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IDA/R2019-0102/1

April 25, 2019

**Closing Date: Tuesday, May 14, 2019
at 6:00 p.m.**

FROM: Vice President and Corporate Secretary

Kosovo - Financial Sector Strengthening (FSSP) Project

Project Appraisal Document

Attached is the Project Appraisal Document regarding a proposed credit to Kosovo for a Financial Sector Strengthening (FSSP) Project (IDA/R2019-0102), which is being processed on an absence-of-objection basis.

Distribution:
Executive Directors and Alternates
President
Bank Group Senior Management
Vice Presidents, Bank, IFC and MIGA
Directors and Department Heads, Bank, IFC, and MIGA

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Report No: PAD2892

INTERNATIONAL DEVELOPMENT ASSOCIATION

PROJECT APPRAISAL DOCUMENT

ON A

PROPOSED CREDIT

IN THE AMOUNT OF EUR 22.3 MILLION

(US$25 MILLION EQUIVALENT)

TO THE

REPUBLIC OF KOSOVO

FOR A

KOSOVO FINANCIAL SECTOR STRENGTHENING PROJECT

April 23, 2019

CURRENCY EQUIVALENTS

(Exchange Rate Effective - March 31, 2019)

Currency Unit =	Euro (EUR)
US$ 1: Euro 0.891	
US$ 1.122:	Euro1

FISCAL YEAR
January 1 - December 31

Regional Vice President:	Cyril E Muller
Country Director:	Linda Van Gelder
Global Director:	Alfonso Garcia Mora
Practice Manager:	Mario Guadamillas
Task Team Leader(s):	Blerta Qerimi, Cevdet Cagdas Unal

ABBREVIATIONS AND ACRONYMS

CE	Citizen Engagement
CPF	Country Partnership Framework
CBK	Central Bank of Kosovo
CGS	Credit Guarantee Scheme
EIB	European Investment Bank
ESMF	Environmental and Social Management Framework
FDI	Foreign Direct Investment
FSAP	Financial Sector Assessment Program
FSSR	Financial Sector Stability Review
GDP	Gross Domestic Product
ICT	Information Communication Technology
IFC	International Finance Corporation
IFI	International Financial Institution
IOSCO	International Organization of Securities Commission
KCGF	Kosovo Credit Guarantee Fund
KFW	German Development Bank
MFI	Microfinance Institution
MSME	Micro, Small and Medium Enterprise
MoF	Ministry of Finance
MTI	Ministry of Trade and Industry
NBFI	Non-Bank Financial Institution
NGOs	Non-Governmental Organizations
PAD	Project Appraisal Document
PCGs	Partial Credit Guarantees
PDO	Project Development Objective
PPSD	Project Procurement Strategy for Development
ROA	Return on Asset
ROE	Return on Equity
SECO	Swiss State Secretariat for Economic Affairs
SIDA	Swedish International Development Cooperation Agency
SME	Small and Medium Enterprise
USAID	United States Agency for International Development
WB	World Bank

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DATASHEET

BASIC INFORMATION

Country(ies)	Project Name	
Kosovo	Kosovo Financial Sector Strengthening Project	
Project ID	**Financing Instrument**	**Environmental Assessment Category**
P165147	Investment Project Financing	F-Financial Intermediary Assessment

Financing & Implementation Modalities

[ ] Multiphase Programmatic Approach (MPA)	[ ] Contingent Emergency Response Component (CERC)
[ ] Series of Projects (SOP)	[✓] Fragile State(s)
[ ] Disbursement-linked Indicators (DLIs)	[ ] Small State(s)
[✓] Financial Intermediaries (FI)	[ ] Fragile within a non-fragile Country
[ ] Project-Based Guarantee	[ ] Conflict
[ ] Deferred Drawdown	[ ] Responding to Natural or Man-made Disaster
[ ] Alternate Procurement Arrangements (APA)	

Expected Approval Date	Expected Closing Date
14-May-2019	31-Dec-2023

Bank/IFC Collaboration
No

Proposed Development Objective(s)

The objective of the Project is to improve access to finance for Micro, Small and Medium Size Enterprises by strengthening the financial and technical capacity of the Kosovo Credit Guarantee Fund.

Components

Component Name	Cost (US$, millions)

Enhancing the Credit Guarantee Framework	24.00
Project Implementation and Institutional Strengthening of KCGF	1.00

Organizations

Borrower:	Ministry of Finance
Implementing Agency:	Kosovo Credit Guarantee Fund Central Bank of Kosovo

PROJECT FINANCING DATA (US$, Millions)

SUMMARY

Total Project Cost	25.00
Total Financing	25.00
of which IBRD/IDA	25.00
Financing Gap	0.00

DETAILS

World Bank Group Financing

International Development Association (IDA)	25.00
IDA Credit	25.00

IDA Resources (in US$, Millions)

	Credit Amount	Grant Amount	Guarantee Amount	Total Amount
National PBA	25.00	0.00	0.00	25.00
Total	**25.00**	**0.00**	**0.00**	**25.00**

Expected Disbursements (in US$, Millions)

WB Fiscal Year	2019	2020	2021	2022	2023	2024
Annual	0.00	10.35	10.26	4.10	0.29	0.00
Cumulative	0.00	10.35	20.61	24.71	25.00	25.00

INSTITUTIONAL DATA

Practice Area (Lead)

Finance, Competitiveness and Innovation

Contributing Practice Areas

Climate Change and Disaster Screening

This operation has been screened for short and long-term climate change and disaster risks

Gender Tag

Does the project plan to undertake any of the following?	
a. Analysis to identify Project-relevant gaps between males and females, especially in light of country gaps identified through SCD and CPF	Yes
b. Specific action(s) to address the gender gaps identified in (a) and/or to improve women or men's empowerment	Yes
c. Include Indicators in results framework to monitor outcomes from actions identified in (b)	Yes

SYSTEMATIC OPERATIONS RISK-RATING TOOL (SORT)

Risk Category	Rating
1. Political and Governance	High
2. Macroeconomic	Moderate
3. Sector Strategies and Policies	Low
4. Technical Design of Project or Program	Low
5. Institutional Capacity for Implementation and Sustainability	Moderate
6. Fiduciary	Substantial
7. Environment and Social	Moderate
8. Stakeholders	Low
9. Other	Low
10. Overall	Substantial

COMPLIANCE

Policy

Does the project depart from the CPF in content or in other significant respects?

[ ] Yes [✓] No

Does the project require any waivers of Bank policies?

[ ] Yes [✓] No

Safeguard Policies Triggered by the Project	Yes	No
Environmental Assessment OP/BP 4.01	✓	
Performance Standards for Private Sector Activities OP/BP 4.03		✓
Natural Habitats OP/BP 4.04		✓
Forests OP/BP 4.36		✓
Pest Management OP 4.09		✓
Physical Cultural Resources OP/BP 4.11		✓
Indigenous Peoples OP/BP 4.10		✓
Involuntary Resettlement OP/BP 4.12		✓
Safety of Dams OP/BP 4.37		✓
Projects on International Waterways OP/BP 7.50		✓
Projects in Disputed Areas OP/BP 7.60		✓

Legal Covenants

Sections and Description
Except the Association shall otherwise agree, not later than one month after the Effective Date, the Recipient, through MoF, shall cause KCGF to hire: (i) an environmental and social specialist; and (ii) a procurement specialist; all with terms of reference and qualifications acceptable to the Association.

Conditions

Type	Description
Effectiveness	Signing of the Subsidiary Agreement between MoF and KCGF

Type	Description
Effectiveness	Legal opinion issued by KCGF and MoF on the Subsidiary Agreement

Type	Description

I. STRATEGIC CONTEXT

A. Country Context

1. **Kosovo faces a unique set of challenges and opportunities as one of Europe's poorest countries in terms of its GDP per capita and as the youngest country in the continent.** Kosovo is landlocked with a population of approximately 1.8 million. According to the Kosovo Statistics Agency, poverty is high with 17.6 percent of the population living below the national poverty line in 2015**.** At the same time, with its new statehood and majority of its population under the age of 30[1] Kosovo is the youngest country in Europe. Since independence in 2008, the country has made considerable socioeconomic progress, benefiting from the support of the international community and its own diaspora.

2. **Despite the progress achieved so far, some of Kosovo's institutions need further strengthening.** Building strong institutions is a long-term endeavor which requires continuous work and support**.** Developing the structures, legal frameworks, processes and the capacity within the government institutions is an underlying challenge that cuts across numerous sectors that needs to be addressed by the government, civil society, private sector and international donors. Faster progress in reforms in governance institutions and the regulatory environment are needed, as are infrastructure investments particularly in energy supply, regional roads, and information and communication technology (ICT), which are essential to support private sector productivity and competitiveness. Developing strong institutions and legal frameworks is crucial to creating an environment that is conducive to growth and private sector development.

3. **Kosovo has enacted several reforms since independence, but barriers to creating a more dynamic, vibrant economy remain.** With policies anchored in its overarching political objective of joining the European Union (EU), Kosovo has made progress in promoting growth, reducing poverty, and improving the business climate. Between 2008 and 2017 gross domestic product (GDP) per capita grew at an average of 3.5 percent in real terms and reached USD3,893 at end 2017 making Kosovo the fastest growing county in the Western Balkans. However, it has one of the lowest living standards in Europe, with per capita GDP (PPP terms) of USD10,064 in 2016. Poverty rates are still high with 17.6 percent of the population living under the national poverty line in 2015 despite the considerable reduction of 5.3 percentage points in the poverty rate during the period between 2012-2015. Ranked at the 113^{th} place in the Doing Business Report in 2010, by 2019 the country had moved to the 44^{th} rank, becoming the third top-performer in the lower middle-income category. Yet, serious barriers to greater economic growth remain. These include: i) a narrow base for goods exports, ii) FDI that is mostly concentrated in non-tradable and unproductive sectors and not large enough to transform the Kosovo economy, iii) persistently limited improvement of competitiveness and iv) productivity of the private sector and existing disparities within population along geography, ethnicity, and gender. Kosovo is also prone to natural hazards some of which will be exacerbated by a changing climate including floods, landslides, droughts,

[1] Kosovo Statistics Agency

earthquakes, and wildfires that could pose damages to the economy, fiscal balance and well-being of vulnerable populations.

4. **The Kosovo economy is characterized by low labor force participation and high unemployment, especially for women and youth, limiting the growth potential of the economy.** According to the Kosovo Statistics Agency, the country scores particularly low on labor dimensions of gender equality, including from a regional perspective. According to the 2018 Labor Force Survey of Kosovo Statistics Agency, female labor force participation is low at 18.4 percent (63.3 percent among men). Female employment rate is also low at 12.3 percent (45.3 percent among men), and unemployment rate is high at 33.4 percent (28.5 percent among men). Unemployment rates are persistently high in general with 29.6 percent of the active population unemployed in 2018. Youth unemployment remains high at 55.4 percent.

B. Sectoral and Institutional Context

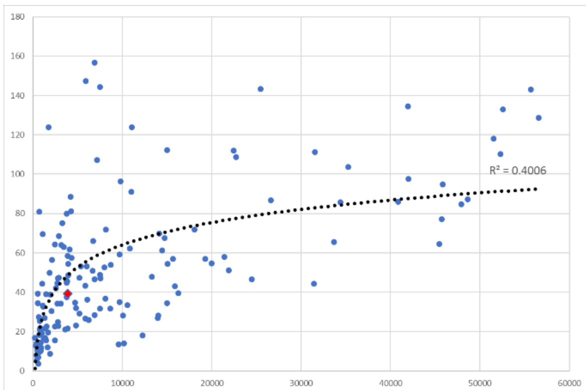
5. **The financial sector in Kosovo is dominated by the banking sector.** According to the data provided by the Central Bank of Kosovo**,** as of February 2019, the financial system included 10 private commercial banks, 14 insurance companies, 2 pension funds, and 22 microfinance institutions (MFIs). Banking sector assets represented by far the bulk of the financial system with 65.5 percent of total assets of the financial sector. The banking sector is dominated by foreign banks, both in number of banks (8 out of 10) and share of total assets (87 percent). The sector is concentrated, with the three largest foreign banks holding 57.4 percent of total assets as of February 2019.

6. **The banking sector remains well-capitalized and profitable.** As of February 2019, ROE and ROA were high at 16.6 percent and 2 percent respectively while the capital adequacy ratio reached 16.8 percent, comfortably above the minimum regulatory level of 12 percent. The sector is liquid with liquid assets/short term liabilities amounting to 37.2 percent. The NPL ratio at 2.6 percent in February 2019 is significantly lower than in neighboring countries. Loan-loss provisions to NPLs were also high at 158.8 percent mitigating relevant risks.

7. **Micro Finance Institutions (MFIs) play an important role in providing lending to underserved segments but their growth potential is constrained.** MFIs represent around 3.5 percent of total financial sector assets. They are licensed, regulated and supervised by Central Bank of Kosovo (CBK). The majority are registered as non-deposit taking Non-Governmental Organizations (NGOs); while only 2 have been registered as joint stock companies. The microfinance sector is making significant contributions to the real economy in Kosovo by providing credit to a client base that is approximately half of the client base of the commercial banks. MFIs' business is limited solely to lending activities and the current regulatory framework for MFIs needs to be revised to encourage the growth and development of the sector. In particular, the impact of MFIs in financing consumers and SMEs could be enhanced if the MFIs had access to additional capital and if the strongest MFIs could provide deposit services to their clients.

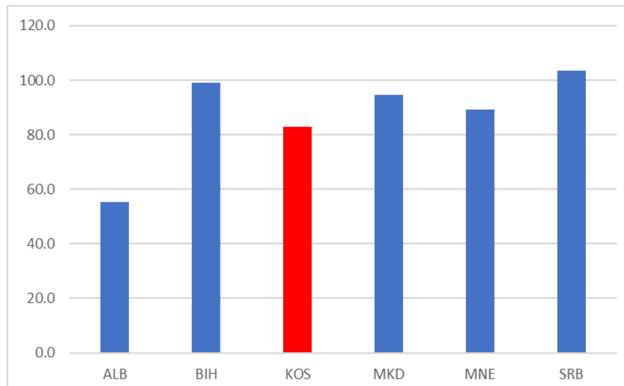
8. **Despite robust credit growth in the last two years, the level of financial intermediation remains low.** Based on February 2019 CBK's data, annualized credit growth averaged 11.4 percent thanks to falling interest rates, good liquidity conditions and reforms to improve contract enforcement. Yet, credit growth has been uneven; the highest credit growth occurred in mortgages and unsecured consumer lending, while lending to productive sectors remains low. Overall, credit penetration remains low in Kosovo compared to its income level with a private sector credit to GDP ratio of 39.6 percent by the end of 2017 (figure 1). The financial sector is also relatively underleveraged with a loan to deposit ratio of 84.9 percent leaving room for further credit expansion (figure 2).

Figure 1. Credit Penetration vs GDP per capita (2016)



Source: WDI

Figure 2. Loan to deposit ratios in Western Balkans (percent, 2017 Q2)



Source: WB Staff calculations

9. **Authorities have implemented important financial sector reforms in recent years to ensure financial stability.** Having adopted the Euro as the sole legal tender, Kosovo does not have access to independent monetary policy instruments. Hence, the CBK has maintained a focus on preserving banking sector stability since its establishment. Most of the 2012 Financial Sector Assessment Program (FSAP) recommendations have been implemented in recent years. To improve crisis management and contain systemic risks, authorities adopted emergency liquidity assistance and a macro-prudential framework. The institutional capacity of the banking supervision function has been also strengthened through the adoption of a risk-based framework. Meanwhile, cross-border supervision is a specific challenge for Kosovo because of the country's political status and the small size of the banking subsidiaries in the foreign groups. Authorities continue to address remaining vulnerabilities in crisis preparedness and supervisory frameworks through technical assistance provided by the World Bank (WB) and the IMF.

10. **Authorities acknowledge that further reform progress is needed to support financial intermediation and has started working in this direction with the support of the World Bank.** Reform efforts to support financial intermediation have not been prioritized until recently. While the establishment of the partial credit guarantee framework and amendments to enforcement procedures were steps in the right direction, more

needs to be done. Going forward, authorities should improve the efficiency of the judiciary system, establish a functioning cadaster system, enhance retail payment system and remove the obstacles against the growth of the MFI sector among others. Authorities have already started to take actions to address some of these challenges with the support of the WB. The WB financed Real Estate Cadaster and Registration Project has helped the authorities to improve the cadaster system both on the municipal and country level. The legislative process for the new MFI law, which was supported by the WB technical assistance, is underway. Currently the CBK is working on further development of the retail payment system with the support of the World Bank through a Swiss State Secretariat for Economic Affairs (SECO) funded technical assistance. In addition, CBK is going under a Financial Sector Stability Review (FSSR) by IMF. In its efforts to further improve financial intermediation, Kosovo has expressed interest to conduct an FSAP developmental module by the WB in estimating the dynamics of the financial intermediation for the following areas: i) estimating the financing gap including contextual factors, demand for credit by the real economy, supply of credit by intermediaries, financial infrastructure and ii) assessing the Core Principles for Financial Market Infrastructure.

11. **Access to finance for SMEs is limited.** Based on 2017 Structural Business Survey data, Micro, Small and Medium Size Enterprises (MSMEs) dominate the real sector in Kosovo. MSMEs are classified by number of employees. Microenterprises have one to nine employees while small and medium firms have 10-49 and 50-249 employees, respectively. MSMEs compose over 98.7 percent of the private sector in Kosovo with the total number of registered enterprises reaching 49,386[2] in 2016, out of which 34,696 are active. Microenterprises represent 91 percent of total firms.

