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Albania Credit Guarantee Scheme Assessment

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CONTENTS

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ABBREVIATIONS

AASF	Albania Agribusiness Support Facility
ALL	Albanian Lek (currency)
CESEE	Central, Eastern and South-Eastern Europe
CGS	Credit Guarantee Scheme
CHF	Swiss Franc (currency)
COVID-19	Coronavirus Disease 2019
EBRD	European Bank for Reconstruction and Development
EIF	European Investment Fund
EU	European Union
EUR	Euro (currency)
GBP	Pounds Sterling (currency)
GDP	Gross Domestic Product
INSTAT	Albanian Institute of Statistics
KFW	German Development Bank
MSME	Micro, Small and Medium Enterprise
NBFI	Non-Bank Financial Institution
NPL	Non-Performing Loan
RCGF	Rural Credit Guarantee Fund
SLA	Savings and Loan Association
SME	Small & Medium Enterprise
TFP	Trade Facilitation Program of the EBRD
USAID	United States Agency for International Development
USD	United States Dollars (currency)

EXECUTIVE SUMMARY

Micro, small, and medium enterprises (MSMEs) in Albania are significant contributors to the economy. In 2018, according to the Albanian Institute of Statistics (INSTAT), 99.8 percent of active enterprises were MSMEs[1], employing 79.8 percent of the workforce and realizing around 69 percent of value added. At the same time, the MSME sector is generally characterized by high informality (especially in agriculture), limited availability of collateral, and low levels of financial capability.

Limited access to finance, particularly bank credit, poses a challenge for MSMEs in Albania. MSMEs can only reach their full potential if they obtain the finance necessary to start, sustain, and grow their business. Albania's financial sector ranks at 102nd place out of 141 countries in the World Economic Forum 2019 Global Competitiveness Report. Credit to the domestic private sector represents only 33 percent of gross domestic product (GDP) compared to above 50 percent in regional peers, reflecting very low levels of financial intermediation. MSMEs – the backbone of the Albanian economy – face significant constraints in accessing finance, with 16 percent of small and 34 percent of medium-sized enterprises reporting access to finance as a major constraint in Albania.[2] The overall MSME finance gap in Albania is estimated at 9 percent of GDP.[3] The Albanian banking sector is extremely liquid and prevailing interest rates are low; however, Albanian banks are reluctant to lend to MSMEs as they perceive the sector as risky and there is a limited secondary market for movable and immovable collateral.

Improving access to finance for MSMEs in the country must be tackled in a holistic and strategic manner, addressing supply, demand, and enabling environment aspects. There is strong consensus among domestic stakeholders on the need to improve access to finance for enterprises and a number of activities are already ongoing. Using the recommendations of the World Bank 2018 MSMEs Finance for Growth Assessment,[4] the authorities have been discussing a set of comprehensive and concrete measures covering a wide range of areas related to access to finance. In addition to stimulating lending as the major source of financing, efforts are needed to increase product diversity (both in banks and non-bank sectors), foster digital financial services, reduce informality, improve credit infrastructure, modernize payments, as well as strengthen consumer protection. Substantial financial education and awareness activities and supporting programs to MSMEs to improve their financial management and reporting, as well as business planning capacities, are indispensable to generate demand for financial services and improve its quality. Better coordination and policy targeting by the government authorities is needed to increase the effectiveness of ongoing and new MSME support programs.

An increasingly popular form of government intervention are credit guarantee schemes (CGSs) to address market failures and imperfections in the MSME credit market. Public CGSs are government-established mechanisms that provide credit risk mitigation to lenders with the objective of increasing access to credit for enterprises (typically MSMEs). Well-designed CGSs facilitate financing to creditworthy customers, which would have been denied credit in the absence of sufficient collateral. CGSs are among the most market friendly interventions as they cause minimal market distortion, compared to more direct forms of intervention, and represent little competition to genuine market players. CGSs

[1] This is according to the INSTAT's definition used in Albania, which slightly differs from the official one and also from the European Union's definition.
[2] This is up from 8.4 percent of firms reporting access to finance as a major constraint in 2013, potentially reflecting increased needs for access to finance as the economy develops. World Bank Enterprise Surveys (2019).
[3] SME Finance Forum, IFC Enterprise Finance Gap.
[4] http://documents.worldbank.org/curated/en/492421531243270171/Albania-MSME-finance-for-growth-assessment

are also a useful instrument for crowding in private capital as banks typically share some of the risk. CGSs work particularly well in highly liquid banking systems, which is the case in Albania. Compared to direct lending programs, credit guarantee schemes have much lower initial cash flow needs and, as such, have a leverage component. As a consequence, they can also be used when fiscal constraints are tight. Worldwide, more than half of all countries have a CGS in place and the number is growing. Many EU countries as well as neighboring countries in the Western Balkans have made CGSs available. However, CGSs may add limited value and prove costly when their design and implementation is flawed.

CGSs can also be leveraged to provide countercyclical financing to MSMEs during a downward economic cycle such as the one induced by the coronavirus disease 2019 (COVID-19) pandemic, when financial institutions may become unwilling to lend. The COVID-19 crisis has further aggravated the financing needs of MSMEs. Firms, especially MSMEs, are confronted by plunging incomes and disruptions in supply chains. This translates into a liquidity crunch which - as a consequence - raises demand for additional financing, in particular working capital loans. At the same time, banks - focused on maintaining safety and soundness in their lending - may refrain from extending new loans to firms, amplifying procyclical behavior. Bank bridge financing for viable enterprises who have become cash-strapped is crucial to help mitigate COVID-19 impacts, avoid a wave of defaults, and provide the needed financing support during the recovery phase. In response to the COVID-19 pandemic, governments have launched guarantee programs to support bank lending to companies, especially MSMEs.[5]

The targeted credit guarantee programs launched by the government in response to the COVID-19 crisis should, over time, transform into a regular public CGS to help kick-start economic recovery. Designing and implementing a well-functioning CGS with transparent governance structures and rigorous risk management and monitoring frameworks takes time. The benefits of building full-fledged CGS framework are twofold. First, it allows to better leverage resources to maximize impact including from the private sector and international donors. Second, it helps mitigate the risks of possible misallocation of resources, political interference, or crowding out as well as long term fiscal costs. Beginning this work soon (i.e. during the crisis period) will help ensure that it is ready and available to be used during the recovery period. The Principles for the Design, Implementation, and Evaluation of Public Credit Guarantee Schemes for SMEs, a set of international best practices developed by the World Bank in 2015, can guide the design of a new CGS.[6] Below is an initial overview of what a public CGS could look like for Albania, with the caveat that the parameters would need to be carefully assessed and calibrated based on the country context.

Table 1. Considerations on key parameters for a new public CGS in Albania

Key Parameters	Credit Guarantee Scheme
Legal, regulatory, and institutional setup	Best set-up will need to be carefully assessed (either building on existing structures/creating a new structure) including potential transitory arrangements. Important to envisage independent and transparent corporate governance and risk management arrangements. Set clear boundaries separating legitimate government control and oversight from day-to-day operations.
Prudential regulation and supervision	Introduce prudential regulation and supervision of the CGS. Carefully assess the regulatory prudential treatment of guarantees and adjust design accordingly.
Funding	Government to provide initial capital, as funded schemes benefit from the security and credibility of the paid-in capital, but international donors and private sector could also be willing to contribute equity if the scheme is designed well.

[5] Financial Stability Institute of the Bank for International Settlements, Brief No 5, Public guarantees for bank lending in response to the Covid-19 pandemic, April 2020.
[6] See http://documents.worldbank.org/curated/en/576961468197998372/Principles-for-public-credit-guarantee-schemes-for-SMEs.

Key Parameters	Credit Guarantee Scheme
Leverage	Suggested targeted leverage ratio should be no more than three times in the early years, moving to max of five times in later years when the CGS is well established.
Coverage ratio	The coverage ratio needs careful negotiation with the lenders to provide sufficient protection against credit risk, while also preserving incentives for banks to screen and monitor borrowers. It is recommended to consider 50% plus increased coverage ratios to incentivize certain sectors according to identified market failures or to help with crisis recovery.
Delivery Modality	A portfolio scheme may be most appropriate given efficiency and cost gains.
Fees	To be agreed with government and participating lenders. As a general principle, fees should reflect the cost of risk of the underlying loan portfolio, the cost of capital, and should cover the operating expenses. Fees should be reviewed on an annual basis with full and transparent disclosure and over time move to a risk-based fee system.
Eligibility criteria	To be agreed with government and participating lenders. Most likely with particular emphasis on MSMEs per the national definition.
Minimum and maximum loan amounts	To be agreed with government and participating lenders.
Type of financing	To be agreed with government and participating lenders. The CGS should be designed to be flexible to enable it to cover several loan products (e.g. working capital and investment loans).
Collateral requirements	Guarantee schemes should be allowed to require collateral up to reasonable limits. This commits the borrower to an obligation to repay the loan. In many countries, CGSs take personal guarantees, or guarantors, to increase incentives for repayment.
Claim handling	The claim payout should be quick and predictable, in order to build the credibility of the CGS, while encouraging loan collection. Triggers for payout should be clear and the process should be simple. Lenders should continue efforts to recover the collateral through the legal system after pay-out. Successful schemes do not require that legal action is completed before claims are paid out.
Monitoring	Establish a clear division of responsibility between guarantee scheme and lenders, with the main screening and monitoring functions the responsibility of the lenders.
Evaluation	Establish a comprehensive evaluation of the CGS's performance to account for the use of public resources, measure the achievement of CGS policy objectives, and improve its operations.
Capacity Building	Consider providing capacity building programs to MSME borrowers as additional value added (i.e. business development services).

1

BACKGROUND

OVERVIEW OF THE FINANCIAL SECTOR

The Albanian financial system is bank-centric, with shallow non-bank sectors and a small capital market. Banks account for about 90 percent of financial sector assets, considerably more than in the euro area (45 percent). Since fall 2018, the number of banks has dropped from 16 to 12 due to mergers and removal of the license of a small non-operational bank. 31 licensed non-bank financial institutions (NBFIs)[7] operate in Albania, their size and role vary substantially.[8] Eight are registered to perform regular lending activities (solely or combined with other services),[9] five to conduct microcredit activities, nine offer leasing products, and eight offer factoring services. Savings and loan associations (SLAs) have undergone a process of consolidation, from 126 in 2015 to only 13 in 2018. At 0.7 percent of assets to GDP their role is rather limited. Insurance and private pension assets account for only 2.4 percent of GDP, while investment funds have grown to 4.3 percent since their emergence in 2012 (see Table 2).

Table 2. Share of segments of the financial system as percentage of GDP

Licensing & Supervising Authority	Bank of Albania			Financial Supervisory Authority			Financial Inter-mediation
Financial System	**Banking Sector**	**NBFIs**	**SLAs**	**Insurance companies**	**Pension Funds**	**Investment Funds**	
2011	88.1	2.7	0.8	1.5	0		93.1
2012	92.1	2.7	0.8	1.6	0	1.2	98.6
2013	94.8	2.7	0.7	1.7	0	3.9	103.8
2014	97.6	3	0.8	1.9	0	4.8	108.2
2015	97.3	2.9	0.8	2.1	0.1	5	108
2016	100.5	3	0.6	2.1	0.1	4.7	111
2017	99.4	3.1	0.6	2.1	0.1	5	110.3
2018	96.8	3.5	0.6	2.1	0.2	4.5	107.6
2019	95.5	4.2	0.7	2.2	0.2	4.3	106.9

Source: Bank of Albania, Albanian Financial Supervisory Authority

[7] The term NBFI in this report refers only to those institutions that provide mainly credit and payment services, and excludes insurance, pension funds, investment funds, and other participants of capital markets (e.g. brokers).
[8] Bank of Albania, *List of licensed non-bank financial institutions* (May 2019).
[9] At present in Albania there is a distinction between lending and micro-lending, based on limits to the size of loans they are allowed to provide. Lending institutions are non-deposit taking microfinance institutions which can provide larger loans than can be offered by microlending institutions.

ENTERPRISE SECTOR IN ALBANIA

MSMEs in Albania are significant contributors to the economy. In 2018, according to INSTAT, 99.8 percent of active enterprises were MSMEs,[10] employing 79.8 percent of the total number of employed people.[11] The highest number of MSMEs were in the trade sector (41.4 percent), followed by the services sector (21.2 percent). 69.1 percent of value added was realized by MSMEs in 2018, compared to 68.3 percent in the previous year. The highest percentage of value added in micro-enterprises is realized in the accommodation and food services sector (69.2 percent). The trade sector has the highest percentage realized by small enterprises (28.6 percent). Medium enterprises realized the highest percentage of value added in manufacturing industry (38.2 percent) (see Table 3).[12]

Sectors of the economy dominated by MSMEs are characterized by high levels of informality. Many MSMEs in Albania operate on an informal basis. Despite recent progress increasing the number of registered businesses (Figure 1), they often still do not declare taxes or workers and mainly transact in cash. Informal businesses generally have lower productivity than formal businesses, which is both a drag on firms and a drag on the economy. Workers in the informal sector lack social protection, especially insurance and pension benefits. Public revenues are reduced by hidden economic activity, resulting in diminished provision of public goods. Business conducted outside the regulated economy raises safety, health, and environmental risks for workers and communities. Widespread informality impedes not only the development of those businesses that decide to remain informal but is also a hindrance to the formal companies faced with competition from the informal sector. By being outside the formal economy these companies lack the opportunity to benefit from access to formal finance, access to formal markets, and from the legal protection of their property, contracts, and investments. The Government of Albania has previously taken measures aimed at increasing registration of companies, greater declaration of workers, improving tax collection, and granting of fiscal amnesties. To allow businesses to better contribute to the economy it is important that the government continues to invest substantially in formalizing these MSMEs, through efforts that go beyond mere registration.

