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*Micro Small Medium Enterprises and their connection to  
finance - Case of Albania*

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**1. An introduction to the economic conditions of MSMEs**

After the small business has passed through the early stages in Albania, new MSMEs tend to be highly risky with intangible assets, a lack of trading history, and informational opacity. The most important sources of initial and seed stage financing for small businesses are the personal savings of entrepreneurs, family, and friends, as well as second mortgages on property. In the phase of development during the start-up stage, external sources of funding become necessary. Investment in small businesses at this stage is still regarded as high risk and the business is not large enough to attract the attention of venture capitalists. Government grants or other programs for seed funding become relevant, especially for innovative

firms. Wealthy individuals, like business angels, can also fill the gap between personal funds and institutional finance. A further injection of capital is required to fund growth. The MSME may still not qualify for longer term debt financing due to its reliance on intangible assets, inability for investors to assess its future growth prospects, low profitability, and short track record. This is where alternative lending products such as leasing and factoring, invoice discounting platforms, marketplace finance platforms, integrated on-line merchant platforms, and alternative credit scoring are useful. Once the firm has established a track record, has the ability to provide collateral and information regarding its performance, and has become more transparent it may access longer term lending. Development of corporate governance structures, real-estate registries, as well as debt and potentially equity capital markets become relevant in this stage.

In 2018, according to INSTAT, the highest percent of active enterprises were MSMEs, employing 80 percent of the total number of employed people. The highest numbers of MSMEs were in the trade sector, followed by the services sector. The highest percentage of value added in micro-enterprises is realized in the accommodation and food services sector. The trade sector has the highest percentage realized by small enterprises. Medium enterprises realized the highest percentage of value added in manufacturing industry.

The Law on Small and Medium Enterprises defines MSMEs based on the number of employees and annual turnover. The Albanian Institute on Statistics (INSTAT), however, categorizes MSMEs by the number of

people employed rather than by employees, and local banks, claiming that the current legal definition is too broad, have adopted their own definitions based on exposures. These differences between the existing legal definition of MSMEs and the definitions used by banks make it difficult for the Institutions and other relevant government authorities to gather and analyze lending data in a consistent manner.

Although being significant contributors to economy, sectors of the economy dominated by MSMEs are characterized by high levels of informality. Despite recent progress in increasing the numbers of registered businesses they often still do not declare taxes or workers and mainly transact in cash.

## **2. MSMEs' access to credit products**

According to the World Economic Forum Global Competitiveness Report access to finance is considered the third most problematic factor influencing low competitiveness in Albania, following tax rates and corruption. In comparable economies such as Greece, Croatia, and Serbia access to finance is ranked 6th, 7th, and 2nd respectively in terms of the most problematic factors for doing business.

The difficult access to finance for MSMEs in Albania impairs their growth and development. Many MSMEs are dependent on internal funding or borrowing funds from family and friends to finance their operations.