12. **MSMEs are concentrated in a few sectors**. 47.7 percent of them are in the trade sector followed by 13.6 percent in business and other services and 13.5 percent in manufacturing. In terms of the turnover, MSMEs in the trade sector account for 57.7 percent of the total turnover compared to 11.9 percent and 10.5 percent for the ones in manufacturing and construction, respectively. They are also concentrated geographically with approximately 35 percent of firms located in Pristina.

13. **MSMEs play a critical role in job creation.** According to WB Job Diagnostic Report (2017), Kosovo stands out in international comparisons in terms of the greater contribution of micro firms to employment. MSMEs account for 65 percent of employment while micro enterprises alone provide 36 percent of total employment. In other countries, large firms provide a higher proportion of all jobs because they are proportionally more numerous.

14. **One of the key constraints to growth for MSMEs is access to finance**. IFC MSME Financing Gap Estimates (2017) indicate that 33 percent of MSMEs are financially constrained with an estimated financial gap of at least EUR304 million. According to the WB Enterprise Survey (2013), 45 percent of firms identified access to finance as a major constraint compared to 17.2 percent in the ECA region. In particular, micro enterprises are

[2] Results of the Structural Business Survey 2017. Survey does not include agriculture, forestry, fishing, finance, education, health, household activities and public administration.

significantly underserved as banks' loan portfolios are concentrated in financing SMEs and the corporate sector.

15. **Lenders conservative approach and high collateral requirements contribute to the access to finance challenges.** Despite ample liquidity and underleveraged balance sheets, lenders in Kosovo are somewhat risk-averse thanks to stable non-interest income and high margins. Based on CBK Financial Stability Report by the end of 2017 net non-interest income of the banks was EUR41.7 million from the total profit of EUR85.4 million. Income from fees and commissions are among the main drivers of profit. At around 5 percent, the interest rate spread is the highest in the region giving rise to competition and efficiency concerns. Although discussions with lenders suggest that the level of collateral is closer to 200 percent of the loan value, the CBK Credit Registry data suggests that the ratio reaches up to 400 percent for non-guaranteed loans in line with the 2013 Enterprise Survey results. Among others, lack of financial reporting, problems with property and land registration and shallow secondary markets are the main reasons behind the high level of collateral requirements.

16. **Public credit guarantee schemes are widely used and effective instruments to alleviate the constraints facing MSMEs in accessing finance.** Credit guarantee schemes provide guarantees on loans to borrowers by covering a share of the default risk of the loan. They can reduce the required level of collateral from the borrower as the guarantor effectively provides a substitute albeit not perfect for collateral. Beck, Demirgüç-Kunt and Martinez Peria (2008)[3] show that banks view guarantee schemes as the most common and effective government program to support SME financing ahead of directed credit and interest rate or regulatory subsidies. Public schemes are the most popular type in developing countries. Abraham and Schmukler (2017)[4] study found that they have proven useful to increase access to finance as 50 percent of loans guaranteed have been granted to MSMEs that otherwise would have not obtained credit due to access to finance constraints. The same study also indicates that in many cases, public credit guarantee schemes improve firm performance in terms of growth, investment and employment.

17. **The Kosovo Credit Guarantee Fund (KCGF) was established in January 2016 to provide guarantees to eligible businesses in Kosovo**. The KCGF's target businesses are MSMEs that are viable but do not have enough collateral and, or credit history; MSMEs needing long-term financing; MSMEs that can increase local production and reduce imports and/or increase exports; women-owned MSMEs; and MSMEs that will create new jobs. Loans to certain sectors are not permitted to be guaranteed[5]. The initial capital of the KCGF was EUR 8.6 million which was provided by the government, USAID and KFW.

[3] Beck, Thorsten, Aslı Demirgüç-Kunt, and Maria Soledad Martinez Peria. 2008. "Banking Services for Everyone? Barriers to Bank Access and Use around the World." World Bank Economic Review 22 (3): 397–430.
[4] Abraham, Facundo; Schmukler, Sergio L.. 2017. Are public credit guarantees worth the hype? (English). Research & policy briefs; no. 11. Washington, D.C. : World Bank Group. http://documents.worldbank.org/curated/en/431261511201811430/Are-public-credit-guarantees-worth-the-hype.
[5] These include any business connected with the military or weapons production; gaming or gambling activities; illegal activities; nightclubs; production or sale of tobacco or hard liquor, if the production or sale of these products constitutes more than 25 percent of the borrower's annual turnover (gross revenues); residential mortgage loans; real estate development; municipalities, district or state-owned enterprises; and any businesses that have material negative environmental impacts.

18. **The KCGF's existing scheme is somewhat conservative.** Currently the KCGF is not used for start-ups, borrowers with a slightly lower debt service coverage ratio or for borrowers in a new line of business. The maximum guaranteed amount is relatively small at EUR 250,000 and the Law on the Establishment of the KCGF limits the guaranteed amount to 50 percent of the principal amount. The Law also restricts refinancing of existing debts. The scheme is relatively new and has not experienced significant amount of losses yet although the anticipated loss rate is 2 percent. If the scheme continues to operate without losses, this will be further evidence of the conservative approach in place.

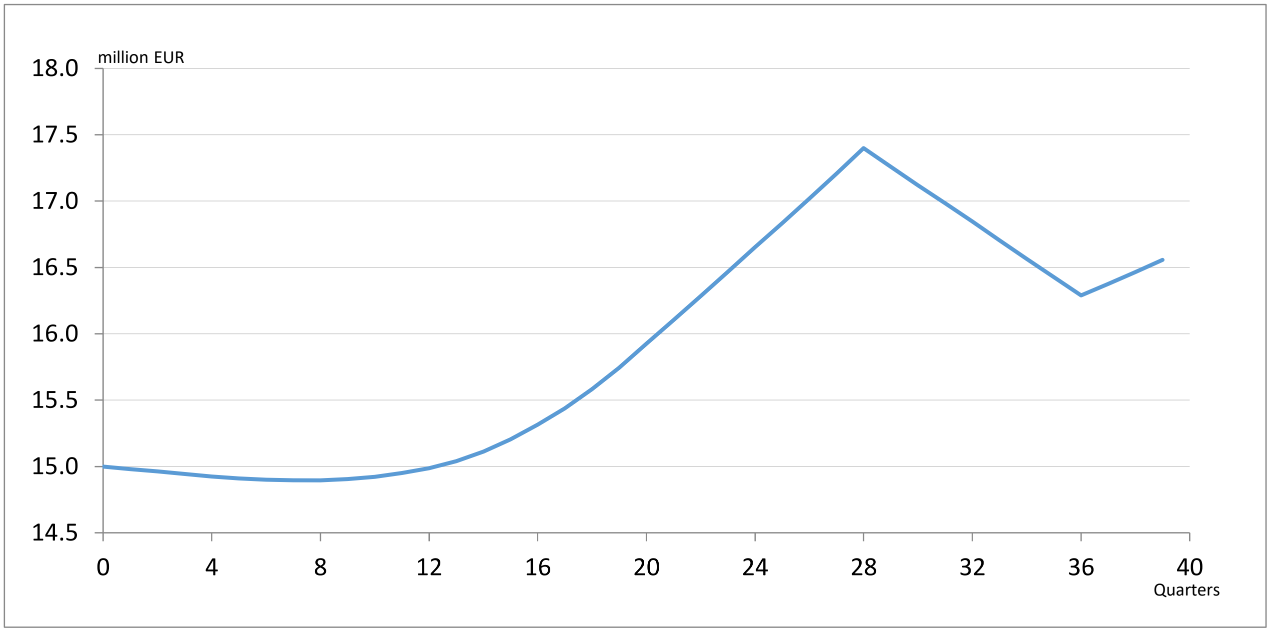
19. **The guarantee framework is portfolio based with lenders making the credit decision and the KCGF being responsible for oversight.** Reasonable due diligence is performed by the KCGF on lenders that apply to use the scheme. This includes an analysis of the SME lending portfolio currently at the bank and a determination that the bank has adequate experience to process and service SME guaranteed loans. Furthermore, the agreement must be renewed every two years. This is considered to be a good practice as it gives the KCGF a chance to review the lenders performance and ensure their staff are adequately trained. Once accepted, the lenders submit loans on an individual basis to be added to their portfolio for a guarantee. In addition to randomized checks on individual loans, lenders must provide monthly portfolio performance reports to KCGF. KCGF can suspend the lender's ability to approve loans if there is concern regarding the quality of the portfolio. The final opportunity to ensure compliance with scheme requirements has been met is when a lender requests the payment on a guarantee. At that time, KCGF can review the file to ensure that all requirements were met within the 30-day timeframe and refuse to pay if the requirements were not met.

20. **Current leverage (outstanding guarantees over KCGF capital) is around 2:1 and in the future the KCGF plans to keep it under 3:1 in the near future against the legal limit of 5:1.** It is appropriate to operate a newly-established Fund with a relatively conservative leverage for two reasons. The first is the need to gain the trust of lenders. Once the lenders know that their guarantee is secure, they are more likely to use the scheme. Keeping the leverage ratio below certain level shows that the guarantee is backed heavily by cash and is therefore very secure. The second reason is to gain experience in terms of how the scheme will operate and see if the actual experience matches projections. Once the initial data is available, projections can be recalibrated to determine an appropriate leverage rate. The current track of losses would suggest that the leverage could be increased if necessary to meet the demand.

21. **According to the Project team's analysis the scheme is financially self-sustaining for at least the next 10 years, assuming full deployment of its capital.** Currently, the KCGF has a capital base of around EUR15 million, which has supported around EUR99.6 million loan portfolio in cumulative terms. About 31 percent (EUR5 million) of the capital base is set aside for agricultural loans (with a leverage limit of 2:1). The average loan size is around EUR35,000. Its operating expenses were covered by USAID through the end of calendar year 2018 (the Balance Sheet and Income Statement of KCGF are provided in Annex 6). The Fund collects a 2 percent annual fee based on the guaranteed balance outstanding (except agricultural loans) and earns about 1.1 percent interest on its capital base. It has a seven-year secondary guarantee agreement with the Swedish International Development Cooperation Agency (SIDA) in which SIDA will assume 50 percent of the risk for up to around

EUR10 million in loans with a tenor longer than 24 months for a fee of 50 basis points. The WB team's simulation model showed that the scheme was likely to make a profit over the next ten years using the current projections, a 2.5:1 leverage (KCGF's average estimation during the Project implementation) and the 50 percent coverage level (figure 3). The default rate assumption is conservative at 6 percent compared to the NPL ratio of around 2.7 percent and the recovery rate is 35 percent and the number of staff are increased to 6.

Figure 3. KCGF capital projections, before injection over the next 40 quarters (EUR million)



22. **Lenders are assessed rigorously through a due diligence process prior to being accepted into the scheme and must report monthly on their loan activity.** Active lender oversight is important to ensure that lenders continue following KCGF guidelines and continue making prudent credit decisions. Prudent credit decisions are crucial for the Fund to be self-sufficient. The Board has been actively involved in providing policy guidance designed to keep the scheme on track to meet its financial targets. These factors also contributed to a good financial performance of the Fund.

23. **The Fund has solid operational capacity and the corporate governance structure is satisfactory, still further improvements are needed.** The KCGF is a well-functioning institution with competent staff, who are committed and possess professional banking experience. However, the staff size is rather small with six experts, requiring some staff to assume too many responsibilities. In particular, credit risk assessment and oversight are adequate with reasonable due diligence being performed on borrowers. Procurement and financial management responsibilities are undertaken by only one staff which is against best practices as explained in the implementation arrangements section. The corporate governance structure is appropriate, with the Board

actively providing policy guidance. The Board consists of two members from government bodies (Ministry of Finance and Trade and Industry), and four independent members. Partner IFIs (KfW, SIDA, USAID) have also observer seats at the Board. Legal framework is assessed to be in line with the WB's Principles for Public Credit Guarantee Schemes (CGSs) for SMEs. Yet, to better serve its objectives, the KCGF should differentiate its products and services, revise its operational and marketing strategy, and strengthen the risk assessment and monitoring and evaluation frameworks along with improvements in financial management and procurement functions.

24. **Payment process is somewhat rigid, while the moral hazard issue is handled by the banks.** The law stipulates that KCGF shouldn't make payment on the guarantee until all collection procedures have been exhausted. Once the claim is made, the KCGF has 30 days to check the eligibility criteria and complete the payment. Some of the banks inform the borrower that the loan has a guarantee and the loan would not qualify for financing without the guarantee. Other banks do not inform the borrower regarding the guarantee due to the fear that the borrower may not repay, assuming that the guarantor will pay or that the loan is a grant. Overall there is a correlation between the size of the loan and the willingness of the lender to disclose the guarantee in that the lenders making larger loans seem to be more willing to disclose information about the guarantee.

25. **Loan level analysis indicate that initial impact of guarantees provided by KCGF are positive.** Since its establishment, by March 2019 the KCGF provided guarantees to loans amounting to EUR99.6 million. According to the analysis of the Project team with the support of the WB Development Economics Research Group and Credit Registry of Kosovo, guarantees provided by the KCGF had a positive impact on access to finance both on the intensive and extensive margins. On the extensive margin, more than 25 percent of guarantees were provided to firms with no credit history. On the intensive margin, guaranteed loans had better financial terms (maturity, interest rate, amount and collateral value) than non-guaranteed loans (see Table 1.). Although more data points are needed to gauge the economic impacts, initial estimates of the KCGF revealed that credit guarantees contributed to creation of over 3,500 jobs since its establishment.

Table 1. Impact of KCGF guarantees on credit terms (2016-2018)

Average 2016-2018	**Guaranteed**	**Non-guaranteed**
Interest Rate	9.2%	11.8%
Maturity	3 years	1.8 years
Collateral value/Loan	150%	205%
Loan amount	35503.84	32694.13

Source: Credit Registry of Kosovo, WB staff calculations (2016-2018)

26. **Demand is expected to increase over time, with wider range of products and delivery channels.** Presently, the Fund has only two different windows (and products) including the general and agricultural

windows. Further product differentiation is expected to make the scheme more attractive without undermining the financial stability of the Fund particularly for the client segments suffering from a lack of collateral. In this context, there is demand for additional products aimed at women owned businesses, energy efficiency, revolving working capital, contract financing, supply chain financing and startups. On the supply side, expansion of the guarantee scheme to MFIs and NBFIs is being considered in line with the KCGF legislation which might be a positive step to increase absorption capacity.

27. **Importantly, the CBK has revised the credit risk regulation that will reduce the risk weight on the guaranteed portion of loans.** This is expected to substantially decrease the capital cost and increase the profitability for banks from guaranteed loans which in turn will increase the demand for credit guarantees. The proposed changes will enter into force in 2020. The new regulation is also expected to provide a new opportunity for the KCGF to market the scheme.

28. **All in all, there is significant potential for the financial expansion of the KCGF in Kosovo both on the extensive and intensive margins, yet the current level of capital is not sufficient to meet this demand under a reasonable and conservative leverage assumption and needs to be increased.** Financial gap analysis referred above confirms the potential of the credit guarantees to improve access to finance on the extensive margin. In addition, only less than 5 percent of existing loans are guaranteed as of end-2018, which signals for substantial room for market expansion for PCGs on the intensive margin. Changes in credit risk regulations, further product differentiation and increased awareness are likely to boost the demand for guarantees. On the demand side, interviews with MSME representatives suggest that the loan appetite is also increasing. Yet, the current level of capital is insufficient to meet this demand and close the financing gap under a reasonable and conservative leverage assumption. These factors along with the existing financing gap requires enhancement of the KCGF and confirms the need for proposed capital injection of EUR21.5 million.

29. **However, the financial enhancement should be supported by further institutional development of the KCGF which is essential to ensure successful implementation without any risks to financial sustainability of the Fund.** Areas of improvement includes; information technology, risk assessment policies and procedures, control framework and financial reporting process, monitoring and evaluation framework, environment and social safeguards, design and development of new products, and marketing.

C. Relevance to Higher Level Objectives

30. **The Project is in line with the WBG's Country Partnership Framework (CPF) for Kosovo and contributes to the Government's objective of increasing access to finance.** In recognition of the country's pressing development issues and government priorities, the CPF for FY17-F21 is structured around three focus areas: (i) Enhancing Conditions for Accelerated Private Sector Growth and Employment, (ii) Strengthening Public Service Delivery and Macro-Fiscal Management, and (iii) Promoting Reliable Energy and Stewardship of the Environment. The Project is expected to directly contribute to the CPF objective 6 "Improve business environment and deepen financial integration", which is part of the first focus area, while it has the potential to

contribute to the CPF objective 8 "Enhance employment opportunities for youth, women and vulnerable groups". Finally, as per the Government's strategy, the Project is in line with the objectives underlined in the Economic Reform Program (2018-2020) in increasing access to finance through increase of capital for KCGF.

31. **Increasing access to finance for MSMEs is essential for poverty reduction and shared prosperity.** As MSMEs dominate the real economy and the labor market, improving their access to finance through enhanced financial intermediation will support job creation and economic growth. With a focus on the underserved and productive segments of the economy, the Project will have the potential to directly impact poverty reduction especially among youth and women. There are creditworthy MSMEs that currently do not have access to finance due to information asymmetries and market failure for credit. The Project will focus on these firms along with improving financial terms for firms who already have access to finance.

