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KOVOSO CREDIT GUARANTEE FACILITY FEASIBILITY STUDY

May 2012

FINAL REPORT

DISCLAIMER

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ACRONYMS

AMIK	Association of Microfinance Institutions of Kosovo
CBK	Central Bank of Kosovo
DCA	Development Credit Authority
FI	Financial Institution
GOK	Government of Kosovo
IMF	International Monetary Fund
KBRA	Kosovo Business Registration Agency
KCGF	Kosovo Credit Guarantee Facility
MFI	Micro Finance Institution
MTI	Ministry of Trade and Industry
NBFI	Non-bank Financial Institution
NLB	Nova Ljubljanska Banka
NPL	Non-performing Loan
RBK	Raiffeisen Bank of Kosovo
SEE	South Eastern Europe
SME	Small and Medium Enterprise
TAK	Tax Administration of Kosovo
USAID	United States Agency for International Development

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FEASIBILITY STUDY

KOSOVO CREDIT GUARANTEE FACILITY (KCGF)

1. INTRODUCTION

Kosovo's economy has been growing steadily over the past years, with a GDP growth rate of 4% in 2010 and 5.3% in 2011.[1] Yet, it still faces many challenges as this growth is dependent upon foreign aid and remittances (15% of GDP in 2009), and is too low to address the high unemployment rate and to absorb new job market entrants estimated at 30,000 per year. In addition, Kosovo faces a massive trade imbalance. Although exports have grown faster than imports (in percentage terms) for the past two years, the annual trade deficit is 45% of GDP (2009).

The informal market, self-employment and remittances, provide income to many of those officially categorized as unemployed. The vast majority of Kosovo's enterprises (98%) have fewer than 9 employees, fewer than 2,000 companies have more than ten employees, and they face key constraints including: lack of product standards, the unreliable electricity system, insufficient transportation corridors, high cost of financing, weak courts and contract enforcement, and the overall weak economic demand.

The financial sector is stable, although small and not fully developed. There are 8 commercial banks and 17 microfinance institutions, and most commercial banks are foreign owned. Three foreign banks (Pro Credit Bank, Raiffeisen Bank of Kosovo and Nova Ljubljanska Banka) hold approximately 80% of total bank assets. According to Kosovo's Central Bank (CBK), several factors characterize the banking system:[2]

- Continues to have the lowest level of non-performing loans among the SEE region countries, at 5.9 percent.
- Enterprise financing continues to be dominated by loans to the trade sector, which in June 2011 represented 52.5% of total loans to enterprise.
- Average interest rate for loans issued by commercial banks was 14.3% during the first half of 2011, while the average interest rate on deposits was 3.4%.
- Continues to be quite conservative regarding the level of reserves, which continuously exceeds the minimum level required by the CBK.

Financial institutions are cautious when lending to businesses for a number of reasons, including an uncertain rule of law and unclear property rights. Unfamiliarity by the banks when lending to certain sectors, such as agriculture, exacerbate the lack of lending, and of competition among banks. Banks are also hesitant to explore other forms of financing, such as leasing. More recently, signs of change are evident as banks are now more willing to explore lending opportunities and new forms of financing, such as factoring.

One of the tools that can be used to expand access to credit for the private sector is guarantees. USAID has had a very successful experience with Raiffeisen Bank of Kosovo, and currently have another DCA in place for young entrepreneurs, while developing a third DCA to address the needs of the agricultural sector. As a result, USAID is interested in looking at the feasibility of a more sustainable credit guarantee institution.

The objective of this feasibility assessment is to determine whether a local credit guarantee facility can be successfully established and become self-sustainable. The assessment will review legal considerations, various operating models for credit guarantees facilities, market demand, and financial analysis. The intent is to establish a credit guarantee facility that is free from political capture, requiring an institution

[1] Estimate from 'Southeast Europe: Regular Economic Report', World Bank, November 15, 2011

[2] Financial Stability Report #2, Kosovo Central Bank, November, 2011

that is fully independent or quasi-governmental, and will likely involve numerous partners, such as other donors, banks and the Government of Kosovo (GOK).

As a result, USAID engaged the services of a team of experts, familiar with both the Kosovo financial system and with the establishment and management of credit guarantee institutions (see Annex 1 for the Scope of Work). They visited the key institutions – IMF, CBK, commercial banks, non-bank financial institutions (NBFI) and GOK entities (see Annex 2 for a list of individuals and institutions visited) – and then presented their findings, along with a model institution for discussion to the same group, prior to finalizing this report. As a result, the contents of this report have been vetted with a broad section of interested parties. At the same time, KfW, the German reconstruction bank, commissioned an independent study to examine the same question, and while the consultants were not in the country at the same time, they were able to share information and coordinate activities so that the two studies would complement each other.

2. CREDIT GUARANTEE FACILITIES

Credit guarantee facilities first appeared in Europe in the 19th and early 20th century as governments, NGOs and entrepreneurs sought to ease access to finance constraints for small and medium enterprises (SME). Currently, there are over 2,250 facilities of different forms in almost 100 countries.[3] Credit guarantee facilities provide guarantees to borrowers who have difficulty accessing credit, by covering a share of the risk of loan default. In the case of default, the lender can recover the value of the guarantee. Credit guarantee facilities are thus designed to diminish the risk associated with lending to SMEs, and can help to improve loan terms and facilitate access to credit.

There are three types of guarantee facilities:

1. **Program**: Public guarantee schemes are established by public policy, nationally or internationally and usually involve state subsidies, especially during the initial periods, and are typically managed by an administrative unit of a government. An advantage of this system is that, in case of loan default, the guarantee is paid out directly from the government budget, although political influence can be an issue. These are often called "unfunded" guarantee facilities.
2. **Corporate**: Corporate guarantee schemes are generally financed and operated by the private sector, e.g. banks, chambers of commerce, and can often be a public-private partnership. Corporate guarantee schemes have the advantage of being managed by experienced corporate leaders, and generally benefit from the direct participation of the banking sector. By accessing private funding, these schemes reduce the dependency on public funds, which can sometimes be unstable. These facilities are often referred to as "funded" guarantee facilities.
3. **Mutual**: These schemes are also known as mutual guarantee associations, societies or funds. They are private and independent organizations formed and managed by borrowers, often within an industry segment such as taxi drivers, eye glass manufacturers, with limited access to bank loans. Although they are largely funded from membership fees, in many instances, they operate with some form of government support. Mutual guarantee schemes benefit from the active involvement and experience of their members.

A 2008 World Bank study of 76 guarantee schemes across 46 developed and developing countries (Klapper, Beck and Mendoza, 2008) has shown that mutual guarantee funds tend to operate in high-income countries as they require a large critical mass of "like" SMEs, while most middle and low-income countries have publically operated (program) funds. The report also found that public facilities are, on average, younger than mutual facilities and are more likely to operate in emerging

[3] Credit Guarantee Schemes for Small Enterprises: An Effective Instrument to Promote Private Sector-Led Growth? 2003

markets. In many countries without locally capability, relatively sizeable international donor facilities have been used, but with limited terms, ie. USAID Development Credit Authority (DCA).

Credit guarantee facilities use a leverage factor as an indicator of the level of risk that the fund is able or willing to accept. Generally, funded facilities have lower leverage factors, than unfunded facilities, for obvious reasons, since the latter rely upon relatively deep public funds. A partial list of credit guarantee facilities and their associated leverage factors are included in Table 1.

Table 1. Country Credit Guarantee Funds

Country	Institution	Year Established	Leverage (Year measured)
Argentina	FOGABA	1995	0.5 (2001)
Brazil	SEBRAE	1995	1.9 (2001)
Colombia	FNG	1982	10 (2009)
Croatia	HGA	1995	20 (2001)
France	SOFARIS	1971	22 (1995)
Germany	Bürgschaftsbanken	1954	26 (1994)
India	DICCG	1981	11 (1994/5)
Japan	CIC & NFCGC	1937	15 (1995)
Korea	KCGF	1976	15 (1995)
Malaysia	CGC Berhad	1972	8 (1995)
Mexico	Nacional Financiera	1997	5 (20010
Peru	FOGAPI	1979	14 (2001)
RAFAD[4]	Swiss Agency	1985	3.5 (1994)
Taiwan	SMBCGF	1974	10 (1994)
Romania	RLGF	1993	1.5 (2000)
US[5]	Accion Bridge Fund	1984	1.4 (2001)

Given the fact that Kosovo is a small country, with restrictions imposed upon it by the International Monetary Fund (IMF) for their financing arrangements, it is unreasonable to contemplate a solely publicly-funded credit guarantee facility. In addition, this direction may be counterproductive to a government that is already facing human resource challenges. Furthermore, Kosovo does not have the critical mass of like enterprises to support the creation of a mutual guarantee association. Hence, ***the model that would seem most appropriate for Kosovo would be a corporate model,*** possibly involving the public sector to an extent that would encourage dialogue and cooperation, but minimize the risk of political interference. Pursuing a mixed ownership model would secure the commitment and engagement of the financial sector and those interested in developing the SME sector, leading to higher chances of sustainability.

REGIONAL GUARANTEE FACILITIES:

There are several guarantee facilities currently operating in the South East Europe (SEE) region, which were established to facilitate access to credit for SMEs, as SMEs in this region are required to supply an **average of 153 percent of collateral** to loan value (Klapper, Beck and Mendoza, 2008). A similar figure for SMEs within the European Union is 100 to 120 percent of collateral to loan value.