Table 3. Overview of the enterprise sector in Albania, 2018

		Micro (1-9 employed)	Small (10-49 employed)	Medium-sized (50-249 employed)	MSMEs (1-249 employed)	Large (250+ employed)	Total
Enterprises	No	100,876	5,246	1,147	107,269	181	107,450
	%	93.90%	4.90%	1.10%	99.80%	0.20%	100.00%
Employed	No	194,867	102,950	113,911	411,727	103,979	515,706
	%	37.80%	20.00%	22.10%	79.80%	20.20%	100.00%

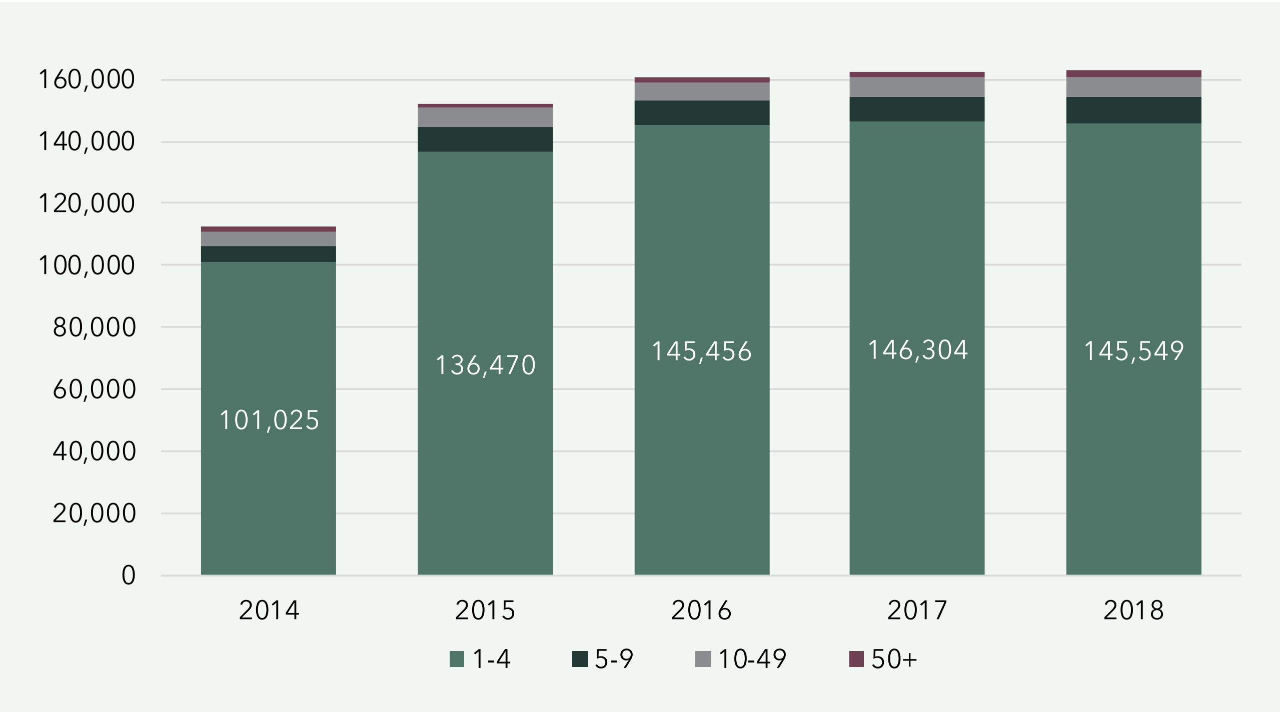
[10] This is according to the INSTAT definition used in Albania, which slightly differs from the official one and also from the European Union's definition.
[11] INSTAT, Statistics on small and medium enterprises, 2018.
[12] Albania MSME Finance for Growth Assessment, World Bank, 2018.

		Micro (1-9 employed)	Small (10-49 employed)	Medium-sized (50-249 employed)	MSMEs (1-249 employed)	Large (250+ employed)	Total
Net Sales	Million ALL	409,991	713,963	564,666	1,688,620	491,685	2,180,305
	%	18.80%	32.70%	25.90%	77.40%	22.60%	100.00%
Investment	Million ALL	32,469	65,700	69,935	168,104	70,041	238,145
	%	13.60%	27.60%	29.40%	70.60%	29.40%	100.00%
Value Added	Million ALL	116,099	130,690	143,799	390,588	174,890	565,478
	%	20.50%	23.10%	25.40%	69.10%	30.90%	100.00%

Source: INSTAT

The financial health of large companies is weak. According to a recent analysis of 230 of the largest Albanian companies for 2014-2016, about 80 percent of large companies have demonstrated medium to low level of financial health, within which 54 percent are classified as low and almost low performers. The low performers have low profitability, are highly leveraged, and have low liquidity ratios. The supply chains of these companies, comprised of numerous MSMEs, are therefore subject to financial risks, which are spread to the entire economy.

Figure 1. Number of registered businesses over recent years by size



Source: INSTAT, 2018

MSME FINANCING CONSTRAINTS

Despite being the backbone of the Albanian economy, MSMEs face difficulties in accessing finance which impedes their growth. They face significant constraints in accessing finance with 16 percent of small and 34 percent of medium-sized enterprises reporting access to finance as a major constraint in Albania.[13] The overall MSME finance gap in Albania is estimated at 9 percent of GDP.[14]

Bank lending represents a key element of financial intermediation which needs to be further developed. The financial sector is dominated by banks which are characterized by high levels of liquidity, strong risk aversion after the financial crisis, increasingly conservative policies from their parents, and lacking proper incentives or capacity to explore new and innovative approaches to finance. Albania's financial sector ranks at 102nd place out of 141 countries in the World Economic Forum 2019 Global Competitiveness Report. Credit to the domestic private sector represents only 33 percent of GDP compared to above 50 percent in regional peers, reflecting very low levels of financial intermediation in Albania (see Table 4). Although gradually improving, non-performing loans (NPLs) are still significantly higher than pre-crisis levels, burdening banks' balance sheets and making it harder for banks to support economic growth through the credit channel. Provision of credit to MSMEs is further undermined by weak law enforcement, shallow secondary markets for collateral, and in some instances stringent customer-due diligence and documentary policies. The Albanian financial sector is very liquid and interest rates are low; however, Albanian banks are reluctant to lend to MSMEs as they perceive the sector as risky and there is a limited secondary market for movable and immovable collateral.

Table 4. Domestic credit-to-GDP ratio for Western Balkans economies

Economy	Albania	Bosnia and Herzegovina	North Macedonia	Montenegro	Serbia	Kosovo
2014	39.3	60.2	50.5	51.3	40.8	35.4
2015	37.2	58.7	52	49.8	40.7	36.4
2016	36.6	57.9	49	48.8	41	38.7
2017	35.1	58.3	50	48.7	40.3	41.3
2018	33.1	58.6	50.3	49.6	41.5	44.3
2014–18 abs. change	-6.2	-1.6	-0.2	-1.7	0.7	8.9
2014–18 credit growth	-0.2	17.4	24.7	27.8	24	51.9
2014–18 GDP growth	18.4	20.6	25.1	32.2	22	21.4

Source: World Bank data, WBG staff calculation

[13] This is up from 8.4 percent of firms reporting access to finance as a major constraint in 2013, potentially reflecting increased needs for access to finance as the economy develops. World Bank Enterprise Surveys (2019).
[14] SME Finance Forum, IFC Enterprise Finance Gap.

The availability of a wider range of financing instruments that meet the varying needs of MSMEs should be further enhanced. Lending by microfinance institutions, the second largest providers of finance - especially in rural areas - has increased in recent years. Nevertheless, their growth is restricted as they face difficulties in accessing affordable wholesale funding or appropriate risk sharing mechanisms. Financial leasing is limited mainly to motor vehicles, with a weak secondary market for repossessed equipment presenting the biggest constraint for its development. Venture capital funds and/or angel investor networks that would target start-up or scale-up ready MSMEs are also missing. Accounts receivable based finance (e.g. factoring or invoice discounting) is barely practiced.

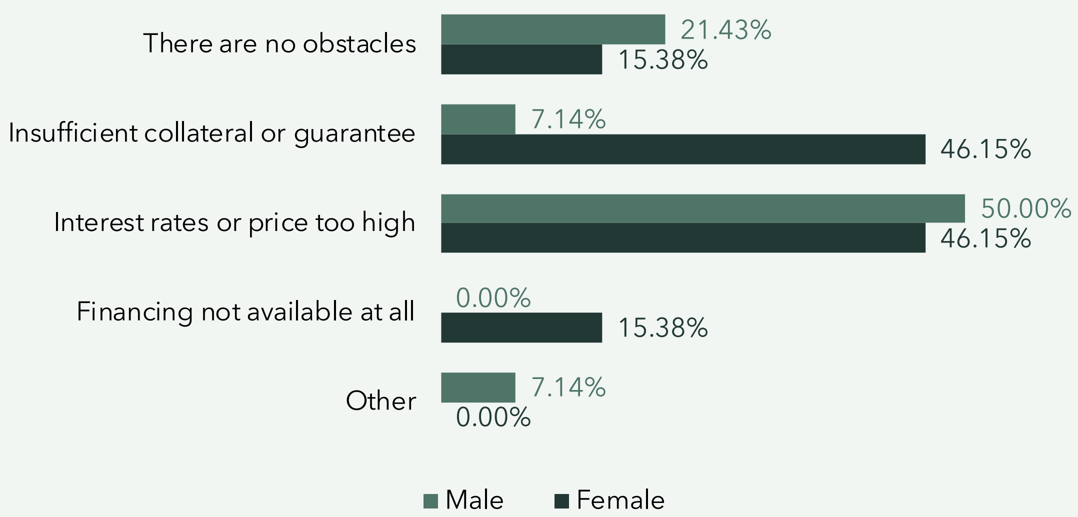
Box 1. MSME focus groups on access to finance constraints

In October 2019, two focus groups were undertaken with MSMEs and women-owned MSMEs to discuss access to finance issues in Albania. 27 MSMEs - 13 of which were women-owned – participated in the focus groups. In terms of sectoral distribution, 37 percent were operating in the trade sector, 30 percent in services, and 26 percent in manufacturing. Key points raised by the participants are as follows:

- Banks are very conservative, seek high collateral, have high interest rates, and limited durations of loan repayment.
- Bank contract terms are often not clear on fees for loan approval and other expenses.
- Banks mostly purchase government bonds and treasury bills rather than provide lending.
- Alternative financing options are limited.
- High interest rates charged by microfinance institutions often lead MSMEs to bankruptcy.
- Insufficient training is available to assist MSMEs with business planning and loan applications.
- Few initiatives are available to assist women with starting a business.

Access to finance constraints appear to be more pressing for women-owned enterprises. When asked about the most important factors limiting access to finance, around half of men and women-owned enterprises perceived interest rates as too high, while women appear to be particularly constrained by insufficient collateral. Only 21 percent of men-owned enterprises and 15 percent of women-owned enterprises reported no perceived obstacles to access to finance.