32. **The Project integrates Maximizing Finance for Development agenda.** The common WB approach to support financial intermediation in developing countries is providing financing for credit lines where the private sector plays only the role of a distributor. Alternatively, this Project aims to crowd in private sector funds to financing MSMEs by providing support to the partial guarantee scheme. A traditional credit line approach would provide EUR21.5 million of additional financing to MSMEs. By using the same amount as a partial credit guarantee the Project has the potential to provide around EUR215 million (EUR194 million of which is through the private sector) to the MSMEs with the current coverage limit of 50 percent and a maximum leverage ratio of 5:1.

33. **The Project is expected to contribute to the WB's Climate Change Action Plan.** Kosovo is vulnerable to natural hazards some of which will increase in frequency and severity due to a changing climate. It has emissions per unit GDP almost double in comparison to those of the EU average (0.4kg/EUR). Hence, the Project intends to contribute to the country's efforts to address and mitigate climate change challenges. At the end of the first quarter of 2018, around 1.5 percent of outstanding guarantees are provided to the sectors with potential climate co-benefits including investments for, energy efficiency, water supply improvements, waste management and remediation activities which will be maintained under the Project's support to the general window activities. In addition, as described in the next section, a strategic window will be established under the project 1.5 percent of which is expected to be used to provide new guarantee products for these sectors. Finally, Project implementation and institutional strengthening component aims to help the KCGF to design products for sectors with potential climate co-benefits and monitor their impacts.

34. **Gender.** Female labor force participation remains very low at 28 percent in Kosovo coupled with high unemployment rates. Based on Kosovo Business Registration Agency (KBRA) data, the number of women-owned businesses in Kosovo is also low at 11 percent. In line with this background, women-owned firms are facing more challenges to access finance. According to the Enterprise Survey, 63 percent of firms with female top managers have a bank loan compared to 67 percent for firms with male top managers. The Project team's consultations suggest that lack of property ownership for women could be a factor undermining access to finance due to high collateral requirements. The Project will support KCGF to develop a special product targeted

to women-owned businesses and develop monitoring and evaluation framework to track financial and economic impact of beneficiaries of KCGF. Additional outreach activities will be specifically designed to target women-owned businesses including through the Business Associations. In the results framework, the share of guaranteed loans to women-owned businesses will be tracked and will also disaggregate the number of financial institutions (members of KCGF) staff trained by gender.

II. PROJECT DESCRIPTION

A. Project Development Objective

PDO Statement

35. The objective of the Project is to improve access to finance for Micro, Small and Medium Size Enterprises by strengthening the financial and technical capacity of the Kosovo Credit Guarantee Fund.

PDO Level Indicators

36. The PDO-level indicators are: (i) number of guaranteed loans; (ii) total amount of outstanding guaranteed loans through the Project.

B. Project Components

37. The Project has two main components: (i) Enhancing the Credit Guarantee Framework and (ii) Project implementation and institutional strengthening.

38. **Component 1: Enhancing the Credit Guarantee Framework (EUR21.5 million)**. Under this Component, the Project will provide funds to KCGF to issue partial credit guarantees to support access to finance to eligible MSMEs, including specific segments and sectors that have strategic importance for supporting the sustainable growth of the Kosovo's economy. The Project will increase the KCGF's capital. Significant part of the Project funds will be channeled to the existing guarantee window (general window) of the KCGF. In addition, the KCGF will establish a new window (strategic window) focusing on underserved and strategic segments which will also be capitalized by the Project. In line with the KCGF's current mandate, the funds under this Component of the Project will be only used for providing PCGs to MSMEs, definition and eligibility of which is determined by the Project Operation Manual in accordance with the KCGF legislation. Accordingly, this Component consists of two subcomponents.

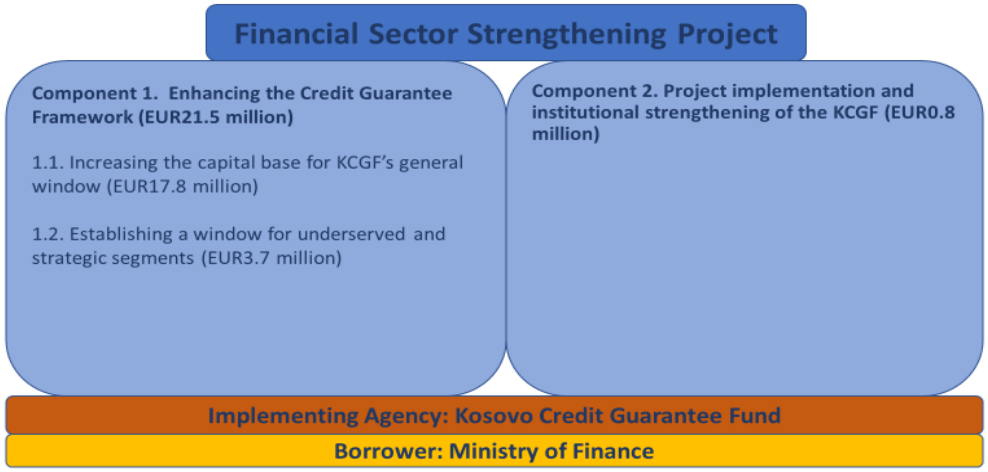
39. **Subcomponent 1.1: Increasing the capital base for KCGF's general window.** Under this subcomponent, the WB will provide EUR17.8 million to expand the capital base for the KCGF's general window. The additional capital will allow an increase in usage of the Fund and allow the KCGF to address a larger portion of the financing gap for SMEs. Financing gap estimates and the team's consultations with financial institutions and other donors indicated that there is enough room in the financial sector to absorb the expansion. The CBK's revision of the

risk weightings for guaranteed portfolio is expected to have a positive impact on guarantee demand. The KCGF estimates the leverage ratio to be around 2.5:1 for this subcomponent.

40. **Subcomponent 1.2: Establishing a window for underserved and strategic segments.** Under this subcomponent, the WB will provide EUR3.7 million to be used for the capitalization of a new KCGF window which will provide partial credit guarantees for specific themes/segments/sectors that have strategic importance for supporting the sustainable growth of the economy. These are expected to include startups, young entrepreneurs, women business owners and others (energy efficiency, waste management and movable collateral). Establishment of the strategic window, including the identification process of underserved and strategic segments and product customization, will be supported by the institutional strengthening component of the Project. The KCGF will develop tailor-made products by altering price, guarantee terms and type for different segments and pilot those under this window. For this subcomponent, the KCGF aims to keep the leverage ratio at around 1.5:1 given the higher risk profile of the segments and possible changes in fee and guarantee structure. World Bank staff have reviewed possible scenarios that included a lower fee on these pilot loans and have concluded that these loans are unlikely to have a substantial negative impact on the financial viability of KCGF. The pilot loans were stress tested by increasing the default rate by 50 percent and by reducing the recovery rate by 50 percent over the estimated default rate for the current portfolio. Detailed analysis are provided in the Technical, Economic and Financial Analysis section below.

41. **Component 2: Project implementation and institutional strengthening of the KCGF (EUR0.8 million).** Under this Component, approximately EUR0.8 million will be provided to the KCGF through MoF for Project implementation and institutional strengthening which will be essential to efficiently use the proposed additional capital. Under this Component, technical assistance will be provided to KCGF to (i) strengthen its capacity to implement the Project; (ii) improve its information technology; (iii) enhance its risk assessment policies and procedures; (iv) enhance its internal control framework and financial reporting process; (v) strengthen the Project's monitoring and evaluation framework, including environment and social safeguards; (vi) design and develop new products tailored for MSMEs in segments and sectors that have strategic importance for supporting the sustainable growth of the economy; and (vii) design and implement a marketing and public awareness campaign and a communications strategy (detailed list of activities and draft ToRs have been developed and are included in the Project Operational Manual). Under Component 2, training will be provided for financial institutions' loan officers to raise their awareness and knowledge of KCGF products.

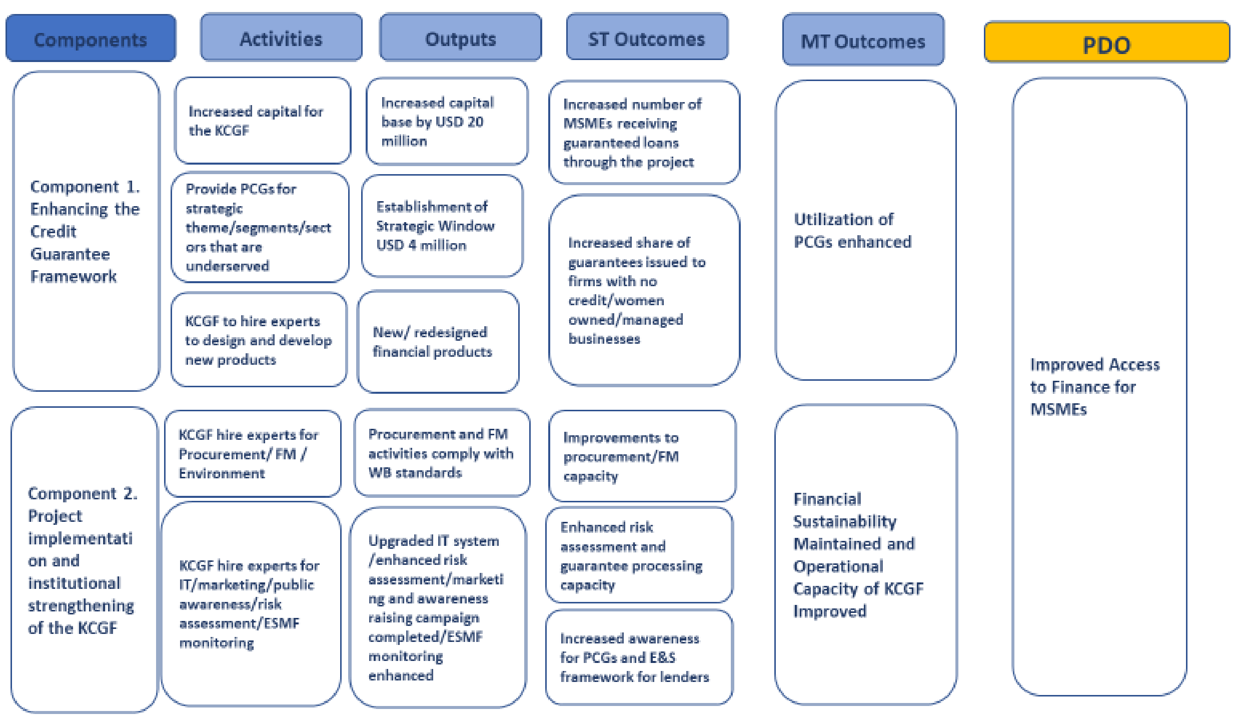
Figure 4. Project Structure



42. **The main Project beneficiaries will be**: (i) MSMEs including startups and women-owned businesses and others, (ii) banks, MFIs and NBFIs in Kosovo and (iii) KCGF.

C. Results Chain

Figure 5. Financial Sector Strengthening Project results chain to improve access to finance for MSMEs.



D. Rationale for Bank Involvement and Role of Partners

43. **Information asymmetries and market failures require public sector involvement supported by IFIs.** MSMEs in Kosovo are faced with constraints in accessing financing due to high informality, unclear property rights and weak judicial system which contributed to conservative lending practices and the risk aversion of banks. The same reasons also discouraged the investors to establish a private guarantee scheme as it is the case in most of the developing countries. This situation required a public-sector intervention and hence the KCGF was established in 2016 as an independent, legal institution. By the Law, the KCGF can only accept funds from the government, IFIs and donors, and cannot borrow from registered financial institutions. Accordingly, IFI intervention to expand the capital base and strengthen institutional capacity of the KCGF is well-justified and will contribute to eliminate above-mentioned market failures.

44. **The WB is a globally-recognized standard setter for public credit guarantee schemes.** The WB includes international experts working on the credit guarantee schemes. The WB recently issued "Principles for Public Credit Guarantee Schemes (CGSs) for SMEs[6]" which sets standards for Public CGS on legal and regulatory, corporate governance, risk management, operational, monitoring and evaluation issues. In addition, the WBG's advantage is that it combines long-term funding and institutional strengthening services. The WBG has worked on partial credit guarantees in a number of countries recently including Laos, Saudi Arabia and the Eastern Caribbean Currency Union. These projects span through both capitalization and technical assistance.

45. **The WB has collaborated with USAID, KFW and SIDA in the design of the Project to date.** The USAID played an important role during the establishment of the KCGF and provided financial support for current expenditures till the end of 2018. KFW has been providing capital and capacity building to the institution. SIDA also supported the credit guarantee framework by providing a secondary guarantee to the KCGF. All three institutions have observer seats at the Board of the KCGF. Throughout the preparation process, the Project team worked closely with these partners to identify complementarities and refrain from duplications. The Project team met with above mentioned representatives throughout the Project design and benefited from their comments and experience.

46. **The IFC is also considering partnering with the KCGF as part of the Small Loans Guarantee Program (SLGP) and support the Project**. The IFC is working with private banks in Kosovo and complementing the existing credit guarantee schemes. The Project benefited from the SLGP's experience in the country both in project design and technical specifications including pricing. Furthermore, the IFC is considering cooperating with the KCGF to offer additional guarantee for the strategic window in line with the Project's objectives.

[6] http://www.worldbank.org/en/topic/financialsector/publication/principles-for-public-credit-guarantee-schemes-cgss-for-smes

E. Lessons Learned and Reflected in the Project Design

47. **The Implementation Completion Report (ICR) for the Financial Sector Strengthening and Market Infrastructure Project (FSSMIP) included important lessons for financial sector projects in Kosovo.** The ICR highlighted that it is important to fully assess all required actions during the preparation stage of a project and identify and assess the implementing agency's internal capacity to execute or manage all required functions. Accordingly, the project team launched its activities with a mission focusing on diagnostic assessment of the KCGF. The findings were reflected in the PAD and used to design the Project components. In particular, the diagnostic was used to define the areas to be included in the institutional strengthening component. Similarly, the ICR identified project implementation problems in the context of a fragile and post-conflict environment given the capacity constraints and institutional uncertainties. Accordingly, the Project includes a component to improve implementation capacity in the KCGF including on procurement, financial management and environmental and social safeguards. In addition, during the Project design interviews were conducted with private sector representatives to better understand Kosovo context and determine the underserved and strategic segments.

48. **Lessons learned from similar WBG projects contributed to the Project design.** These include recent experiences in Jamaica, Papua New Guinea, Jordan, Sri Lanka, Ghana, Croatia and Organization of Eastern Caribbean States. These projects in developing countries provided insight into the specific challenges for new or struggling partial credit guarantee schemes. Capacity constraints in risk management and monitoring and evaluation were among critical factors for functioning guarantee frameworks in the developing country context. As a result, they were included as an important part of the institutional capacity building component.

49. **The Project also benefited from international experience.** The WB's Principles for Public Credit Guarantee Schemes (CGSs) for SMEs were a useful framework for assessing the existing credit guarantee framework in Kosovo at the initial stage. Additionally, besides consultations with other IFIs, on determining the suitability of the partial credit guarantees as an instrument to support the MSME growth, the Project started with a literature review[7] for global experience and benefited from Vienna Initiative's and EIB's regional studies.

[7] For global results see Beck, T., Klapper, L. F., & Mendoza, J. C. (2010). For Canada see Riding, A. L. (1997). For the Middle East see Saadani, Y., Arvai, Z., & Rocha, R. D. R. (2011). For Latin America see Larraín, C., & Quiroz, J. (2006). For general global principles see Honohan, P. (2010)

III. IMPLEMENTATION ARRANGEMENTS

A. Institutional and Implementation Arrangements

50. **The KCGF will be responsible for the implementation of the Project.** KCGF is a local, independent, sustainable, credit guarantee facility established in 2016 by the Law on Establishment of KCGF. KCGF enjoys full operational and administrative autonomy and functions outside the framework of the Kosovo governmental structures and the Kosovo Civil Service. Based on the Law the KCGF offers credit guarantees to Registered Financial Institutions on selected loans to MSMEs. The Board of Directors oversees the KCGF and its strategic objectives. Due to limited capacities of KCGF, Component 2 of the project is designed to provide support for Project implementation through hiring of experts to carry out procurement, financial management and monitoring and evaluation processes including for environment and social safeguards as well as for reporting on the use of funds and activities. Implementation support will be provided by the WB throughout the Project and will include regular implementation support missions and a midterm review.

51. **The Project is designed to provide capital injection to KCGF, support KCGF in designing and piloting new products for underserved segments and support Project implementation.** The disbursement schedule will take into account a larger capital injection to the KCGF at the beginning of Project implementation. An interinstitutional agreement between MoF and KCGF will be signed.

B. Results Monitoring and Evaluation Arrangements

52. **The KCGF will monitor and evaluate progress towards achieving the PDO.** The KCGF will be responsible for monitoring and evaluating the PDO-level and intermediate results indicators for the Project by providing semi-annual and annual Project Reports as described in the results framework. Further, as a legal body, the KCGF also has its own reporting requirements to its Board. Further details on the results framework are in section VII and in Annex 2. In addition, the Project will include a citizen engagement (CE) survey to loop in feedback from beneficiaries of the Project.

