

Bank Loans as a Source of Financing Small to Medium-Sized Enterprises in Western Balkans. The Kosovo Case Study

Prof. Ass. Dr Qazim TMAVA
University of Mitrovica "Isa Boletini"
qazim.tmava@umib.net

Abstract- *It is accepted worldwide that a healthy banking system play a crucial role in the economic development of a country. Also, the role and importance of the banking system in developed and developing countries (including Kosovo) is unquestionable. This is evident especially in financing business needs of Small and Medium Enterprises (SMEs), which generate income and employment. However, financing SMEs' needs by banks, often is accompanied with problems and various challenges. The aim of this paper is to highlight the role and importance of banks on financing business needs of SMEs, identify problems which arise, by giving recommendations on solving the aforementioned, which would be beneficial for both parties. Hence, this paper offers important implications for banks, SMEs, as well as for policymakers.*

Key words- *banking system; SME; financing; bank loans; NPL*

1. INTRODUCTION

Small and medium-sized enterprises are the backbone of economic development generating income and lowering unemployment (Ayyagari et. al. 2012)[2]. They are a source of innovation, encourage entrepreneurial spirit and also play a major role in business growth and development as well as economic development in general. However, SMEs while doing business are always faced with major problems, especially when it comes to securing financing for business activities even in developed countries. Financial means secured by internal sources are never sufficient for their rapid development. Anyhow, they are obliged to search for alternative sources of finance. In the Western Balkan countries, where Kosovo is also located, the financial markets are not developed or are in the initial phase, so for SMEs, applying for bank credit despite very unfavorable conditions still remains among the few external sources of financing.

Therefore, bank credit remains the main source of financing for small enterprises (Storey DJ, 1994)[16]. Accessing such financial means is very difficult for these enterprises due to asymmetrical information between banks and businesses (Stiglitz and Weiss, 1981)[15].

It is especially difficult for start-up SMEs to access bank credit when compared to SMEs that already possess a business history.

The binomial business-bank relationship is a partnership relation, but in this relation the bank has its own rigorous criteria, which often businesses have difficulties to fulfill. Especially when it comes to securing collateral as a cover for the loan.

Therefore, the discrepancies between the criteria for credit approval and the negative attitude towards lending to

SMEs are believed to be key problems for access to finance. (Cziraky, Tisma and Pizarovic, 2002)[8]

Financing of SMEs business activities in Kosovo's through banks (credit) varies from 0.6 to 21.9%, depending on the years. Most of them are self-financed by various sources, or by borrowing from family members and friends. Only a certain portion is financed by foreign banks. (Rinvest, 2012)[14]

On the other hand, according to World Bank estimates, only 10% of SMEs investments are financed by banks, the rest are financed by internal sources (World Bank: 2009)[19] and that is for SMEs that are already carrying out business activity, whilst start-up businesses are exclusively financed by internal sources.

Provision of funds and financial resources from internal sources has several advantages: there is no payment of annuities, no mortgage insurance needs to be provided, easier financial construct closure and there are no fixed financial liabilities for interest and debt payments.

However, these resources are insufficient, that is why SMEs are obliged to search for alternative sources where bank credit remains as the most affordable option.

2. BANKING SYSTEM AND CREDIT SUPPLY OF COMMERCIAL BANKS IN KOSOVO

The banking system, as a component of the financial system, is among the key factors that influence economic development in general. Contemporary trends, such as deregulation, globalization, derivative financial products etc., impose the interconnection of economies of different countries. Thus, the relationships between the economies of different countries appear to be a necessity and these relationships materialize through import, export, exchange of investments, exchange in the sphere of

education, culture, sports etc. In this regard, the interconnection of banking systems of different countries, which have banks, branches or units in one another also plays a major role.

In Kosovo, 90.1% of the banking sector's capital is foreign, while only about 9.9% of the capital is local. (CBK, 2016)[6].

In Kosovo, the structure of the financial system, which includes the banking industry, the insurance industry, pension funds and other financial institutions that are established in the microcredit scheme, has not changed much over the years.

This is evident from the following table:

Table 1 : The number of financial institutions in Kosovo throughout the years

Description	2008	2009	2010	2011	2012	2013	2014	2015
Commercial banks	8	8	8	8	9	9	10	10
Insurance companies	12	11	11	11	13	13	14	15
Pension funds	2	2	2	2	2	2	2	2
Financial aid	29	28	29	32	38	39	42	44
Micro-financial institutions	16	19	17	20	17	17	18	18

Source: Annual Reports of CBK, throughout the years

As witnessed, the largest share of financial supply consists of commercial banks (ten commercial banks) and microcredit institutions (eighteen of them) which has not changed for several years. Therefore, the financial sector is dominated by commercial banks, which account for over 75% of all financial system assets in general. The following are insurance companies whose asset structure varies from 15 to 17%, followed by microfinance institutions with 3.7 - 4.4%, pension funds with about 3%, while the participation of financial aid in the overall assets in the country is symbolic.