As measured by the OECD Investment Reform Index, results within the region have been mixed (Table 2). As is stated in the latest report (Investment Reform Index, 2010) "*Many initiatives exist in SEE to develop guarantee schemes. However, numerous schemes do not seem to have achieved the expected results and visibility. The design, scope and impact of schemes should be more fully assessed*."

[4] RAFAD is a Swiss-based guarantee fund that operates in several countries.
[5] This is a US-based fund which operates in other countries.

In the more developed of these programs, several types of guarantees are available, and the volume and number of loans covered is increasing, indicating that borrowers and lender perceive value. Generally the procedures are fair and transparent, however some weaknesses include low-risk coverage (guaranteed portion of the loan is not high enough to attract the interest of banks), and poor resourcing. And most of the regional models are programmatic or corporate, with only Croatia maintaining a mutual guarantee mechanism.

Table 2. Regional Credit Guarantee Facilities

Country	Institution	Impact (OECD Investment Reform Index)
Albania	Export Credit Guarantee (Albinvest)	Very limited
Bosnia & Herzegovina	Export Credit Agency	Very limited
Bulgaria	National Guarantee Fund European Investment Fund	Relatively young, limited impact
Croatia	Croatian Agency for Small Business (1994)	Well established, good impact
Macedonia	Macedonian Bank for Development Promotion	Extremely limited in coverage
Moldova	Interbank Guarantee Society (Garantivest 2005)	Very limited impact
Montenegro	Serbia and Montenegro Export Credit Agency	Very limited impact
Romania	Loan Guarantee Fund for SMEs (FNGCIMM) Rural Credit Guarantee Fund (NFI)	Well developed scheme
Serbia	Development Fund of Serbia	Well developed scheme

More specific information on the performance and effectiveness of these facilities are not publicly available, but two regional experiences that are worth noting are described below:

- **The Development Fund of Serbia**: The Fund (http://www.fondzarazvoj.gov.rs/) is 100% government owned, providing loans and guarantees with the aim of encouraging economic growth, equal regional development, employment and capital market development, and promoting the competitiveness of the domestic economy and service industries. Interest rates are capped at 3% per annum for short-term loans, and between 2.8 and 4% per annum for investment loans. Minimum loan amounts are RSD 500,000 for firms. Serbia also has a small Dinar guarantee program, as well as a regional guarantee program in Vojvodina. Further investigation is required to determine the strengths, weaknesses and performance of these schemes.
- **Macedonia Bank for Development Promotion (MBDP) Guarantee Fund:** The MBDP Guarantee Fund was established in 2005 to facilitate SME access to long-term finance, and it is 100% government owned. To date, the fund has only issued two guarantees. It would appear that little, if any, input was obtained from local banks. The maximum loan size was € 150,000, with only 33% coverage and a cap of € 35,000. As a result, uptake by the banks was minimal and given that the MBDP had its own legislation, changing the parameters would require the changing of the law.

Should the establishment of a credit guarantee facility be pursued, then the wide variety of regional experiences – and others – will provide a valuable training ground prior to establishing the scheme.

3. SME BORROWING

The two key factors in determining the feasibility of a credit guarantee facility are demand for the guarantee and "additionality" – whether the bank would have made the loan without the guarantee. Estimating demand is more "*an art than a science*" as noted in the study by Beck, Klapper and Mendoza (2008), who reviewed 76 guarantee funds, further noting that "*demand is the hardest factor to estimate.*" While additionality can be estimated, it is something that needs to be tracked to ensure that the mission of the facility is being achieved, and through the setting of certain parameters such as percentage of

guarantee, fee structure, and sector focus, additionality can be proactively managed to encourage banks to extend more credit to SMEs.

This exercise has confirmed the findings by Klapper, Beck and Mendoza, that demand for a facility in Kosovo is difficult to accurately estimate. As a result, the approach to estimate demand included an analysis of the characteristics of the SMEs, such as number of SMEs, their size, their turnover, as well as the borrowing trends[6]. In addition, success of previous guarantee programs was examined, as well as gauging the reaction of the financial community – banks, non-bank financial institutions, GOK, IMF, CBK – to the concept of a credit guarantee facility, including a model that is presented later in this study, and which included investment costs that they would need to support.

Together, these findings help to rationalize the need for a credit guarantee facility, and also provide sufficient data to forecast the sustainability of the KCGF.

Characteristics of SMEs: The GOK definition of SMEs is laid out in Law No. 2005/02-L5 and in the Law for Supporting Small and Medium Enterprises No. 03/L-031. It uses the number of employees as the sole criteria for defining SMEs: Micro have up to 9 employees; Small have between 10 and 49 employees; Medium have between 50 and 249 employees; and Large have in excess of 250 employees (Table 3). Banks on the other hand, define SMEs through their own internal set of definitions that are linked to borrowing levels, with some consistency across institutions (see Table 5).

Of the 103,755[7] enterprises registered at the Kosovo Business Registration Agency (KBRA), 98% are microenterprises employing less than 9 people, and the micro, small and medium categories employed 216,799 people (80% of private sector, and 62% of total employment), in 2010. 90% of enterprises were sole proprietorships, 6% limited liability companies and 3% general partnerships. Given the large number of micro enterprises ***it is reasonable to expect that the average size of loan to SMEs will be small.***

Table 3. Registered Enterprises (2010, KBRA)

Size	Employees	Number	%
Micro	0-9	102,070	98.38%
Small	10-49	1,406	1.36%
Medium	50-249	221	0.21%
Large	> 250	58	0.06%
Total		103,755	

SMEs are concentrated mostly in the retail sector (50%), 14% in transport, storage and distribution, 9% in food products, beverages and tobacco, and 9% in hotels and restaurants. The agricultural sector, particularly farmers, are not included in this definition of SMEs, most likely because the information is collected at the KBRA, although the service providers of the agricultural value chains are included in these numbers. According to officials at the Ministry of Trade and Industry (MTI), this distribution has remained steady over time.

Contribution to GDP: From data collected at the Tax Authority of Kosovo (TAK), there is a sharp difference in the number of enterprises that are registered (Table 3) and those that pay taxes (Table 4). Only 16,421 enterprises paid taxes in 2010, versus a total population of over 100,000 registered enterprises, possibly implying that the actual number of active enterprises is less than the reported figure. Of those that paid taxes, 15,000 are

Table 4. Turnover by Size (2010, TAK)

Size	Number	Turnover (€)	Average T/O	% of GDP
Micro	14,968	656,885,164	43,886	16.8%
Small	1,210	667,585,915	551,724	17.1%
Medium	185	369,455,655	1,997,058	9.4%
Large	58	528,558,359	9,113,075	13.5%
Total	16,421	2,222,485,093		56.8%

[6] All figures cited below are from the SME Development Strategy, 2011, Government of Kosovo

[7] There is a question as to how many of these registered enterprises are still active. The GOK is working towards a harmonization between the two systems – business registration and taxation.

micro-enterprises and 99.6% of the reporting enterprises are SMEs, as defined by the MTI. Average turnover/sales of € 43,886, for micro-enterprises is small, less than the annual salary for a management-level employee within the banking sector. Turnover rises sharply from micro to small enterprises, but with a corresponding drop in the number of enterprises, pointing ***to lower borrowing needs of a majority of enterprises in the SME sector, and to a relatively small market for bank lending to larger enterprises.***

Credit to SMEs: To determine how banks define SMEs, they were asked to describe their loan size criteria, which is summarized in Table 5. Banks use loan size and annual turnover to define what they classify as micro, small, medium and large or corporate, but no two banks use the same definitions.

Using average loan size, there is a large degree of variation: the average loan size for TEB's micro, small and medium clients is € 25,000, while for Pro Credit it is € 36,000 for small enterprises and € 365,000 for medium enterprises, and RBK average loan size for small enterprises is between € 80,000 and 100,000. It is clear that the banks' definitions of SMEs straddles that of the MTI (Table 3), and it is also clear that loans less than € 365,000 would cover the bulk of the lending activity to the SME and corporate sector, ***pointing to a low maximum size of loan to be covered by a guarantee facility***.

Table 5. Banks Definitions of SMEs

Bank	Criteria	Micro	Small	Medium	Large
RBK	Loan size		< € 1 M		
	Turnover		< € 5 M	> € 5 M	
	Average Loan	**€ 10 K**	**€ 80-100 K**		
Pro Credit	Loan size	€ 2-30K	€ 30-150K	€150K– 8M	
	Average Loan		**€ 36 K**	**€ 365 K**	
BKT	Loan size		< € 150 K	€ 150-1 M	> € 1 M
	Average Loan		**€250K**		
TEB	Turnover	< € 300 K	< € 700 K	< € 1.2 M	> € 1.2 M
	Average Loan	**€25K**			

To get a better idea for the total lending activity to enterprises by loan size, the CBK provided raw data on the number of loans made by banks to enterprises from 2007 to 2011 by loan size (Table 6).