Most important factors limiting access to finance, gender disaggregated, percent

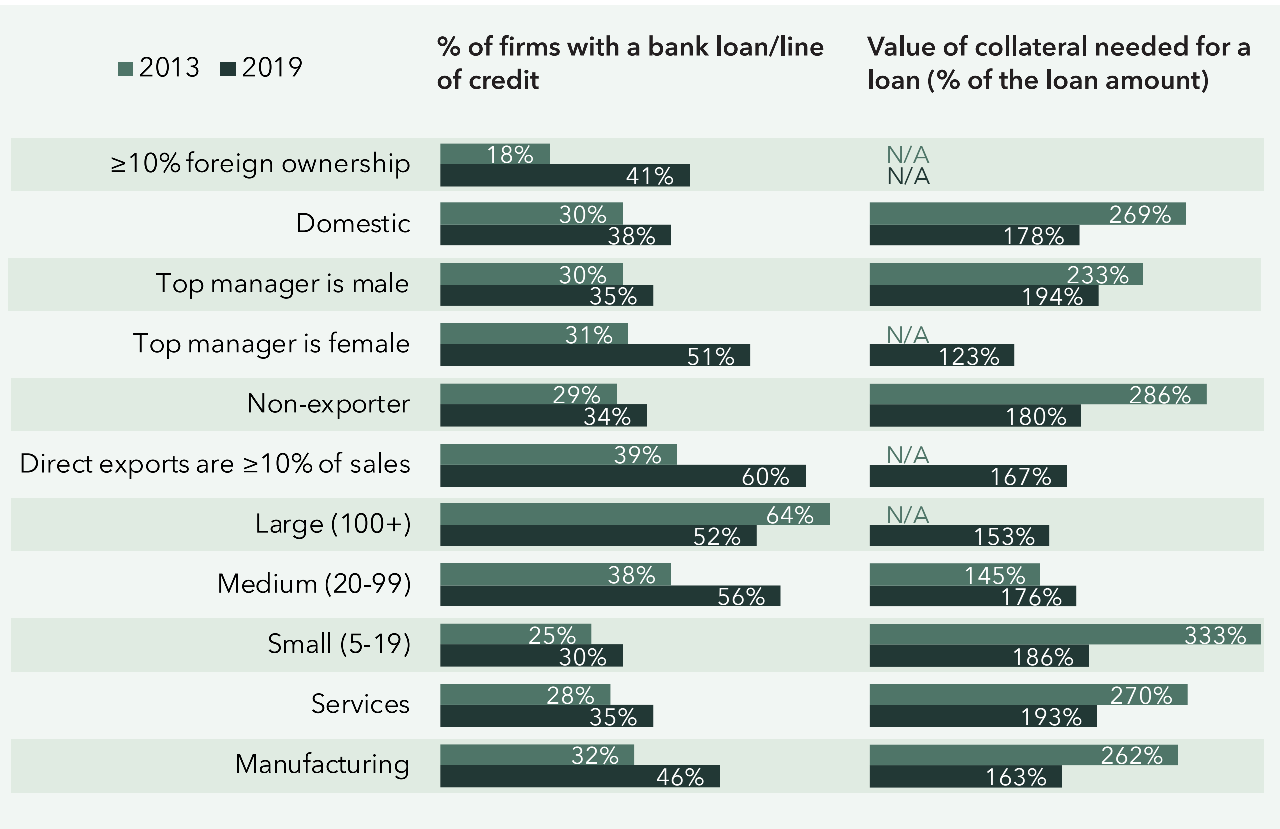


Source: Focus group survey results, WB own calculations

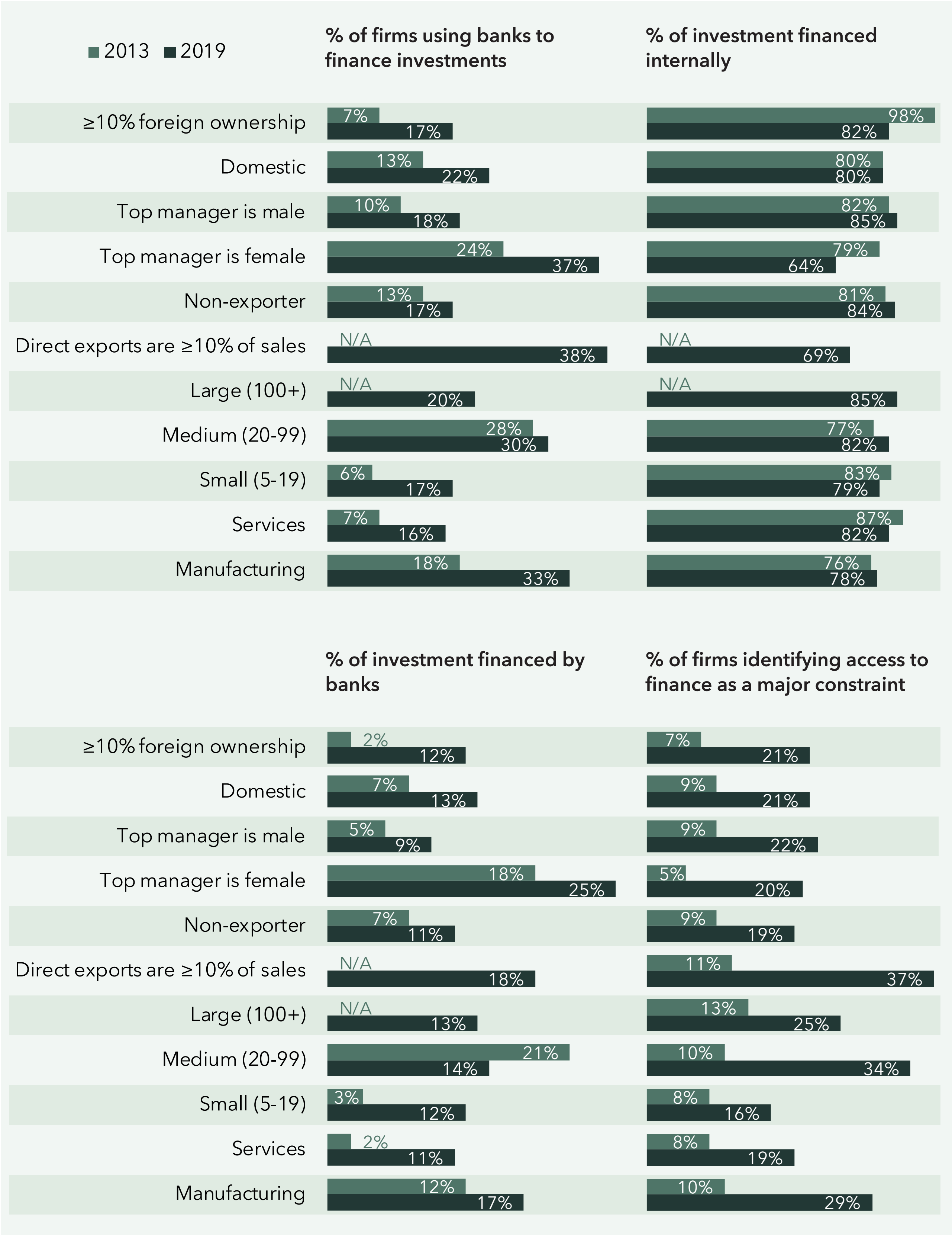
On the demand side, the MSME sector is generally characterized by high informality (especially in agriculture), limited availability of collateral, and low levels of financial capability. Many MSMEs, especially in the agricultural sector, lack understanding of financial products and the potential benefits which various formal financial solutions might have for their businesses. High collateral requirements, caused by the perception of risk and the shallow secondary market for collateral, makes it difficult for most MSMEs to qualify even for plain vanilla loan products. This is especially true in the agriculture sector where agricultural land is partitioned into small unconnected plots, often with unclear ownership status due to unfinished land reform and ownership restitution process. Financial reporting practices need to improve as the quality and credibility of financial statements remains low, especially for MSMEs. Capacity building programs, including linked to financial support facilities, improved levels of consumer protection, as well as enhanced financial reporting practices, are required to further strengthen the bankability of MSMEs. See Box 1 for further details on MSMEs perceived access to finance constraints.

According to the latest Enterprise Survey of Albania in 2019, access to loans has increased and collateral requirements have gone down. At the same time, finance is reported as a bigger obstacle in 2019 and investments are still predominantly financed internally. The percentage of firms with a bank loan or a line of credit increased to 37.8 percent in 2019 from 29.4 percent in 2013. Peaking after the global financial crisis of 2008, due to increased risk averseness in the banking sector, the value of collateral required for a loan declined towards pre-crisis levels, from 267 percent in 2013 to 177 percent in 2019. Although there has been a significant increase from 12.4 percent in 2013 to 21.5 percent in 2019, the percent of firms using banks to finance investments remains largely below regional peers. The proportion of investments financed internally remains high at about 80 percent. The percentage of firms identifying access to finance as a major obstacle has increased significantly compared to 2013, reflecting that firms' economic opportunities are greater – so firms have more demand for credit than in 2013, while credit supply conditions have only slightly improved and banks' balance sheets are still hampered by high NPLs. Medium-sized enterprises, manufacturing companies, and exporters appear to be particularly affected (see Figure 2).[15]

Figure 2. Access to Finance



[15] This is up from 8.4 percent of firms reporting access to finance as a major constraint in 2013, potentially reflecting increased needs for access to finance as the economy develops. World Bank Enterprise Surveys (2019).

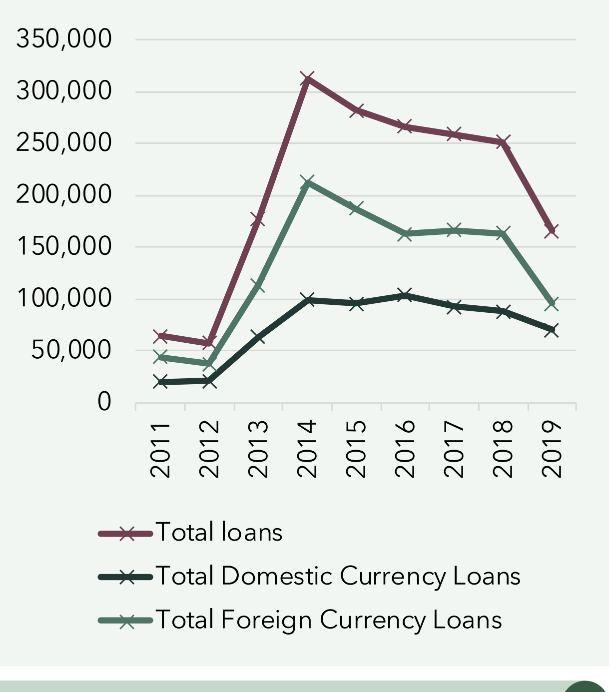


Source: 2019 Enterprise Survey

An analysis of Albanian Credit Registry data[16], including on all commercial loans, provides helpful insights on the provision of finance to enterprises in Albania. Loans were provided by a total of 31 financial institutions (around 88 percent of all loans were extended by banks). The share of loans provided by non-bank entities has been increasing from less than 1 percent in 2014 to almost 5 percent in 2019. Following 2014, credit growth was quite limited and the share of foreign currency loans decreased. On average, some loan conditions such as interest rates and collateral coverage ameliorated, whereas in some other dimensions such as loan maturity the gains were limited.

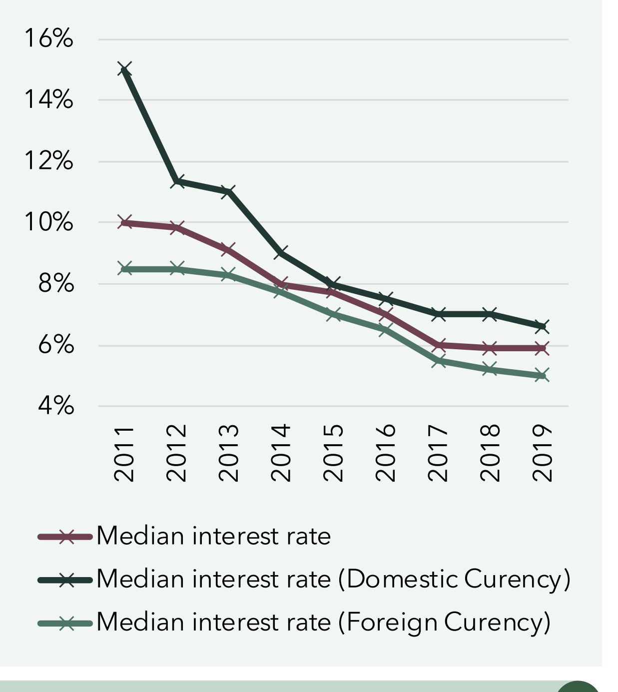
Disaggregating data by firm size allows analysis of how currency denomination, nonbank financing, and various loan characteristics change with firm size. Over the years, large firms (that make up only around 3 percent of all firms) received 35-50 percent of the total loan provision. Micro and small size enterprises received 20-30 percent of the total loan volume, even though they constitute around 83 percent of all firms. Micro and small firms have to pay the highest interest rates and must quite often post high amounts of collateral, many times larger than the value of the loans.[17] This may be severely restricting access to finance. Large firms receive around 70-80 percent of their borrowing in foreign currency. The use of foreign currency loans is generally lower for MSMEs, varying between 55-65 percent of all funding. Nonbank financial entities play a bigger role for MSMEs, accounting for almost 5 percent of all loans for MSMEs compared to 2 percent for large firms.

Figure 3. Total loans by currency (millions of LEK)



Source: World Bank own calculations based on Bank of Albania Credit Registry Database

Figure 4. Median interest rate by currency (%)

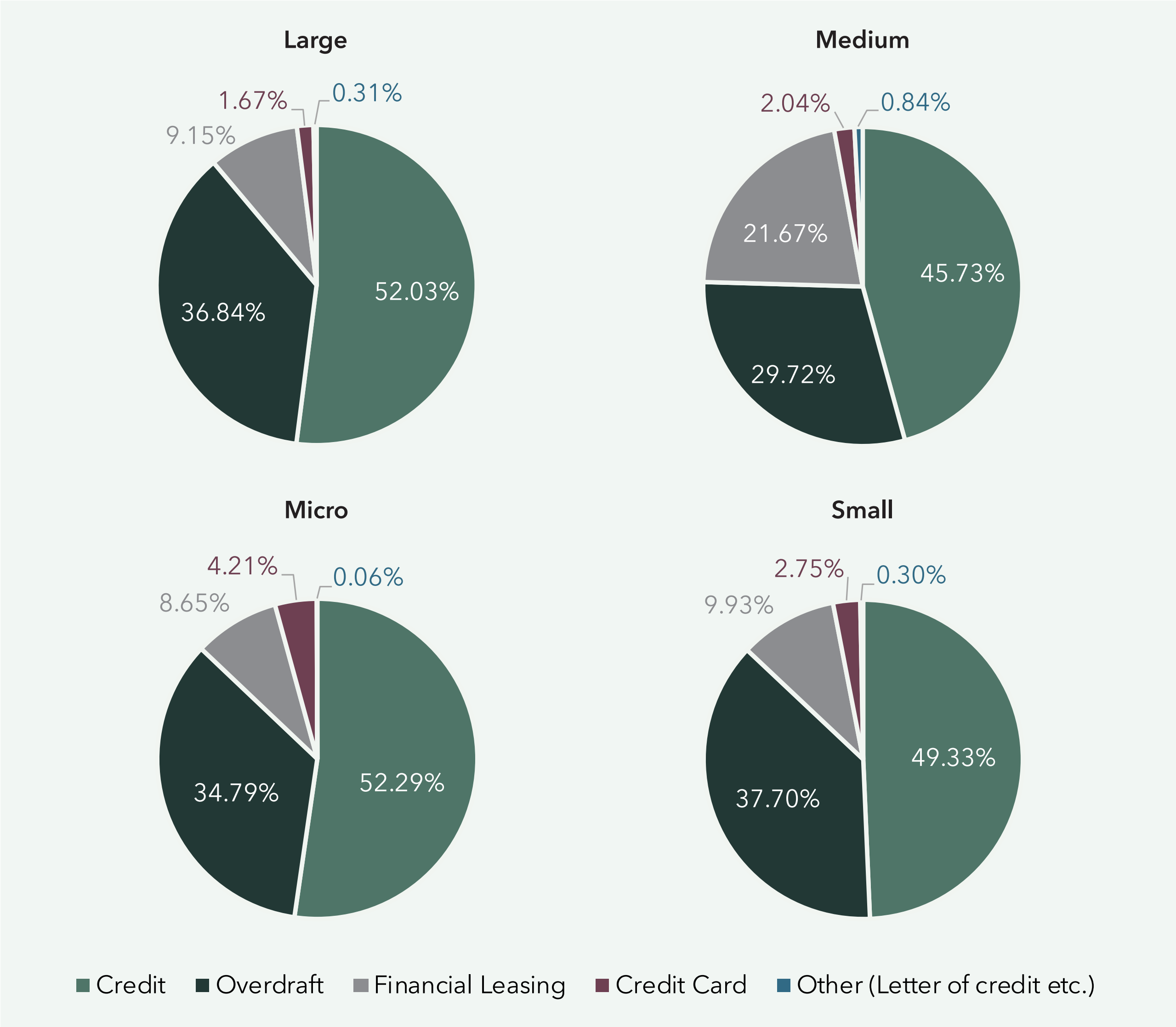


Source: World Bank own calculations based on Bank of Albania Credit Registry Database

[16] The analysis includes a total of 62,179 loans from 18,267 firms over a time period of 7 years (2011-2019). Loans with missing or zero interest rate or maturity, and loan volume smaller than ALL 100,000 were dropped. In addition, the interest rate and maturity variables were trimmed at 1 percent and 99 percent to avoid unreasonable outlier values - possibly caused by differences in reporting - driving the analysis. In a second step, as the credit registry lacks firm size information, relevant data from the National Business Center is merged with the credit registry data. The sample size drops considerably to 6,000 firms and the average firm age is higher, suggesting that generally it is the more established firms that provide financial information to the authorities.