C. Sustainability

53. **The Government remains committed to improving access to finance for MSMEs to support private sector growth agenda.** The Government established and capitalized the KCGF as part of the 2017-2019 Economic Reform Program's 12th reform measure "Improved access to finances for SMEs through the Kosovo Credit Guarantee Fund". Plans for further enhancement of the KCGF through partnerships with IFIs were reiterated in the 2018-2020 Economic Reform Program. In addition to being the main borrower and granting the funds to KCGF, the Government agencies are (Ministry of Finance and Ministry of Trade and Industry) actively supporting and overseeing the operations of KCGF as they have two seats at the Board of the institution.

IV. PROJECT APPRAISAL SUMMARY

A. Technical, Economic and Financial Analysis (if applicable)

54. **The net present value of the Project is estimated to be around EUR100 million.** IFC MSME Financing Gap Estimates (2017) indicate that 33 percent of MSMEs are financially constrained with an estimated financial gap of at least EUR305 million. Assuming that EUR21.5 million of additional capital will be used to provide PCGs to around 3700 firms (assuming 2.5:1 leverage, average loan size of EUR35,000 and 50 percentage guarantee) as targeted, the total amount of loans provided to MSMEs will reach to EUR130 million over 4 years. The present value of this would be around EUR100 million contribution to addressing the financing gap assuming no change in the coverage ratio and 10 percent annual discount rate. As KCGF is responsible to cover the losses and additional cost of capital is zero (MoF transfer the funds to KCGF as grant), only the portion of expected losses is used to adjust these positive inflows. Furthermore, there are externalities beyond this calculation from capacity building activities.

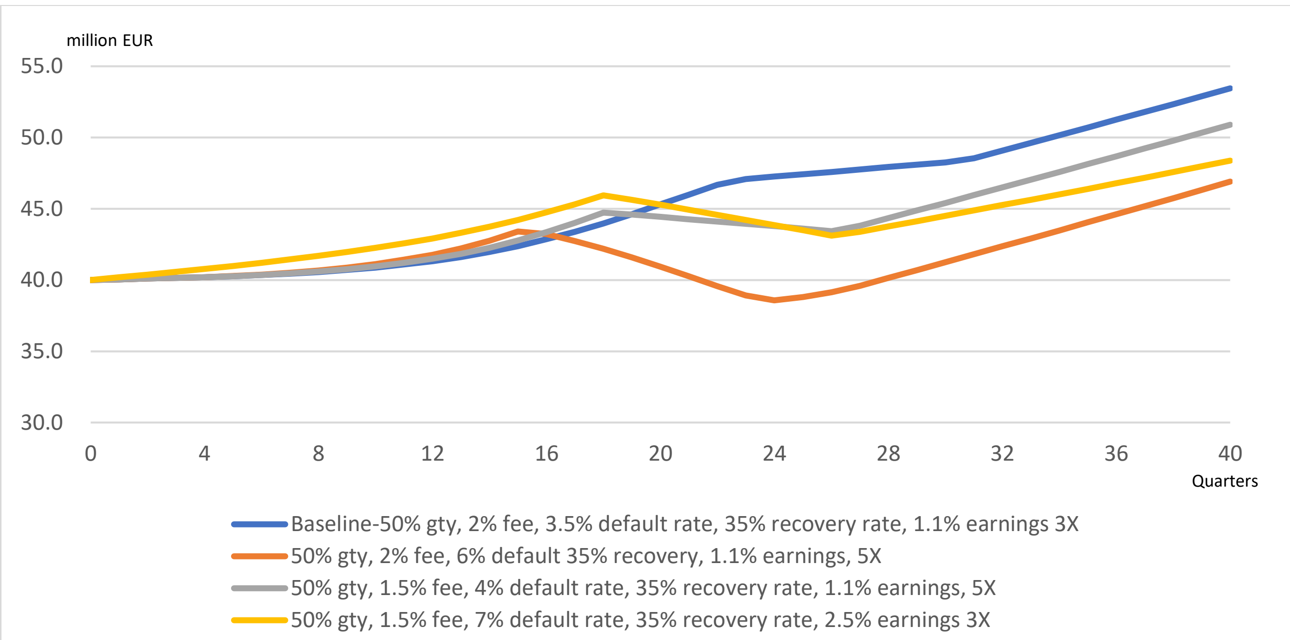
55. **The economic benefits of the Project can be measured in terms of additionality.** On financial front, the DEC study reveals that the partial guarantee scheme positively affects credit conditions for MSMEs in Kosovo through extended maturities, lower collateral requirements and interest rates (Table 1). Although it is hard to measure given the data constraints, the Project is also expected to provide economic additionality in terms of firm-level employment, asset size growth and promoting innovation. Indeed, experience with properly designed and implemented credit guarantee schemes in various countries show clear economic benefits of these schemes. A recent WB research by Abraham and Schmukler (2017) indicated that guaranteed loans increased employment in the United States and Eastern Europe, improved sales and survival rates in the Republic of Korea and resulted in higher growth rates in France.

56. **As per the WB team's assessment the KCGF is a well-established and financially self-sustaining institution.** Costs to supporting the scheme are favorable since the MoF will provide a grant to the scheme that will be financed by the WB. A detailed financial model was built to understand the risks to KCGF's financial sustainability[8]. The key risks to financial sustainability are leverage, the default rate, the recovery rate on defaulted guarantees, the guarantee coverage and the fees for guarantees. According to the Project team's analysis, the scheme is financially self-sustaining for at least next 10 years, assuming full deployment of its capital. Under the assumptions of return, loss and operating costs akin to the baseline scenario, KCGF remains financially sustainable with the capital growing reaching EUR53 million in ten years with a grant from the Kosovo Government financed by the World Bank (Figure 6). With 5 times leverage, the capital will increase by 15 percent, even using a higher default rate and maintaining the 1.1 percent earnings rate. This demonstrates that there is room to provide improvements through product differentiation that will encourage lenders to increase

[8] Model was developed for OECS MSME Guarantee Facility (P157715) and tailored for the purposes of this Project.

participation. The guarantee fee can be lowered to 1.5 percent, the default rate can be increased from 3.5 percent to 4 percent and the capital will still increase about 20 percent over the 10-year period. This remains true even if the leverage is increased to 5. Assuming a loss rate of about twice the current bank loss rate would permit KCGF to guarantee almost EUR200 million of lending. Even in times of economic distress resulting in a higher loss rate, the scheme can remain in operation. Assuming the default rate increases to 7 percent which results in a loss rate more than three times the current loss rate of banks, and including staff costs, KCGF would retain about EUR48 million in capital after 10 years. In such a scenario, it is likely that investment returns would increase, and leverage would decrease, which have been included in this model (3x leverage and 2.5 percent investment return) (see Figure 6 for all scenarios). By its design, if the capital level declines to an unsafe level, issuing additional guarantees can be stopped which would permit the capital to grow using investment earnings. Importantly, the Project is designed to ensure capacities are strengthened and remain with KCGF during and after the Project implementation process through establishment of internal processes related to monitoring and evaluation, environmental and social impact, and risk management.

Figure 6. KCGF capital projections, after injection, under different scenarios over the next 40 quarters (EUR million)



B. Fiduciary

(i) Financial Management

57. **An financial management (FM) assessment has been carried out to determine the FM implementation risk and help establish adequate FM arrangements for the proposed operation**. The overall FM risk is

moderate. KCGF will assume fiduciary responsibility for the Project. Bank policies and procedures on FM and disbursements require that the KCGF maintain FM arrangements that are acceptable to the Bank and that, as part of the overall arrangements for implementing the operation, provide reasonable assurance that the proceeds of the loan are used for the intended purposes.

58. **The credit proceeds will be disbursed based on the regular IPF disbursement mechanism using traditional disbursement methods such as advances, reimbursement and direct payments**. The financing proceeds will be disbursed through two Euro denominated Designated Accounts (DAs) which will be managed by KCGF. A DA will be maintained in the Central Bank of Kosovo (CBK) for advances with respect to Part 1, and the other will be maintained in a commercial bank, acceptable to the WB, for handling payments under Part 2 activities. KCGF will be accountable for withdrawing credit proceeds through its authorized signatures. The Project will include retroactive financing up to an amount of EUR100,000 for payments made after January 1st, 2019 for eligible expenditures under category 1 of the disbursement table.

59. **Semiannual accrual-basis IFRs covering all Project activities and audited KCGF financial statements will be submitted for the Bank's review not later than 45 days from the end of the semester and 6 months from the end of the year, respectively**. KCGF audited annual financial statements prepared in accordance with International Financial Reporting Standards will be required. The financial statements will contain adequate disclosures on the Project operations, its financial position and financial performance and cash flow statement. The audits will be conducted annually by independent auditors acceptable to the Bank based on International Standards on Audit (ISA). The audit reports would be provided to the Bank within six months after the end of each fiscal year. No separate audit report for the Project will be needed. The audit reports would be made publicly available, as per the WBG Policy on Access to Information.

(ii) Procurement

60. **KCGF Senior Legal Officer and Senior Financial and Office Manager, both cover the procurement function within the agency.** The procurement activities of the KCGF are therefore conducted based on their own agency procurement procedures not according to the Kosovo Public Procurement Law, as it is an independent institution. As the agency is new, the staff involved in procurement have limited experience in procurement in general. The agency's procurement regulations differ from the Bank's Procurement Regulations. The team discussed with KCGF staff the Procurement Regulation applicable to the Project, as well as the features of the PPSD that apply under this Project. As mitigation measure, a local procurement specialist with knowledge on Bank's procurement would need to support the procurement activities of KCGF.

61. **Procurement will be carried out according to the WB's Procurement Regulations for Investment Project Financing Borrowers' (the Regulations), issued in July 2016, revised Nov 2017 and Aug 2018 for the supply of goods, works, and non-consulting and consulting services, and provisions stipulated in Financial Agreement**. The Guidelines on Preventing and Combating Fraud and Corruption in Projects Financed by IBRD Loans and IDA Credits and Grants, dated October 15, 2006 and revised in January 2011 and as of July 1, 2016,

shall also be observed. The Project will use the Systematic Tracking of Exchange in Procurement (STEP) system. The STEP is a planning and tracking system, which will provide data on procurement activities, establish benchmarks, monitor delays and measure procurement performance.

62. **Based on procurement capacity assessment conducted for KCGF, it was determined that the procurement risk is High**. The identified risk and the mitigation measures are detailed in the PPSD, which is summarized in Annex 1 of this PAD. A Project Procurement Strategy for Development (PPSD) was prepared to outline the selection methods to be followed by the borrower during Project implementation for procurement of goods, works, and non-consulting services and consulting services financed by the Bank. The underlying Procurement Plan will be updated at least annually or as required, to reflect the actual Project implementation needs and improvements in institutional capacity.

C. Safeguards

(i) Environmental Safeguards

63. **The design of the Project,** specifically activities under the Component 1: Enhancing the Credit Guarantee Framework which will increase the capital base of the KCGF (Subcomponent 1.1 Increasing the capital base of KCGF) and expand the range of products offered (Subcomponent 1.2 Establishing a window for underserved and strategic segments) calls for FI category. Under both subcomponents the KCGF will issue guarantees for MSMEs contracted at PFIs (commercial banks). Targeted MSMEs are those residing in Kosovo, that are viable, but do not have enough collateral and/or credit history. As it will be possible to distinguish guarantees issued from the capital base increase, subject of adherence to the WB Safeguard Policy will be only for KCGF guaranteed subprojects (loans) approved hence guarantees issued from the capital base increase by the WB. All economic sectors are eligible, except those on KCGF and the WB exclusion list which are compatible. Given that the maximum guaranteed single loan under the scheme is EUR1,000,000, no large infrastructural investments are expected. High-risk and category A projects are excluded from financing.

64. **The project triggers only Environmental Assessment (OP/BP 4.01)** for environmental aspects of eligible activities possibly supported under the Component 1. While the Subcomponent 1.1 does not specify eligible sectors, under the Subcomponent 1.2 focuses on strategic sectors which, amongst other, include women in business, start-ups and other (production, energy efficiency). The environmental aspects include wastewaters, emissions, earthworks, occupational health and safety, community health, and more. KCGF prepared a process Environmental and Social Management Framework (ESMF) to ensure their adequate and efficient environmental management. ESMF document provides guidelines and procedures for environmental due diligence of the Project activities implemented by KCGF within capital base increase by the WB, PFIs and final users of guaranteed loans. Project exclusion list is defined in the ESMF in order to avoid triggering of other policies or category A projects. Projects triggering OP 7.50 Projects on International Waterways, OP4.04 Natural Habitats and other environmental and social OPs are not eligible.

65. **Only B and C category projects will be supported;** B+ category will be assigned to larger investment, those are included in Annex II of Kosovo EIA legislation, provided Ministry of Environment and Spatial Planning decision that no EIA is needed for the proposed sub-project, while B- encompass rehabilitation works, small civil works, small construction, adaptation and similar.

66. **The ESMF was prepared by the KCGF, satisfactory to the WB and publicly consulted in Albanian, Serbian and English languages before appraisal**. The ESMF with the call for comments and public consultations meeting announcement was disclosed on February 12, 2019 on the KCGF website (*http://www.fondikgk.org/sq/lajme* , hard copy available at premises). In addition to the public call through KCGF website, the government and relevant non-governmental organizations were invited through official invitations sent out by the KCGF and PFIs. Public consultation meetings were held on February 22, 2019. ESMP Checklists and site specific ESMPs prepared during this Project were disclosed, in Albanian, Serbian and English, on KCGF website for 14 days with calls for comments. The environmental document has integrated and addressed all relevant comments.

(ii) **Social (including Safeguards)**

67. **Social safeguards*:*** Sub-projects that require involuntary land acquisition and/or resettlement will not be eligible for financing under the Project**.** Thus, the policy on Involuntary Resettlement (OP/BP 4.12) is not triggered**.** Given the nature of the qualifying sub-beneficiaries (100 percent privately owned MSMEs), involuntary land acquisition is an unlikely risk. The Project provides capital injection to the KCGF to enable it to increase its provision of partial credit guarantees to be provided by eligible financial institutions (FIs) to MSMEs in Kosovo. The partial credit guarantees will be provided to specific credit applications submitted to FIs. The ceiling of credit lines eligible for partial guarantees under the project will be EUR500,000. Some of the activities engaged by beneficiary MSMEs may be simple building upgrades, small construction (adding annex to buildings), and rehabilitation of existing buildings for the sake of expanding business activities. Sub-projects that may involve involuntary land acquisition and associated impacts on livelihoods and assets will be explicitly deemed ineligible by means of a screening process defined in the Environmental and Social Management Framework (ESMF). The KCGF (and PFIs, if necessary) will provide training on WB Safeguards Policies, including the Bank's OP 4.12 on Involuntary Resettlement, in order to reduce the risk of non-compliance with OP 4.12.

68. **Citizen engagement:** As part of Project preparation, numerous stakeholders were consulted including MoF, MTI, MSMEs from a variety of sectors, representatives from business associations, central bank, donors, IFIs, and commercial banks were consulted on a number of regulatory and practical barriers to improving access to finance in Kosovo. These extensive consultations were used to inform the current Project design. During implementation, the Project will assess the MSMEs beneficiaries' satisfaction with Projects' interventions aimed at improving their access to finance through surveys administered at the beginning, mid-term and project end. Their satisfaction will be tracked with a correlated citizen engagement indicator included in the results framework. KCGF will publish the survey results and organize workshops to discuss the findings with project stakeholders and beneficiaries. In addition to PFI's existing complaint mechanisms, the KCGF will establish a

Grievance Redress Mechanism (GRM) within three months of project effectiveness to address any concerns related to the project that anyone can bring, including beneficiary MSMEs and their host communities. Information about the project GRM will be made available on the KCGF website, at public consultations, and workshops.

69. **Other Safeguards:** Communities and individuals who believe that they are adversely affected by a WB supported project may submit complaints to existing Project-level grievance redress mechanisms or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address Project-related concerns. Project affected communities and individuals may submit their complaints to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the WB's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the WB's corporate Grievance Redress Service (GRS), please visit http://www.worldbank.org/en/projects-operations/products-and-services/grievance-redress-service. For information on how to submit complaints to the WB Inspection Panel, please visit www.inspectionpanel.org.

V. KEY RISKS

70. **The overall Project risk is substantial.** The risk assessment is influenced mostly by an overall weak political and institutional environment. Political risk is assessed as high and it can affect the Project's expected effectiveness date if a prolonged political uncertainty akin to the one after 2017 elections occurs.

71. **Political and governance risk is high**. Political and governance risk is considered high. The Project has a planned support to enhance the capacities of the KCGF in strengthening further its corporate governance to address this risk. However, frequent political changes may affect Board representation of MoF and MTI at the KCGF and KCGF may be prone to external interferences. The robust legal statue regarding the independence of KCGF and high donor presence in the Board of KCGF is expected to mitigate this risk.

72. **Macroeconomic risk is moderate.** An important precondition for guarantee schemes is a sound and stable financial sector. Financial sector risks are low at present. Yet, credit growth is significantly influenced by external developments as almost 90 percent of banking sector assets are foreign owned. The CBK has been working on strengthening the supervisory and crisis management framework to mitigate financial stability risks with the support of the WB and the IMF. Kosovo is one of the countries with the highest growth rate in the region. The financial sector in Kosovo has not been affected largely by the financial crisis and the NPLs remain the lowest in the region.

73. **Sector strategies and policies risk is low.** The KCGF provides portfolio-based guarantees with the individual banks that have signed formal guarantee agreements which stipulate terms and conditions. CBK has revised its regulation on risk weighting by reducing the weighting for guaranteed portfolio of banks. This

regulation is expected to increase banks absorption capacity and risk appetite.

