened because companies and businesses that were risk-averse to loans, had more incentives to get a loan because they had the guarantee of the fund. Such companies take less risk even in projects they implement and finance and for this reason the chances are smaller that these new companies lose economically[24].

Regarding models of managing the fund in the region, there are different types of funds or credit guarantee mechanisms. They can be public, private or co-owned by government and private entities and could even be supranational where the organization and administration of funds is carried out in an international level with the contribution of each participating state. Most similar funds in Central and South East Europe are public, fully funded by the government.[25]

Of the states that have public funds, 2/3 function as public corporation and 1/3 as structures integrated in the government. Most of the funds assess loans in individual basis and not as portfolios of loans. However, for small amounts of credit it is preferred to consider them as portfolio and not individually, because bureaucratic procedures are reduced. More than half of public funds in the region delegate most of the tasks to the banks, and a very small part contact directly with the borrower. The guarantee usually does not cover the interest earned by the bank. In most cases, borrowers pay a fee to the fund before they obtain the guarantee, which is used to make the fund financially self-sustainable. Borrowers that fail to return the debt to the bank, pay more the next time they request a guarantee from the fund or are entirely refused by the fund. The experience of some countries has shown that in some cases these fees should

[24] Alan Grimshaw and Robert 0.Eidmister "SBA &fault Rates Selection Bias and Credit Deterioration"
[25] Vienna Initiative "Credit Guarantee Schemes for SME lending in Central, Eastern and South-Eastern Europe"

receive subsidies from the government because without government subsidies they were unaffordable for small and medium businesses.[26]

In some banks in the region even after applying the guarantee funds the collateral is required as a condition for the loan[27]. Technically, the collateral may be required from the clients that approach the bank for credit, but the value of collateral and the value of guarantee should not exceed the total value of the loan. However, this fact shows that even after the implementation of the guarantee funds for the loan, businesses again needed collateral to compete with other companies for funds from banks.

Countries in the region, as well as other countries in the world, constantly assess the performance and effect of such guarantee funds. Performance is evaluated in two aspects: in scope, i.e. fulfillment of the need for credit guarantee in the market and in financial sustainability, i.e. how the fund can cover 'losses' or payments for non-performing loans. These two ways are easily measured compared to criteria that is used to assess the effect of the fund. To understand the latter, one needs to understand how many loans were granted that would otherwise not be granted in absence of the fund (*financial additionality*), as well as how the fund affected the overall wellbeing of citizens by focusing on investments and jobs (*economic additionality*).

Table. 1. Credit Guarantee Funds

Country	Type of fund	Percentage of guarantee	Amount of fund (million Euro)
Hungary	Public-private	Up to 80%	1,000
Romania	Public-private	Up to90%	116
Poland	Public	50-80%	287
Bosnia and Herzegovina	Public	50-90%	21
Slovakia	Public	70%	73
Bulgaria	Public	Up to50%	174
Slovenia	Public	60-80%	190
Albania	Multinational	70%	40
Serbia	Public	50-70%	400

[26] Vienna Initiative "Credit Guarantee Schemes for SME lending in Central, Eastern and South-Eastern Europe"
[27] Vienna Initiative "Credit Guarantee Schemes for SME lending in Central, Eastern and South-Eastern Europe"

Czech Republic	Public	60-70%	5,000
Croatia	Public	Not fixet	800
Macedonia	Public	42%	15

5. Best practices of fund management

A study published by Vienna Initiative (VI), on countries listed in Table 1 has summarized best practices regarding credit guarantee funds. Initially, it is recommended that such funds, especially public ones, have a clearly defined mandate that sets the target sector, market positioning and financial sustainability. The mandate of the fund should indicate which the problem is and how it can be mitigated by the fund, and how it would achieve financial sustainability with the income it receives from borrowers. All those who request guarantee from the fund pay a membership fee. This sum, which is ensured that it would be affordable for all those who apply for loans, contributes for the financial sustainability of the fund.

Moreover, according to the VI study it is very important to create good communication channels between the fund, the government and the central bank, to harmonize efforts of these three factors for economic development.