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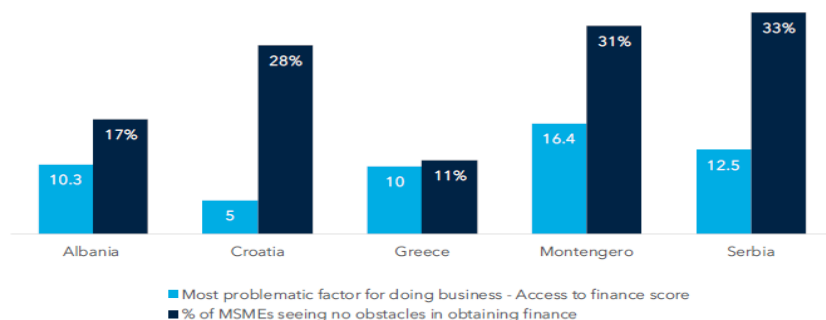
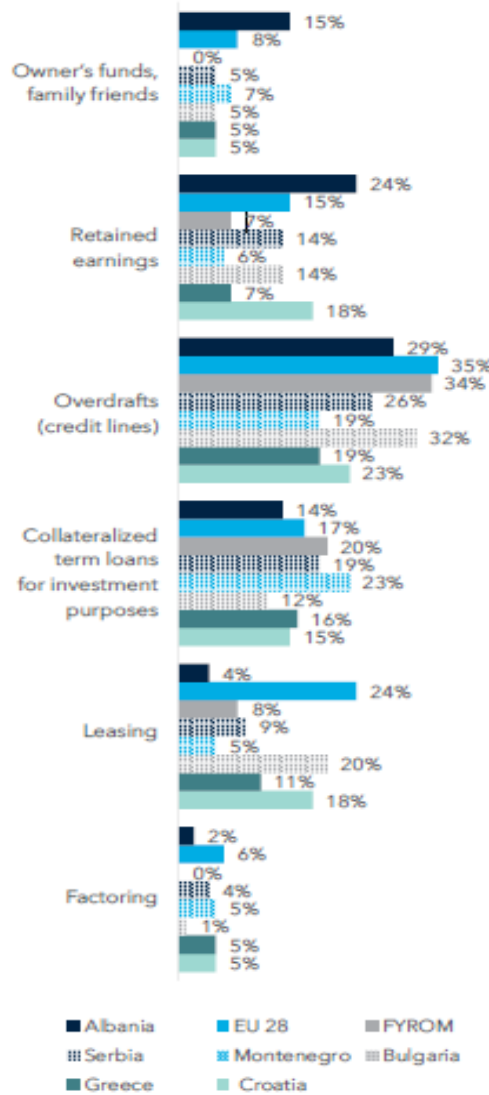


Figure 1 Perception of obstacles in obtaining access to finance and its impact on doing business

Rejection rates for MSMEs seeking formal finance are high. These rejections are mainly caused by strict lending standards, high collateral demand, low business capacity, and high opacity (informality) of MSMEs. Smaller firms are particularly disadvantaged in access to formal finance when compared to medium and large ones. While this would be expected, the difference in terms of uptake of accounts, access to credit, and the demand for collateral, is telling of the underprivileged position smaller firms find themselves in. Rejection rates are especially high in the agricultural sector and among microenterprises. The majority of agricultural enterprises which applied for a loan in 2017 saw their loan rejected. Many micro enterprises did not even apply for loans because they either feared they will be rejected or they perceived the processes as too complicated.



While the actual number of MSMEs using bank financing is very low compared to other countries in the region; MSMEs still represent a big part of banks' financing portfolios. There is a lack of alternative credit products for MSMEs that could help overcome issues of limited access to immovable collateral or high levels of information asymmetry. The majority of loans are collateralized (land or real estate) and many MSMEs do not have such collateral available to offer as security for finance. While use of formal financing is very low, many MSMEs rely

Figure 2 Types of Credit Products MEMEs Use on informal sources or retained earnings to finance their activities. 15 percent of Albanian MSMEs use informal third-party finance (family, friends, etc.), significantly more than MSMEs in Bulgaria (5 percent), Montenegro (7

percent), Serbia (5 percent), Croatia (5 percent) or FYROM (2 percent). 25-24 percent of Albanian MSMEs finance their operations from retained earnings, much higher than for Bulgaria (14 percent), Montenegro (6 percent), Serbia (14 percent), Croatia (18 percent) or FYROM (7 percent).

### **3. Formal Accounts and Electronic Products**

According to Global Findex Data, only 40 percent of Albanian adults had an account at a formal financial institution, compared to 77 percent in FYROM, 68 percent in Montenegro, 59 percent in BIH, and 52 percent in Kosovo. 68 percent of small firms, 88.6 percent of medium firms, and over 96 percent of large firms have an account at a formal financial institution.<sup>27</sup> Use of accounts for payments for goods and services is very low. Significantly more adults in urban areas have access to an account; implying that those living in rural areas, including for example smallholder farmers, may have difficulties not only accessing credit but also in accessing formal financial services in general. Albania has fewer bank outlets and automated teller machines (ATMs) per 100,000 than other comparable economies (see Figure 6) but, while the number of bank branches and ATMs have steadily declined, point of sale (POS) terminals and e-money agents have seen a slightly positive trend. Cash is predominant in all payment transactions of businesses, both received and initiated. The recent cost study revealed that businesses in Albania incur annual costs equal to 0.6 percent of GDP in the context of receiving and

initiating payments across all payment instruments, with cash representing half of total costs (0.3 percent of GDP). Although banks recently started investing more in digital channels (on-line banking primarily), and POSs are becoming more and more accessible, the level of innovation and uptake of digital payments of enterprises is still very low.