74. **Technical design of Project risk is low**. The Project will support an already established and well-run institution through capital injection that will be disbursed in tranches. The KCGF intends to draw down on the capital component of the loan in tranches, maintaining their conservative approach to gradually increase the leverage ratio. The MoF is the borrowing agency while KCGF is the implementing agency. MoF will grant the funds to KCGF and will borne the costs of loan repayment to the Bank. This arrangement will be prescribed through an intermediary agreement between MoF and KCGF.

75. **Institutional capacity for implementation and sustainability risk is moderate**. The risk is fully dependent on the caliber of the Board of Directors and of the team members selected to operate the KCGF. The Law on KCGF provides specific requirements for the Board and Directors of KCGF including their fields of expertise. Experience since KCGF's establishment has been good to date. The Managing Director and all the team members are well trained and well qualified. They are responsible for maintaining the policies that are necessary for the scheme to remain financially viable while serving the MSMEs. The Project will support recruitment of expertise related to procurement, financial and risk management, marketing and outreach and internal processes related to monitoring and evaluation and environmental and social impact.

76. **Fiduciary risk is substantial.** Although the procurement activities and FM functions envisaged in the Project are simple, the fiduciary risk is substantial due to limited systems related to procurement and financial management.

77. **Environment and social risk is moderate.** The Project triggers WB environmental policy OP. BP 4.01. An ESMF was prepared by the client. The Project will support only category C and B subprojects. The capacity of the KCGF and PFIs will be built over the project implementation. KCGF will hire environmental specialist to support capacity building of PFIs.

78. **Stakeholder risk is low.** The stakeholders are MoF, KCGF, CBK, MTI and donors USAID, KfW and SIDA. Improving access to finance is one of the key objectives of all the stakeholders involved. The team has been coordinating closely with the government counterparts and relevant donors throughout the Project design.

VI. RESULTS FRAMEWORK AND MONITORING

Results Framework
COUNTRY: Kosovo
Kosovo Financial Sector Strengthening Project

Project Development Objectives(s)

The objective of the Project is to improve access to finance for Micro, Small and Medium Size Enterprises by strengthening the financial and technical capacity of the Kosovo Credit Guarantee Fund.

Project Development Objective Indicators

Indicator Name	DLI	Baseline	Intermediate Targets				End Target
			1	2	3	4	
Improved access to finance for MSMEs							
Total amount of guaranteed loans through Project (Number)		0.00	20,000,000.00	45,000,000.00	75,000,000.00	130,000,000.00	130,000,000.00
Number of Guaranteed Loans (Number)		0.00	570.00	1,300.00	2,140.00	3,700.00	3,700.00

Intermediate Results Indicators by Components

Indicator Name	DLI	Baseline	Intermediate Targets				End Target
			1	2	3	4	
Enhancing the Credit Guarantee Framework							

Indicator Name	DLI	Baseline	Intermediate Targets				End Target
			1	2	3	4	
Number of MSMEs receiving guaranteed loans through project (Number)		0.00	400.00	800.00	1,300.00	2,000.00	2,000.00
Share of guarantees issued to firms with no credit history (Percentage)		25.00					30.00
Share of guarantees issued to women owned or managed MSMEs (Percentage)		0.00					5.00
The ratio of outstanding guarantees to equity (Text)		0.00					below 2.5
Proportion of guarantees paid-out (Text)		0.00					below 5 percent
Percentage of beneficiaries that feel project activities reflected their needs (Citizen Engagement Indicator) (Percentage)		0.00					75.00
Project Implementation and Institutional Strengthening							
Procurement, Financial Management and Environmental Monitoring capacity of the KCGF is improved (Text)		No distint functions for procurement, FM and environment					Procurement, FM and environmental specialists are hired.
Number of loan officers trained (Number)		0.00					600.00

Monitoring & Evaluation Plan: PDO Indicators					
Indicator Name	**Definition/Description**	**Frequency**	**Datasource**	**Methodology for Data Collection**	**Responsibility for Data Collection**
Total amount of guaranteed loans through Project	This is the total amount of loans guaranteed by the KCGF during the Project to lenders (in Euros). This will be tracked cumulatively and will include outstanding, expired or cancelled loans.	Semi-annual	Project Report		KCGF
Number of Guaranteed Loans	This will be calculated as the cumulative number of guaranteed loans approved by the KCGF, a given share of which will be targeted to women. The KCGF will track approved guarantees, expired or cancelled guarantees, and the net number of guarantees used. .	Semi-annual	Project Report		KCGF

Monitoring & Evaluation Plan: Intermediate Results Indicators					
Indicator Name	**Definition/Description**	**Frequency**	**Datasource**	**Methodology for Data Collection**	**Responsibility for Data Collection**
Number of MSMEs receiving guaranteed loans through project		Semi-annual	Project Report		KCGF

Share of guarantees issued to firms with no credit history		Annual	Project Report		KCGF, CBK Credit Registry
Share of guarantees issued to women owned or managed MSMEs	Share of guarantees issued to women owned or managed MSMEs	Annual	Project report	CGF K	KCGF
The ratio of outstanding guarantees to equity	the ratio of outstanding guarantees to equity will be used to measure stability. The ratio is aimed to be kept under 2.5 through out the project.	Semi-annual	project report		KCGF
Proportion of guarantees paid-out	The ratio of guarantees paid out to total guarantees provided. The target is to keep this ratio below 5 percent through out the Project.	Semi-annual	Project Report		KCGF
Percentage of beneficiaries that feel project activities reflected their needs (Citizen Engagement Indicator)	A survey will measure the satisfaction of the Project's final beneficiaries regarding the activities implemented under the project. During mid-term review and every year after that, the KCGF will organize workshops targeting different project stakeholders or beneficiaries. Workshops will be organized taking into account the type of product or activity and the type of	Annual	Project Report		KCGF

	beneficiary. To measure the level of satisfaction among the beneficiaries, the KCGF will develop a set of questions and other tools with the support of the WB team. Field visits and interviews will also be considered.				
Procurement, Financial Management and Environmental Monitoring capacity of the KCGF is improved					
Number of loan officers trained	Number of loan officers (of financial institutions including banks and MFIs) trained by KCGF.	Annual	Project Report		KCGF

ANNEX 1: IMPLEMENTATION SUPPORT PLAN

COUNTRY: Kosovo
Kosovo Financial Sector Strengthening Project

Project Implementation Support Plan

1. **The implementation support plan was developed considering that KCGF is a new institution with limited capacity in terms of staff and resources.** The primary implementation support will be providing ongoing technical assistance to the KCGF and its team. While the Project Operational Manual contains a substantial amount of details and is intended to be a road map for daily operations, it is likely that the team may seek additional guidance on specific items discussed in the manual.

(a) **Technical support:** An Environmental Specialist will be recruited to support strengthening of the capacities within KCGF and member PFIs. Other technical support areas include financial, information technology systems, risk assessment.

(b) **Procurement:** A Procurement Specialist will provide ongoing guidance during the design and implementation phase of the Project. While guidance is provided in the Project Operational Manual KCGF will be able to reach out to the WB team for guidance.

(c) **Financial Management:** A Financial Management Specialist will provide implementation support to the KCGF and especially to the Financial Officer.

(d) **Operations:** The WB will provide implementation support to the team members of the KCGF as issues arise.

(e) **Safeguards:** The Environmental Specialist will provide support and ongoing guidance to the KCGF regarding environmental safeguards including the application of the guidance included in the ESMF. In addition, the Specialist will participate in Project implementation support missions and site visits.

2. **The Implementation Support Plan will be reviewed periodically to ensure that it continues meeting the implementation support needs of the Project.**

Implementation Support Plan and Resource Requirements

Time	Focus	Skills Needed	Resource Estimate	Partner Role
First year	Implementation	TTL / Financial Sector Specialist	12	

	Procurement	Procurement specialist	4	
	Financial Management	FM specialist	8	
	Safeguards	Environmental specialist	6	
	Operations support	Operations officer	6	
	Technical support	Financial Sector Expert,	15	
12–60 months	Ongoing Operations	TTL / Financial Sector Specialist	32	
	Procurement	Procurement specialist	8	
	Financial Management	FM specialist	16	
	Safeguards	Environmental specialist	12	
	Operations support	Operations officer	8	

	Resource Estimate (total)	Partner Role
First year	51	
12–60 months	76	

Skills Mix Required

Skills Needed	**Number of Staff Weeks**	**Number of Trips**	**Comments**
Team Leader/ financial sector specialist	44	10	
Procurement specialist	12	4	
FM specialist	24	6	
Environmental specialist	18	6	
Financial Sector Expert	15	4	

Technical support	18	3

ANNEX 2: IMPLEMENTATION ARRANGEMENTS

Project Institutional and Implementation Arrangements

1. **Kosovo Credit Guarantee Fund (KCGF) will be the implementing agency for this Project.** KCGF has been established as an independent, autonomous legal entity by the Law No.05/L-057 on establishment of KCGF approved in December 2015. KCGF has been fully operational since 2016. The KCGF will be responsible to coordinate, implement, supervise, finalize, and document all the activities related to the Project. The KCGF will designate a small team of relevant staff (the Project Implementation Team) led by the KCGF Managing Director. The Project will finance recruitment of Procurement Specialist, Financial Management Specialist and Environmental Specialist to support Project implementation.

Staffing

2. **The KCGF will hire an Environmental Specialist, FM Specialist and a Procurement Specialist, who will be responsible for the overall respective aspects of the Project**. The hiring of the above-mentioned staff will strengthen KCGF capacity to enable Project implementation. The WB team will provide input to the TORs and assess the qualifications of the selected staff to ensure that they are capable to perform the expected functions. The WB team will provide hands-on training on the World Bank's policies and guidelines to the newly selected staff.

Financial Management

3. **An FM assessment has been carried out to determine the FM implementation risk and help establish adequate FM arrangements for the Project**. The overall FM risk is moderate. KCGF will assume fiduciary responsibility for the project. Bank policies and procedures on FM and disbursements require that the KCGF maintain FM arrangements that are acceptable to the Bank and that, as part of the overall arrangements for implementing the operation, provide reasonable assurance that the proceeds of the loan are used for the intended purposes. The existing arrangements are considered adequate for Project implementation; however, there are areas that require further strengthening and need to be addressed before Project implementation starts, such as:

(i) Establish financial management procedures, including planning, budgeting, accounting, internal control, funds flow, financial reporting, and auditing arrangements and document as part of the POM. The POM will describe the roles and responsibilities of MoF in the implementation of the Project and KCGF reporting requirement to MoF.
(ii) Establish separate windows in the KCGF's MIS for Component 1 operations and trace separate Project transactions in Navision.
(iii) KCGF will recruit a Financial Management Specialist to support the Head of Finance and Internal Operations in the implementation of FM requirements for the Project and
(iv) Provision of continuous training and support on Bank FM and disbursement procedures for both the FM Specialist and staff in the Finance department.

4. **Use of country systems:** The Project would rely on some elements of Kosovo's public FM systems, specifically (i) planning and budgeting. Kosovo has participated in several detailed reviews of its PFM, among them a series of central government PEFA assessments (2007, 2009, and 2015); a municipal PEFA (2011); a country fiduciary review (2012); annual EU-SIGMA reviews; and other analyses by the World Bank. The various reviews have plotted the significant progress Kosovo has made in improving PFM. The Country Fiduciary Assessment conducted in March 2012 showed that key strengths include the sound legal framework, the integrated central Treasury system, and an increasingly effective external audit office. The strengths are offset by limited professional capacities and gaps in implementation. There is considerable scope for improving budget planning and preparation, internal financial control, audits, debt management, and capital investment management. The authorities are aware of these limitations, and progress is occurring with support from donor community. Lagging areas include (i) limited coordination of budgets, MTEF, sector plans, and budget ceilings; (ii) budget preparation that is not fully linked with Treasury systems; and (iii) FM control and audits that are not fully effective.

5. **Implementing agencies and the FM staff:** The Project's financial management will be the responsibility of the KCGF's Finance and Internal Operations (FIO) department. Though a relatively new institution, KCGF has established a governance model adequate for its size and complexity operations, including board oversight, management structure, and operational, financial, risk management and reporting policies. KCGF organization structure properly defines, authority line, roles and responsibilities of departments and employees. KCGF demonstrates through the quality of the audited financial statements to have implemented sound financial management practices. The Head of the Finance department is well experienced with donor financial management requirements, since KCGF has implemented previous donor supported activities. However, currently the function is covered only by one staff. As the operations are expected to scale up following the capital increase, in addition to the implementation envisaged project activities, it is sensible to hire an additional full time FM staff, that will report to the FIO Director. In addition, it will provide a response to increased financial management risk due to lack of segregation of duties.

6. **The FM Specialist will provide support on payments ex-ante controls, planning and budgeting activities, preparation of quarterly IFRs and other reporting, and withdrawal applications**. Both FIO Director and the new FM Specialist could avail of available project financial management courses, in addition to, tailored on the job training and workshops organized by the WB WFA and FM community.

7. **Close coordination between KCGF and MOF is envisioned for the proposed operations**. The relationship between KCGF and MOF will be regulated in a Subsidiary agreement, whereby budgeting, allocation and reporting requirements for the operations will be described. Project annual disbursement forecast should be reflected in the medium-term budget framework and annual budget, as well as annual budget allocation.

8. **Budgeting**. In general, the mechanisms for budgeting and opening the budget (release of funds) in MoF are considered adequate for the needs of the proposed Project. The MoF budget instructions guide budget and planning preparation process. KCGF would be responsible to prepare annual Project budget plans and forecasts

will be based on approved project implementation plan and procurement plan. These budgets would form the basis for allocating funds to Project activities. To mitigate the risk pertaining to insufficient or untimely budgetary appropriation and allocations, MOF and KCGF should coordinate in a timely and effective manner and ensure a realistic Project budget and forecast, prepared as above, are included in the MTEF and the Annual Budget Law, beginning in the year the Project is expected to become effective. Project estimates have been included in the draft annual budget for 2019. The annual budget preparation process will be monitored by the Bank team.

9. **Internal controls.** While KCGF internal control framework is comprehensive, including operations, FM, procurement personnel, investment and provisioning policies. Financial management policy is complete, however is not detailed at the level of processes, control activities, and roles and responsibilities. The KCGF is committed to maintaining an effective internal control system to ensure that Project expenditures are properly verified and authorized; supporting documents are maintained; accounts are reconciled periodically; and Project assets, including cash, are safeguarded. The Financial Management Manual, part of the POM, will describe the FM, disbursement and internal controls policies and procedures, intended to guide staff and minimize the risk of errors and omissions, as well as delays in recording and reporting. These written standards are to clarify segregation of duties and responsibilities, including level of authority, clear control over funds and assets, and it ensures timely and accurate financial reporting. Special attention will be given to provide clarity on roles and responsibilities between MoF and KCGF for the implementation of project, and respective reporting requirements.

10. **Accounting System**. KCGF is using Navision for their accounting and financial reporting purposes. This system is linked with the KCGF management information system. Navision is adequate for keeping accounting records of project financial transactions, resources and uses. The Project transactions, bank accounts, assets and liabilities, may be separately identified and tagged, through the chart of accounts and dimensions.

11. **KCGF has in place a modern MIS system for the management of guarantee operations**. Separate windows can be created for part 1.1 and part 1.2 of the Project (segregation required based on the Bank safeguard policies) and the related financial information may be transferred to accounting system. Therefore, the segregation is ensured through the tracking functionalities of the information systems in place, by tracking transactions related to Bank operations and reporting separately.

12. **Financial reporting**. The Interim un-audited Financial Reports (IFRs) will be submitted on semiannual basis to the Bank within 45 days after the end of each semester. These reports will be prepared on accrual basis based on the financial information registered in the KCGF accounting system and will contain at least the following: (i) statement of financial position, (ii) statement of financial performance, (iii) statement of sources and uses of funds (with expenditure classified by disbursement category), (iv) contract monitoring, and (v) bank account statements. The periodic IFRs will ultimately reconcile with the annual financial reporting for the Project. The format and content of IFRs will be part of the POM. In addition, the IFRs will be submitted to MoF in compliance with reporting requirements to be established in the subsidiary agreement.

13. **KCGF audited annual financial statements prepared in accordance with International Financial Reporting Standards will required**. The financial statements will contain adequate disclosures on the project operations, its financial position and financial performance and cash flow statement. Notes to the financial statements will include financial and non-financial disclosures related to the project transactions, including a summary of expenditures paid, disbursements, assets and liabilities The entity financial statement prepared as above are considered adequate for project purposes as they reflect project operations, resources and uses of funds. Financial reporting period will cover the government's fiscal year, which coincides with the calendar year. The functional and reporting currency is Euro.

14. **Audit**. The KCGF financial statements as described above will be audited annually and audit report will be submitted to the Bank not later than 6 months from the end of the year. The KCGF's financial statements prepared based on International Financial Reporting Standards (IFRS) are audited annually and submitted to its Board of Directors. The most recent KCGF's audit report presents a true and fair opinion. The audits will be conducted annually by independent auditors acceptable to the Bank based on International Standards on Audit (ISA).. The audit reports would be made publicly available within two months from their issuance, as per the WBG Policy on Access to Information.