Table 6. Bank Loans to all Businesses for 2007 to 2011 (CBK data)

Loan Size (€ 000)	2007		2008		2009		2010		2011	
	€ 000	#	€ 000	#	€ 000	#	€ 000	#	€ 000	#
< 50	226,245	49,986	276,452	65,981	281,660	65,089	265,731	58,643	288,406	54,995
50 to 100	62,302	891	83,082	1,158	82,446	1,123	94,746	1,604	107,723	2,261
100 to 250	82,044	540	102,878	699	90,332	620	103,698	898	122,840	1,329
250 to 1,000	103,488	252	133,982	311	129,546	318	148,872	429	148,896	518
> 1,000	17,805	13	38,108	20	49,728	30	77,269	60	84,294	81
Total	**491,884**	**51,682**	**634,502**	**68,169**	**633,712**	**67,180**	**690,316**	**61,634**	**752,159**	**59,184**

The loan size ranges were selected after meeting the banks and taking into consideration their different classification systems (above). The objective here is to examine the growth rate of loans – both numbers of and value – by loan size, giving us an idea of what the market has done, and where is might be going. ***It is important to note that the number of loans reported above, does not equate to the number of borrowers,*** as the identity of the borrower is protected for privacy reasons, and the data collected each month by the CBK is on the number of new loans that are approved.

From 2007 to 2011, overall loan volumes increased by 153% (€ 491M to € 752M) while the number of loans increased by 115% (51,682 to 59,184). Loan growth flattened during the world economic crisis in 2008 and 2009, but has since started to grow again. Growth was noted across all sizes of loans, but it is clear that the number and value of loans below € 50,000 has been growing slower than the larger categories (Table 7). There are several probable reasons for the slower growth in the loan market below € 50,000:

- Two of the major banks – Pro Credit and RBK – started lending at the lower end of the market focusing on micro- and small enterprises, so this segment of the borrowing market may have already reached saturation. This situation is quite different than situations in other countries, where often the larger enterprises are "better banked" than the smaller ones.
- These same two banks have gradually been increasing their minimum loan amount, with Pro Credit no longer making loans below € 2,000. So, the number of loans reported by the banks at the lower borrowing amounts has been falling.
- The arrival of micro-finance institutions has more than likely reduced borrowing from the banking sector, at the lower end of the loan size range. For example, as of December 31, 2010, the outstanding portfolio of the MFIs – both business and consumer loans – exceeded € 100 million and over 62,000 loans (€ 1,600 average loan size).[8]
- Finally, it is quite probable that some SMEs have increased their borrowing needs, and that the banks are following their clients "up-market."

Table 7. Loan Trend Analysis 2007-2011

Loan Size	€ 000	#
< 50	127%	110%
50 to 100	173%	154%
100 to 250	150%	246%
250 to 1,000	144%	206%
> 1,000	473%	623%
TOTAL	**153%**	**115%**

This data does tell us that total loans under € 250,000 account for 69% of the total new borrowings in 2011, and 99% of the number of loans, which means that ***if the KCGF established a maximum loan of € 250,000, it would be able to support the majority of loans made to the SME sector***. It also tells us that the number of loans being made above € 50,000 is growing steadily, and it is reasonable to assume that these are coming from smaller enterprises growing their businesses. However, it could also signal that the borrowing market has plateaued, due to a combination of reasons, including banks' reluctance to extend further credit without additional guarantees.

In addition, with a total of 59,000 new loans made by the banking sector in 2011, and assuming even a nominal level of borrowers taking out loans at different banks, some enterprises, particularly if the total population is at 103,000, are not receiving credit, signaling a possible funding gap***. This would be supportive of the establishment of a credit guarantee facility***. However, without the actual number of

[8] AMIK consolidated figures for 2010.

borrowers for the loan data, and the actual number of active enterprises, this funding gap is difficult to estimate. [9]

Finally, the data presented in Table 6, ***can be used as the baseline from which additionality of the KCGF could be measured.*** If the number of loans increases faster than the 2007-2011 trend line, then the use of the KCGF is increasing investment into the economy. If the number of new loans made follows the trend line, then the financial community is using the guarantee facility, but not increasing their appetite for risk, despite having to pay additional fees for the guarantee. Similarly for the value of total lending.

When asked "*How much more lending could a bank have done with a credit guarantee facility in place*?" bankers organized their response into three categories:

1. Borrowers that self-select out of the borrowing process before they even get to the banks, which is very difficult to estimate. Attempting to estimate this volume of financing via survey methodology would normally not produce any more insight, as the normal response to the question "Do you want or need credit?" is the affirmative. A credit guarantee facility would offer these borrowers an option to explore with the banks.
2. Borrowers that get refused at the branch level, but that never make it into the banks database because no paperwork has been filled in. This information could be collected by the banks if needed to help to support the demand curve for credit guarantees.
3. The last level is what will be referred to as the underserved client, namely those who are in the banks systems, have applied for a loan amount that is greater to that amount that the bank finally accorded, the difference being the "underserved" amount.

Bankers anecdotally indicated that borrowing could be increased by up to 10% of their outstanding portfolios, if a guarantee facility was available to them. Applying this 10% figure to the total new loans made in 2011 (Table 6) for amounts less than € 250,000, ***equates to an additional € 50,000,000 of lending from banks to SMEs per year***.

Positive Factors Affecting Lending to SMEs: Overall, the SME sector is well served by the banking sector:

- Unlike other developing or emerging countries Kosovo's banking system has evolved from the bottom up. Most notably, Pro Credit (previously Micro Credit Bank) and RBK (previously American Bank of Kosovo) both started their lending operations with micro and small size loans, and as the opportunities for making larger loans increased, the banks moved into that market segment. As such, the banking system generally knows how to lend to SMEs, and has substantial experience doing so, but may require the development of some additional products. Both of the banks cited above have a reputation for targeting smaller borrowers, versus more commercial clients.
- Banks have also been holding excess liquidity at the CBK. Some of this liquidity is being used to invest in GOK T-bills, who issued € 10 million in January, and despite this there are still sufficient funds and liquidity within the system to allow banks to increase lending to SMEs ***if bankable opportunities are presented***.[10] It has to be assumed that for-profit banks will try to maximize their profits, using these deposits where they will earn the best return, which would be loans.

[9] KfW has requested loan rejection data from the banks, as well as more accurate borrowing figures from the Credit Registry in an attempt to reconcile some of these gaps.

[10] It is important to note that a "bankable opportunity" can have a completely different meaning for an entrepreneur and for a bank.

- The credit registry is used systematically by the banks, and all reports indicate that this method of verifying credit history is effective.
- As productive sectors such as agriculture and forestry continue to develop, and as progress is made on the clarification and strengthening of property rights, opportunities for increased lending by the financial system to SMEs will increase. From all perspectives, banks are ready to support these activities.

Constraints to lending to SMEs: Kosovo SMEs have more or less similar constraints as other countries when it comes to accessing credit from banks:

- Bankers cite lack of business planning, lack of sufficient markets, shortage of equity, and a lack of collateral. Kosovo is a small market, and efforts to reduce imports through competitive import substitution, and exporting to neighboring countries have to be the foundations for future economic growth.
- Bankers cite difficulty in recovery procedures because of rule of law issues that are prohibiting them from realizing collateral taken to secure loan advances. The Pledge Registry is not as effective as it needs to be to allow banks to place enforceable liens on movable assets. Continued improvement in the enforcement of contract law, should encourage banks to take more risks in lending to enterprises, and will also help to reduce the interest rate spread that is currently being practiced by lenders.
- Enterprises maintain that the cost of borrowing is too high, and often point to neighboring countries where interest rate subsidies are being practiced. While we do not support the introduction of subsidies, interest rates can be gradually affected downward through increased competition for loans; improvement in the area of contract enforcement, along with the introduction of a guarantee facility, will also help in reducing interest rates, the former much more so than the latter.
- The range of lending products available to SMEs is still fairly limited, but slowly evolving, presumably as pressure on profits necessitate a deepening of the products available on the market. This would include a deepening of the overall financial sector, including the development of an active secondary market for financial transactions. A credit guarantee facility would fall into this category.

4. PROPOSED FACILITY

4.1. Justification

As indicated above, the expectation of finding a clear indicator of demand to support the development of a credit guarantee facility is low, confirming the conclusion in the World Bank review that this is more of an art than a science. However, despite the lack of a definitive quantitative indicator, the combination of qualitative and quantitative findings, complemented by the findings in the KfW report, and underscored by a collective financial commitment of the GOK and the Kosovo financial community, the development of a credit guarantee facility to play a longer term role in the development of the economy is justified, for the following reasons:

- The GOK has indicated in their SME Development strategy that a credit guarantee facility is a key factor to help the SME sector to develop, and they are prepared to provide funding to support this type of an institution.

- The banking community, represented by the banks visited during the execution of this study, has indicated support for the development of such an institution.[11]
- Both the IMF and the CBK have also indicated their support, to allow the GOK, most probably through the MTI to contribute financially, and to provide supervision services, respectively.
- Lending activity to SMEs is robust, but dominated by three banks, so a facility that would encourage other banks to enter into this market would be welcomed. More competition should lead to more competitive interest rates, reducing the current interest rate spread. A supportive example is, RBK's entry into the agricultural sector following their successful experience with the USAID DCA.
- Banks have factored the cost of working in a less-than-perfect regulatory environment, into the interest rate spreads, so a product that would reduce the risk that is driving this pricing, would be welcome.
- NBFIs can use such a product to increase their offering in the marketplace, adding more competition and encouraging positive reactions from banks for products such as leasing and factoring.
- SMEs constrained by a lack of collateral, would benefit from the availability of a credit guarantee facility, in particular SMEs whose growth is faster than the ability of the enterprise to provide the collateral requested by the banks. SMEs can also use such a facility "shop" their business to other banks, increasing competition, and reducing pricing.
- MFIs are facing a constriction of capital for on-lending. A credit guarantee facility would allow banks to supply this capital, with sufficient comfort that in the event of a deterioration of the performance of a particular MFI, that their loans would be partially secure. This would also help to begin to develop a secondary market.