#### **4. The supply side**

Albania's banking sector is small and dominated by foreign banks. In terms of financial sector depth, domestic deposits and private credit to GDP are low in comparison to other countries in the region. The banking sector dominates the market (banks' assets in 2017 stood at 92.5 percent of GDP) while non-bank financial institutions (NBFIs), namely microfinance institutions (MFIs), leasing, factoring companies, and savings and loan associations (SLAs) are small in terms of their assets. As of December 2017, there were 31 registered NBFIs in Albania: their total assets amounted to ALL 45 billion, accounting for 3.1 percent of total banking system assets. Recent consolidation of SLAs has reduced their number from over 120 down to 13. In December 2017, the total assets of all SLAs amounted to ALL 7.7 billion, accounting for only 0.5 percent of the banking system.

### 5. Banking Sector

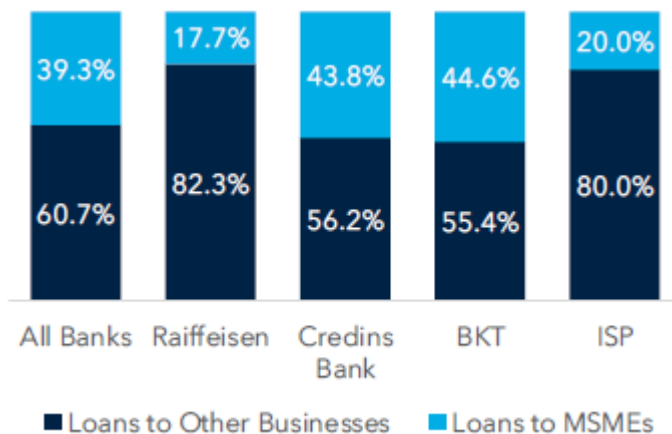


Figure 3 Overview of the bank lending portfolio for the four largest banks

Most banks have a dedicated MSMEs department, although they approach and define MSMEs in different ways. Some smaller banks focus exclusively

on MSME and retail markets. Recently, due to adverse effects of the global financial crisis, even larger banks are declaratively shifting their focus towards MSMEs as this sector is perceived as less risky in comparison to larger corporations. Despite having branches in all prefectures, banks' clients are mainly in urban areas, possibly because rural clients (including farmers) are perceived as riskier/less profitable clients as well as due to the lack of trust in the formal financial sector caused by lower levels of financial education. High levels of NPLs in the aftermath of the global financial crisis have been reduced but bank lending has remained fairly stagnant in recent years. As a response to the financial crisis, banks have adopted more conservative policies, seeking highly collateralized loans in particular by real estate. Concentration in the banking sector, resulting in



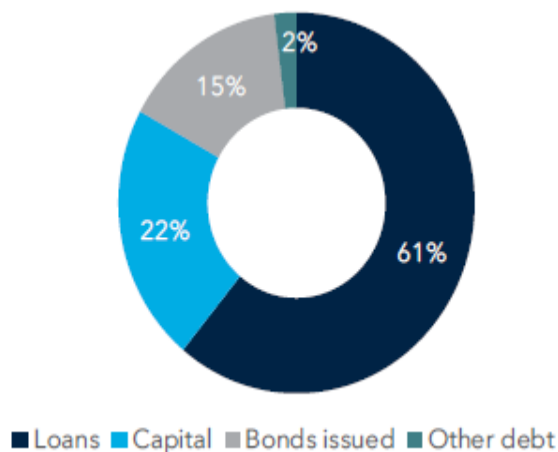
limited competition, the adoption of conservative lending policies post-financial crisis, and a lack of capacity and proper incentives have resulted in banks appearing not to be focused on developing new strategies to meet the specific financing needs of MSMEs.