Disbursements

15. **The Project would be financed entirely by an IDA financing.** The financing proceeds will be disbursed on the basis of the regular IPF disbursement mechanism using traditional disbursement methods: reimbursement, advances and direct payments. The financing proceeds will be disbursed through two Designated Accounts (DAs) managed by KCGF, a DA to be maintained in the Central Bank of Kosovo (CBK) for advances with respect to Part 1, and the other to be maintained in a commercial bank, acceptable to the WB, for handling payments under Part 2 activities. While CBK already is included in the list of banks acceptable for holding Designated Accounts, the other commercial bank will be communicated and then checked for its acceptability to the WB. The DAs will be denominated in Euro.

16. **For Part 1, the financing proceeds will be withdrawn in the form of advances into the respective DA**. KCGF will transfer proceeds as capital parts to their capital account held in CBK. A few high-volume transactions are envisaged throughout the implementation period. The funds transfer (bank statement) together with the KCGF board decision for capital increase would substantiate the eligible expenditure to be reported.

17. **For Part 2, financing proceeds may be drawn down in the form of advances into the respective DA**. KCGF will use the funds according to implementation schedule and procurement plan. In addition, reimbursement and direct payments to the third parties (consultants and suppliers) may be used. The Bank will require either copies of the original documents evidencing eligible expenditures, such as invoices and receipts, or summary reports of expenditure to substantiate eligible expenditure reported for this part.

18. The FIO department would prepare all relevant documents in support of applications for withdrawal. KCGF and MoF authorized official would act as authorized signatures. KCGF is required to maintain original documents evidencing eligible expenditures, making them available for audit or inspection. These documents should be maintained for at least two years after receipt by IDA of the audit report and for a period required by local legislation.

Procurement

19. Procurement will be conducted according to the World Bank's Procurement Regulations for Investment Project Financing (IPF) Borrowers' (the Regulations) which were issued in July 2016, revised Nov 2017 and Aug 2018 for the supply of goods, works, and non-consulting and consulting services, and the Guidelines on Preventing and Combating Fraud and Corruption in Projects Financed by IBRD Loans and IDA Credits and Grants, dated October 15, 2006 and revised in January 2011 and as of July 1, 2016. Under the Regulations, the Project Procurement Strategy for Development (PPSD) is used to analyse and determine the optimum procurement approach to deliver the right procurement result. The PPSD carried out for the project entailed a strategic assessment of the operating context and beneficiaries' capabilities, as well as the market, the different stakeholders, and the risks impacting procurement processes, and it informed the Procurement Plan. Most of the consulting services under Component 2 of the Project would involve competition using national market approach. Project Component 1 does not involve any procurement activities. The Project will use the online tool STEP (Systematic Tracking of Exchanges in Procurement).

20. Project Procurement Strategy Development. As per the requirement of the Regulations, a Project Procurement Strategy Document (PPSD) has been developed and finalized after review by the Bank. Market analysis has been carried out for different consulting services to ensure adequate participation of firms/individuals. Based on the PPSD, the procurement plan has been prepared to set out the selection methods to be followed by the Borrower during project implementation in the procurement of consulting services financed by the Bank.

21. Project Procurement Development Objectives (PPDO). The project procurement development objectives are the following:

(a) To ensure procurement efficiency and ensure value for money that contributes to Project activities that will also increase KCGF capacity to on-lend credit guarantees to private sector;
(b) To ensure appropriate market participation in relatively low to medium value technical services that are critical for realizing Project development objectives; and
(c) To ensure effective contract management of Component 2 activities in order to support KCGF financial capability increase and its capacity to issue credit guarantee to its clients.

22. Project Procurement Result Indicators. The achievement of the PPDO will be measured by the following indicator:

(a) Timely completion of major contracts by 75 percent.

23. Key procurement under the Project. The following procurement methods are anticipated under the project:

(a) ***Procurement of Goods and Non-Consulting Services*.** Goods required under the Project would include IT and office equipment for PIU staff, for which shopping procedures will be followed.
(b) ***Selection of Consultants***: Consulting services identified under Component 2 would be for training in banking sector, public relations expertise, website development, surveys on new products, local media campaign on new products, software/new modules development, monitoring and evaluation expert, expertise on developing risk model based on IFRS and IFRS consultancy, internal review process, etc. Short lists of consultants for services estimated to cost less than USD300,000 equivalent per contract may be composed entirely of national consultants in accordance with the provisions ECA Regional Procurement Thresholds. Consulting firms and individual consultants will be selected in accordance with Regulation for Borrowers. All Terms of References (TORs) are subject to the Bank's prior review irrespective of prior/post review status.

24. Advertisements: A General Procurement Notice (GPN) will be published online on the UNDB website. Specific Procurement Notices (SPN) will be published as the corresponding bid documents become available. All these advertisements shall be made through STEP system.

25. Debarments: The Borrower will respect debarment decisions by the Bank and will exclude debarred firms and individuals from the participation in the competition for Bank-financed contracts. Current listing of such firms and individuals can be found at the following website address: http://www.worldbank.org;/debarr

26. Assessment of the Agency's capacity to implement procurement: The Bank team has carried out an assessment of the procurement capacity of KCGF, as implementing agency under the Project. The procurement assessment concluded that:

(a) As the KCGF is a new agency, the staff involved in procurement has limited experience in procurement in general; The KCGF and its staff lack experience with the Bank project financing;
(b) The agency's procurement regulations differ from the Bank's Procurement Regulations;
(c) Hiring of new PIT staff with experience under the Bank procedures would be a challenge given the MoF Decision issued on June 2016 in regard to the salaries of the civil servants, as it may reduce the interests of qualified staff to participate in competition;
(d) Kosovo environment has been identified with high risk on corruption; pressure of high-level officials to influence in the results of the selection/tendering process is an issue identified in the Bank's project portfolio;

27. Based on the above, the procurement risk is assessed as High. To mitigate the identified risk, the following measures are proposed to be taken: (i) hiring a local Procurement Specialist with knowledge on Bank procurement which will support the agency on the activities under Component 2, (ii) additional technical staff to support KCGF on technical matters, may be hired; (iii) the PIT team, including the Procurement Specialist and FM Specialist shall report to PIT Coordinator; (iv) the agency should set up in timely manner the evaluation committee for evaluation of proposals, and further, the KCGF will ensure the committee members should have solid knowledge in the field of the assignment. In addition, the PIT staff should attend the procurement trainings/workshops organized by the Bank in the region. After all of the above measures are undertaken, the risk rating is expected to be Substantial.

28. **Frequency of Procurement Supervision.** In addition to the prior review supervision to be carried out by the Bank team, the capacity assessment of the Implementing Agency recommends supervision missions every six months during the first year of implementation, and once every subsequent year. Post reviews will be carried out regularly with a minimum sampling of two into ten.

29. **Procurement methods and prior review thresholds:** The procurement plan shall set forth those contracts which shall be subject to the WB's mandatory Prior Review. It is proposed to follow the procurement thresholds applicable effective July 2016, as part of the Regulation. All other contracts shall be subject to post review by the Bank. The prior review thresholds will be periodically reviewed and revised as needed during the Project implementation period based on implementation of risk mitigation measures, reports from procurement post-reviews, and improved capacity of the implementing agencies.

30. **Procurement Methods Thresholds**

Thresholds for Procurement Approaches and Methods (US$ thousands) As of June 15, 2016									
		Works			Goods, IT and non-consulting services			Shortlist of national consultants	
Country	Region	Open international ≧	Open national <	RfQ ≦	Open international ≧	Open national <	RfQ ≦	Consulting services <	Engineering & construction supervision
Kosovo	ECA	5,000	5,000	200	1,000	1,000	100	300	N/A

31. **Thresholds and Prior Review by the Bank of Procurement Decisions**
Except as the Bank shall otherwise determine by notice to the PIT/KCGF, the following contracts shall be subject to Prior Review by the Bank:

	Procurement Method	Procurement method threshold US$	Prior Review Threshold US$
	Goods, works and non-consulting services		
1.	Request for Bids (international) goods	> $1,000,000	Works above $10 Million per contract
2.	Request for Bids (international) works	>$5,000,000	
3.	Request for Bids (national) goods	< $1,000,000	

4.	Request for Bids (national) works	<$5,000,000	Goods above $ 2Million per contract All national approach tenders are subject to post review
5.	Request for quotations (goods)	< $100,000	-
6.	Request for quotations (works)	<$200,000	-
	Selection Method		**Prior Review Threshold**
	Consulting Services		
1.	Quality Cost Based Selection (QCBS)	>$300,000	Firms consultant Services above $ 1Million per contract
2.	Least Costs Selection (LCS)	>$300,000	
3.	Single Source Selection (SSS) (Firms and individuals)	-	
4.	Consultant Qualifications (CQ)	CQ < $300,000	
5.	Individual Consultant (IC)		Individuals above $ 0,3 Million per contract

B. Procurement Plan

Nr	*Contract name/description*	*Estimated cost (Euro)*	*Bank oversight*	*Selection method*	*Procurement approach*	*Evaluation Method*	*TOR start date*	*Contract start date*	*Contract completion date*	*Duration (months)*
	Component 2 - Institutional Strengthening of KCGF									
1	Consultant for training of loan officers		Post	Individual Consultant	National	Shortlisting				48
2	Public Relation specialist		Post	Individual consultant	National	Shortlisting				48
3	Consulting firm for website development		Post	Consultant’s Qualification	National	Shortlisting				48
4	Consulting firm to conduct survey on new products		Post	Consultant's Qualification	National	Shortlisting				48
5	Local experts on economy/business (summer interns)		Post	Individual Consultant	National	Shortlisting				48
6	Media campaign for new product announcement		Post	Consultant's Qualification	National	Shortlisting				24
7	System modification of four new windows (current vendor)		Post	Direct Selection	N/A	N/A				48

8	Legal expert		Post	Individual Consultant	National	Shortlisting				12
9	Monitoring & Evaluation / Reporting specialist		Post	Individual Consultant	National	Shortlisting				48
10	Environmental specialist		Post	Individual Consultant	National	Shortlisting				48
11	Consulting firm for IFRS compliance		Post	Consultant's Qualification	National	Shortlisting				48
12	E Internal process review and control		Post	Consultant's Qualification	National	Shortlisting				48
13	Procurement expert		Post	Individual Consultant	National	Shortlisting				48
14	FM specialist		Post	Individual Consultant	National	Shortlisting				48
15	IT and office equipment for PIT		Post	Shopping	National/ limited	Lowest evaluated cost				3
16	Operating cost									48
	Total									

Environmental and Social (including safeguards)

32. **For the Component 1, that triggers environmental safeguard policies for the Project, the Kosovo Credit Guarantee Fund (KCGF) is the Project implementing agency**. Preliminary assessment of the KCGF environmental management capacity indicated no functioning environmental and social management system (ESMS) for processing and overseeing guaranteed loans exists. In addition, KCGF has no WB Safeguards experience, only three PFIs eligible for the Project participation have ESMS and enforcement of environmental legislation is still a weak spot in the Republic of Kosovo. Therefore, the ESMF has a special focus on the KCGF and PFIs environmental and social capacity strengthening, including establishment of functioning ESMS with guidelines and procedures for environmental and social screening, management and supervision of sub-projects, appointment of the ESMS responsible person(s) (e.g. Environmental and Social Focal Point/Manager) as well as trainings to the appointed KCGF staff.

33. **The KCGF will contract Environmental Specialist, a Project Implementation team (PIT) member, on part or full-time basis.** The Environmental Specialist will be responsible for ensuring ESMF implementation and Project's adherence to national environmental regulation and WB Safeguards policies. The Environmental Specialist will be experienced in environmental management, environmental and risk assessment and will be additionally trained in WB Safeguard Policies and procedures (by the WB Environmental Specialist). The Environmental Specialist will be expected to provide training (supported by the WB when necessary) to the PFIs and supervise their environmental performance during implementation.

34. **In the course of Project implementation, any shortcomings identified on the part of PFIs will be addressed.** The initiatives to address the shortcomings will involve (i) training sessions, the content of which will

be prepared by KCGF Environmental Specialist and approved by WB Environmental Specialist, (ii) guidelines, (iii) building EMS and (vi) other corrective measures. The training program will be optimized based on the existing capacity of PFI, feedback from the PFIs on later stages, and will be presented by KCGF engaged Environmental Specialist, supported by WB safeguard specialist as necessary. The Environmental Specialist will regularly report to the WB on capacity and performance of PFIs in regular progress reports.

35. **The ESMF will be implemented by KCGF, PFIs and final users of loans (sub-project applicants).** In its procedures, the ESMF will define screening and assessment procedures that will ensure all subprojects are correctly categorized and undergo complete environmental review appropriate for the category. Environmental review will be carried out by the KCGF and PFIs in line with the ESMF defined procedures including eligibility establishment, categorization, assigning appropriate environmental assessment (EA) to activities, reviewing and approving the EA documents ensuring the high quality of all necessary components including environmental and other permits, national EA legislation is respected, public consultation and information dissemination, supervision in the implementation phase and confirming compliance with the ESMF, WB Policies and national environmental and other regulation.

36. **The ESMF with well elaborated ESMP Checklists for B- sub-projects (small construction) was disclosed on February 12, 2019 for 14 days on KCGF website in English, Albanian and Serbian**. Hard copy of the document was also made available to the public at the KCGF's reception. KCGF launched a call for submission of comments containing postal and email address for sending comments and suggestions as well as call for public consultation meetings that took place on February 22, 2019. All relevant comments and questions raised in/during the public consultations were addressed, then summarized and enclosed to the ESMF as Annex 4 which made the document final. meeting. Final ESMF was redisclosed. PFIs will publish ESMF on their web site to make ESMF and ESMP Checklists for B- sub-categories available to Applicants and public only after the signing of the agreement for the participation in the project. EAs (ESMP) prepared for individual B+ sub-projects will have to be disclosed in Albanian, Serbian and if needed English and publicly consulted (disclosed for at least 14 days) by applicant, relevant Ministry or Municipality web-site with a call for comments. Hard copy of the document must be available to the public as well. Comments will be requested on the documents disclosed (the call will provide both postal and email address for sending comments and suggestions). Local newspaper advertisements may be used as a mean for calling the public to comment on the same documents. All relevant comments and questions raised in/during the public consultations will be addressed, then summarized and enclosed to the EA. Only when the minutes of the consultations are included to the document, it will be considered final. As consulted within ESMF public consultations, ESMP Checklist for B- individual sub-projects do not have to be publicly reconsented/ redisclosed (as it was disclosed as part of the ESMF), but it will be recommended to do so to the final users and PFIs as a sign of good practice.

Monitoring and Evaluation

37. **Key indicators for measuring the PDO include:**

(a) Total amount of guaranteed loans through Project

(b) Number of guaranteed loans

38. Key intermediate results indicators include:

(a) Number of MSMEs receiving guaranteed loans through Project
(b) Share of guarantees issued to firms with no credit history
(c) Share of guarantees issued to women owned or managed MSMEs
(d) The ratio of outstanding guarantees to equity
(e) Proportion of guarantees paid-out
(f) Percentage of beneficiaries that feel Project activities reflected their needs (Citizen Engagement Indicator) (Percentage)
(g) Procurement, Financial Management and Environmental Monitoring capacity of the KCGF is improved
(h) Number of loan officers trained

ANNEX 3: KOSOVO FINANCIAL SECTOR OVERVIEW

1. **The financial system in Kosovo is characterized by a stable, bank-denominated financial sector.** At the end of November 2018, the financial system included 10 private commercial banks, 14 insurance companies, 2 pension funds, and 22 microfinance institutions. Banking sector assets represented approximately 70 percent of the financial system. It is dominated by foreign banks both in terms of the number of banks (8 out of 10) and total assets (87 percent). The banking sector is healthy, highly liquid, and profitable. The ROE and ROA remained high at 19.1 percent and 2.3 percent respectively. Banks are also well capitalized with the capital adequacy ratio reaching 16.8 percent, comfortably above the minimum regulatory level of 12 percent. Liquid assets/short term liabilities amounted to 36.3 percent. NPLs stood at 2.7 percent of total loans in November 2018 remaining significantly lower than in neighboring countries. Loan-loss provisions to NPLs were also high at 156.3 percent mitigating relevant risks.

2. **The activities of Non-Bank Financial Institutions – pension, insurance, and microfinance institutions - have all recently experienced a positive increase of activity but continue to remain lowly linked and a smaller percentage of the financial sector's asset.** The value of pension sector assets experienced an annual increase of 16.0 percent in 2018.[9] The increase was attributed to the positive return on investments, increase of new contributions and increase of price of pension funds shares. Nevertheless, insurance penetration remains low at 1.4 percent – gross written premiums as a percentage of GDP. The 14 insurance companies operating in Kosovo accounted for EUR181.1million or above 3 percent of total financial sector assets. It continued to record profits, 2nd year in a row since the sector has been operating, however the sector remains thinly capitalized. The 22 microfinance institutions (MFIs) have a total assets amount to EUR247.7, approximately 3 percent of total financial sector assets. The microfinance sector in Kosovo is relatively strong compared to other countries, but its business is limited to lending activities and its current regulatory framework for MFIs needs to be adjusted to procure for the growth and development of the sector. As of November 2018, a draft law has been submitted to the parliament and passed the first reading.