According to CBK data (2015), foreign-owned banks dominate the banking market in the country, managing over 90.1 percent of total banking system assets. The remaining assets are managed by two local-owned banks. Moreover, the banking system in Kosovo is characterized by a high degree of market concentration, where about 76 percent of total assets of the banking system are managed by the three largest banks (Pro credit bank, Raiffhaissen bank and NLB bank) Therefore, it is rightly concluded that the banking system in Kosovo is bank-centric.

Commercial banks in Kosovo offer a considerable range of banking products and services. Generally, the products and services offered by banks today include: account management, deposits, loans, payment services (internal and external transfers), business documents (guarantees and credit letters), electronic services and other products. Although most of these products are classic banking services, banks have recently started expanding the range of services that they offer with several market innovations such as: electronic bank services (e-banking, mobile banking), leasing, factoring and other services.

The banking sector in Kosovo, despite the fact that it is dominated by foreign banks, the majority of the sector it is financed by domestic deposits.

3. ASSETS AND LOANS ON KOSOVO BANKING SYSTEM

The following sector analyzes important indicators of the banking system in Kosovo that compile the financial supply.

Table 2: Assets, loans and their participation in GDP, in Kosovo, throughout the years

Years	2008	2009	2010	2011	2012	2013	2014	2015
Assets	1.808	2.204	2.455	2.649	2.829	3.059	3.185	3.387
% of assets in GDP	50.0	54.3	55.8	55.0	55.9	57.4	57.2	56.8
Loans and leasing	1.183	1.289	1.458	1.698	1.741	1.806	1.882	2.019
% of Loans in Assets	65.43	58.48	59.39	64.10	61.54	59.04	59.09	59.61

Source: Annual reports of CBK, throughout the years. Author's calculations

Banking sector assets show constant growth year after year and at the end of 2015 reach the value of 3.387 million euros, which is an annual increase of 6.3%.

Asset participation in GDP varies between 50.0% (2008) and 55.9% (2012). While in 2015 it reaches the value of 56.8%.

Loans and leasing, which account for the most of the banking sector's assets, also show an increase even during the time of the global financial crisis, which shook the world. Their participation in assets varies between 58.48% (2009) and 65.43% (2008), while in 2015 it was 59.61 %.

The main contribution to the growth of banking sector assets was the expansion of the loan portfolio, which remains the dominant category in the asset structure.

The accelerated growth of assets in the banking sector in Kosovo also reflects the stable deposit performance, which also increased at an accelerated pace despite the drastic decrease of interest rate on deposits.

4. LIABILITIES AND DEPOSITS ON KOSOVO BANKING SYSTEM

The following sector analyzes liabilities and deposits of the banking system in Kosovo.

Table 3 Liabilities and deposits of the banking sector, throughout the years

Years	2008	2009	2010	2011	2012	2013	2014	2015
Liabilities	1.808	2.204	2.455	2.660	2.829	3.059	3.186	3.387
Deposits	1.444	1.745	1.937	2.102	2.279	2.449	2.537	2.701
% of Deposits in Liabilities	79.9	79.2	78.9	79.0	80.6	80.1	79.7	79.9

Source: Annual reports of CBK, throughout the years. Author's calculations

Banking sector liabilities also grow steadily during the years even during the time of the global financial crisis. The impact of the crisis on the financial and banking sector were minor in comparison to the impact it had on developed countries due to the fact that Kosovo had barely been involved in international financial markets. The deposit is the main source of commercial banks' financing and is perpetuated with a permanent increase

over the years where in 2015 it reaches the value of 2,701 million Euro. The participation of deposits in the banking sector liabilities over the years varies between 78.9% (2010) and 80.6% (2012). This value in 2015 was at 79.9%.

The ratio between deposit and credit potential is described in the following table:

Table 4: Bank credit to deposit %, by years

Years	2008	2009	2010	2011	2012	2013	2014	2015
Bank credit to deposit %	82.0	78.4	75.3	80.8	76.4	73.7	74.8	74.5

Source: Annual reports of CBK, throughout the years. Author's calculations

Ratio: Loans \ Deposits, shows the participation of loans in total deposits and varies between 82.0% (2008) and 73.7% (2013). In 2015 this ratio was at of 74.5%. The requirement of the Regulatory Authority in Kosovo is 80%.

countries, are interest rates, both in deposit, lending and their spread.