A credit guarantee facility is but one piece of the financial infrastructure that can help an economy grow. Others include the development of an active secondary market, venture and angel funds, the ability of financial institutions to serve several sectors – insurance, banking, securities – and a dynamic entrepreneurial culture. Kosovo's financial market is young, and developing slowly under competent supervision by the CBK, with minimal public sector influence. In addition, Kosovo's entrepreneurial spirit is showing positive signs, but will continue to need support if the country is to provide the 30,000 jobs per year that is required. With the active involvement and investment of key stakeholders, international support for the development of a credit guarantee facility – a missing pillar of the financial sector – is logical and justified. The key questions will be: "*How big of an investment will be required*?" and "*How long will it take for this facility to become self-sufficient*?"

4.2. Details

The proposal is to create a joint-stock company, with mixed ownership – public and private – but with the latter holding a predominant majority position. The selection of this model is justified as a public sector-only facility would require scrutiny by the parliament and IMF, as it would have an impact upon the national debt loan, and would require a 70% majority to pass parliament, and would be susceptible to political influence. A corporate model (private sector only) may be perceived by the business community and GOK as yet another ploy by the banks to capture additional profits, and not participate in the development agenda. So, a mixed model (joint-stock company) would show cooperation and a commitment to development and promote shared objectives, and would reduce the need for public sector funding and support for SMEs.

[11] This interest was manifested in two series of meetings, independent one-on-one and then in a general presentation. Further commitment needs to be confirmed through a meeting with the Kosovo Bankers Association.

Structure and Objective: The KGCF would be a NBFI, regulated and supervised by the CBK, and by the applicable laws and regulations for joint stock companies. The objective will be to facilitate access to credit for all new investments by SMEs supported with good business plans, but which do not have the collateral normally required by formal financial intermediaries. Ownership would be split between the private financial institutions and the GOK, most logically represented by the MTI, with a recommended 70/30 split[12]. The split will need to be confirmed by the bankers and the GOK working together, with the goal of minimizing public sector influence, while encouraging public-private partnership, and which can be monitored through the governance structure outlined below.

Governance: By-laws and guarantee procedures will be developed following international best practices and OECD guidelines. The General Assembly will vote in a five to seven member Board of Directors, accountable to the Company's shareholders and responsible for ensuring the strategic guidance of the KCGF and effective monitoring of its management so as to protect the best interests of the KCGF and shareholders, and maximize share value. A key decision will be whether the GOK has a voting or non-voting position on the board. While they can be a shareholder, they could also supply funding, but not participate as a shareholder. The Board may appoint independent advisors as and when needed. Once elected by the General Assembly, the Board will elect a Chairman, who will appoint two Directors to each standing committee:

- Audit – responsible for overseeing the completeness and integrity of financial controls, and to liaise with the company's external auditor.
- Risk Management – responsible for overseeing risks associated with asset and liability management, the guarantee portfolio, and associated policies and procedures.
- Corporate Governance – responsible for overseeing corporate management best practices and procedures, staffing and compensation policies.

The KCGF would be audited by a recognized auditing firm, following internationally recognized best practices, and will be supervised by the CBK as a NBFI. The KCFG will be open to receiving support from donors in the form of technical assistance and funds to support operations, subject to the conditions established by the donors and to approval by the Board. Currently both USAID and KfW are interested in participating, and it would be logical for them to have some representation to ensure the prudential and productive use of the taxpayer's funds that would be invested in this institution.

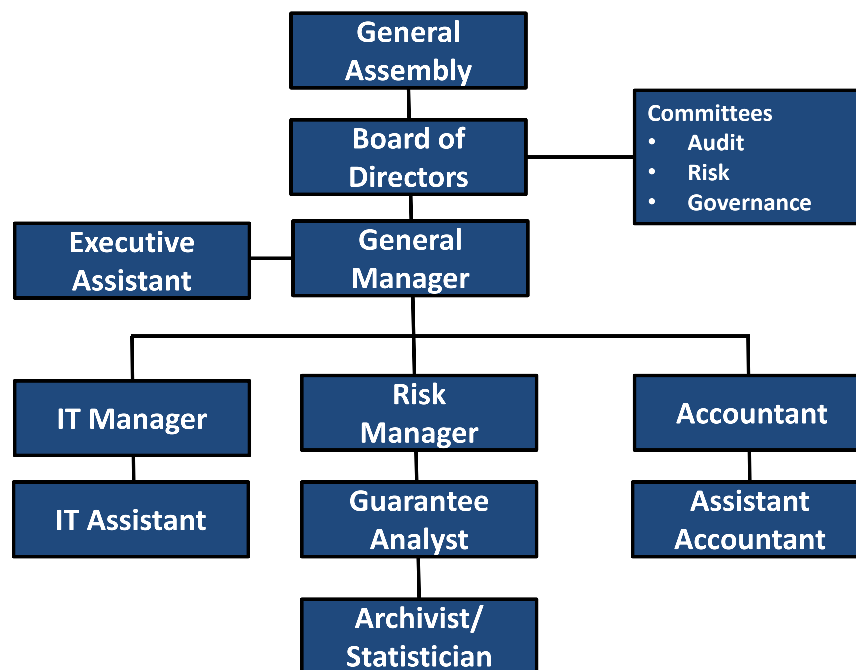
Capital Structure: Banks will be invited to invest € 2 million, and the GOK € 1.3 million of equity capital. These amounts can be paid-in incrementally, according to need and to conditions established through donor agreements. Donors, including USAID will place € 7 million in the guarantee fund ($6.5 million from USAID). Paid-in capital shareholders – banks and GOK – will not be able to withdraw dividends until donor funds are expired, and all capital will be invested in T-bills and/or foreign accounts and interest earned will be used to offset expenses and any residual retained in a capital account.

[12] This percentage should be open to discussion between the GOK and the bankers. Other considerations include the possibility of further USAID DCA involvement in funding activities or providing a re-guarantee. If this is envisaged, then the percentage of the GOK involvement should be limited to the maximum ownership by a public-sector entity permitted by the USAID DCA to permit their involvement.

FIGURE 1. KCGF INITIAL FUNDING STRUCTURE

Organizational Structure**:** The organization will include the Board of Directors, with a General Manager (GM) responsible for the day-to-day activities. The GM will have three major reports, an IT Manager, who will be responsible for maintaining the systems that link the KCGF with the participating financial institutions (all systems will be online); a Risk Manager who will be responsible for a team of professionals that will review the guarantees and evaluate the risk that the KCGF is accepting; and an Accountant who will be responsible for preparing the financial reporting and projections.

FIGURE 2. KCGF ORGANIZATIONAL CHART



Loan Guarantee Product: The loan guarantees will target loans to SMEs, offering 50% coverage of the principal value of the loan, and through special consideration by the Board, some guarantees may extend up to 70% coverage. KCGF will provide guarantees for loans up to € 250,000, made for periods of up to seven years, with repayment to match the cash flow generated by the investment. Loans made by the financial institutions will bear market rates of interest, but financial institutions should show that they are valuing the guarantee in the pricing of the loan, and they should also be free to require additional collateral, as determined by their own internal risk assessment. Other products can be developed as the need arises, and as the KCGF develops the capabilities to successfully manage such products. This situation can also be supervised by the CBK.

Eligible Activities**:** Loan guarantees can be used to support loans made for new productive business investment purposes, including the following:

- Short-term loans to support working capital needs
- Medium-term loans to acquire fixed or non-fixed assets from one to seven years
- Revolving credit facilities
- Purchase order financing
- Leasing and factoring
- Portfolio financing for micro-finance institutions
- Products developed for special objectives targeting women, vulnerable groups, etc.

***Ineligible Activities*:**

- Refinancing or retirement of any existing loans
- Consumer purchases
- Manufacture or selling of arms and munitions and services
- Activities violating the rights of workers
- Activities violating international or Kosovo laws
- Illegal environmentally hazardous
- Gaming or gambling activity
- Currency speculation
- Securities investment
- Real estate speculation
- Financial intermediate, except for microfinance institutions
- Drugs or narcotics
- Money laundering
- Financing of terrorism
- Activities that violate bi-lateral or multi-lateral donors contributing to the KCGF

Pricing: The KCGF will charge a guarantee fee, and can establish a flexible fee scheme that takes into risk sharing agreements on a case-by-case basis. The higher the percentage of the loan covered by KCGF's guarantee, the higher would be the corresponding fee for that operation. In addition, the KCGF may adjust pricing for particular financial institutions when it is determined that an adjustment may be needed. For example, if women borrowers have a substantially lower rate of default, the fees on loans made to women could be reduced. KCGF can also increase/reduce its fees for a specific bank, depending on past year's claims experience of that bank, and in some cases, it can even suspend issuing guarantees to a poorly performing bank. Initially, the pricing will be set at 1.75% of the loan amount (not on the amount guaranteed).

Eligible Financial Institutions: The KCGF guarantees will be open to all financial institutions, licensed and operating in Kosovo. The approval process requires relevant information about the institution's overall financial standing, access to its loan policy and procedures, as well as its lending personnel. To maintain the KCGF guarantees, the participating institutions must demonstrate the capability to administer and cater to SME loan portfolio development and also to maintain credit quality as per loan eligibility criteria. In addition, a clean bill of health from the CBK would also be required. Eligibility should not be limited to shareholders.