[17] More than 150 percent of the loan value for the median loan.

Figure 5. Size distribution of loan types (number of loans)



Source: World Bank own calculations based on Bank of Albania Credit Registry Database

Figure 5 provides information regarding the type of loans used by different sized firms. Around half of all loans are standard *credit* for all firm sizes; *overdraft* facilities are the second most popular credit product for different firm sizes, constituting 30-37 percent of all loans. Interestingly, *financial leasing* is mostly used by medium sized firms (21.6 percent of all loans are leases, whereas for other firms this share is around 9-10 percent). One last observation is that *credit cards* are used more frequently by micro- and small-sized firms (4.8 percent and 2.8 percent, respectively) possibly reflecting the inability to secure loan facilities with better terms.

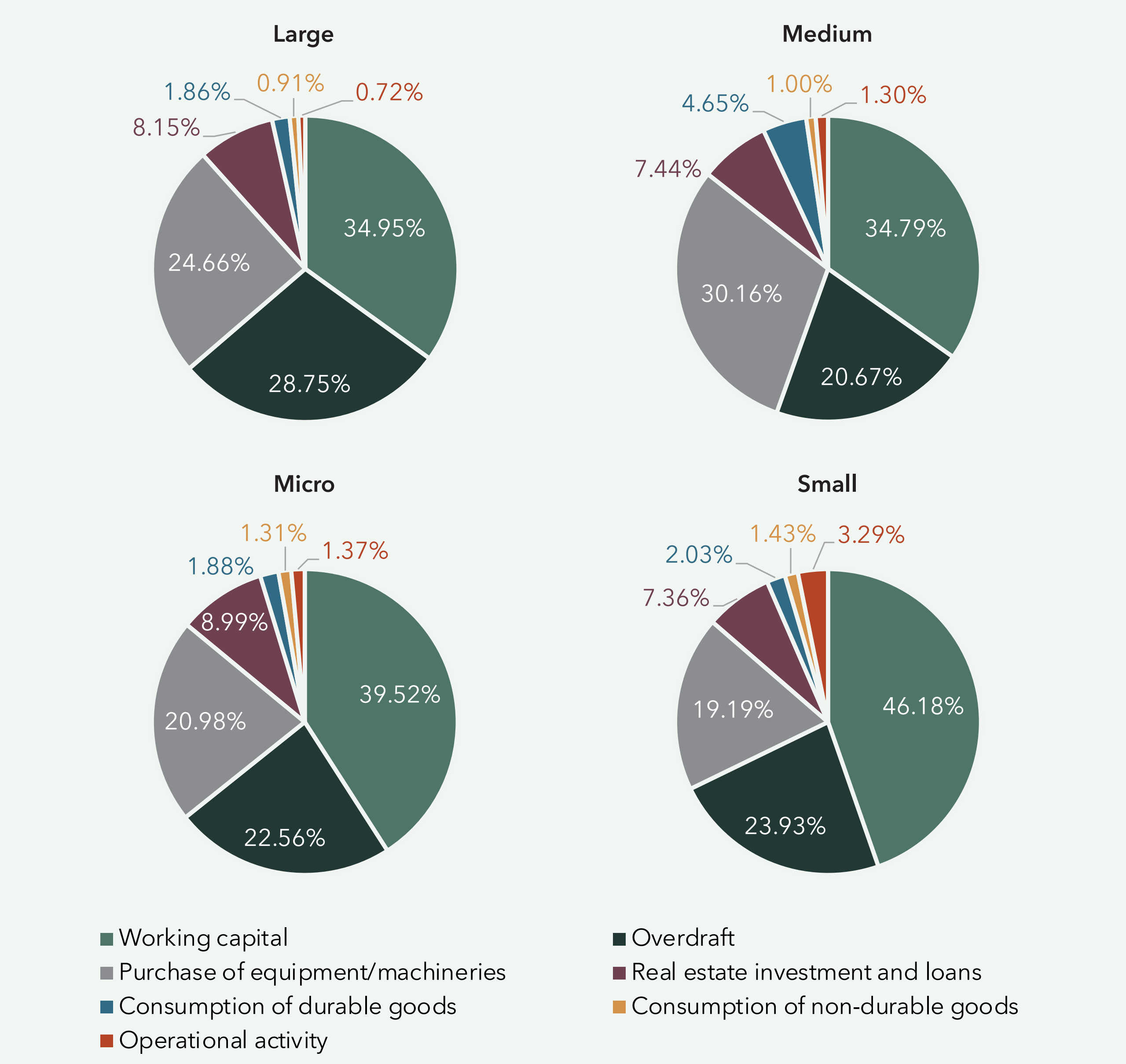
Figure 6 indicates that regardless of firm size, the most common use of loans is toward *working capital*. This share is higher for micro- and small-sized firms (40 percent and 46 percent, respectively). Large and medium sized firms make greater use of the loans to buy equipment and machinery than their smaller counterparts.

Finally, a number of weaknesses in the current setup of the credit registry were identified during the analysis. Bank of Albania is currently working on upgrading its credit registry. It is recommended that the following issues are addressed by the authorities as part of this reform process:

- The time-series coverage of the registry is rather limited. The registry included all financial institutions only recently (in 2018). This implies that the coverage was changing over time, possibly impacting the analysis.

- Approval date entry is optional so not all loans have an approval date, which can differ from disbursement date. Data seems to be reported on all disbursed credit but not necessarily all approved credit.
- Loan applications and rejections are not reported, thus the credit registry does not provide any information on loan demand.
- The credit registry does not collect firm-level information. This limits further granular analysis of loan-level data. Other databases including such information can be merged (as done in the current analysis), yet information over time may still be missing.
- The interest rate entry in the credit registry is not standardized. It is not clear which interest rate is reported by the banks (e.g. nominal interest rate vs. effective interest rate, or monthly vs. yearly). Related to this point, the credit registry does not include any information on costs related to the loan.
- The address field does not have a standardized format leading to difficulties in categorization of locations (e.g. cities). The credit registry also does not include information on which bank branches provide the loan.
- Credit guaranteed loans are not explicitly identified. Credit guarantees are only listed under "Other" collateral types.

Figure 6. Loan purpose by firm size



Source: World Bank own calculations based on Bank of Albania Credit Registry Database

3

REVIEW OF EXISTING CREDIT GUARANTEE SCHEME FACILITIES IN ALBANIA

There are a number of guarantee schemes operating in Albania focused on specific sectors which can provide insights for the design of credit guarantee programs going forward. Several main schemes operate in Albania. The Albania Agribusiness Support Facility (AASF)[18] aims to promote and enhance access to finance for agribusinesses in Albania. The German Development Bank (KFW) Rural Credit Guarantee Fund (RCGF)[19] was established in 2015 as a not-for-profit foundation under the Laws of the Republic of Albania for the purpose of facilitating access to finance for Albanian farmers and rural entrepreneurs with insufficient or lack of collateral. The Italian - Albanian Program for the Development of SMEs provides credit guarantees for loans to finance SME investment projects related to the purchase of machinery, equipment, and services made in Italy.[20] Further information on the design features of select guarantee schemes is provided in Box 2

Box 2. Design features of select CGS operating in Albania

AASF

- **Institutional set up**
  - o Financing framework developed by European Bank for Reconstruction and Development (EBRD) in cooperation and with support from the Government of Albania
- **Type of guarantee**
  - o Portfolio based risk-sharing instrument covering up to 50% of the aggregate amount of a portfolio of outstanding eligible agribusiness sub-loans
  - o First loss risk cover provided by the Government of Albania, covering the first 20% of losses of the aggregate amount of sub-loans financed with the proceeds of loans provided under the AASF.
- **Beneficiary**
  - o Agribusinesses
- **Coverage ratio**
  - o 50% for portfolio based pari passu guarantee
  - o 20% first loss guarantee
- **Size of fund**
  - o EUR 36 million

The Italian - Albanian Program for the Development of SMEs

- **Institutional set up**
  - o Project Implementation Unit at the Ministry of Finance and Economy
- **Type of guarantee**
  - o Individual guarantee
- **Beneficiary**
  - o Albanian enterprises; at least 70% of the loan amount on goods and services of Italian origin
- **Coverage ratio**
  - o 50%
- **Size of fund**
  - o EUR 5 million

The KFW RCGF

- **Institutional set up**
  - o Not-for-profit foundation
- **Type of guarantee**
  - o Portfolio guarantee
- **Beneficiary**
  - o Farmers and rural entrepreneurs
- **Coverage ratio**
  - o 50%
- **Size of fund**
  - o EUR 33.8 million

[18] EBRD
[19] KFW
[20] Other guarantee programs that operate regionally and to a smaller extent also in Albania are the EU's COSME Loan Guarantee Facility program, the EBRD Trade Facilitation Program, the InnovFin SME Guarantee Facility and the European Investment Fund EaSI Guarantee Instrument dedicated to microfinance and social entrepreneurship.

as well as Annex 1. Anecdotally, several issues have impacted uptake of existing schemes including the definition of target sectors and other eligibility criteria that were in some instances perceived as too narrow, lengthy administrative procedures in particular as regards to payout, as well as the lack of business advisory services tied to the guarantee program. Only limited information on the financial and evaluation data of the different schemes has been made available publicly.

Analysis of existing credit guaranteed loans backed by various programs suggests rather limited benefits to firms. Using the Bank of Albania credit registry database, only 37 loans covered by various CGSs could be identified out of about 62,000 loans.[21] A comparison of this limited number of credit guaranteed loans with non-credit guaranteed loans, to the same firms and to the rest of the sample, suggest rather limited benefits of credit guarantees: the average loan size is smaller; the interest rate is higher; and collateral coverage is not significantly lower (even with the credit guarantee support). Guaranteed loans appear to benefit from a longer maturity and there may also be benefits of credit guarantees facilitating better credit in the future. Comparing the pre- and post-CGS loans of the firms which received a CGS loan at some point in time suggests that pre-CGS loans have similar terms to the CGS loans but with much higher collateral coverage - documenting a clear benefit of the CGSs. More importantly, the loans to firms that are granted following CGS loans are much larger, with lower interest rates, and much lower collateral coverage. These comparisons suggest that CGS loans may be helping MSMEs to access more favorable conditions on subsequent loans. The only exception is lower maturity of these post-CGS loans (see Box 3 for further information).

Box 3. Credit guarantee backed loan characteristics compared to others (2011-2019)

34 individual firms that received 37 CGS loans of under ALL 100 million were identified in the sample.[22] For eleven of these firms (around 1/3), the credit guaranteed loan was the first loan to be recorded in the credit registry - indicating financial access benefits of these programs.[23]

In the first three columns of Panel A, the CGS loans are compared with non-CGS loans (all loans and collateralized loans) of the firms which received CGS loans at some point. Then, in columns 4 and 5, they are compared with the full sample of firms (for loans under ALL 100 million) which never received credit guaranteed loans.

The comparisons provide similar results: CGS loans are smaller and have a higher interest rate but also longer maturities and smaller collateral coverage (when they are compared with collateralized loans but not compared to all loans, which include noncollateralized loans). These results may suggest limited benefits of credit guarantees and a tradeoff between maturity and interest rate. Yet, given the reported valuation of credit guarantees included in the collateral coverage, the collateral benefits are actually higher.[24] More importantly, there may be dynamic benefits to the firms in their ability to get better credit in the future.

Pre- and post-CGS loans of the firms which received a CGS loan at some point in time are compared in Panel C. This suggests that pre-CGS loans are similar to CGS loans but with much higher collateral coverage - documenting a clear benefit of the CGSs. More importantly, the loans firms are granted following CGS loans are much larger, with lower interest rates, and much lower collateral coverage. These comparisons suggest that CGS loans may be helping MSMEs to access more favorable conditions on subsequent loans. The only exception is lower maturity of these post-CGS loans.

[21] Credit guarantees are listed under "Other" collateral types in the Credit Registry. In some cases the collateral description enables identification of specific loans as guaranteed loans backed by existing credit guarantee schemes. It is important to note that the 37 loans identified therefore most likely do not encompass the full universe of loans backed by CGSs.
[22] One firm which received 4 large credit guarantee backed loans was excluded from the analysis in order to focus on MSMEs.
[23] Even though this is a limited sample, it is important to note that none of the credit guaranteed loans were identified as non-performing.
[24] Mean (median) collateral coverage provided by the credit guarantees is 41 percent (50 percent).

Panel A	Ever-CG sample (mean firm age=10.4)			Full never-CG sample under 100 million LEK (mean firm age=10)	
	CG loans (n=37)	Non-CG loans without CG (n=282)	Collateralized non-CG loans (n=204)	Non-CGF loans (n=54,592)	Collateralized non-CGF loans (n=43,280)
Loan size (millions of LEK)	17.87	26.29	27.7	10.5	11.2
Interest Rate (%)	8.44%	7.01%	7.04%	8.90%	7.90%
Collateral used (% of loans)	100%	72%	100%	79%	100%
Maturity (years)	3.64	2.2	2.44	2.9	3.2
Collateral coverage	391%	331%	459%	463%	593%

Panel B	Ever-CG MSME sample (mean firm age=10.6)			Full never-CG MSME sample under 100 million LEK (mean firm age=10.9)	
	CG loans (n=24)	Non-CG loans (n=158)	Collateralized non-CG loans (n=117)	Non-CGF loans (n=29,904)	Collateralized non-CGF loans (n=24,960)
Loan size (millions of LEK)	18.9	27.9	30.1	11.44	11.72
Interest Rate (%)	8.77%	6.89%	7.00%	7.83%	7.27%
Collateral used (% of loans)	100%	74%	100%	84%	100%
Maturity (years)	3.55	2.26	2.37	2.65	2.89
Collateral coverage	375%	290%	392%	527%	638%

Panel C	Ever-CG MSME sample		
	Pre-CG loans (n=35)	CG loans (n=24)	Post-CG loans (n=123)
Loan size (millions of LEK)	19.4	18.9	30.4
Interest Rate (%)	8.54%	8.77%	6.43%
Collateral used (% of loans)	94%	100%	69%
Maturity (years)	3.51	3.55	1.86
Collateral coverage	536%	375%	217%

Source: World Bank staff calculation. Note: Values provided are simple averages.