The following paragraph analyzes the movement of interest rates on loans and deposits, as well as their spread, in Kosovo over the years.

5. INTEREST RATES IN DEPOSITS AND LOANS AND THEIR SPREAD

Issues that have incited debate in both academic and business societies, both in developed and developing

Table 5: Interest rates in deposits and loans and their spread, in Kosovo throughout the years

Years	2008	2009	2010	2011	2012	2013	2014	2015
Interest rate on credit	13.8	14.1	14.3	13.7	12.7	11.1	9.6	7.4
Interest rate on deposit	4.4	4.0	3.4	3.6	3.7	2.4	1.1	1.1
Interest rate spread	9.4	10.1	10.9	10.2	9.1	8.7	8.2	6.54

Source: Annual reports of CBK, throughout the years. Author's calculations.

Permanent growth of loan volume over the years has had little impact on lowering the interest rate on lending to the economy, especially for businesses. From the data above it can be seen that the average interest rate on loans in 2011 was 14.15%, whereas in 2010 it was 14.60%, which implies a symbolic decrease of the interest rates of 0.45%, respectively for 45 points. Compared to previous years, the movement of interest rates on loans has experienced a decrease over the years and is currently at 7.4% (2015). Meanwhile, the interest rate on deposits from 4.4% in 2008 experiences a dramatic decrease to 1.1% in 2015, which is discouraging for savers.

However, it is quite interesting to treat the interest rate spread, which implies the difference between the interest rate payable by the borrower and the interest rate paid to the depositors. (Tmava and Jakupi, 2019)[17]

In Kosovo, the interest rate spread varies from 10.93 per cent in 2010 to 6.5 per cent in 2014, meaning that banks in Kosovo feel very comfortable with the interest rate

spread since they are enabled to generate permanent profit.

This indicates that lending conditions are unfavorable and that high interest rates are a major barrier to businesses.

High interest rates on loans, when added the taxes of additional expenses such as: administrative expenses of loan processing and tracking (that vary from 1.5% to 2%) and other expenditures that are not directly related to the bank: cadastral costs, guaranty registration fees, asset evaluation ... show clearly that despite the relatively broad spectrum of services supplied by the banks, the borrowing conditions are tightened in the country.

6. NON-PERFORMING LOANS (NPL)

Banks during doing their business makes possible capital allocation from surplus agents to deficit agents, across the various sectors of the economy.

Waweru and Kalami (2009)[18] point out that commercial banks, due to the nature of their business, are exposed to the risk of default by borrowers.

Banks as financial institutions are highly exposed to the risk of non-return of loans. The risk of non-return is treated through non-performing loans. Banking theory and practice have not yet given a definition for NPL, which would be acceptable to all countries. This is also stated to the Vienna Initiative¹. In most banking systems of different countries, the most accepted parameter for defining the non-performing loans are the loans which are ninety days or more past due, or those loans which are not generating income. According to Alton and Hazen (2001)[1] the NPL are those loans which are 90+ days past due, or no longer accruing interests. Also, Central Bank of Kosovo, as a Regulatory Authority, applied the same criterion.

Below, we present NPL, in Kosovo, by years.

Table 6: Non-performing loans and provision

Years	2008	2009	2010	2011	2012	2013	2014	2015
NPL	3.4	4.3	5.8	5.7	7.4	8.5	8.4	6.5

Source: Annual reports of CBK, throughout the years. Author's calculations.

Non-performing loans experienced an increase after the financial crisis (reaching 8.5% in 2013), however, this has never put the banking sector security in question. In recent years, there has been a tendency of decrease of NPLs and in 2015 the NPL level was 6.5%.

The banking sector in general has undergone conservative behavior over the years, thus resulting in the lowest rate of non-performing loans compared to all other Western Balkan countries.

Based on the data from IMF (2015), Serbia with 21.6% and Albania with 18.2%, are the countries with the highest level of NPLs in the Western Balkans.

They are followed by Montenegro with 17.1% and Bosnia and Hercegovina with 13.7%. Macedonia is at 10.3%, whilst the lowest level of non-performing loans is in Kosovo, the only country with a one-digit index, with a total of 6.2%. Therefore, we can conclude that non-performing loans are not the cause of high interest rates on lending and the interest rate spread in Kosovo.