Also, the study of VI shows that it is important to encourage the participation of private sector in these funds, especially of commercial banks that will provide the loans themselves. The experience of other countries has shown that banks consider their clients carefully when they are partial owners of the fund. Further, the government should aim to create such an environment so that there would not be any need for such funds. So the ultimate objective of the fund is to encourage cooperation between the bank and the clients without facilitation of a third party.

Regarding the coverage of the loan through the guarantee, based on the VI's research, the coverage of less than 50% has not shown any effect in increasing the number of small businesses that request loans from banks. However, higher coverage, for instance in the range of 90-100% had a negative effect, especially on banks. That is because almost the whole value of the loan was covered by the fund and banks were not very motivated to monitor and conduct proper due diligence of clients.

The assessment of potential clients, according to the abovementioned study, is preferably left to the private sector, namely banks, since the private sector has more capacity and experience in this regard. Large amounts of loans are recommended to be evaluated individually by the banks, whereas the small loans are recommended to be evaluated as part of credit portfolios.

VI suggests that the method of payment from the fund to the banks for bad loans is designed as such as to be profitable for the banks. There should be as less bureaucratic procedures as possible and efficient methods in order for banks to cooperate with the fund. A very important factor is rule of law and its implementation in practice. For this reason, each country, based on its characteristics, should draft laws and regulations that give banks the possibility to request return of debt and simultaneously push them to cooperate with the fund.

To ensure smooth operations of the processes connected with the fund, it is very important to have assessments of performance and effects of the fund in the country. VI's study results that oversight should be done by an independent and apolitical body while the monthly or annual reports should be published and be accessible to all.

6. Comparing the guarantee fund with subsidies

Compared to other methods of stimulating economy, such as subsidies or joint investments, banks prefer such a guarantee fund. The advantage of this method compared with others subsidies relies on that the banks can collect the debts towards them more quickly and with less expenses[28]. Moreover, different countries prefer such a system to provide possibilities of sustainable and long term cooperation between banks and new businesses, as one of the main pillars of economy. Such funds serve as a bridge between new businesses and banks, with the goal that their relation continues even without the support of the funds.

[28] Irani Arraiz, Marcela Melendez and Rodolfo Stucchi "Partial credit guarantees and firm performance: evidence from Colombia"

The experience of other countries has shown that such guarantee funds are preferred more than subsidies. Because loans are administered by commercial banks, based on the fact that banks are more efficient and better equipped than public agencies to disburse funds in the right places, ultimately they give better results for the overall economy compared with methods administered by public agencies. [29]

Another advantage of this method compared to the subsidies method or co-investments in new businesses is that in general financial means that are used throughout the program are significantly smaller. Therefore the financial cost of such a credit guarantee program is smaller than that of other methods that could be utilized to assist small businesses and start-ups. This feature is considered as an advantage, but precisely because its low cost it can be used for political gains. Credit guarantees can be provided to businesses that do not fulfill the requirements to be granted such loans because there is no cost of issuing the guarantee. To avoid such situations, many countries have dedicated a lot of time to design such programs and implementing criteria for guarantee and have assessed continuously these programs.[30]

7. Challenges for implementing KCGF

First challenge with regard to effectiveness of this fond is the sum of the new loans which is going to cover. As mentioned above, for six years this fond will generate approximately 360 million euro of new loans, while 600 million euro new loans are issued to businesses in Kosovo within only a year. Therefore taking into account the size of this fond compared to the aggregate demand for loans by businesses, it is not expected that it will have a significant effect in increasing lending activity of commercial banks toward businesses.

In order for KCGF to function, it is necessary to undertake some changes in advance. Based on the experience of other countries, it can be deducted that it is important for banks to have the possibilities to collect their debts through other methods before they turn to the

[29] Vienna Initiative "Credit Guarantee Schemes for SME lending in Central, Eastern and South-Eastern Europe"
[30] Vienna Initiative "Credit Guarantee Schemes for SME lending in Central, Eastern and South-Eastern Europe"

fund. This would be difficult to be implemented in Kosovo taking into account that the justice system, to date, did not assist in collection of debts in the form of mortgages.[31] According to the World Bank report "Doing Business in Kosovo 2015" out of 189 countries in the world, Kosovo is ranked 138th on enforcement of contracts and 164th regarding settlements of bankruptcies. This challenge should be addressed before the establishment of the fund.