COVID-19 IMPACTS ON ACCESS TO FINANCE

From March 28 to May 5, 2020, the Secretariat of the Albania Investment Council reached out to more than 8,200 companies with a survey aimed at evaluating the impact of COVID-19 on their operations. 833 firms completed the survey, among which 44 percent operated in the service sector, 20 percent in tourism, 17 percent in manufacturing, 9 percent in trade, 6 percent in construction, and 3 percent in agriculture. More than half of the responding firms had an annual turnover of over ALL 14 million (approx. EUR 113,300) and around 21 percent made less than ALL 5 million (approx. EUR 40,500) per year.

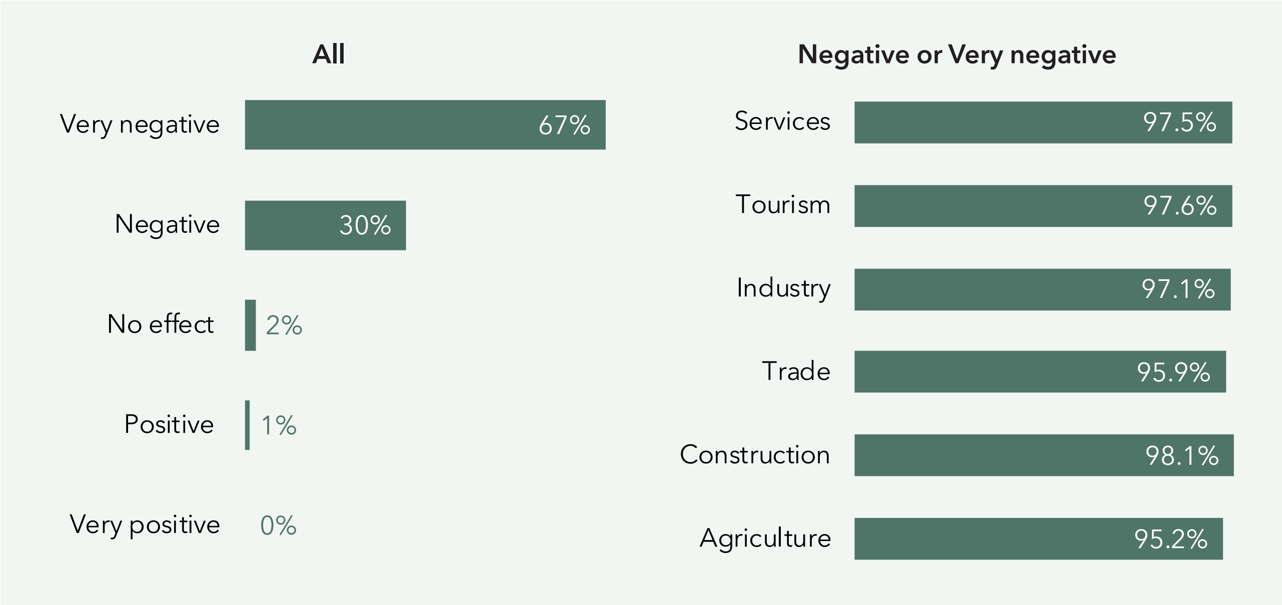
The COVID-19 pandemic is having devastating effects across main industries of the economy. According to the survey, the COVID-19 crisis had caused a significant reduction of economic activities, with 47 percent of the surveyed firms having completely shut down their operations. 97 percent of businesses were experiencing very negative or negative impacts from the COVID-19 situation. Only 1 percent of the respondents expected to gain positive results from the situation, mainly trade and construction companies (see Figure 7).

The reduction of demand for goods and services is the most pressing challenge firms currently face. 24 percent of survey respondents pointed to a lack of clients as their number one challenge (Figure 8). This negative demand shock was more prominent in the tourism (32 percent) and services industries (28 percent) than either the manufacturing (19 percent) or agricultural sector (19 percent).

Liquidity problems are severe. The second most important issue firms reported was a lack of liquidity, this was the main issue for 17 percent of respondents. Difficulties paying salaries and taxes were the third and fourth ranked issues respectively.

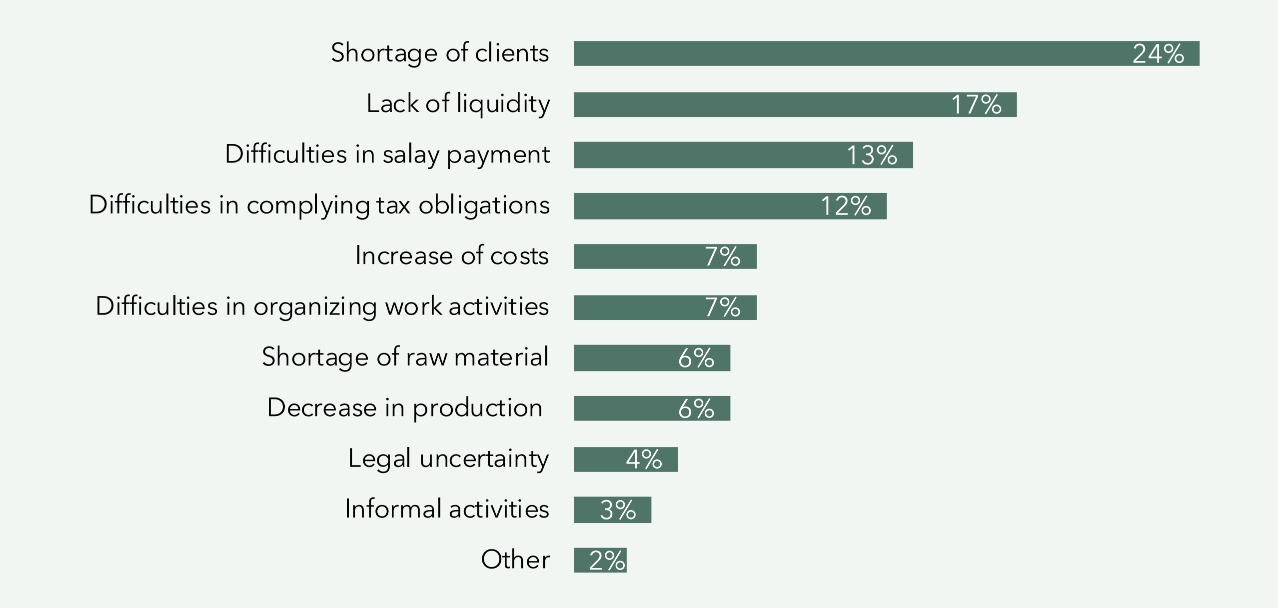
Supply side factors are not as serious as the demand shocks. While only 11 percent of the surveyed firms were fully operational, companies did not perceive the effect of negative supply shocks quite as seriously as the reduction in demand. As Figure 8 shows, only about 19 percent of the firms believed their biggest challenge came from the supply-side, either as a result of difficulties in organizing work activities (7 percent), reduced labor productivities (6 percent), or shortage of supply (6 percent). However, for firms that relied on imports for their raw material, 52 percent were facing problems, of which 69 percent expected serious disruptions as they depended completely on imports.

Figure 7. Impact of COVID-19 on business activities



Source: Albania Investment Council Secretariat

Figure 8. Main challenge reported by firms during COVID-19 pandemic

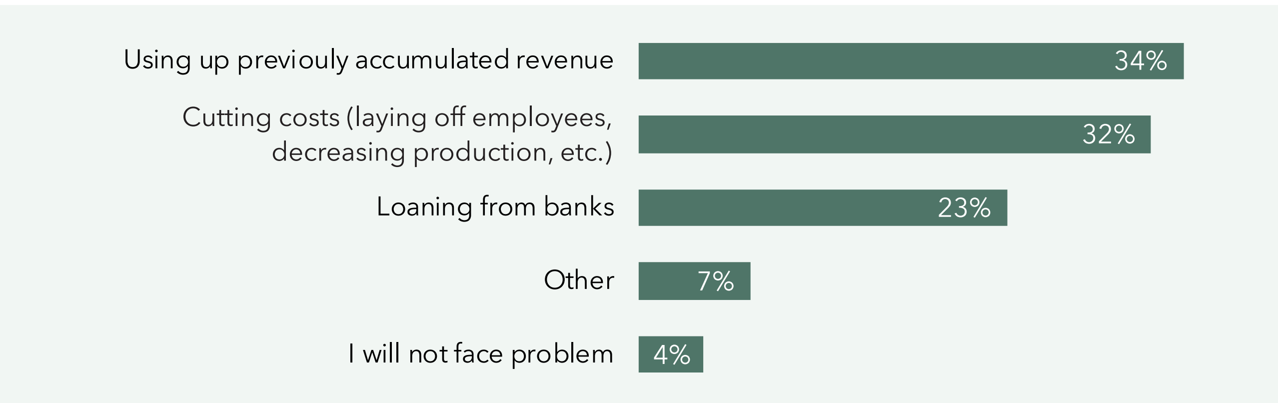


Source: Albania Investment Council Secretariat

Access to finance is a major issue, especially for services. Albanian firms may face substantial constraints in their ability to obtain credit. Despite facing a serious liquidity shortage, as discussed, two thirds of firms in the survey prioritized either using previously accumulated revenues or cutting costs to ensure the continuity of business activities. 23 percent of firms plan to seek new loans (see Figure 9).

As a response to the COVID-19 crisis, several governments have launched programs of public guarantees on bank loans, especially for MSMEs. The guarantees can preserve incentives for bank lending, and leverage banks' credit risk expertise. Fiscal balances are protected if beneficiaries remain solvent, and in the short term the fiscal impact is limited as the guarantees are only drawn down if a credit turns bad. This strategy is not without risks, however, as the long-term viability of borrowers can now be hard to gauge, and fiscal space to support the guarantees may be limited in some cases. See further information on public guarantees for bank lending in response to the COVID-19 pandemic in Box 4.

Figure 9. Measures firms will take to ensure the continuity of their businesses



Source: Albania Investment Council Secretariat

Box 4. Public guarantees for bank lending in response to the COVID-19 pandemic[25]

The Financial Stability Institute of the Bank for International Settlements reviewed a number of public credit guarantee schemes for bank lending in response to the COVID-19 pandemic. All programs in the sample looked at by the Financial Stability Institute require that companies be in good financial standing and have no non-performing loans as of a cut-off date just prior to the onset of the pandemic. Proof of direct losses due to COVID-19 is not a prerequisite in all programs, partly for operational reasons but also reflecting the severity of the economic contraction, which will affect most companies at some stage. The target beneficiaries vary in the sample, but every country has a program for SMEs. Many have a coverage ratio of 100 percent, mostly for smaller loans. Even where the ratio is below 100 percent, it may have been increased in comparison to normal times. The higher ratios may reflect the desire to overcome banks' proportionally higher operational costs when dealing with smaller loans, but also the extreme urgency of the crisis situation. While a very high coverage ratio removes concerns for banks, it comes at the risk of moral hazard and possible fiscal costs later on.

Key features of select bank guarantee programs

Jurisdiction	Beneficiary	Coverage ratio/ maximum loan size	Closing date	Terms	Loan Maturity
Croatia (HAMAG-BICRO)[26]	SMEs	80%	n/a	Working capital, maximum amount of guarantee up to EUR 1 million	Up to 5 years
Germany (KFW)	Companies of all sizes	90% for SMEs, 80% for others; EUR 1 billion per company	31 Dec 2020	Loan is subsidized (lower interest rate range for SMEs)	Up to 5 years
Italy (Fondo di Garanzia PMI)	SMEs	80–90%: loans up to EUR 1.5 million 100%: loans up to EUR 800,000	17 Dec 2020	Guarantee cost waived; loan rates set by lenders	n/a
Poland (Bank Gospodarstwa Krajowego)[27]	SMEs	80%	n/a	0% guarantee fee	n/a
Spain (Instituto de Credito Oficial)	Any Spanish company	60–80% (varies with company size and new/renewed loan); no explicit cap	End-Sep 2020	Guarantee fees of 20–120 basis points (to be borne by the bank)	Up to 5 years
Switzerland	Companies with turnover below CHF 500 million	100% up to CHF 500,000, 85% up to CHF 20 million; cap of 10% of annual turnover and never above CHF 20 million	30 July 2020	0% interest rate up to CHF 500,000; portion over CHF 500,000: 0.5%, plus a premium on the remaining 15% of the loan	Up to 5 years

[25] Financial Stability Institute of the Bank for International Settlements, Brief No 5, Public guarantees for bank lending in response to the COVID-19 pandemic, April 2020.
[26] http://aecm.eu/wp-content/uploads/2020/03/AECM-position-overcoming-economic-effects-of-corona-outbreak-final.pdf.
[27] http://aecm.eu/wp-content/uploads/2020/03/AECM-position-overcoming-economic-effects-of-corona-outbreak-final.pdf.