Eligible SME Borrowers: While these criteria can be changed, initially, to be eligible for a KCGF loan guarantee, the borrower must meet the following criteria:

- A private for-profit small or medium enterprise (firm, joint-stock company, limited-liability company, joint-liability company, or sole proprietorship)
- Legally registered under the laws of Kosovo
- Operating for a minimum of two years

- Maximum of 250 full-time employees (consistent with MTI definition)
- Not a subsidiary of, related to, or under common ownership with, another enterprise, if the combined enterprises exceed the SME classification
- Cannot hold a majority stake in a larger company
- No default (by the enterprise, its main shareholders, or its guarantors if any) under any credit facility shall have occurred during the three prior years
- The enterprise shall keep regular accounting records and shall produce standard financial statements
- Any relationship of the enterprise to any Manager or Director of the Bank or the KCGF must be disclosed, in full, in the application by the Borrower and the Bank (non-disclosure of such a relationship can result in the revocation of the guarantee, if approved)
- All potential or actual conflicts of interest must be disclosed in full by the Borrower and the Bank, and non-disclosure can result in the rejection of the guarantee.
- The enterprise must not be engaged in any of the activities excluded by the KCGF (see Ineligible Activities).

***Additional Security*:** The KCGF guarantees should not encourage financial institutions to make irresponsible loans, so the institutions are expected to secure the collateral that they normally would take, according to their policies and procedures. All repayment of the loan should be from the projected cash flow of the operations, and not from other sources.

***Loan Servicing*:** The financial institutions are responsible for loan servicing. The KCGF would rely on the institutions' lending operations and personnel for the servicing of the KCGF guaranteed loans and for their credit risk monitoring. Loan reporting procedures will be established and agreed to in writing between the financial institutions and KCGF to ensure adequate information flow.

***Loan Collection Responsibility*:** The financial institutions will exercise all rights and remedies relevant for recovery of the loans in accordance with pre-agreed application of recovery proceeds. KCGF and the banks ensure there is no conflict of interest between various loans to the same borrower.

***Process Flow Chart*:** The process of obtaining a loan guarantee will begin with the signing of an agreement between the financial institutions (FI) and the KCGF (see Annex 4 for a sample agreement). This includes reference to the SME eligibility criteria and conditions for issuing and claiming a guarantee.

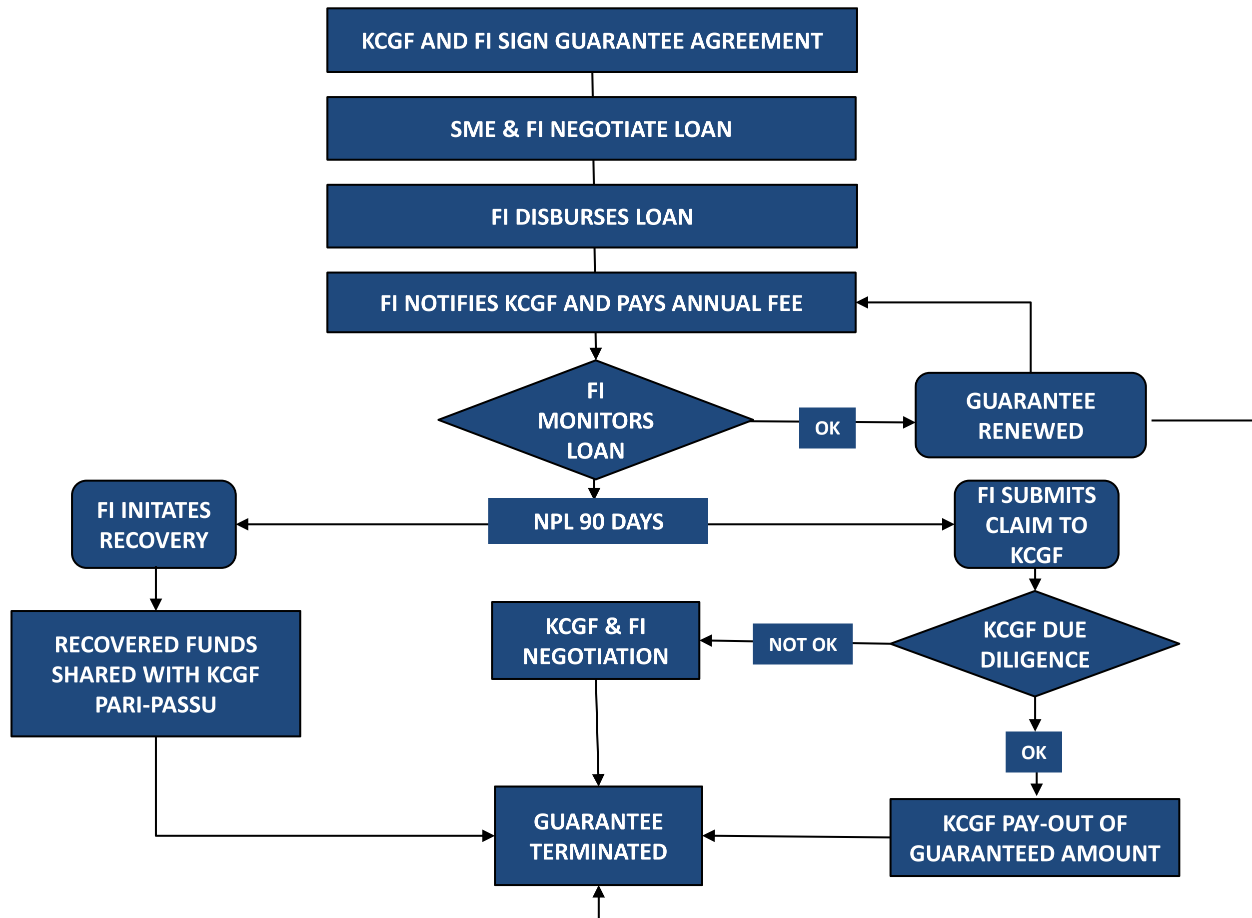
The FI then conducts its business as usual, making loans to SMEs, and if they deem that a guarantee is required they will send a declaration form and the associated fees at the end of each month – electronically – to the KCGF. The coverage is noted by the Risk Manager, and then the FI continues to service and monitor the loan as it would normally do.

In the event of a default – defined as in arrears for more than 90 days (NPL) – the FI has to initialize legal procedures and registers a claim with the KCGF, presenting a copy of the court order, and transferring the loan file to the KCGF. The KCGF Risk Officer will conduct the due diligence to ensure that all of the conditions precedent were met, and that the loss is a normal loss covered by the KCGF.

In the event that there are no issues, the KCGF will pay out the guaranteed portion within 30 days of receipt of the claim; the FI will continue to pursue recovery of the loan, sharing any recovered proceeds *pari-passu* with the KCGF.

In the event that the KCGF due diligence process uncovers fraud or wrong-doing, then the KCGF can terminate the Guarantee Agreement; can cancel all new operations with that bank; or can even withdraw from any other guarantees already issued. If needed, it can take legal action, either through the Kosovo courts or through an international court. And it will be required to notify the CBK.

FIGURE 3. KCGF PROCESS FLOW CHART



5. FINANCIAL PROJECTIONS

To determine the financial sustainability of the KCGF under the described structure, a financial model was developed, utilizing the following assumptions[13]:

Loan characteristics:

- **Loan size**: € 10,000. This amount increases annually by the Gross Domestic Product (GDP) of 4.5% in year 1; 5% in year 2, and 5.5% in year 3; and 6% for every year thereafter.
- **Number of loans**: 2,000. Demand for the guarantee grows quickly initially at 30% per year, then 20% per year, reducing to 10% per year in the 4th year of operation.
- **Term**: 36 months on average.
- **Leverage**: 8 times the accumulated capital base, and funding contributions from non-shareholders. This target should be achieved gradually and progress towards this leverage factor will be monitored by the Risk Management Committee, donors, and the CBK. This is the generally accepted current practice for funded programs, with some more institutions moving as high as 10.

[13] These assumptions were vetted with a number of financial institutions as being reasonable, and as discussions continue, can be modified.