a) Non-Financial Bank Institutions

Eight NFBIs are registered to perform regular lending activities (solely or combined with other services), five to conduct microcredit activities, 10 offer leasing products, six offer factoring services, and 10 are licensed to conduct payment services. Despite the relatively large number of NFBIs, their assets represent only 2.8 percent of the total financial sector assets.

b) Microfinance Institutions

MFIs are the largest and most prominent NFBIs, with a substantial presence in rural areas where they, jointly with SLAs, serve this segment of the market. While there are currently 8 licensed MFIs and 5 microcredit institutions, 2 of them dominate the sector. MFIs serve in particular smaller and micro enterprises as well as farmers. The quality of their portfolio demonstrates their ability to be able to lend to MSMEs while managing risks.



MFIs overall lending portfolio is stable and NPLs do not represent a major problem for the sector. Difficulties accessing long term and low-cost funding are limiting

MFIs sustainability in providing credit, including long term credit to MSMEs.

c) Financial Leasing and Factoring

In terms of other NBFIs, financial leasing and factoring companies play a small role in the market. Financial leasing activities are constrained by a weak secondary market for re-possessed assets, especially specialized equipment. Leasing is mainly limited to the financial lease of personal transport vehicles (54.8 percent in 2016) and work transport vehicles (24.1 percent in 2016). Weak secondary markets for repossessed equipment is a significant constraint to further development of leasing services, although at least one provider is solving this issue by selling repossessed assets through its international network of sister companies. While it should also be possible for financial leasing companies to offer operational lease products, there is a lack of clarity on this issue in the Financial Leasing

Law. There seem to be concerns that financial institutions do not fully understand the product, that courts lack capacity to understand the commercial construct of factoring transactions, and that limited trust exists in business partners and enforcement of creditors' rights.

d) Savings and Loan Association

The SLA sector had faced difficulties in the past, but has been completely revised as a result of a consolidation process and the entry into force of new legislation.<sup>44</sup> This restructuring has allowed SLAs to become more profitable and grow bigger; hence, the two major players are now seeking to “expand” towards the MSMEs sector. Following restructuring of the sector, have begun reviewing their business model seeking to better serve small and micro enterprises. While they do not yet have enough capacity, SLAs could potentially be leveraged more to serve rural MSMEs given their presence in rural areas. SLAs have a strong presence in rural areas; in fact, the recent consolidation process avoided closing the smallest associations, transforming them instead into branches of larger associations. Although at present SLAs mainly offer loans to their members for consumption purposes, their deposit base is growing fast. Together with their strong rural presence and their knowledge of the agricultural sector, this could enable SLAs to increasingly serve MSMEs. SLAs have potential to provide more business advisory services to increase the bankability of MSME clients, especially in rural areas.

## **6. Different Ways for Financial Innovation**

Supply Chain Finance (reverse factoring) is also not widely offered. Unlike traditional factoring, a reverse factoring product represents a buyer-centric model of accounts receivable finance.<sup>46</sup> This direct relationship helps to bridge some information asymmetries and other risks (e.g. invoice fraud) and is what makes this model especially well adaptable for MSME finance in developing markets.

Agricultural warehouse receipts financing is also missing from the market. As the country further develops infrastructure in the agricultural sector, a vision about the nature of warehousing capacity development in Albania will be needed.

Albania does not currently have the comprehensive and well-developed venture capital ecosystem required to support business innovation, productivity gains, and sustainable economic growth. This is the result of a combination of factors including: (i) lack of a legislative/regulatory environment conducive to the creation of private equity funds; (ii) low supply-side activity, which makes it difficult for entrepreneurs to find external sources of funding to support their businesses; and (iii) an underdeveloped high-quality pipeline of investable companies on the demand-side. With respect to potential institutional investors in the private equity/venture capital (PE/VC) industry the supply is almost inexistent. The domestic pension funds nor the insurance companies appear to be eligible to invest in alternate assets, nor do they seem to have

the capacity to do so. According to the World Bank Albanian Venture Capital Ecosystem Diagnostic report (WB VC Report), the multilaterals appear to have been the most active partners in Albania, albeit to a very small degree. The World Bank's Enterprise Development and Innovation Facility program, along with the European Bank for Reconstruction and Development (EBRD) and its subsidiary, the European Investment Fund, have co-invested in South Central Ventures.