Jurisdiction	Beneficiary	Coverage ratio/ maximum loan size	Closing date	Terms	Loan Maturity
United Kingdom Coronavirus Business Interruption Loan Scheme	SMEs	100% up to GBP 250,000, 80% above GBP 250,000; up to GBP 5 million	n/a	Interest holiday in first 12 months[28]; guarantee fee waived; lenders pay a fee; loan terms set by each lender	Up to 6 years
United States Paycheck Protection Program – CARES Act	SMEs	100% to end-2020; up to the lesser of USD 10 million or a payroll-based amount	20 June 2020	1% interest rate; optional interest payment holiday for first 6 months	2 years

The Albanian Government has similarly responded, with the launch of two targeted and time-bound credit guarantee programs. In April, the Government introduced an ALL 11 billion (0.6 percent of GDP) credit guarantee program. This aims to facilitate access to loans for COVID-19 affected enterprises to pay employees' wages for up to 3 months. The interest rate is capped at 2.85 percent (subsidized by the Government), with a maturity of up to 2 years and a coverage ratio of 100 percent. A second program of ALL 15 billion, approved on 13 May 2020, will provide working capital and investment loans for affected businesses (see Box 5 for further details).

Box 5. Albania Guarantee Programs launched in response to COVID-19

1st guarantee program (ALL 11 billion)

- Portfolio scheme intermediated by banks
- Level of coverage 100 percent of the principal
- Target are all private companies (no sector specifics) affected by the COVID-19 situation
- Purpose of loans covered is payment of employee salaries for up to 3 months (max monthly salaries of ALL 150,000 per employee)
- Currency ALL
- Maturity up to 2 years
- Grace period of 3 months
- No administrative costs charged, penalties for early repayment
- Interest – 12 months T-Bill rate (3 last auctions average) plus a margin of 0.5 percent, but in total not higher than 2.85 percent. Interest cost fully subsidized by the government.
- Banks can claim the guarantee 120 calendar days from the first date of default.

2nd guarantee program (ALL 15 billion)

- Portfolio scheme intermediated by banks
- Level of coverage 60 percent of the principal
- Target are all private companies (no sector specifics) affected by the COVID-19 situation
- Purpose of loans covered is working capital or investment
- Currency ALL
- Maturity up to 5 years
- Amount of single loan up to ALL 300 mm
- Grace period no less than 6 months, unless the borrower prefers otherwise
- No penalties for early repayment
- Interest – 12 months T-Bill rate plus a margin up to 3%, but in total not higher than 5%
- Banks can claim the guarantee 180 calendar days after the last repayment date from first date of default.

[28] The government also pays the first 12 months of interest and any arrangement fees charged by the lender.

4

PUBLIC CREDIT GUARANTEE SCHEMES: PRINCIPLES AND PRECONDITIONS

INTRODUCTION

There have been a number of studies on CGSs, reflecting the increasing interest in this type of policy intervention to support SMEs access to finance. The World Bank conducted the first large scale cross-country survey of public CGSs in 2008 (Beck, et al. 2008) to provide an overview of the key features of guarantee schemes around the world. One of the many interesting findings of the survey is that few guarantee schemes around the world rely on risk management mechanisms or risk-based pricing models, although in principle they should. Even though measuring the impact of CGSs accurately remains technically challenging, some past studies have shown that CGSs have been able to extend finance to firms that would otherwise have remained constrained. In the case of Canada (Ridding, 2007) estimates show that 75 percent of guarantees are used by firms that would not have been able to obtain a loan otherwise. Rocha et al. (2010) show that credit guarantee schemes have contributed to more SME lending in the Middle East and North Africa. In Chile, the guarantee scheme increased the probability of small firms getting a loan by 14 percent (Larrain and Quiroz, 2006). At the same time, CGSs may add limited value and prove costly when they are not well designed. As noted by Honohan (2008), loose eligibility criteria, low fees, and overly generous coverage ratios may result in the provision of guarantees to enterprises that would have obtained credit anyway. They may also result in financial imbalances requiring recurrent government contributions. For CGSs to be effective, they need to be able to target financially constrained MSMEs, reach a significant number of these firms, and remain financially sustainable.

CGS PRINCIPLES

The Principles for the Design, Implementation, and Evaluation of Public Credit Guarantee Schemes for SMEs, a set of international best practices developed by the World Bank in 2015,[29] identified important aspects for the success of public CGSs. Among the most important ones are: (i) the legal and regulatory framework; (ii) corporate governance and risk management; (iii) operational framework; and (iv) monitoring and evaluation (Box 6). See Annex 2 for further detail on the principles and international lessons learned.

Box 6. Public CGS Principles

The 16 principles cover four key areas that are critical for the success of CGSs:

Legal and regulatory framework

1. Establish the CGS as an independent legal entity.
2. Provide adequate funding and keep sources transparent.
3. Promote mixed ownership and treat minority shareholders fairly.
4. Supervise the CGS independently and effectively.

[29] http://documents.worldbank.org/curated/en/576961468197998372/Principles-for-public-credit-guarantee-schemes-for-SMEs.

Corporate governance and risk management

5. Clearly define the CGS mandate.
6. Set a sound corporate governance structure with an independent board of directors.
7. Design a sound internal control framework to safeguard the operational integrity.
8. Adopt an effective and comprehensive enterprise risk management framework.

Operational framework

9. Clearly define eligibility and qualification criteria for SMEs, lenders, and credit instruments.
10. Ensure the guarantee delivery approach balances outreach, additionality, and financial sustainability.
11. Issue partial guarantees that comply with prudential regulation and provide capital relief to lenders.
12. Set a transparent and consistent risk-based pricing policy.
13. Design an efficient, clearly documented, and transparent claim management process.

Monitoring and evaluation

14. Set rigorous financial reporting requirements and externally audit financial statements.
15. Publicly disclose non-financial information periodically.
16. Systematically evaluate the CGS' performance and publicly disclose the findings.

PRECONDITIONS FOR EFFECTIVE DESIGN, IMPLEMENTATION, AND EVALUATION OF CGSS

CGSs are established to address market failures, which prevent or constrain MSMEs from accessing credit. Hence, CGSs are not an end themselves but rather are a means to solve a problem. Therefore, market failures must be comprehensively analyzed to identify and define the problems to be addressed through a CGS and to determine if government intervention through a CGS is justified. Governments are nonetheless encouraged to pursue all necessary legal, regulatory, and institutional reforms to create environments that facilitate access to credit for MSMEs. Even if the analysis of market failures suggests that intervention through a CGS is justified in principle, an effective CGS requires a number of external elements or preconditions that may directly affect the achievement of its policy objectives. These preconditions include the following: (a) a system of business laws, including corporate, bankruptcy, contract, collateral, consumer protection, and private property laws, which provides an acceptable degree of enforcement and a mechanism for the fair resolution of disputes; (b) a sufficiently independent and efficient judiciary; (c) a comprehensive and well-defined set of accounting standards and rules and reasonably well regulated legal, accounting, and auditing professions; and (d) a sound and liquid financial system able to originate and manage credit effectively.[30]

[30] http://documents.worldbank.org/curated/en/576961468197998372/Principles-for-public-credit-guarantee-schemes-for-SMEs.

5

CONSIDERATIONS FOR THE ESTABLISHMENT OF A PUBLIC CREDIT GUARANTEE SCHEME IN ALBANIA

The targeted credit guarantee programs launched by the government in response to the COVID-19 crisis should, over time, transform into a regular public CGS to help kick-start economic recovery. Designing and implementing a well-functioning CGS with transparent governance structures and rigorous risk management and monitoring frameworks takes time. It is essential that sufficient paid-in capital is available to ensure viability and credibility of the scheme. On the other hand, unfunded/pay-as-you-go schemes funded by annual budgetary subventions should be discouraged because of the lack of transparency and reliability of such arrangements. The benefits of building full-fledged CGS framework are twofold. First, it allows to better leverage resources to maximize impact including from the private sector and international donors. Secondly, through a sound risk and governance framework, it helps mitigate the risks of possible misallocation of resources, political interference, crowding out as well as long term fiscal costs. Beginning this work soon (i.e. during the crisis period) will help ensure that it is ready and available to be used during the recovery period.

LEGAL, REGULATORY, AND INSTITUTIONAL FRAMEWORK

The preferred institutional set-up will need to be carefully assessed in the context of Albania. CGSs should ideally be administered by independent legal entities or by existing development finance institutions running earmarked programs as opposed to being implemented by ministerial departments, which should remain focused on policy-making and overall coordination of measures and programs in support of economic and business development. This is to ensure transparency and professional capacity.[31] Out of 60 public CGSs worldwide surveyed in 2016, 80 percent were established as an independent legal entity and a large majority (87 percent) were established by law, decree, or other special legislation.[32] Guarantee providers in Central, Eastern and South-Eastern Europe (CESEE) are typically publicly owned and are publicly operated.[33]

In the context of Albania, the best set-up will need to be carefully assessed - either building on existing structures or creating a new structure - including potential transitory arrangements for the two COVID-19 programs. No matter which setup is chosen it will be important to envisage independent and transparent corporate governance arrangements, rigorous risk management and internal control mechanisms, as well as technically competent staff. A functional review of institutional set-up options is currently being conducted by the Ministry of Finance and Economy with World Bank support. A number of agencies are being assessed, weighing the advantages and disadvantages of each option in light of cost and time considerations while avoiding further fragmentation in the current development finance framework. It will be important to avoid a situation where several state-run or state-supported CGS programs compete with one another, suggesting different risk coverage and pricing. In the Albanian context, it is therefore recommended to identify an anchor scheme for consolidation of existing and newly proposed schemes under independent and professional governance arrangements.

The legal and regulatory framework should clearly define the Government's policy and oversight functions while ensuring that the CGS operates at arm's length from the Government. The CGS's legal and regulatory framework should clarify the ownership policy of the government, as well as any general terms and conditions that apply to its investment. The framework should also specify how the government will exercise its ownership, identifying who represents the government and which government body is charged with supervising the CGS (see further information on prudential supervision below). In addition, the legal and regulatory framework should set clear boundaries and should define the relationship between the

[31] http://documents.worldbank.org/curated/en/576961468197998372/Principles-for-public-credit-guarantee-schemes-for-SMEs.
[32] Assessing Implementation of the Principles for Public Credit Guarantees for SMEs: A Global Survey, World Bank 2016.
[33] Credit Guarantee Schemes for SME lending in Central, Eastern and South-Eastern Europe, Vienna Initiative 2014.

government-as-shareholder and the CGS's board and management. Such boundaries separate legitimate government control and oversight from day-to-day operations; this in turn ensures the CGS's managerial autonomy and accountability, both of which are necessary for decision making.[34]

PRUDENTIAL REGULATION AND SUPERVISION

It is recommended that the CGS be subject to minimum prudential requirements such as capital, liquidity, risk management and corporate governance. Moreover, the CGS operational framework should be developed in consultation with Bank of Albania to assess the regulatory prudential treatment of the scheme. In order to be able to provide capital relief to lenders for the proportion of the underlying loan exposure covered by the guarantee (so called "credit risk mitigation" under the Basel capital framework) it is important that the public guarantee itself meets certain minimum legal conditions in terms of seniority, irrevocability, maturity, and effectiveness. It will also need to be clarified whether a problem may arise in the context of consolidated exposures of banking groups when the home authorities of internationally active banks may not recognize the preferential treatment applied by the host authority for subsidiaries. While Bank of Albania's capital adequacy regulation recognizes that central government guarantees get 0 percent risk weight, guarantee schemes can receive this treatment only if they are solid and cover all risk elements of the exposure. For schemes provided by established IFIs (e.g. the EBRD scheme) the risk weight is set at 0 percent for the guaranteed portion. Some schemes are compliant with the European Union's (EU) Capital Requirement Regulation and therefore eligible for capital relief in EU countries. Bank of Albania is currently in the process of assessing the prudential treatment of the emergency schemes which are already under implementation. In order to create legal certainty, ideally such an evaluation process would have already taken place during the design phase.

FUNDING

It is essential that sufficient paid-in capital is available to ensure an effective launching of the CGS and its subsequent viability. It is recommended that the government provides initial capital, as funded schemes benefit from the security and credibility of paid-in capital. In addition to government funds, the CGS could be capitalized with voluntary contributions from domestic banks, business associations and other private sources. Finally, multilateral and bilateral funding in the form of capital, counter-guarantees and co-guarantees, could contribute to leverage government resources to maximize impact. Determining the size of the CGS should ideally be preceded by a market sounding exercise including consultations with local lenders to assess the demand for finance. The calculation of funding requirements should also consider what effect leverage (outstanding guarantees to equity) will have on the fund. The CGS needs to establish a broad diversified investment structure and sound investment policies and guidelines to ensure capital protection in terms of liquidity, profitability and stability. This will also strengthen the scheme and provide assurance to financial organizations seeking guarantees that the CGS will honor its guarantee commitments in the event of an MSME's default.

[34] http://documents.worldbank.org/curated/en/576961468197998372/Principles-for-public-credit-guarantee-schemes-for-SMEs.

LEVERAGE

It is recommended that in the early years the leverage ratio is set at no more than three times, moving to a maximum of five times in later years when the CGS is well established. This is in line with a Vienna Initiative survey conducted in CESEE countries (the majority of CGSs were found to have a leverage ratio of less than 5)[35] as well as a recent World Bank study (median leverage ratio of 3.3 overall and 3.8 in Europe).[36] Leverage is important to minimize unnecessary commitment of public funds. However, while high leverage achieved by granting a large number of guarantees can theoretically contribute to a CGS' sustainability, through higher income from fees, it can also threaten the solvency and credibility of the public backstop, through higher amounts of claims. A maximum level of leverage should therefore be specified, which will largely depend on expected fluctuations in income from investment, administrative expenses, and the costs arising from claims.

COVERAGE RATIO

The coverage ratio needs to provide sufficient protection against credit risk, while also preserving incentives for banks to screen and monitor borrowers. In principle, the guarantee coverage ratio should not be lower than 50 percent and could be higher for certain riskier sectors/borrowers. On the other hand, high coverage rates of 100 percent or slightly below lead to moral hazard – and thus high default rates – and have a sizeable fiscal impact. Having variable coverage ratios that are linked to borrowers' risk profile can help to enhance additionality while providing some flexibility (less risky borrowers can use the benefit from the guarantee but with a lower coverage ratio and paying a lower fee). The ratio should be clearly indicated in the contractual agreements between the CGS and the lender. These agreements should also clarify whether the losses are shared pari passu between the CGS and the lender or whether the CGS covers the first loss.[37]

DELIVERY MODALITY

A portfolio approach, with a pre-agreed maximum amount guaranteed for each lender, seems the most appropriate mode of CGS delivery in the context of Albania. An advantage of portfolio guarantees is that lenders make the credit underwriting decisions, helping limit potential duplication of processes and contributing to timely, efficient, and cost-effective decision making. In addition to banks, it would also be important to include well established microfinance institutions and savings and credit associations in the scheme, which can help reach out to micro enterprises and individual entrepreneurs.