3. **Regulatory and Supervision improvements continue but gaps remain.** Credit Risk management regulations were passed in 2017, which regulates the criteria and timelines for write -off loans for the purpose of standardization and unified application of these criteria for the whole banking sector.[10] Importantly, Kosovo has showed significant progress in the area of contract enforcement in recent years which improved the collection process and gave banks greater confidence to lend at lower rates while demanding less collateral. Despite these improvements, gaps remain in the legal framework and the private enforcement agent system. The monetary and fiscal authorities have pursued an important structural reform agenda, in which context EUR46 million from treasury deposits were earmarked for a fund for Emergency Liquidity Assistance and a Deposit Insurance Fund was established. The CBK has also approved a macro-prudential framework in order to contain systemic risks in the financial sector. The institutional capacity of the banking supervision function is also

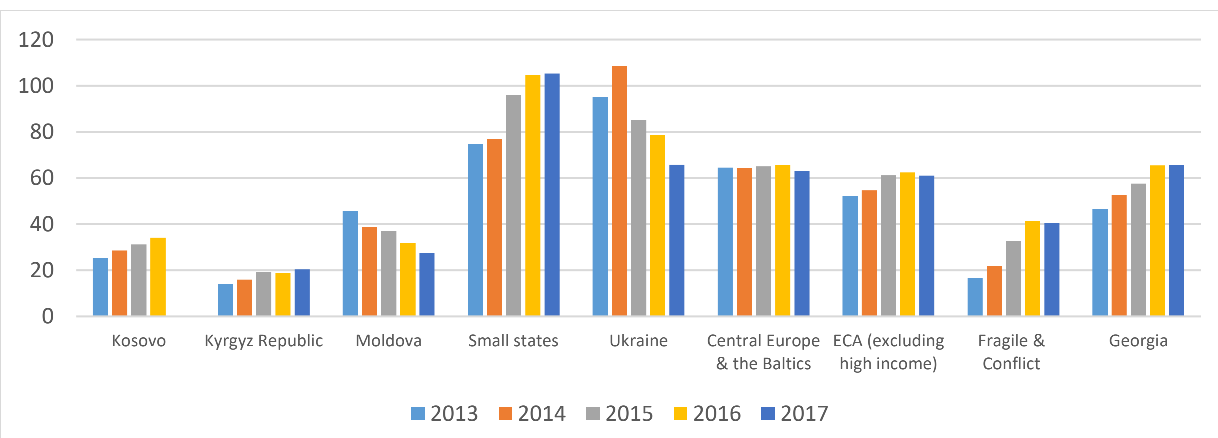
[9] Central Bank of Kosovo. Financial Stability Report. October 2018.
[10] Central Bank of Kosovo. Financial Stability Report. October 2018.

improving with the ongoing adoption of risk-based framework, but it still lags behind neighboring countries. Cross-border supervision is a particular challenge for Kosovo because of the country's political status, and the small size of the banking subsidiaries in the foreign groups.

4. **Financial Infrastructure in Kosovo, comprised of the Payment System and Credit Bureau, continue on the trajectory towards modernization.** The relatively new Automated Transfer System (ATS), which replaced the old interbank payment system with a real time gross settlement of large and small value transactions, both the volume and value of transactions increased in the past year -1.0 percent and 9.2 percent, respectively. The Point of Sale (POS) and e- Banking accounts continues strong growth with a 8.6 percent and 30 percent increase, respectively year-on-year between 2017 and 2018. The technology expansion of outreach outpaces bank branches and sub-branches and ATMs growth for the same period. While credit bureaus do not exist in Kosovo, the highly functional public credit registry ensures that credit exposure of legal entities as well as individuals is captured. Regular updating of the registry is mandatory for all registered formal sector providers. Overall, in 2017, Kosovo scored 6 out of 8 in the WDI's depth of credit information index compared to the ECA average of 6.3 while the coverage of the credit bureau was 40.5 relative to the ECA average of 22.2 percent. The public credit history can be benefit from more inclusive credit data, such as retailers and utility companies and it does not offer credit scoring as a value-added service to help banks and financial institutions assess the creditworthiness of borrowers.

5. **Kosovo's financial sector is still at an early stage of development and it has one of the lowest levels of credit penetration amongst its peers.** The year-on-year credit growth in 2018 was approximately 11 percent, mainly due to trade and the construction sector.[11] However, despite consistent credit growth and the banks' robust financial health, Kosovo has the lowest level of credit penetration in the Western Balkans and amongst its peers of Small States, Central Europe and the Baltics as well as for Fragile and Conflict Areas. (figure 1).

Figure 1: Domestic Credit by Financial Sector (percent of GDP)

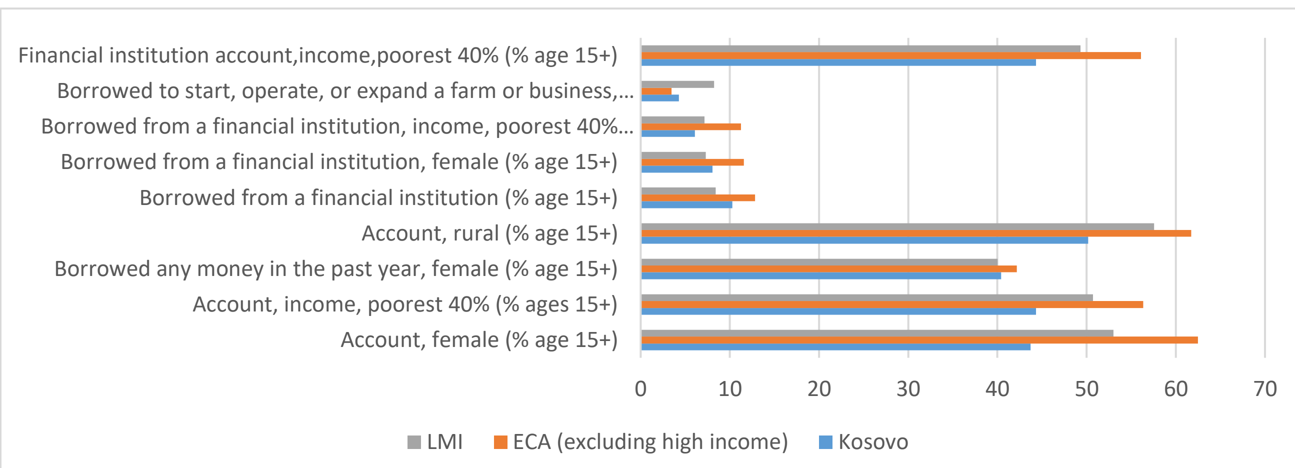


[11] IMF. Article IV. Kosovo. December 2018.

Source: World Development Indicators (WDI) February 2019

6. **Despite strong credit growth, widening financial intermediation is necessary to increase the level of financial access and inclusion.** Household access to financial services are still limited in comparison to regional standards. With 48 percent of adults having access to a bank account, access to finance remains low compared to other countries to its peers. In particular, only 44.3 percent of low-income households and 43.7 percent of women have access to a bank account.[12] (Figured 2) At the same time usage of lending and savings services are limited in comparison regional standards. 39.3 percent of adults reported saving any money in the past year, while only 8.7 percent did so at a formal financial institution. Access to Finance for Small and Medium Enterprises has eased with recent structural changes. The large majority of companies, which are small to medium-sized companies, face constraints the high cost of capital and lack of long-term finance as a major impediment to expand, add jobs grow, and compete. According to BEEPS[13], 45 percent of firms identified access to finance as a single biggest constraint. While high collateral requirements and difficulties with debt collection were reported to as a constraint against the growth of commercial bank lending in the previous years, reforms in the enforcement framework through introduction of private enforcement agents have had positive results. The recent establishment of the Kosovo Credit Guarantee Fund in January 2016 has encouraged banks to lend more to MSMEs by increasing the amounts of lending, expanding products and services available to MSMEs and improving the terms and conditions for lending.

Figure 2: Kosovo Financial Inclusion



Source: World Bank. Global Findex. February 2019.

7. **Deepening financial intermediation would involve continuing the important structural reform efforts**

[12] World Bank FinDex.
[13] Business Environment and Enterprise Performance Survey.

currently underway in the sector.[14] The contract enforcement reforms should continue to include enforcement of the regulatory reforms. For example, this would include creating a commercial court including the training of specialized judges to deliberate and oversee the resolution of commercial cases. Collateral requirements for financing can be eased through the continued strengthening of the property registration and the cadaster system. The legislation currently in Parliament regarding the widening range of MFIs activities would need to be promulgated. Also, the regulatory efforts by the Central Bank to allow the creation of investment funds should continue.

[14] IMF. Article IV. Kosovo. December 2018.

ANNEX 4: FINANCIAL INTERMEDIARY ASSESSMENT

1. **The Kosovo Credit Guarantee Fund (KCGF) was established in January 2016 to provide guarantees to eligible businesses residing in Kosovo**. The KCGF target businesses are MSMEs that are viable but do not have enough collateral and/or credit history; MSMEs needing long-term finance; MSMEs that can increase local production and reduce imports and/or increase exports; women, non-majority and entrepreneur-owned MSMEs; and MSMEs that will create new jobs. Loans to certain sectors are not permitted to be guaranteed. These include any business connected with the military or weapons production; gaming or gambling activities; illegal activities; nightclubs; production or sale of tobacco or hard liquor, if the production or sale of these products constitutes more than 25 percent of the borrower's annual turnover (gross revenues); residential mortgage loans; real estate development; municipalities, district or state-owned enterprises; and any businesses that have material negative environmental impacts.

2. **The KCGF has a good relationship with all relevant stakeholders including with the Central Bank of Kosovo (CBK).** The CBK would like to see further expansion of the credit guarantee scheme and is supportive of efforts by the WB to help the KCGF increase uptake.

3. **Lending in Kosovo is quite conservative.** Although conversations with lenders suggest that the level of collateral is closer to 200 percent of the loan value, the CBK data suggest that the ratio reaches up to 400 percent for non-guaranteed loans in line with the 2013 Enterprise Survey results[15]. It was reported that lenders recently raised the permitted ratio of the loan payment to cash available to make loan payments from 50 percent to 70 percent. This would make it easier for borrowers to qualify for loans. While this is a positive development, the collateral requirement remains quite high. The Enterprise Survey also shows that only 16 percent of investments were financed by banks and that 71 percent were financed internally. Only 56 percent of firms use banks as a source of working capital. The working capital financing provided by banks only meets about 20 percent of the total working capital need. Almost half of all firms (44.9 percent) indicated that access to finance was a major constraint on their business.

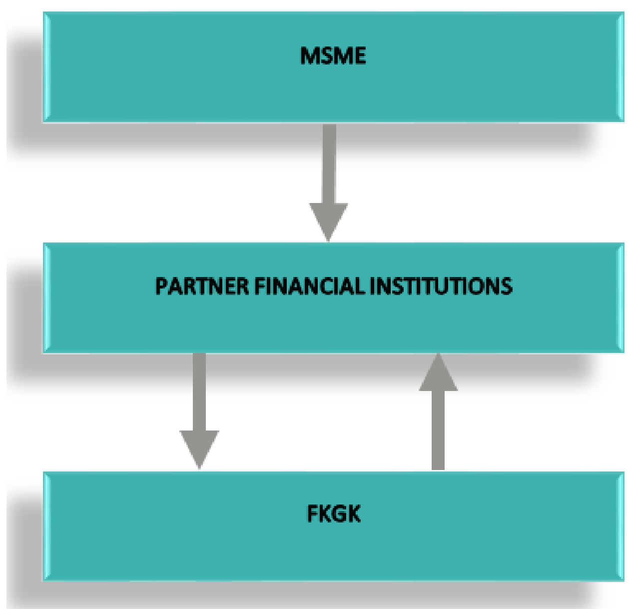
4. **There are several structural aspects of the lending market in Kosovo that encourage conservative lending**. There is a well-functioning credit registry, but it is relatively new. It does not calculate credit scores. There are challenges on collateral and property registration which makes it hard to determine if there are existing liens on collateral which in turn raises the cost of collateral backed lending.

5. **When the Kosovo Credit Guarantee Fund (KCGF) was created, it was set up quite conservatively as it seems to be designed only as a substitute for collateral for those applicants that could not meet high thresholds**. It is not used for borrowers with a slightly lower debt service coverage ratio or for borrowers in a new line of business. In some countries, the credit guarantee schemes are used by banks when the debt service

[15] Business Environment and Enterprise Performance Survey (BEEPS) 2013

coverage ratio is lower than that required for conventional loans or when the bank may not feel it has sufficient understanding of the applicant's line of business and wishes to have the guarantee to help protect it from losses.

6. **The 50 percent guarantee, stipulated in in the KCGF Statutes, is conservative by global standards, where 70 percent to 80 percent guarantees are more typical.** It may be appropriate to consider a higher guarantee in some circumstances. The guarantee approval process is as following: A potential borrower (MSME) applies for credit to a registered financial institution (FI) member of KCGF. The registered FI carries out the regular credit analysis applying the respective approval standards: i) will decide if the applicant is eligible for the KCGF guarantee, ii) will approve the credit to the MSME and iii) will submit the case to the MIS system. After that KCGF checks the criteria and receives the request with the idea that the FI submitting the case has already completed the due diligence on credit risk assumption and has determined the eligibility of the borrower and the credit. The ex-ante and ex post monitoring mechanisms are developed by KCGF to monitor/check the performance of each registered FI.



7. **The scheme appears to be self-sustaining for at least the next 10 years**. USAID covered its operating expenses through the end of calendar year 2018. The KCGF staff consists of seven individuals. The office size is adequate and functional for the current staff.

8. **The KCGF uses the guarantee fee and earnings on its capital to fund its operations.** The guarantee fee is 2 percent of the guaranteed balance collected on an annual basis. The capital base is currently EUR15 million. All capital has been donated. The KCGF invests its capital in sovereign debt which is currently paying about 1.1 percent. The low interest environment has limited the earnings on capital at the present time. The KCGF recently signed a seven-year agreement with the Swedish International Development Cooperation Agency

(SIDA) in which SIDA will assume the risk for up to EUR10 million in loans with a tenor in excess of 24 months for a fee of 50 basis points. Thus, the KCGF will be making a 1.5 percent spread on the guarantee fee for those loans.

9. **The 2 percent guarantee fee is a typical globally average for the fee**. The legislation in Kosovo specifies that the fee must cover operational costs and loan losses but does not prescribe a specific fee. This gives the KCGF the flexibility to offer additional products with a different fee structure.

10. **Lenders are assessed through a rigorous due diligence process prior to being accepted in to the scheme and must report monthly on loan activity**. The Board has been actively involved in providing policy guidance. These two factors also contribute to good financial performance.

11. **The annual audit of 2016 raises concerns about the KCGF is an going concern**. The auditor notes that USAID has been covering most of the operating expenses and that this commitment is time limited. The auditor stated that unless the KCGF finds additional revenues to replace the grants from USAID, its ability to continue ongoing operations cannot be assured. Since the auditor's opinion, the KCFG has signed an agreement with SIDA to assume many of its liabilities while charging a fee substantially less than what the KCGF is charging its clients. In addition, the KCGF is about to receive additional capital from KFW which will increase its investment earnings potential. This will increase the financial cushion available while volume is increased.

12. **The KCGF's product offerings are limited**. The sole focus is applicants with less than the amount of collateral required for a conventional loan. There may be room for additional products aimed at women owned businesses, agribusiness, renewable energy, energy efficiency, revolving working capital, contract financing, and supply chain financing or startups. Meanwhile, expansion of the guarantee scheme to Micro Finance Institutions (MFI) and Nonbank Financial Institutions (NBFI) is being considered in line with the legislation which might be a positive step for further development of the scheme.

13. **The scheme is structured as portfolio-based with lenders making the credit decision.** Although mentioned as a portfolio-based program, the lenders submit loans on an individual basis for a guarantee. The notion of a portfolio guarantee may have arisen as each approved lender is given an allotment of guarantee authority, which is then referred to as their portfolio. All of the lenders indicated that they use the same credit standards, so delegating the decision should not be a big risk. The fact that only 50 percent of the loan is guaranteed acts as an internal control to prevent lenders from submitting improper credits for a guarantee.

14. **The staff quality is high and corporate governance is satisfactory**. The WB team noted that the KCGF is a well-functioning institution with a highly competent staff, who are committed to high standards of operation. Most of the staff members have previous banking experience.

15. **The corporate governance structure is appropriate.** There is a seven-member Board which includes four independent members, one ex-officio member appointed by the Ministry of Trade and Industry, one ex-officio

member appointed by the Ministry of Finance and the KCGF managing director. With the exception of the representative of the Ministry of Trade and Industry, all board positions are filled. It is important to note that the four independent members are appointed by the donors. This should provide adequate outside guidance.

16. **KCGF is a standalone entity that is not controlled by the government of Kosovo.** KCGF is an independent, autonomous, legal entity established by the law number 05/L-057, the Law on the Establishment of the Kosovo Credit Guarantee Fund.[16] Article 10, paragraph 3 of the law states that KCGF shall enjoy full operational and administrative autonomy and function outside the framework of the Kosovo government structures and the Kosovo Civil Service. [17]

17. **Marketing of the scheme needs to be expanded**. Some lenders did not seem fully aware of the details of the scheme. The KCGF holds semiannual sessions for senior managers and visits with bankers frequently. An upcoming change to the capital treatment of the guarantee may provide an opportunity for additional marketing. It may be appropriate to develop a marketing strategy that is more oriented on explaining to the bankers on using the scheme rather than educating them on the details. As described above, all of the bankers were stated that the 2 percent guarantee fee is high compared to their 1.8 percent loss rate, yet none thought an extra 1 percent interest (2 percent fee on 50 percent of the loan) would cause a borrower to decline a loan offer. It would also be helpful if the KCGF could explore with the banks' management to assign targets to branch managers for guaranteed loans.