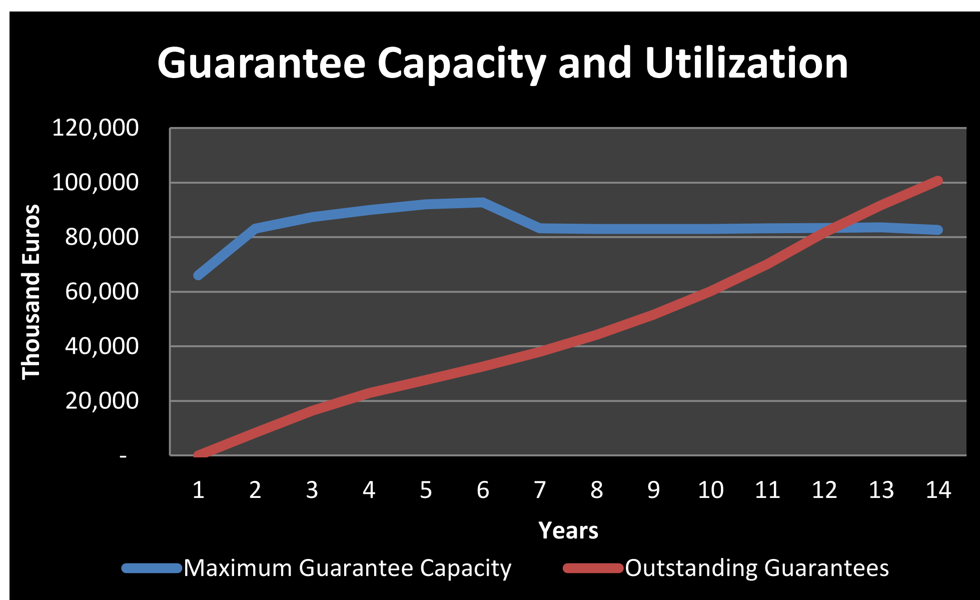
Expenses:

- **Inflation**: 3.5% constant, and applied to salaries and operating costs.
- **Pay out rate**: 4% per annum, starting in the second year of operation. Currently the banking system is experiencing a 5.9% NPL ratio, with a substantially lower write off percentage.
- **Operating costs**: start-up costs, salaries and administrative expenses.
- **Taxes**: 10% per annum on profits

Revenues:

- **Interest earned on deposits**: 3.5%- equivalent to the current T-bill rate.
- **Fees**: 1.75% annually, on the outstanding beginning balance of the loan.

Guarantee Capacity and Utilization: Under these assumptions[14], the KCGF will attain the maximum leverage (8 times capital and funding base) in the 12th year after operations begin, and will have supported a ***cumulative lending amount of € 668 million and cumulative loans of 46,968 loans***. At this time, additional capital or guarantee funding, will be required for the KCGF to continue to issue guarantees. There are several potential avenues to explore to ensure that this additional capital will be available, including the EBRD, USAID DCA, both for re-guarantees; future commitments from shareholders to inject additional capital; and the GOK.

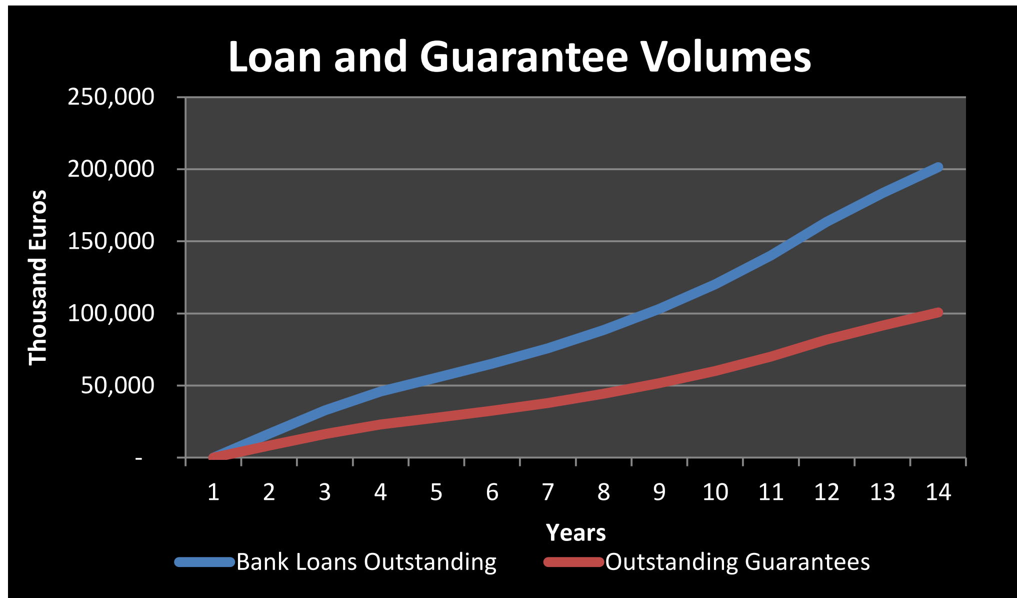


In addition, due in particular to the low average loan size, and the projected growth rates, the capital and funding could be injected more gradually over a period of time, and not necessarily during the first two years. This could be done through a series of share issues and legal commitments from the shareholders and funders (donors).

The KCGF will achieve financial self-sufficiency in year 2, with a surplus cash flow of € 361,000. But this also assumes that all capital is paid-in during the first two years of operation, which will need to be negotiated. So, it is reasonable to expect that some up-front subsidization of operational costs will be required once these negotiations are completed.

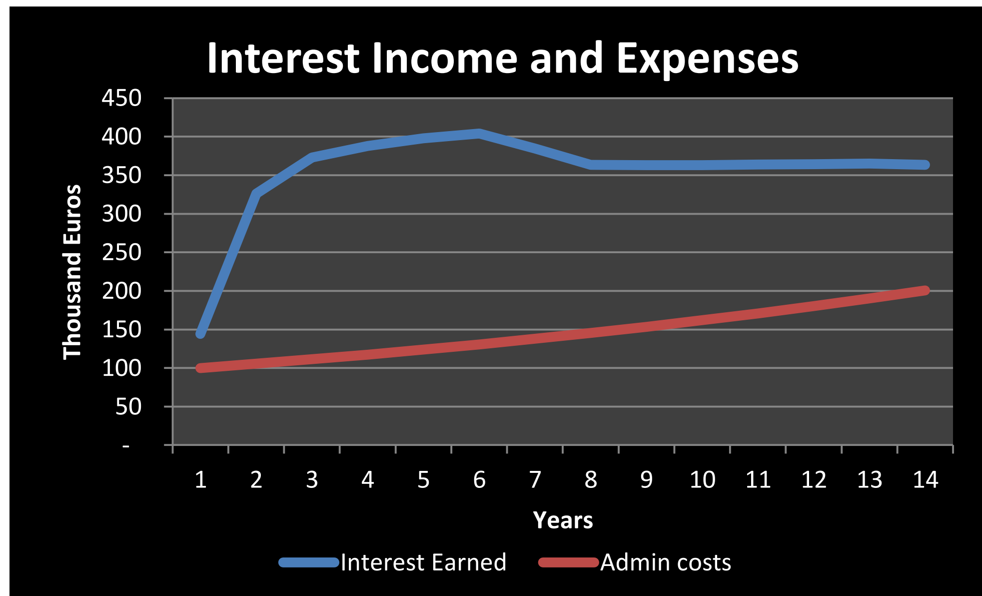
[14] See Annex 5 for the detailed spreadsheet.

Loan and Guarantee Volumes: The slide below shows that the outstanding loans covered by guarantees in year 12, is in the vicinity of € 160 million. This figure is equal to about 30% of the new loans under € 250,000 by the banking system in 2011 (Table 6).



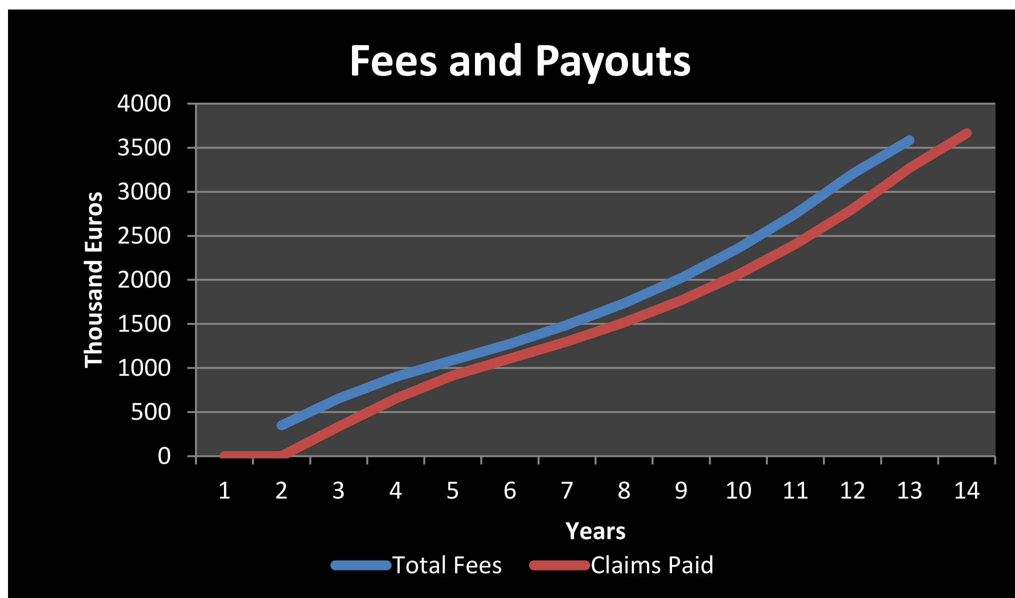
In the 12th year, the KCGF will guarantee 6,688 loans at an average loan size of € 17,656. The number of loans made represents 11.4% of the total loans made by the banking system under € 250,000 in 2011 (Table 6), which is close to the 10% figure that was cited by bankers.

Interest Income and Expenses: A generally accepted best practice is to keep a balance between operating expenses and the interest earned from deposits. Given the assumptions, this relationship is projected to be healthy. This is occurring because the model has all of the capital paid-up in the first two years, and further suggests that a more gradual injection of capital could be considered.



Note that the operating costs are projected to grow at the rate of inflation, and that the interest revenues are projected to grow at the rate of interest earned on T-bills, and that there are no additions to staff during this period, which is unlikely.