[35] Credit Guarantee Schemes for SME lending in Central, Eastern and South-Eastern Europe, Vienna Initiative 2014.
[36] Assessing Implementation of the Principles for Public Credit Guarantees for SMEs: A Global Survey, World Bank 2016.
[37] In case of a pari passu guarantee, the guarantee scheme assumes a fixed share of the loss, irrespective of it size. In case of a first loss guarantee, the burden from defaults is fully assumed up to a predetermined amount, above which the guarantee scheme has no further obligation.

FEES

When determining the size of the fees, it is important to ensure the financial sustainability of the CGS. As a general principle, fees should reflect the cost of risk of the underlying loan portfolio, the cost of capital, and should cover the operating expenses. There are usually two types of fees: facility fees (payable annually) and utilization fees (payable quarterly on the outstanding guaranteed portfolio). Based on survey results globally and regionally, fees are usually set at an average of 2-2.5 percent annually. Fees should be reviewed on an annual basis with full and transparent disclosure and over time it is recommended to move to a risk-based fee system.

ELIGIBILITY CRITERIA AND LOAN TERMS

Eligibility criteria and loan terms should be defined based on a comprehensive market sounding exercise and in agreement with government and participating lenders. There should be particular emphasis on MSMEs and underserved sectors. The CGS should be designed to be sufficiently flexible to cover several loan products (i.e. working capital and investment loans) and related minimum and maximum loan amounts. Guarantee schemes should be allowed to require collateral up to reasonable limits. This commits the borrower to an obligation to repay the loan. In many countries, CGSs take personal guarantees, or guarantors, to increase incentives for repayment.

CLAIM HANDLING

The claim payout should be quick and predictable, in order to build the credibility of the CGS, while encouraging loan collection. In well-designed schemes, claims are paid out 180 days from the date of default, giving the lender time to determine if the delay in repayment is a temporary cash flow issue which needs restructuring or a more serious problem. Payment of the guaranteed principal sum outstanding should be made within 7 days of receipt of acceptable claim documentation. Time based payment will give lenders comfort that they know exactly when they will be paid subject to completion of necessary procedures. Triggers for payout should be clear and the process should be simple. Lenders should continue efforts to recover the collateral through the legal system after pay-out. Successful schemes do not require that legal action is completed before claims are paid out.

MONITORING AND EVALUATION

Comprehensive monitoring and evaluation of the CGS's performance should be established to account for the use of public resources, measure the achievement of CGS policy objectives, and improve its operations. The performance of the CGS should be measured and evaluated along the dimensions of outreach, additionality, and financial sustainability. "Outreach" refers to the capacity of the CGS to meet the demand for guaranteed loans by MSMEs. The effect of the CGS should be assessed through measurement and evaluation of the CGS's financial and economic additionality. "Financial additionality" refers to incremental credit volumes granted to eligible MSMEs as a result of CGS activities. Financial additionality also includes more favorable conditions for eligible MSMEs in loan size, pricing and maturities, reduced amount of collateral required to obtain credit, and faster loan-processing time. "Economic additionality" refers to the economic welfare that the CGS generates as a result of its operations. In particular, economic additionality speaks to the effect of guarantees on employment, investment, and ultimately, economic growth. The CGS needs to establish a clear division of responsibility between guarantor and lender, preferably leaving the main screening and monitoring functions with the lender. Close attention needs to be placed on guarantees with NPLs which can impact the level of the CGS reserves.

CAPACITY BUILDING

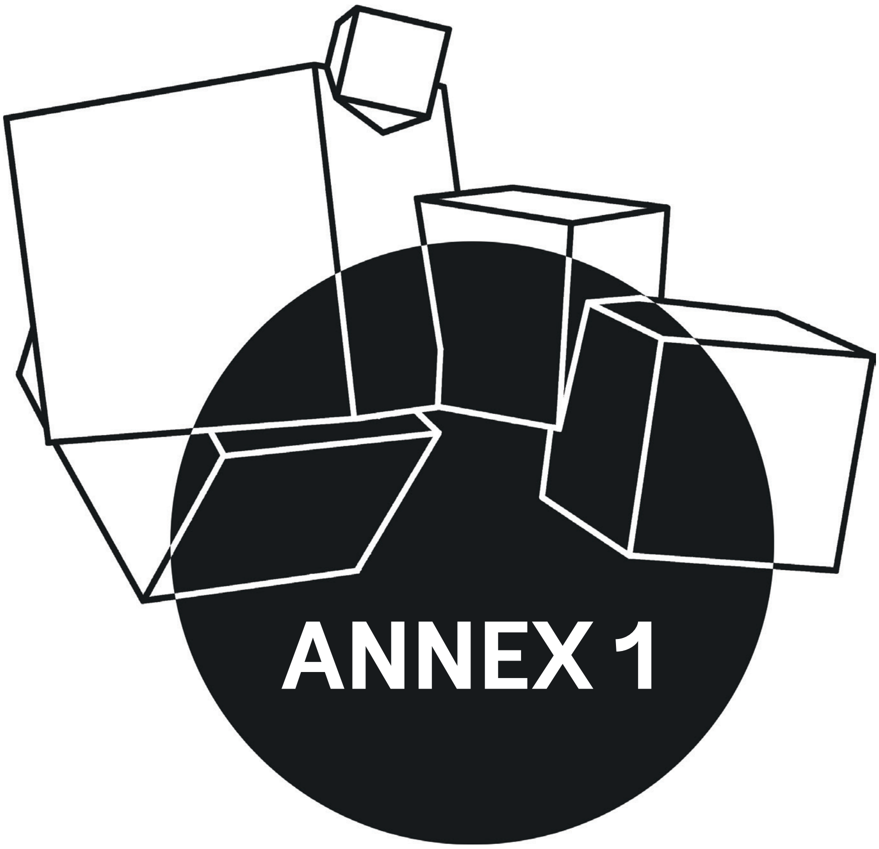
Providing additional capacity building programs to borrowers would help improve financial capability in Albania and increase knowledge of, and support access to, the CGS. One reason for the limited use of existing schemes by MSMEs is likely to be low levels of financial capability. Going forward it would be important to have special educational programs, for both banks and borrowers, to ensure that the guarantee scheme is able to achieve the envisaged targets. Many CGSs provide technical assistance to borrowers such as business development services or help with preparing applications and this service can contribute significantly to the effectiveness of the scheme. Capacity-building can constitute a major positive externality of guarantee schemes resulting ultimately in improved outreach, additionality, and sustainability.

Below is an initial overview of what a public CGS could look like for Albania, with the caveat that the parameters would need to be carefully assessed and calibrated based on the country context.

Table 5. Considerations on key parameters for a public CGS in Albania

Key Parameters	Credit Guarantee Scheme
Legal, regulatory, and institutional setup	Best set-up will need to be carefully assessed (either building on existing structures/ creating a new structure) including potential transitory arrangements. Important to envisage independent and transparent corporate governance and risk management arrangements. Set clear boundaries separating legitimate government control and oversight from day-to-day operations.

Key Parameters	Credit Guarantee Scheme
Prudential regulation and supervision	Introduce prudential regulation and supervision of the CGS. Carefully assess the regulatory prudential treatment of guarantees and adjust design accordingly.
Funding	Government to provide initial capital, as funded schemes benefit from the security and credibility of paid-in capital, but international donors and private sector could also be willing to contribute equity if the scheme is designed well.
Leverage	Suggested targeted leverage ratio should be no more than three times in the early years, moving to max of five times in later years when the CGS is well established.
Coverage ratio	The coverage ratio needs careful negotiation with the lenders to provide sufficient protection against credit risk, while also preserving incentives for banks to screen and monitor borrowers. It is recommended to consider 50% plus increased coverage ratios to incentivize certain sectors according to identified market failures or to help with crisis recovery.
Delivery Modality	A portfolio scheme may be most appropriate given efficiency and cost gains.
Fees	To be agreed with government and participating lenders. As a general principle, fees should reflect the cost of risk of the underlying loan portfolio, the cost of capital, and should cover the operating expenses. Fees should be reviewed on an annual basis with full and transparent disclosure and over time move to a risk-based fee system.
Eligibility criteria	To be agreed with government and participating lenders. Most likely with particular emphasis on MSMEs per the national definition.
Minimum and maximum loan amounts	To be agreed with government and participating lenders.
Type of financing	To be agreed with government and participating lenders. The CGS should be designed to be flexible to enable it to cover several loan products (e.g. working capital and investment loans).
Collateral requirements	Guarantee schemes should be allowed to require collateral up to reasonable limits. This commits the borrower to an obligation to repay the loan. In many countries, CGSs take personal guarantees, or guarantors, to increase incentives for repayment.
Claim handling	The claim payout should be quick and predictable, in order to build the credibility of the CGS, while encouraging loan collection. Triggers for payout should be clear and the process should be simple. Lenders should continue efforts to recover the collateral through the legal system after pay-out. Successful schemes do not require that legal action is completed before claims are paid out.
Monitoring	Establish a clear division of responsibility between guarantee scheme and lenders, with the main screening and monitoring functions the responsibility of the lenders.
Evaluation	Establish a comprehensive evaluation of the CGS's performance to account for the use of public resources, measure the achievement of CGS policy objectives, and improve its operations.
Capacity Building	Consider providing capacity building programs to MSME borrowers as additional value added (i.e. business development services).



OVERVIEW OF CREDIT GUARANTEE SCHEMES OPERATING IN ALBANIA

Several guarantee schemes already operate in Albania and in the region. This annex summarizes some of their design features.

INNOVFIN SME GUARANTEE FACILITY

The InnovFin SME Guarantee Facility is managed by the European Investment Fund (EIF).[38] It provides guarantees and counter-guarantees on debt financing of between EUR 25,000 and EUR 7.5 million in order to improve access to debt finance for innovative small and medium-sized enterprises and small mid-caps (up to 499 employees). Pro Credit Bank is the financial intermediary. Under the InnovFin SME Guarantee, financial intermediaries are guaranteed by the EIF against a proportion of their losses incurred on debt financing. The InnovFin SME Guarantee supports:

- SMEs investing in the production or development of innovative products, processes, and/or services that present a risk of technological or industrial failure; or

[38] European Investment Fund https://www.eif.org/news_centre/publications/eif_flyer_innovfin_sme_guarantee_en.pdf

- SMEs and small mid-caps that are "fast growing enterprises", i.e. their workforce or turnover has increased by at least 20% per annum over the last 3 years; or
- SMEs and small mid-caps that have significant innovation potential or are research and innovation-intensive enterprises, i.e. satisfying at least one "innovation criterion" out of a set of pre-defined eligibility criteria.

Summary of the InnovFin SME Guarantee Facility:

- Loans, bonds, and lease financing are eligible.
- The purpose of financing can be investments (tangible or intangible assets), working capital, or business transfers.
- Both term and revolving facilities are eligible.
- Amount: at least EUR 25,000, up to a maximum of EUR 7.5 million.
- Maturity: at least 1 year, up to a maximum of 10 years.
- Currency: EUR and/or local currency.

COSME LOAN GUARANTEE FACILITY

The COSME Loan Guarantee Facility is provided by EIF.[39] EIF and Alpha Bank Albania signed a EUR 25 million agreement to support Albanian SMEs' access to financing in July 2019. Under this agreement, from October 1, 2019 Alpha Bank Albania may grant loans to Albanian SMEs with limited available collateral, with the backing of COSME guarantees. Around 200 SMEs are expected to benefit from this new financing with its more favorable conditions.

Summary of the COSME Loan Guarantee Facility:

- Policy objective: Support transactions which otherwise would not have taken place because of perceived higher risk, lack of collateral (e.g. start-ups, micro-companies).
- Risk sharing: Capped portfolio guarantees for newly generated SME financing portfolios (commercial banks, promotional banks, guarantee societies, leasing companies…), guarantee rate maximum 50 percent.
- Agreements with financial intermediaries: type 1 - a dedicated, riskier product; type 2 – increase of volume of transactions.
- Broad coverage: Working capital, bank loans, subordinated loans, bank guarantees, leasing transactions, predominantly up to EUR 150,000.

EASI GUARANTEE INSTRUMENT

The EaSI Guarantee Instrument is funded from the EIF EaSI Program and is specifically dedicated to microfinance and social entrepreneurship.[40] One of its key objectives is to increase the access to finance for vulnerable groups wishing to launch their own enterprises, micro-enterprises, and social enterprises, both in their start-up and development phases. EaSI offers two different financial instruments to selected financial intermediaries:

- Microfinance (Counter-) Guarantee Facility
- Social Entrepreneurship (Counter-) Guarantee Facility

[39] European Investment Fund https://www.eif.org/news_centre/publications/eif_flyer_easi_en.pdf
[40] European Investment Fund https://www.eif.org/news_centre/publications/eif_flyer_easi_en.pdf

Further financial instruments will be offered in 2016, including funded instruments and capacity building investments.

Existing financial intermediaries are:

- FED Invest Microfinance Portfolio - Guarantee EUR 1,200,000
- NOA Sh.a. Microfinance Portfolio - Guarantee EUR 168,000
- Fondi Besa Sh.a Microfinance Portfolio - Guarantee EUR 262,400

Summary of the EaSI Guarantee Instrument:

- Guarantee rate: maximum 80 percent.
- Cap rate: maximum 30 percent.
- Availability period: up to 60 months.
- Guarantee coverage for credits (including revolving facilities).
- Unconditional guarantee (regulatory capital relief benefits).
- Microloans up to EUR 25,000.
- Loans to social enterprises up to EUR 500,000.