Online banking and POS services are increasingly widely available, but penetration of digital credit and digital financial services in general is very low. Banks recently started investing more in digital channels (on-line banking primarily), and POS services are becoming more and more accessible. However, the level of innovation and uptake of digital payments is still very low which undermines the potential to reduce information asymmetry by collecting and processing alternative (payments) data, decrease costs of transactions by lowering cash dependence, and ultimately increase tax revenues through more transparency on the market. This is primarily due to the high costs of POS services, lack of disruptors pushing incumbent players to innovate, a lack of access points in rural areas, and the prevalent cash-based culture (e.g. unwillingness of many merchants to accept electronic payments).

Limitations also exist on the demand side for PE/VC investments. The small pipeline of potential investee companies is attributed to the lack of entrepreneurial attitudes that do not reward risk-taking behavior.

## **7. Using Government to Business payments to inflow finance**

Securing adequate cash flow to execute operations profitably is one of the most critical issues facing businesses across the world today, and Albania is no exception. Long payment terms and late payment (arrears) for products and services put a heavy burden on MSME working capital management. A major cause of liquidity problems are long payment terms and late payments of accounts receivable, i.e. delays in incoming cash flows after the sale of products and delivery of services.

The Government of Albania has invested considerable efforts to tackle the problem of arrears in public sector payments.

In addition to the establishment of strict payment deadlines, the law provides the automatic application of statutorily set amounts of penalty interest in the supply of goods or services from commercial undertakings to other commercial undertakings and public authorities

Interviews with the local private sector reveal that the late payment law is not yet adequately enforced and enterprises rarely seek enforcement for delayed payments (usually finally paid without interest). There seems to be a lack of trust that a payee, particularly a public entity, would pay another creditor (with or without interest). Hence, making a cost-benefit analysis, many MSMEs accept late payments without the due interest. Creditors do not seek enforcement against public companies, fearing either that courts would not rule against the government or that they would not be awarded contracts in the future.

## **8. Conclusions and Recommendations**

Supporting the increased usage of e-invoicing linked to the tax administration (as enabled by the latest amendment of the VAT law), the development of platforms for reverse factoring or invoice discounting, as well as reforms to the moveable collateral registry (see financial infrastructure section) would increase trust and appetite for account receivable financing.

Authorities should create a favorable framework to stir competition and develop innovative products. Different types of frameworks and tools exist for authorities to stimulate Fintech and innovation in the market. In this respect, implementation of the EU PSD II Directive and establishment of a clear and transparent framework of licensing of innovative providers as well as their access to the financial sector infrastructure in general should be supported.

Greater support should be available for innovative firms. Programs in the form of co-investment VC and seed funds should be developed. Mentoring-based “investment readiness” training for companies receiving financial support/grants should be established.

An agricultural warehousing capacity strategy should be developed. Efforts to develop agricultural warehousing should be accelerated and a feasibility study for development of warehouse receipt financing, supporting agribusinesses in accessing post-harvest finance for working capital needs, should be considered.

The feasibility of regional e-platforms for the exchange/sale of repossessed collateral among lenders, with the aim to increase the efficiency of movable collateral execution and hence its perceived value, should be explored.

Allowing public sector accounts payable to MSMEs to be offered for sale on web-based invoice discounting platforms to further support access to working capital finance and to improve payments liquidity in the country. This could have multiple positive effects. Payees accept having to pay interest in case of delayed invoice payments, allowing MSMEs to sell the invoices and receive relatively cheap working capital finance. The potential volume of finance on such a platform could attract Fintech companies to operate in Albania hence increasing competition and bringing innovations to the rather stiff market.

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