It is recommended that private sector participates in the fund as shareholders[32]. However, according to the MTI concept-document, the private sector did not show any interest to participate in such a fund. This lack of interest should be addressed and additional efforts should be made to integrate the private sector in the fund.

Another problem observed in Kosovo is the lack of information that banks have on businesses due to the high level of informality, which for the moment is one of the biggest problems of the banking system in Kosovo[33]. Due diligence of clients will be deficient even after the establishment of KCGF, which would hinder the functioning of the fund. The high level of informality has caused the liquidity of banks not to be fully exploited in Kosovo[34].

Another problem that also occurs in other countries relates to the collateral. One of the reasons of creation of KCGF is to facilitate access to financial means for businesses that have little or no collateral to offer as guarantee. However, even following the establishment of such funds, banks have continued to favor clients with more collateral, as a consequence larger companies had more access in funds leaving less space for small businesses or start-ups. Moreover, in other countries payments towards the fund and percentage of coverage of loans by the funds were based on previous loans and detailed studies. Such studies should be conducted in Kosovo as well, prior to the creation of KCGF.

Table2: Presence of recommended practices in the MTI concept document

[31] European Commission "Progress Report for Kosovo 2014" Source: http://bit.ly/1NumtMW
[32] USAID, Kosovo Credit Guarantee Fund Feasibility Study, May 2012
[33]European Commission "Progress Report for Kosovo 2014" Source:: http://bit.ly/1NumtMW
[34]European Commission "Progress Report for Kosovo 2014" Source:

Recommended practices	Present in concept-document
Clear and specific mandate	Partly
Communication protocol with CBK and Government	Missing
Shareholders from private sector	Missing
Fees from clients	Partly
Due diligence of clients by the banks	Present
Coverage 50-90%	Partly
Percentage of collateral	Missing
Performance assessments	Missing

8. Conclusion and Recommendations

Experiences of other countries that created credit guarantee funds suggest that success is possible. In most cases a stable banking system was somewhat a prerequisite for proper functioning.

These funds mainly serve to increase the number of start-ups and small businesses in the market, by harmonizing the interest of banks with those of businesses. In general these funds did not deteriorate the situation regarding non-payment of loans, but there are cases where positive effect on investment was absent. Taking into account the financial capacities of the KCGF, it is not expected that it will have a significant effect on lending activity of banks toward private businesses.

The main problem that banks in Kosovo have with non-performing loans is that they lack information, especially external audits, to conduct proper due diligence of their clients. Lack of information makes banks more suspicious of small business and leads to non-performing loans. This problem will not be automatically fixed following the creation of KCFG.

Therefore, GAP Institute recommends:

- Law on KCGF sets the percentage of coverage and fees from the beneficiaries of KCGF;
- Financing structure of KCGF should be reviewed. KCGF should have a mix finance, with contribution of government, foreign donors, but also of commercial banks in Kosovo;

- Law on KCGF to clarify communication protocols between CBK, KCGF, MTI and other actors;
- To work in advance and in parallel to strengthen the legal system, especially the sector that deals with debt collection;
- To work in advance and in parallel to decrease informality of businesses; and,
- To regulate by law the issue of collateral that may be requested from clients by the banks.

INSTITUTI GAP

GAP Institute is a local think-tank founded in October 2007 in Kosovo. GAP's main purpose is to attract professionals by creating a professional research and development environment commonly found in similar institutions in Western countries. This will include providing Kosovars with an opportunity to research, develop, and implement projects that would strengthen Kosovo society. A priority of the Institute is to mobilize professionals to address the country's pressing economic, political and social challenges. GAP's main objectives are to bridge the gap between government and people, and to bridge the gap between problems and solutions.

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