THE EBRD TRADE FACILITATION PROGRAM

The EBRD's Trade Facilitation Program (TFP)[41] can guarantee any genuine trade transaction to, from, and between the countries of operations. Guarantees may be used to secure payment of the following instruments issued or guaranteed by participating banks:

- letters of credit and standby letters of credit from the issuing bank;
- deferred payment and "red-clause" letters of credit;
- advance payment guarantees and bonds, and other payment guarantees;
- bills of exchange and trade-related promissory notes;
- bid and performance bonds and other contract guarantees;
- longer tenors are approved (where appropriate) to cover finance of imported capital equipment and for other term guarantees;
- other types of trade finance instruments can also be considered.

In addition to providing trade finance guarantees, the TFP revolving credit facility extends short-term loans to selected banks and factoring companies. These are structured to fund trade-related advances to local companies exclusively for the purpose of pre- and post-shipment finance and other financing of working capital necessary for the performance of foreign trade contracts and domestic and international factoring operations. Credit agreements are signed between the EBRD and the selected banks and factoring companies. Selection criteria are similar to the criteria used for issuing banks. The program aims to promote foreign trade to, from, and amongst the EBRD countries of operations and offers a range of products to facilitate this trade. Through the program the EBRD provides guarantees to international confirming banks, taking the political and commercial payment risk of international trade transactions undertaken by banks in the countries of operations (the issuing banks). It also provides short-term loans to selected banks and factoring companies for on-lending to local exporters, importers, and distributors. The issuing bank for the TFP is Union Bank Sh.a. The facilitating banks are:

- ProCredit,
- NOA,
- Fondi Besa,
- OTP Bank Albania
- Intesa Sanpaolo
- Raiffeisen Bank

[41] EBRD https://www.ebrd.com/work-with-us/trade-facilitation-programme.html

EBRD ALBANIA AGRIBUSINESS SUPPORT FACILITY

The AASF promotes and enhances access to finance for agribusinesses in Albania.[42] EBRD contributes a total of EUR 36 million in grant funding for first-loss risk cover as part of the EBRD EUR 180 million AASF. The EBRD, with the government of Albania, is supporting a portfolio of eligible loans to the sector, risk-shared with its partner banks. The instrument benefits from a first loss risk cover contributed by the government of Albania. Agribusiness is a vital sector of Albania's economy. It provides employment for more than 50 per cent of the population in rural areas and accounts for around 20 per cent of the country's GDP. However, the sector remains underserviced by financial institutions, with loans to agribusiness accounting for only 2 per cent of total lending to the economy. The participating financial intermediaries are:

- ProCredit,
- NOA,
- Fondi Besa,
- OTP Bank Albania
- Intesa Sanpaolo Bank Albania
- Raiffeisen Bank

EBRD is currently reviewing program parameters as only EUR 40 million of the program's €180 million has been committed to date. Factors such as improving financial covenants required of the participating banks and level of fees charged are under consideration.

ITALIAN - ALBANIAN PROGRAM FOR THE DEVELOPMENT OF SMES

The Italian - Albanian Program for the Development of SMEs[43] **is a guarantee fund of EUR 5 million created by the Government of Italy and Government of Albania.** It enables the provision of guarantees in the form of collateral to stimulate crediting from financial institutions for MSME enterprises that face difficulties in accessing bank loans due to insufficient guarantees. In practice, the fund substitutes those guarantees mainly required from MSMEs to obtain a loan, thus reducing the risk in the guaranteed amount. Credit guarantees are granted for loans intended to finance MSME investment projects related to the purchase of Italian machinery, equipment, and services. Currently, the end borrowers need to spend at least 70 percent of the loan amount on goods and services of Italian origin. Program management is considering removing this Italian origin purchase requirement.

The fund can serve as a guarantee for participating banks and NBFIs to cover up to 50 percent of the potential risk in liquidating the loan. The benefiting economic entity pays an initial fee of 1 percent per annum, calculated on the annual amount of the guarantee set for each guaranteed loan. SMEs must meet the following criteria to become eligible for support from the Albanian Guarantee Fund:

- The company is registered in Albania;
- Not less than 51 percent of the company's capital is under the ownership of an Albanian citizen;
- The annual turnover is lower than EUR 10 million; and
- The number of employees is lower than 250.

The participating banks and NBFIs include:

- National Commercial Bank;
- Raiffeisen Bank Albania;

[42] EBRD http://aasf.com.al/about-aasf/

[43] Italian - Albanian Programme for the development of SMEs https://www.prodaps.al/index.php/en/sme-financing/sme-guarantee-fund

- Credins Bank;
- Intesa Sanpaolo Bank Albania;
- OTP Bank Albania;
- American Bank of Investments;
- Tirana Bank;
- Union Bank;
- Fondi BESA;
- FEDInvest;
- NOA.

RURAL CREDIT GUARANTEE FUND

The KFW RCGF was established in 2015 as a not-for-profit foundation under the laws of the Republic of Albania for the purpose of facilitating access to finance for Albanian farmers and rural entrepreneurs with insufficient or lack of collateral.[44] RCGF coverage is for the entire country with no geographic limitations. Support is given to partner financial institutions through a 50/50 risk sharing guarantee mechanism. Guarantees remain invisible to the final beneficiary to mitigate moral hazard. Borrowers have to meet the eligibility criteria based on employment size, sales, loan amount, and overall bank borrowings. In 2018, Germany provided a further EUR 5 million through KFW, its development bank, to increase RCGF's capital in order to improve financing of projects of local farmers. KFW has recently expanded eligibility requirements by allowing SMEs to participate.

KFW's leverage is between 1 and 2 times its current capital and has not had a claim filed by participating financial institutions to date. The current participating financial institutions include:

- CREDINS bank
- National Commercial Bank
- FED Invest
- NOA

KFW is completing due diligence to add 6 additional banks and 4 micro finance organizations to the program. KFW is currently in discussions with the United States Agency for International Development (USAID) and EBRD regarding possible funding for program expansion.

USAID DEVELOPMENT CREDIT AUTHORITY GUARANTEE FOR AGRICULTURE LENDING

The USAID Loan Portfolio Guarantee[45] **established the Development Credit Authority (DCA) Guarantee for Agriculture Lending in September 2012.** It was planned to operate until September 2022, but its portfolio is already exhausted. USAID with Albanian bank partners ProCredit Bank and BKT Bank implemented a USD 15 million Loan Portfolio Guarantee Agreement aimed to increase access for farmers and agribusinesses to financial resources which are needed to expand and increase their competitiveness. The DCA loan portfolio provides a 50 percent risk guarantee to loans issued by participating banks. The DCA guarantee gave banks the incentive to lend to farmers, who would otherwise find it difficult or impossible to obtain financing, in order to demonstrate their potential profitability.

[44] KFW http://rcgf.al/

[45] USAID Loan Portfolio Guarantees https://www.usaid.gov/albania/economic-growth-and-trade

ANNEX 2

PUBLIC CGS: PRINCIPLES AND INTERNATIONAL EXPERIENCE

LEGAL AND REGULATORY FRAMEWORK

A CGS should be established as an independent legal entity, with a clearly defined legal and regulatory framework. An adequate legal and regulatory framework provides the institutional foundations of the CGS, enhancing its credibility and reputation. The legal and regulatory framework should encourage the private sector's participation in the scheme, should clarify the ownership policy of the government, and should separate government control from day-to-day operations, ensuring the CGS's independence and accountability. The direct involvement of governments in the management, credit decision process, and claim payout and loss recovery is not common. Independent management free of interference ensures objectivity, reduces moral hazard, and assures long-term sustainability. A sound legal and regulatory framework facilitates the formulation and implementation of an appropriate strategy to achieve the objectives. The legal framework should specify the sources of funding of the CGS, which should be mainly equity. There should be limits on budget appropriations and subsidies specified in the legislation. The CGS should be supervised by a financial sector supervisory authority, according to the risk posed by its products. Out of 60 public CGSs worldwide surveyed in 2016, 80 percent were established as an independent legal entity and a large majority (87 percent) were established by law, decree, or other special legislation.[46] Guarantee providers

[46] Assessing Implementation of the Principles for Public Credit Guarantees for SMEs: A Global Survey, World Bank 2016.

in CESEE are typically publicly owned and are publicly operated. More than two third of CGSs are fully publicly owned (see Table 6). Exceptions are Romania – where the three typologies (public, private, and mixed) co-exist – and Hungary, where all CGSs operate as mixed public-private schemes.[47] See Box 7 for further information on characteristics of a "typical" CGS in CESEE.

Table 6. Ownership and legal structure of CGSs in CESEE

Ownership \ Legal structure	Government entity	Public Corporation	Private Corporation	Foundation	Total
Public	6	5	1	1	**13**
Public-private		2	2	1	**5**
Private			1		**1**
Total	**6**	**7**	**4**	**2**	**19**

Source: CGS Survey

CORPORATE GOVERNANCE AND RISK MANAGEMENT

The CGS should have a clearly defined mandate, strong internal controls, and a solid risk management framework. The mandate should be set in legislation, include the target market, and any other services in addition to the guarantees (such as technical assistance). Based on the mandate, the CGS should develop strategies for different segments. The CGS should have a sound corporate governance structure, set in legislation, with an independent board of directors appointed in accordance with defined criteria, as political interference is one of the major challenges of CGSs. Effective CGSs have in place strong internal controls, and internal audit and compliance functions. An adequate risk management framework is also essential, with accurate information and timely reporting systems to enable adequate monitoring and management of risks, including credit, liquidity, market, and operational risks. A comprehensive management information system enables loan tracking and a guarantee issuance system facilitates risk identification, monitoring, and remedial action in a timely manner.

[47] Credit Guarantee Schemes for SME lending in Central, Eastern and South-Eastern Europe, Vienna Initiative 2014.

OPERATIONAL FRAMEWORK

Eligibility criteria should be designed to target financially constrained MSMEs, while providing for some flexibility. Some of the criteria typically used include the number of employees in the enterprise, turnover, industry, geographic location, loan ceiling, etc. Eligibility is designed to meet the objectives of the segment that is being targeted.

The coverage ratio refers to the percentage of the loan exposure by the CGS and should be on a risk sharing basis, to provide sufficient protection against the risk of default and moral hazard while preserving incentives for effective loan origination and monitoring. Higher coverage ratios can be provided to riskier types of borrowers, along with higher fees, or during economic downturns. According to the 2014 Vienna Initiative CESEE Survey, guarantee coverage ranges from 50 to 100 percent of the principal amount, depending on the type of borrower or loan product guaranteed, with only one scheme offering 100 percent coverage.

A risk-based pricing policy should be adopted, with fees high enough to discourage banks from using guarantees for good borrowers, but not excessive to avoid adverse selection. The CGS should charge fees according to the riskiness of the guarantee, based on the guarantee coverage ratio, exposure to default, and loss given default. When it comes to pricing, CGSs in CESEE rely mostly on guarantee fees, which are reviewed annually. Only 20 percent of schemes have application fees in addition to a guarantee fee.[48] According to the global survey conducted by the World Bank in 2016 the median annual fee levied by CGSs is 2.4 percent.

The claim payout should be quick and predictable, in order to build the credibility of the guarantee scheme while encouraging loan collection. Well-defined triggers for payout should be clear, and the process should be simple. In well-designed schemes, claims are paid out 180 days from the date of default, giving the lender time to determine if the delay in repayment is a temporary cash flow issue which needs restructuring or a more serious problem. Claims are paid on the premise that the lender will continue its collection effort through all means, including legal action. Successful schemes do not require that legal action is completed before claims are paid out. In a well-managed CGS, actual claim payouts have been kept under 4 percent, with the majority under 2 percent. Efficient processing for approvals and claims significantly enhances the credibility of the scheme.

Guarantee schemes should be allowed to require collateral up to reasonable limits. This commits the borrower to an obligation to repay the loan. In many countries, CGSs take personal guarantees, or guarantors, to increase incentives for repayment. After establishing some repayment history, banks are typically satisfied with personal guarantees in the absence of hard collateral.

MONITORING AND EVALUATION

CGSs should also have rigorous financial reporting requirements, have financial statements externally audited, and undertake reviews to assess additionality, outreach, and financial sustainability. Accurate and audited financial statements are important to hold management accountable, and to increase the credibility of the scheme. Periodic reviews are important to provide the checks and balances to evaluate operations and refine procedures with regards to operational efficiency, claim payout, design features, performance, client satisfaction, additionality, sustainability, outreach, new products, and others.

[48] Credit Guarantee Schemes for SME lending in Central, Eastern and South-Eastern Europe, Vienna Initiative 2014.

Box 7. Characteristics of a "typical" CGS in CESEE[49]

General information

- Established in the mid-1990s, it usually provides credit guarantees, often together with other financial services.
- Publicly owned, legally established as a private corporation, and is tax exempt.
- Capitalized upfront, with no explicit restriction on leverage.
- Non-profit, without an obligation to be self-sustainable.
- Provides guarantees to domestic markets only, does not have a banking license, and is regulated by national financial authorities or other government agencies.

Outreach

- Targets SMEs, following the EU definition.
- The primary motivation is to alleviate lack of collateral and increase lending.
- Uses guarantees, beneficiaries, and jobs created as indicators for the operational performance, and default rates and portfolio at risk as indicators for the financial performance.
- Conducts economic additionality study on regular basis, but not necessarily a financial additionality study.
- Operations increased during the crisis, with sunset clauses and additional funds.

Services

- Offers guarantees to banks, leasing companies, and other financial institutions, with borrowers applying directly at the intermediaries, where they are informed about the guarantee.
- The guarantees are mainly for working capital, investments, and trade finance.
- Guarantees are considered on a loan-by-loan basis, and there is mandatory time period for processing the requests.

Pricing & Coverage

- Fees are paid by the borrower and are based on the loan amount.
- Coverage is between 34-81 percent of principal and for 10-15 years.
- Allows lenders to require collateral, which can exceed the loan amount.
- Appraises loans based on the business plan and internal scoring system.

Claims

- The trigger is non-payment or insolvency, with a single payment upon validation.
- The loss-recovery principle is pari passu, with recovery pursued by the lender.
- The lender's rights are subrogated after payment.

[49] Vienna Initiative, Credit Guarantee Schemes for SME lending in Central, Eastern and South-Eastern Europe, 2014.

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