Guarantee Fees and Payouts: Another generally accepted practice is to keep the fees and payouts balanced. Ideally, the two lines should move in parallel, and if there is convergence then this is the signal and some readjustment is required – either in the fees charged, or in the level of risk accepted.



The graph shows the "classic" relationship representing a balance between the fees charged and the payouts on guarantees. This relationship will be affected if the payouts increase above the projected 4%, without a complementary increase in the fees charged. This will be one of the ratios that will be watched by the Risk Management Committee, as well as the CBK.

5.1. Sensitivity Analysis

This model was tested for several of the most sensitive variables.

- Increasing the average loan size to € 15,000 would mean that the maximum leverage of 8 would be attained in year 9, requiring additional capital injection or an increase in the leverage factor at this time. Increasing the initial number of loans to 3,000, would have about the same effect. Neither of these scenarios adversely affect the performance ratios, Income vs Expenses and Fees vs Payouts.
- Increasing the payout rate to 6% - equivalent to the current rate of non-performing loans – without increasing the fee charged for the guarantee would result in the KCGF losing money continuously from year 4 onwards. An unsustainable situation, and to cover these losses, the KCGF would have to begin to draw down on their capital base. While this situation is not improbable, taking a gradual approach to building capacity, understanding and progressively accepting risk, and gradually balancing pricing with loan loss rates, will substantially reduce the chances of this occurring.
- Choosing to gradually increase the leverage factor is one option to monitor the performance and minimize the chance of loss. This would also help to instill a culture of conservative management during the initial stages, increasing the possibility that a leverage factor in excess of 8 could eventually be achieved.

Leverage Factor	2	4	6	8
Number of loans	3,120	4,568	5,527	6,688
Outstanding guarantees	€ 23 million	€ 44 million	€ 60 million	€ 81 million
Cash flow	€ 239,000	€124,000	€ 153,000	€ 202,000

Given the assumptions, the table shows that the KCGF will still be able to produce meaningful results, and stay sustainable. Note that the projected cash flow will initially be higher than anticipated because by the time that the KCGF attains a leverage factor of 2, a relatively lower amount of guarantees will have been paid out.

5.2. Impact

The successful establishment of the KCGF will have substantial impact upon the development of the private sector in Kosovo. By offering the opportunity to banks and borrowers to increase the number and volume of loans, the impact that the KCGF would be the following:

- A € 5 million USG investment ($6.5 million) will initially leverage € 5.3 million in non-USG contributions. Assuming the successful operation, future contributions to capital of the KCGF could increase this factor.
- The KCGF would allow new banks to accelerate lending to SMEs, having a positive impact upon the reduction of interest rates. In addition, SMEs will be able to "shop" their loans to different banks to find the best deal.
- € 668 million in lending over the first 12 years, will have been generated, through 46,968 loans, and most probably an equivalent number of SMEs.
- Assuming a loan size to job created ratio of € 10,000, this would mean 66,000 jobs created, equivalent to 2 years of the required level to absorb new entrants into the job market.

In addition, the KCGC can play a supporting role to special initiatives that target gender and vulnerable populations. It can do this through the design and pricing of products to achieve these objectives, subject to acceptance by the board and risk analysis.

6. CONCLUSION

The KCGF presents an opportunity to add to the financial infrastructure of Kosovo in a novel and collaborative manner. Rarely do we find an opportunity where stakeholders are as interested, engaged and cooperative. In addition, the KCGF is consistent with the GOK policy to develop the SME sector, and while the demand for guarantees may not be clearly quantifiable, all previous experiences point to a positive acceptance of the KCGF, greatly enhancing the possibility of sustainability. And this would be ensured through the active participation of the financial community and the GOK.

Next steps and considerations include:

- USAID and KfW should meet with the Kosovo Bankers Association to confirm their level of interest and identify areas where additional refinement will be required. These projections can then be adjusted accordingly.
- Negotiations need to occur between the GOK and the interested bankers to determine the optimal ownership split – 80/20 or 70/30 – as well as how and when the capital is paid in. Obviously USAID and other donors may have some influence as to how this is accomplished.
- The future role of the USAID DCA and other financial institutions should also be examined, particularly concerning re-guarantees.
- Further discussions need to be had regarding how USAID and other donors, can be represented on the board, particularly during the initial years of operation.

ANNEX 1. SCOPE OF WORK

The objective of the feasibility assessment is to determine whether a local credit guarantee facility can be successfully established and become self-sustainable. The assessment will review legal considerations, various operating models for credit guarantees facilities, market demand, additional funding alternatives, and financial analysis. The intent is to establish a credit guarantee facility that is free from political capture. This will require an institution that is fully independent or quasi-governmental, and will likely involved numerous partners, such as other donors, banks and the Kosovo government.

Should the feasibility assessment provide a positive outcome, USAID anticipates a contribution of approximately $12.5 million in total funding for the effort – $6.5 million to the capital base of the local institution, plus another $6 million in technical assistance over a period of several years to help stand up the institution. These figures are not final and can be adjusted based on the findings of the feasibility assessment.

A key challenge for a local credit guarantee institution in Kosovo will be to leverage the capital funds to achieve much higher levels of lending. Development Credit Authority (DCA) provides leverage factor that is often 15 – 20 times the subsidy cost to the mission. In contrast to the US Treasury guarantee provided by DCA, the Kosovo Central Bank is not a lender of last resort. Under the circumstances, other mechanisms must be explored, such as re-guarantees arrangements, to leverage the capital of a local credit guarantee facility.

USAID provided assistance to establish a local credit guarantee institution in Kosovo and in Jordan. The Kosovo feasibility assessment should consider key lessons learned from the earlier experiences in Kosovo and Jordan, as well as other relevant countries.

In addition to the above considerations, there are many aspects that need to be considered during the feasibility assessment, including some of the following:

1. Impact on lending that a credit guarantee institution will have – target market
2. Potential risks and risk mitigation
3. Ownership and governance structure
4. Capital structure, and funding sources
5. Sustainability scenario analysis, with pricing options
6. Staffing and staff development
7. Timetable to operational self-sufficiency

ANNEX 2. INSTITUTIONS AND INDIVIDUALS VISITED

Kosovo Chamber of Commerce	Safet Gerxhaliu President	www.oek-kcc.org	Safet-gerxhaliu@oek-kcc.org
Ministry of Trade and Industry	Mimoza Kusari Lila Minister/Deputy Prime Minister	www.mti-ks.org	Mimosa.kusari.lila@rks.gov.net
SME Support Agency, Ministry of Trade and Industry	Granit Berisha Chief Executive Officer	www.mti-ks.org	Granit.berisha@ks-gov.net
Kfw Bankengruppe	Bahrije Dibra Project Coordinator Financial Sector		Bahrije.dibra@kfw.de
BKT – Banka Kombetare Tregtare	Cenk Ariöz Deputy Director	www.bkt-ks.com	carioz@bkt.com.al
BKT – Banka Kombetare Tregtare	Albion Mulaku Head of Corporate and SME	www.bkt-ks.com	amulaku@bkt.com.al
BKT – Banka Kombetare Tregtare	Mentor Berisha	www.bkt-ks.com	mberisha@bkt.com.al
USAID Business Enabling Environment Program	Terry Slywka, Director	www.usaidbeep.org	tslywka@usaidbeep.org
Center for Entrepreneurship and Executive Development Kosovoa	Kreshnik Lleshi, Country Director	www.ceed-global.org	kreshnik@ceed-kosovo.org
International Monetary Fund	José Sulemane Resident Representative		jsulemane@imf.org
Embassy of Sweden	Maria Melbing Head of Development Cooperation	www.swedenabroad.org	Maria.melbing@foreign.ministry.se
Embassy of Sweden	Fatos Mulla, Programme Officer Development and Climate	www.swedenabroad.org	Fatos.mulla@foreign.ministry.se
TEB	Dukagjin Shylemaja Deputy Managing Director		dukagjin.shylemaja@teb-kos.com
Swiss Cooperation Office	Nils Rosemann Deputy Director	www.swisscooperation-kosovo.ch	Nils.rosemann@sdc.net
Crimson Finance Fund	Mike Gold		michael.gold@crimsoncapital.org
Central Bank of Kosovo	Nexhat Kryeziu Deputy Governor	www.bqk-kox.org	nexhatkryeziu@bqk-kos.org
Kosovo American Chamber of Commerce	Visa Hapciu Policy and Project Officer	www.amchamkvs.org	Visar.hapciu@amchamksv.org
	Nora Boga	www.amchamkvs.org	Nora.boga@amchamksv.org

	Finance and Admin Manager		
Austrian Embassy Technical Cooperation	Christian Geosits Attaché	www.entwicklung.at	Christian.geosits@ada.gv.at
	Arsim Aziri Program Officer	www.entwicklung.at	Arsim.aziri@ada.gv.at
Kosovo Bankers' Association	Zana Haxha Executive Director	www.bankassoc-kos.com	zanahaxha@bankassoc-kos.com
State Department	Andrea Tomaszewicz Senior Executive Officer		tomaszewiczaj@state.org
European Bank for Reconstruction and Development	Marinela Avdullaj Associate Banker, Financial Institutions	www.ebrd.com	avdullam@ebrd.com
United States Embassy	Ambassador Christopher Dell	www.state.gov	dellc@state.org
Ministry of Finance	Hamza Minister of Finance		
SEAD	David Greer Chief of Party		

ANNEX 3. DOCUMENTS REVIEWED AND CITED

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ANNEX 4. SAMPLE CREDIT GUARANTEE AGREEMENT

SAMPLE PARTICIPATING FINANCIAL INSTITUTION AGREEMENT

This Participating Bank Agreement (the Agreement) is between the Kosovo Credit Guarantee Corporation Ltd., (KCGF) and ____
____ (the **Bank**).