Despite the fact that lending conditions are quite unfavorable (short grace period, short term lending, huge demand for collateral up to double the amount required for loans etc.) not only in Kosovo, but also in other countries of the Western Balkans, nevertheless, "bank financing is ranked as the most widely used source of external financing." (BEEPS, 2009)[4]

¹ The Vienna Initiative was launched immediately after the first wave of international financial crisis, in January 2009, and includes the main international financial institutions (IMF, EBRD, EIB, WB) European Institutions (European Commission, ECB- observers,) and larger banking groups in CESEE countries.

7. PARTICIPATION OF BANK LOANS IN EXTERNAL SOURCES OF FINANCING

The following table shows the participation of external sources of finance (specifically banks) in business financing, in Western Balkan countries.

Table 7. Participation of bank loans in external sources of financing of firms in Western Balkan countries

Country	Albania	B and H	Kosovo	Montenegro	Macedonia	Serbia
Financing from loans %	61	48	43	55	73	58

Source: BEEPS, 2009

From the above data, it is seen that bank loans are represented by 43-76%, in all external sources of financing. Kosovo represents the lowest level with a total of 43%, which indicates that most of the funding is provided by internal sources.

Moreover, the other form of external financing used in developed nations, according to the EIB (2016)[9], the supply of formal equity funding for SMEs is essentially nonexistent.

According to the EIB Report (2016)[9], the total demand for financing SMEs is 730.9 million EUR. This represents 13.2% of GDP and 36.2% of loans in the banking sector.

Therefore, regarding the financing of SMEs, in Western Balkan countries and especially in Kosovo, we can conclude:

-access to finance is the main obstacle of SMEs

-loans from local banks are the dominant sources for external financing, despite inadequate conditions (very short grace period, short term lending, huge collateral requirement up to twice the amount required for loans, demand for two guarantors, etc.)

-In most Western Balkan countries, capital markets are still underdeveloped. This market in Kosovo is in the initial phase. Thus, making other methods of financing difficult (financing through equity or debt).

-State bodies should provide greater non-financial assistance regarding the support of development of SMEs, such as, support for better organized accounting and implementation of accounting standards, trainings related to business plan design, cadastral issues regulation, etc.

8. CONCLUSIONS

This paper aims to provide a reasoned answer to a series of questions related to the credit supply in Western Balkan countries, with a special focus on Kosovo.

From the analysis, it is concluded that the banking sector, despite the fact that it is relatively young (it all started in 1999), has earned the trust of the public. This is evidenced by the continuous increase of deposit rates, even during the years where there is a drastic decrease of interest rate on deposits.

The banking sector has maintained highly conservative behavior towards risk exposure, especially credit risk.

Such behavior has its benefits since it does not question the security of banks, but results in lending to the economy less than there are opportunities. The level of NPL also describes a similar story.

Asymmetric information, inadequate protection of creditors' rights, as well as prolonging the law enforcement of contracts, are the factors for under-lending to the economy in general.

However, depending on the perspective, the difficulties are apparent in both, the supply and the demand side of financial means.

Therefore, depending on the perspective (banks or SMEs) there are certain restrictions that impact the financing of SMEs business activities from external sources of financing (bank loans) in Kosovo.

From the perspective of Banks (the credit supply approach), such limitations are:

- Lack of long-term assets (inadequate deposit bank structure since over 50% of the deposits are in current accounts).
- Lack of transparency in the financial statements presented by SMEs (Many businesses draft different financial statements for the same period of time. They provide a set of financial statements when confronting with fiscal authorities while providing different and overestimated financial statements and when applying for credit). This in fact increases the cost of information therefore loans are more expensive.
- The lack of "good" projects, or the inability to elaborate particular loan applications.
- Unwillingness of SMEs' to sincerely cooperate with banks, which results on information asymmetry.
- Lack of SMEs credit experience,
- Lack of appropriate law enforcement and incomplete legal regulations. This prolongs the settlement of disputes in courts and makes the credit management process as a whole difficult.
- Unresolved property issues, issues with cadastral documentation, mortgage registration issues also negatively influence the assessment of performance and creditworthiness of the applicant.

While from the perspective of SMEs (the credit demand approach), such limitations are:

- High interest rates (above the average of the region)
- Short grace period, usually one-month (even for the agriculture sector, which is very discouraging for lenders)
- High administrative cost (in certain cases up to 2% of the credited amount)
- Short borrowing periods (even for financing long-term investment projects, thus, making loan repayment very difficult).
- A complicated procedure for applying and assessing the applicant's creditworthiness,

- Very strict requirements regarding the required collateral as a guarantee for loan repayment (with collateral coverage up to twice the required amount)
- The issue of guarantors, (in certain cases two or more are required which makes borrowing much more difficult)

9. RECOMMENDATIONS

Therefore, in order to have a sincere, long-term, of mutual interest, between banks and SMEs in Kosovo, it is recommended:

- The relationship between banks and SMEs should be based on long-term cooperation and not only during the loan utilization period. This is related to establishing and deepening of the business - bank binomial relationship.
- Sincere cooperation between SMEs and banks in risk management, especially in presenting financial issues regarding the non-repayment of loans (bank proposals on how to overcome financial difficulties, reprogramming of debt, refinancing)
This can be achieved by putting them in proper correlation: the goals, the models and the financing sources with the needs for financing of existing SMEs and those with potential for credit through the creation of a favorable environment for development and financing of business activities, all of this through:
 - Financing the business needs of SMEs through banks,
 - Models of supporting the financing of SMEs should be done with the banks, not for the banks;
 - The establishment of guarantee schemes, as well as concrete funds, to support the needs of SMEs
- Increase the bank supply by licensing new banks in the banking market, whereby the credit supply would also increase, which would improve the conditions for financing SMEs such as lower interest rates and reduced management cost, longer grace period, more relaxed conditions for collateral, longer period for utilizing financial means especially for SMEs that have long-term investment programs;
- Capacity building through development programs, vocational education and training, empowering entrepreneurial skills, promoting entrepreneurship through the formal and informal education system, etc.
- Initiating innovation support schemes and improving SME access to new technology;
- Advancing of law enforcement procedures, which would accelerate the court proceedings for bad loans and facilitate the execution and selling of collateral executed on behalf of bad loans. This would impact on raising the awareness of businesses, so that funds received in the form of loans should definitely be repaid and that these funds could be re-dispatched to other businesses;

10. REFERENCES

- [1] Alton, R. G. & Hazen, J.H. (2001). *As Economy Flounders. Do we See A Rise in Problem Loans?*, Federal Reserve Bank of St. Louis
- [2] Ayyagari, M., & Demircuc-Kunt, A., & Maksimovic, V. (2012). *Small vs. Young Firms Across the World: Contribution to Employment, Job Creation, and Growth*. Policy Research Working Paper Series 5631, The World Bank
- [3] Bank of Albania, (2008-2015), *Annual Report*, Tirana, 2015
- [4] Business Environment and Enterprise Performance Survey (BEEPS) 2008-2009. *A Report on methodology and observations*, April 2010
- [5] Central Bank of B and H, (2008-2015), *Annual Report*, Sarajevo, 2015
- [6] Central Bank of Kosovo-CBK(2010-2016): *Annual Report*, Prishtina,
- [7] Central Bank of Montenegro. (2008-2015), *Annual Report*, Podgorica, 2015
- [8] Cziraky. D, Tisma. S, and Pizarovic. A, (2002). *Determinants of SME Loan Approval Rate in Croatia: A Latent Variable Structural Education Approach*, IMO
- [9] EIB, (2016). *KOSOVO- Assessment of financing needs of SMEs in the Western Balkans Countries*,
- [10] EU SME 2012: *At the Cross Road, Annual Report on Small and Medium –Sized in the EU, 2011/2012*, Client: European Commission, Rotherdam
- [11] IMF (2012): *Financial System Stability Assessment*,
- [12] National Bank of Serbia, (2008-2015), *Annual Report, Belgrade*, 2015
- [13] National Bank of Macedonia, (2008-2015), *Annual Report*, Skopje, 2015
- [14] RIINVEST Report, (2012). *Banking Sector: Facilitator or Barrier*. Prishtina: Forum 2015 & Riinvest Institute.
- [15] Stigitz, J.E. & Weiss, A.(1981). *Credit Rationing in Markets with Imperfect Information*, American Economic Review, 71: 393-410
- [16] Storey, D. (1994). *Understanding the Small Business*, Sector Routledge, London, The Global economy.com The IMF. <http://www.theglobaleconomy.com>
- [17] Tmava, Q. & Jakupi, S. (2019). *Comparative analysis of Interest rates in Western Balkan Countries. Kosova Perspective*. International Journal of English Literature and Social Science (IJELS), vol-4, Issue -1, Jan-Feb.2019 ISSN:2456-7620
- [18] Waweru, N. M. & Kalami, V.M. (2009). *Commercial Banking Crises in Kenya: Causes and Remedies*, African Journal of Accounting, Economics, Finance and Banking Research, Vol. 4, No. 4, July 20094
- [19] World Bank Report. (2009). *Republic of Kosovo 2009 , Consultation: IMF Country Report*, Washington D.C.; IMF: Publication Services.
- [20] World Bank.(2009) *Development Research Group*, <http://www.worldbank.org/en/research/brief/finance-private-sector>