18. **Lender oversight by the KCGF is adequate**. Reasonable due diligence is performed on lenders that apply to use the scheme. Once accepted, lenders must report on the 15^{th} of each month regarding their loans. Furthermore, the agreement must be renewed every two years. This is a best practice as it gives the scheme a chance to review the lender's performance and ensure the staff is adequately trained. As loan officers move from bank to bank, it is not unusual in other markets for a bank to be left without a manager for its guaranteed loan portfolio. In such cases, the scheme needs a way to suspend additional approvals until a new manager is hired.

19. **The application process for guarantees is electronic**. Lenders use a web portal to submit information regarding a guarantee application and receive the confirmation from the KCGF. Virtually all communication between the KCGF and lenders is electronic.

20. **KCGF Law prescribes reporting and cooperation of KCGF with CBK.** KCGF will comply with reporting requirements prescribed in the law and KCGF internal policies including assessment of guaranteed portfolio risk and any claims paid out on monthly, quarterly, semiannually and annual basis.

[16] http://www.fondikgk.org/repository/docs/LAW_NO._05_L_-057___ON_THE_ESTABLISHMENT_OF_THE_KOSOVO_CREDIT_GUARANTEE_..._294980_527572.pdf
[17] http://www.fondikgk.org/repository/docs/LAW_NO._05_L_-057___ON_THE_ESTABLISHMENT_OF_THE_KOSOVO_CREDIT_GUARANTEE_..._294980_527572.pdf

21. **The Bodies of KCGF are the Board of Directors and Managing Director.** The Board of Directors oversee the KCGF and are responsible for fulfillment of strategic objectives in line with the KCGF Law. The Board of Directors is composed of seven members with the following structure:

(a) An appointed representative of the Ministry of Trade and Industry
(b) An appointed representative of the Ministry of Finance
(c) The Managing Director
(d) The other four independent members are selected by the donors.

22. **Financial Management**. Though a relatively new institution, KCGF has established a governance model adequate for its size and complexity of operations, including board oversight, management structure, and operational, financial, risk management and reporting policies. KCGF organization structure properly defines authority lines, roles and responsibilities of departments and employees. KCGF demonstrates through the quality of the audited financial statements to have implemented sound financial management practices. The Head of the Finance department is well experienced with donor financial management requirements, since KCGF has implemented previous donor supported activities. However, currently the function is covered by one staff. As the operations are expected to scale up following the capital increase, in addition to the implementation envisaged project activities, it is sensible to hire an additional full time FM staff, that will report to the FIO Director. In addition, it will provide a response to increased financial management risk due to lack of segregation of duties.

23. **Close coordination between KCGF and MOF is envisioned for the proposed operations**. The relationship between KCGF and MOF will be regulated in a Subsidiary agreement, whereby budgeting, allocation and reporting requirements for the operations will be described. Project annual disbursement forecast should be reflected in the medium-term budget framework and annual budget, as well as annual budget allocation.

24. **Budgeting**. In general, the mechanisms for budgeting and opening the budget (release of funds) in MoF are considered adequate for the needs of the proposed Project. The MoF budget instructions guide budget and planning preparation process. KCGF would be responsible to prepare annual project budget plans and forecasts will be based on approved project implementation plan and procurement plan. These budgets would form the basis for allocating funds to Project activities. To mitigate the risk pertaining to insufficient or untimely budgetary appropriation and allocations, MOF and KCGF should coordinate in a timely and effective manner and ensure a realistic Project budget and forecast, prepared as above, are included in the MTEF and the Annual Budget Law, beginning in the year the Project is expected to become effective. Project estimates have been included in the draft annual budget for 2019. The annual budget preparation process will be monitored by the bank team.

25. **Internal controls.** While KCGF internal control framework is comprehensive, including operations, FM, procurement personnel, investment and provisioning policies. Financial management policy is complete, however is not detailed at the level of processes, control activities, and roles and responsibilities. The KCGF is

committed to maintaining an effective internal control system to ensure that Project expenditures are properly verified and authorized; supporting documents are maintained; accounts are reconciled periodically; and Project assets, including cash, are safeguarded. The Financial Management Manual, part of the POM, will describe the FM, disbursement and internal controls policies and procedures, intended to guide staff and minimize the risk of errors and omissions, as well as delays in recording and reporting. These written standards are to clarify segregation of duties and responsibilities, including level of authority, clear control over funds and assets, and it ensures timely and accurate financial reporting. Special attention will be given to provide clarity on roles and responsibilities between MoF and KCGF for the implementation of project, and respective reporting requirements.

26. **Accounting System**. KCGF is using Navision for their accounting and financial reporting purposes. This system is linked with the KCGF management information system. Navision is adequate for keeping accounting records of project financial transactions, resources and uses. The project transactions, bank accounts, assets and liabilities, may be separately identified and tagged, through the chart of accounts and dimensions.

27. **KCGF has in place a modern MIS system for the management of guarantee operations.** A separate window can be created for part 1.1 and part 1.2 of the project (segregation required based on the Bank safeguard policies) and the related financial information may be transferred to accounting system. Therefore, the segregation is ensured through the tracking functionalities of the information systems in place, by tracking transactions related to Bank operations and reporting separately.

28. **Financial reporting**. The Interim un-audited Financial Reports (IFRs) will be submitted on semiannual basis to the Bank within 45 days after the end of each semester. These reports will be prepared on accrual basis based on the financial information registered in the KCGF accounting system and will contain at least the following: (i) statement of financial position, (ii) statement of financial performance, (iii) statement of sources and uses of funds (with expenditure classified by disbursement category), (iv) contract monitoring, and (v) bank account statements. The format and content of IFRs will be part of the POM. In addition, the IFRs will be submitted to MoF in compliance with reporting requirements to be established in the subsidiary agreement.

29. **KCGF audited annual financial statements prepared in accordance with International Financial Reporting Standards will required**. The financial statements will contain adequate disclosures on the project operations, its financial position and financial performance and cash flow statement. Notes to the financial statements will include a summary of expenditures paid, presented under project account headings and main categories of expenditures. Financial reporting period will cover the government's fiscal year, which coincides with the calendar year. The functional and reporting currency is Euro.

30. **Audit**. The KCGF financial statements as described above will be audited annually and audit report will be submitted to the Bank not later than 6 months from the end of the year. The KCGF's financial statements prepared based on International Financial Reporting Standards (IFRS) are audited annually and submitted to its Board of Directors. The most recent KCGF's audit report presents a true and fair opinion. The audits will be conducted annually by independent auditors acceptable to the Bank based on terms of reference acceptable to the Bank. The audit reports would be made publicly available within two months from their issuance, as per the WBG Policy on Access to Information.

31. **HR Capacity is adequate**. With a current staff of 4-5 people, a fully functioning HR office is not necessary. HR issues are handled on an as needed basis.

32. **Financial Soundness** –KCGF so far has not experienced a default. As mentioned above, defaults are estimated to be in the 2percent to 3percent range. This is based on the credit standards of the banking community. KCGF has published their plans for complying with IFRS 9 regarding the accounting for guarantees. There is no KCGF data to use for forward looking calculations, so initially these will all be estimates. KCGF has a dedicated risk manager**.**

33. **Projections for financial sustainability.** The current model shows that the scheme will be sustainable for the next ten years based on the current assumptions.

34. **Regulation and Supervision of KCGF.** Prudential supervision of KCGF is an important step in maintaining a self-sustaining PCGS. The Board of Directors and the outside auditor each have a role in the oversight of the scheme, while the CBK, which supervises all the financial institutions, requires timely reporting. There is also a memorandum of understanding between the CBK and KCGF describing the information exchange requirements. Overall, the Board is responsible for checking the implementation of policies and procedures are in place, adequate, and being followed. The outside auditor is more concerned with the finances of the scheme than the operations. Typically, the only time an auditor will comment on operations is if there is a concern that the scheme cannot remain viable.

35. **Areas of concern.** The main areas of concern are having an adequate number of employees to handle the growth, proper funding for expansion of the management information system and the ability to provide adequate lender oversight. As the program grows, the four currently on board will not be adequate to keep up with all of the volume. The current MIS system is designed by KCGF staff but is run by a contractor. World Bank staff were unable to determine the level of back up being done or whether a continuity of operations plan was in place. Both of these issues should be examined during future missions.

36. **The Western Balkans Enterprise Development and Innovation Facility provides competition to the KCGF**. The facility offers guarantees on loans up to EUR500,000[18] for a guarantee fee of 50[19] basis points. WBEDIF offers direct guarantees to financial institutions and counter guarantees through guarantee schemes[20].

[18] http://www.wbedif.eu/about-wb-edif/guarantee-facility/
[19] Information provided by ProCredit Bank
[20] http://www.wbedif.eu/about-wb-edif/guarantee-facility/

37. **In some areas, the current law is specific relative to international best practices, constraining the KCGF in its current business model**. The inability to guarantee a loan involving refinancing is discussed above along with the limitation on the guarantee of 50 percent. A further limitation is that all businesses that receive a guarantee must be registered with the Kosovo Business Registration Agency (KBRA). While this contributes to disincentivizing informality, it also prohibits agro-businesses that are registered with the Ministry of Agriculture, but not with the KBRA.

38. **Payment process is somewhat rigid while the moral hazard issue is handled by banks.** The law requires that the KCGF cannot make payment on the guarantee until all collection procedures have been exhausted. Once the claim is made, the KCGF has 30 days to check the eligibility criteria and complete the payment. Meanwhile the moral hazard issue of the KCGF is handled by the banks. Some of the banks inform the borrower that the loan has a guarantee and the loan would not qualify for financing without the guarantee. Other banks do not inform the borrower regarding the guarantee due to the fear that the borrower may not repay assuming that the guarantor will pay or that the loan is a grant. Overall there is a correlation between the size of the loan and the willingness of the lender to disclose the guarantee in that the lenders making larger loans seem to be more willing to disclose information about the guarantee.

39. **KCGF's data collection has improved over the years and is adequate**. Some additional data may be necessary to monitor the progress of developmental objectives. There is also a credit registry under the CBK which tracks whether a loan has a guarantee from the KCGF. The data base of loans and especially those that have guarantees may be very useful for research purposes.

40. **The moral hazard issue of the KCGF is handled by the banks.** Some of the banks inform the borrower that the loan has a guarantee and the loan would not qualify for financing without the guarantee. Other banks do not inform the borrower regarding the guarantee due to the fear that the borrower may not repay assuming that the guarantor will pay or that the loan is a grant. There seems to be a correlation between the size of the loan and the willingness of the lender to disclose the guarantee in that the lenders making larger loans were more willing to disclose information about the guarantee.

ANNEX 5: DETAILED PROJECT DESCRIPTION

1. **The Project aim is to improve access to finance for MSMEs in Kosovo through enhancing the capital base of the KCGF and strengthening its capacities to design products that are targeted to underserved segments of the economy**. The KCGF, is a local, independent, sustainable credit guarantee facility issuing portfolio loan guarantees to financial institutions to cover up to 50percent of the risk for loans for micro, small, and medium enterprises (MSMEs). KCGF plays a key role in facilitating MSMEs obtaining more financing for their growth. By reducing the risk of lending to MSMEs, it encourages KCGF partner financial institutions to lend to more MSMEs, to increase the amounts of lending to MSMEs, to expand products and services available to MSMEs and improve the terms and conditions for lending. KCGF helps financial institutions lend to viable MSMEs that might not have quite qualified without the guarantee to receive a loan, or, if it had a loan, would not have qualified to obtain the additional financing it needed to grow. The obstacles that KCGF helps overcome include the MSMEs not having adequate collateral or having a limited track record and credit history. Financial institutions that may register with the KCGF and thus be eligible to participate in the guarantee program, include banks, non-bank financial institutions (NBFI), and micro-finance institutions (MFI).

2. **The Project has two main components**: (i)Enhancing the Credit Guarantee Framework and (ii) Project implementation and institutional strengthening.

3. **Component 1: Enhancing the Credit Guarantee Framework (EUR21.5 million)**. Under this Component the Project will provide funds to KCGF to issue partial credit guarantees to support access to finance to eligible MSMEs, including specific segments and sectors that have strategic importance for supporting the sustainable growth of the Kosovo's economy. The Project will increase the KCGF's capital. Significant part of the Project funds will be channeled to the existing guarantee window (general window) of the KCGF. In addition, the KCGF will establish a new window (strategic window) focusing on underserved and strategic segments which will also be capitalized by the Project. In line with the KCGF's current mandate the funds under this Component of the Project will be only used for providing PCGs, to MSMEs, definition and eligibility of which is determined by the Project Operation Manual in accordance with the KCGF legislation[21]. Accordingly, this Component consists of two subcomponents.

[21] Requirements for MSMEs to qualify for financing under the guarantee include, but not limited to:

- An eligible borrower must be fully (100%) owned by private citizens or permanent residents of Kosovo with registration and fiscal numbers, with no government ownership during the period of the credit guarantee coverage,
- Private MSMEs, as defined in the Law on the Establishment of the KCGF, which are not prohibited by applicable legislation, regulatory provisions, or international treaties to which Kosovo is a party,
- MSMEs that have less than 250 employees,
- An eligible borrower includes any related party of the borrower in question, as defined in the Law on the Establishment of the KCGF.

4. **Subcomponent 1.1: Increasing the capital base for KCGF's general window.** Under this subcomponent, the WB will provide EUR17.8 million to expand the capital base for the KCGF's general window. The additional capital will allow an increase in usage of the Fund and allow the KCGF to address a larger portion of the financing gap for SMEs. Financing gap estimates and the team consultations with financial institutions and other donors indicated that there is enough room in the financial sector to absorb the expansion. The CBK's revision of the risk weightings for guaranteed portfolio is expected to have a positive impact on guarantee demand. The KCGF estimates the leverage ratio to be around 2.5:1 for this subcomponent.

5. **Subcomponent 1.2: Establishing a window for underserved and strategic segments.** Under this subcomponent, the WB will provide EUR3.7 million to be used for the capitalization of a new KCGF window which will provide partial credit guarantees for specific themes/segments/sectors that have strategic importance for supporting the sustainable growth of the economy. These are expected to include startups, young entrepreneurs, women business owners and other (energy efficiency, waste management and movable collateral). Establishment of the strategic window including the identification process of underserved and strategic segments and product customization will be supported by the institutional strengthening component of the Project. The KCGF will develop tailor-made products by altering price, guarantee terms and type for different segments and pilot those under this window. For this subcomponent, the KCGF aims to keep the leverage ratio at around 1.5:1 given the higher risk profile of the segments and possible changes in fee and guarantee structure. World Bank staff have reviewed possible scenarios that included a lower fee on these pilot loans and have concluded that these loans are unlikely to have a substantial negative impact on the financial viability of KCGF. The pilot loans were stress tested by increasing the default rate by 50 percent and by reducing the recovery rate by 50 percent over the estimated default rate for the current portfolio. Detailed analysis is provided in the Technical, Economic and Financial Analysis section below.

6. **Component 2: Project implementation and institutional strengthening of the KCGF (EUR0.8 million).** Under this Component approximately EUR0.8 million will be provided to the KCGF through MoF for Project implementation and institutional strengthening which will be essential to efficiently use the proposed additional capital. Under this Component technical assistance will be provided to KCGF to (i) strengthen its capacity to implement the Project; (ii) improve its information technology; (iii) enhance its risk assessment policies and procedures; (iv) enhance its internal control framework and financial reporting process; (v) strengthen the Project's monitoring and evaluation framework, including environment and social safeguards; (vi) design and develop new products tailored for MSMEs in segments and sectors that have strategic importance for supporting the sustainable growth of the economy; and (vii) design and implement a marketing and public awareness campaign and a communications strategy (detailed list of activities and draft ToRs have been developed and are included in the Project Operational Manual). Under Component 2 training will be provided for financial institutions' loan officers to raise their awareness and knowledge of KCGF products.

ANNEX 6: KCGF BALANCE SHEET AND INCOME STATEMENT

Kosovo Credit Guarantee Fund
Statement of Financial Position

	As at December 31, 2017 (EUR)
ASSETS	
Current assets	
Cash and cash equivalents	7,567,694
Deposits	8,500,000
Receivables and other receivables	151,665
Total current assets	**16,219,359**
Non-current assets	
Property, plant and equipment	25,939
Intangible assets	52,600
Total non-current assets	**78,539**
TOTAL ASSETS	**16,297,898**
EQUITY AND LIABILITIES	
Current liabilities	
Deferred Guarantee Fees	166,635
Provision losses for loan guarantees	88,514
Deferred revenues from donated assets	72,716
Accrued expenses	3,244
Total current liabilities	**331,109**
EQUITY	
Capital	15,790,921
Accumulated profit/(loss)	175,868
Total equity	**15,966,789**
TOTAL EQUITY AND LIABILITIES	**16,297,898**

Kosovo Credit Guarantee Fund
Statement of Comprehensive Income

Year ended 31 December 2017
(EUR)

Guarantee fees		134,165
Other income		269,364
Total income		**403,529**
Personnel expenses	(87,043)	
Depreciation	(20,415)	
Operative expenses	(38,759)	
Net provision losses for guarantees	(78,295)	
Profit/(Loss) for the year		**179,017**
Other comprehensive income		-
Total comprehensive profit / loss for the year		**179,017**