In consideration of the agreements of the parties, KCGF and the Bank agree as follows:

1.0 Development of SME Lending Business

1.1 This Agreement is entered into because KCGF and the Bank desire to create and sustain a source of financing for small and medium size enterprises (SMEs) through the private banks operating in the Republic of Kosovo.

1.2 Pursuant to this Agreement, the parties intend that the Bank will establish a SME lending program to make loans to eligible SMEs, and that KCGF will guarantee those loans,

2.0 Obligations of KCGF

2.1 KCGF will support the Bank's SME lending program by providing guarantees for eligible SME loans.

2.2 KCGF will issue guarantees to Banks that meet its lending requirements and on loans that eligible under this guarantee. KCGF will make payments to the Bank on the guarantees if the Bank's borrowers do not repay the guaranteed loans.

2.3 KCGF's role, obligations, and responsibilities are more fully set out in KCGF's Operating Guidelines and Procedures (the Operating Guidelines), as promulgated or amended by KCGF from time to time, which are part of this Agreement and incorporated in it by reference.

3.0 Obligations of Participating Bank

3.1 The Bank will build up its SME lending business and SME loan portfolio by increasing its business development and marketing activities that target SMEs. It will develop its credit analysis practices and credit practices in line with modern credit methods and international best practices. As such, the Bank's portfolio of loans to SMEs will grow and the quality of those loans will improve.

3.2 The Bank's role, obligations, and responsibilities are more fully set out in the Operating Guidelines.

4.0 Modification of Agreement

4.1 No provision of this Agreement may be waived or modified, except in a writing signed by Bank and KCGF.

5.0 Suspension or Termination of Agreement

5.1 KCGF may suspend or terminate this Agreement for cause if the Bank fails to comply with the terms of this Agreement or a change in circumstances resulting in Bank's inability to meet the requirements of this Agreement. A suspension or termination will not invalidate a guarantee

previously issued by KCGF. KCGF will notify Bank of the suspension or termination under this provision in writing at least 15 business days prior to the effective date of suspension or termination.

5.2 KCGF or Bank may terminate this Agreement without cause at any time by giving not less than 60 days written notice to the other party. Termination will not invalidate a guarantee previously provided by KCGF, or relieve the Bank from any obligation to KCGF that accrued before the Agreement terminates.

6.0 Miscellaneous

6.1 This Agreement cannot be assigned by either party.

6.2 In the event of a dispute between the parties concerning this Agreement, the parties shall engage in amicable discussions intended to settle the dispute. If they are unable to amicably resolve the dispute, then either party may initiate an arbitration proceeding before the **TBD Chamber of Commerce**. The decision of the arbitrator shall be final. Neither party may initiate any lawsuit against the other concerning any part of this Agreement. Each party shall bear its own costs and fees in the arbitration.

6.3 This Agreement is prepared in both Albanian and English. In the event of a conflict between the Albanian and English versions of this Agreement, the English version shall prevail.

Signed this ____________ day of ________________, 2012.

Kosovo Credit Guarantee Corporation **Bank**

By: ______________________________ **By: ______________________________**

Director General

ANNEX 5. SUMMARY FINANCIAL PROJECTIONS

Years	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
INPUTS:														
Inflation Rate	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%
GDP Growth	4.50%	5.00%	5.50%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%
€:$ Exchange Rate	1.3144	1.3144	1.3144	1.3144	1.3144	1.3144								
Number of Qualified Loans	-	2,000	2,600	3,120	3,432	3,775	4,153	4,568	5,025	5,527	6,080	6,688	6,889	7,095
Growth in use of guarantees	0%	0%	30%	20%	10%	10%	10%	10%	10%	10%	10%	10%	3%	3%
Average Loan Size (€)	-	10,000	10,500	11,078	11,742	12,447	13,193	13,985	14,824	15,714	16,656	17,656	18,715	19,838
Average Loan Term (months)	36	36	36	36	36	36	36	36	36	36	36	36	36	36
Guarantee percentage	50%	50%	50%	50%	50%	50%	50%	50%	50%	50%	50%	50%	50%	50%
Guarantee Fee	1.75%	1.75%	1.75%	1.75%	1.75%	1.75%	1.75%	1.75%	1.75%	1.75%	1.75%	1.75%	1.75%	1.75%
Net Payout Percentage	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%
Leverage Factor	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00
Interest Earned on Deposits	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%
Tax Rate on Profit	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%
CAPITAL ACTIVITY (M€):														
Paid-in Capital:	3,300	3,300	3,300	3,300	3,300	3,300	3,300	3,300	3,300	3,300	3,300	3,300	3,300	3,300
Banks	2,000													
GOK	1,300													
Non-bank Private Sector	0													
Guarantee Funds:	4,945	6,945	6,945	6,945	6,945	6,945	6,945	6,945	6,945	6,945	6,945	6,945	6,945	6,945
USAID	4,945													
Other donors		2,000												
Total Capital Base:	8,245	10,245	10,245	10,245	10,245	10,245	10,245	10,245	10,245	10,245	10,245	10,245	10,245	10,245
Retained Profits/(Losses):		-445	361	324	239	163	154	134	124	138	153	174	202	83
USAID Project Funding		590	316	666	1,015	1,179								
Total Available Funds:	8,245	10,390	10,921	11,235	11,499	11,587	10,399	10,380	10,369	10,383	10,398	10,419	10,447	10,328
GUARANTEE ACTIVITY (M€):														
Maximum Guarantee Capacity	65,962	83,116	87,371	89,879	91,992	92,699	83,193	83,036	82,956	83,064	83,187	83,356	83,574	82,626
New Bank Lending (+)	-	20,000	27,300	34,562	40,299	46,989	54,789	63,884	74,488	86,854	101,271	118,082	128,922	140,757
Amount Repaid (-)	-	(3,333)	(11,217)	(21,527)	(30,670)	(37,335)	(43,988)	(51,290)	(59,804)	(69,731)	(81,307)	(94,803)	(109,080)	(122,673)
Bank Loans Outstanding (=)	-	16,667	32,750	45,785	55,413	65,067	75,868	88,462	103,147	120,270	140,234	163,513	183,355	201,439
New Guarantees Issued (+)	-	10,000	13,650	17,281	20,150	23,494	27,394	31,942	37,244	43,427	50,636	59,041	64,461	20,000
Claimes Paid (-)		-	(333)	(655)	(916)	(1,108)	(1,301)	(1,517)	(1,769)	(2,063)	(2,405)	(2,805)	(3,270)	(3,667)
= Outstanding Guarantees	-	8,333	16,375	22,892	27,707	32,534	37,934	44,231	51,574	60,135	70,117	81,757	91,677	100,720
Remaining Guarantee Capacity	65,962	74,783	70,996	66,986	64,285	60,166	45,259	38,805	31,382	22,929	13,070	1,599	(8,104)	(18,094)
Actual Leverage Attained		0.80	1.50	2.04	2.41	2.81	3.65	4.26	4.97	5.79	6.74	7.85	8.78	9.75
											Cumulative Lending Amount:	668,517.75		
INCOME STATEMENT:											Cumulative number of loans:	46,968		

INCOME STATEMENT:											Cumulative number of loans:	46,968		
Revenues:														
Total Fees		350	653	902	1,087	1,276	1,487	1,734	2,022	2,358	2,749	3,206	3,585	
Fees on New Guarantees		350	478	605	705	822	959	1,118	1,304	1,520	1,772	2,066	2,256	2,463
Fees on Old Loans			175	297	382	453	529	616	719	838	977	1,139	1,329	3,209
Interest Earned	144	326	373	388	398	404	385	364	363	363	364	364	365	364
Total Income:	144	676	1,026	1,290	1,485	1,680	1,872	2,098	2,385	2,721	3,113	3,570	3,950	6,036
Expenses:														
Start-up/Replacement Costs	300	10	10	20	20	20	20	20	20	21	22	23	24	25
Salaries	190	200	211	223	235	248	261	276	291	307	324	342	360	380
Admin costs	100	106	111	117	124	131	138	145	153	162	171	180	190	201
Claims Paid	0	0	333	655	916	1,108	1,301	1,517	1,769	2,063	2,405	2,805	3,270	3,667
Total Expenses:	590	316	666	1,015	1,294	1,507	1,721	1,959	2,234	2,553	2,922	3,350	3,845	4,273
Profit before Taxes:	(445)	361	360	275	191	173	152	139	152	168	191	221	105	1,763
Taxes Paid:		-	(36)	(36)	(27)	(19)	(17)	(15)	(14)	(15)	(17)	(19)	(22)	(176)
Profit/(Losses) after Taxes:	(445)	361	324	239	163	154	134	124	138	153	174	202	83	1,586
USAID PROJECT ACTIVITIES:														
Total available $	$ 9,500	$ 3,500												
Capital Contribution $	6,500	-												
Available for Project Activities:	3,000	3,500												
Converted to Euros	2,282	4,356	4,040	3,374	2,359									
Less: Total Expenses	(590)	(316)	(666)	(1,015)	(1,179)									
Remaining Project Funding	1,693	4,040	3,374	2,359	1,180									