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Financial Sector In Kosovo

Abstract

Kosovo, the most recent country undergoing a transition process, has overcome various problems related to economic recovery and institution-building, establishing the fundamental framework for a market economy. The adoption of the euro in the economy increased market trust and ensured macroeconomic stability. Challenges for policymakers include high unemployment, poverty, an unfavorable trad balance situation, budgetary sustainability, and the need for fundamental institutional re form. Kosovo's economy, being tiny and open, remains highly responsive to global economic trends.

This sensitivity was seen in both the adverse impacts of the 2008/2009 global crisis and the favorable impacts of the initial stages of the global economy's recovery in 2010. The global economy's performance improved in the first half of the year, leading to positive effects on Kosovo's economy. Exports doubled, foreign direct investments increased by 13% annually, and emigrants' remittances rose by 1.4% annually. All these factors have improved the performance of Kosovo's real economy sector, allowing for the future growth of the financial sector's operations.

Keywords: Finance, accounting, Costs, features, management, reporting

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1.Introduction

By June 2010, the financial sector's assets had reached 2.9 billion euros, showing a 17.5% annual growth rate. This growth rate was nearly equivalent to the 18.4% recorded in 2009, despite a slowdown in the banking sector's asset growth, which holds the largest share of the financial sector's total assets.

Description	June 2007	June 2008	June 2009	June 2010
Commercial banks	7	8	8	8
Insurance companies	10	12	11	11
Pension funds	2	2	2	2
Financial assistants	30	29	28	29
Microfinance institutions.	16	16	19	17

Table.1. Number of financial institutions

2.Investment structure of the financial sector

The financial industry of Kosovo, particularly the Central Bank of Kosovo (CBK), consistently allocates a substantial portion of its assets to the external sector. Net foreign assets (AJN) amounted to 1.74 billion euros in June 2010, showing an annual growth rate of 8.6%. In June 2010, the financial sector's demands on the external sector increased by 17.3% annually, reaching a value of 2.1 billion euros. The external sector is primarily influenced by the requests of the CBK, which accounted for 57% of total requests in June 2010. This was followed by commercial banks at 26.0% and pension funds at 16.7%.

(Additional institutions such as microfinance institutions and pension funds constitute a minimal portion of the investment sector.)

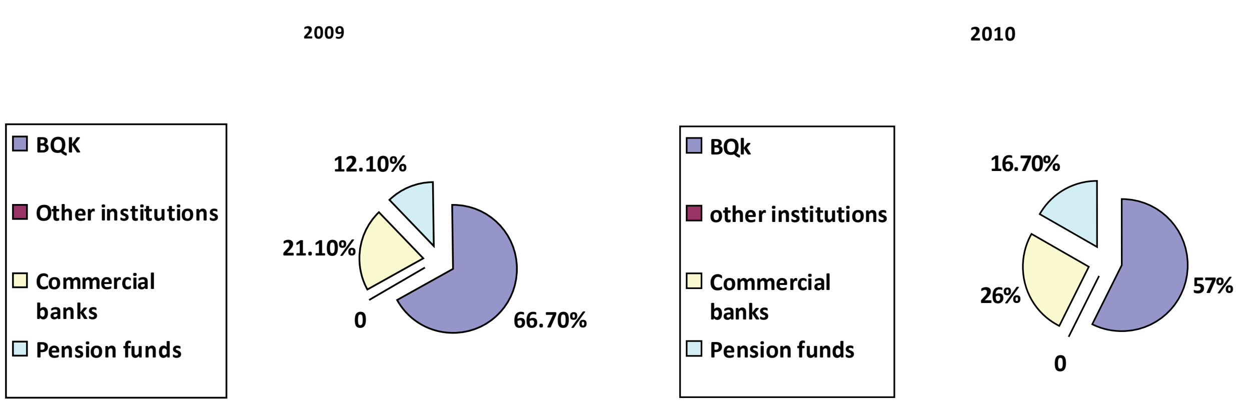

Fig. 1. Investment structure of the financial sector

2.1. Exposure of the banking sector to other financial institutions

The banking sector in Kosovo has little exposure to other sectors within the financial system, and the interbank market is essentially nonexistent. Deposits from other financial institutions in commercial banks in Kosovo account for just 4.8% of the total deposits in the banking sector. The majority of these deposits are funds that insurance companies have in commercial banks. With only 0.3% of all loans made by the banking sector going to other financial institutions, commercial banks have very little credit exposure to these institutions.

The majority of loans from the banking sector to other financial institutions are allocated to microfinance organizations, accounting for 68.6%, with loans to insurance firms following at 29.2%. The lack of interconnectedness among financial institutions is also evident in the ownership structure of these organizations.

Only three instances have been found where people hold shares in both commercial banks and insurance firms among the shareholders of financial institutions in Kosovo. The limited level of interconnection among financial institutions in Kosovo results in low systemic risk in the financial industry. Financial challenges in one area would not significantly impact other industries. Increased collaboration among the stable and high-performing financial institutions in Kosovo could accelerate their growth without significantly raising the risk of the financial industry.

3. Banking Sector

3.1. General characteristics of the banking sector

In June 2010, the configuration of Kosovo's banking sector closely resembled that of the same period in terms of the quantity of banks and the ownership arrangements of banks. During this time, Kosovo's banking system consisted of 8 commercial banks, with 6 being foreign-owned and 2 being domestic-owned. The prevalence of foreign-owned banks in Kosovo's banking sector is shown in the proportion of these banks' assets to the overall assets of the sector.

These banks hold 89.8% of the banking sector's total assets, with locally held institutions overseeing the remaining 10.2%.

3.2. The balance of the state of the banking sector

Asetet

In 2010, the banking sector expanded its activities, with assets reaching 2.2 billion euros by June, marking a 15.1% yearly gain.

Loans and securities were the primary contributors to the overall growth in assets.

Description	2009 Millions of Euros	2009 attendance %	2010 Millions of Euros	2010 attendance %
Ready money	241.9	12.6	268.1	12.1
The balance with B.K.	286.7	14.9	351.6	15.8
Securities	34.1	1.8	114.0	5.1
Loans and leasing	1280.9	66.5	1404.6	63.3
Fixed assets	40.1	2.1	42.6	1.9
Other assets	43.5	2.3	37.8	1.7
in total	1927.1	100 %	2218.8	100 %

Table: 2. Structure of banking sector assets

The decrease in investments in securities was mostly due to the banking sector's increased lending activities, as the high market interest rates provided a more attractive rate of return. The financial market shocks in 2008 and 2009 caused banks to become more hesitant to invest in foreign assets.

The decrease in credit growth and the positive changes in the global financial markets in 2010 led to a notable rise in investments in securities during this time. Banks have redirected some of their resources from providing loans to the domestic economy to investing in overseas securities.

Banks primarily invest in securities issued by governments, financial firms, and non-financial corporations.

The credits

The decline in foreign revenue and its potential impact on economic growth caused uncertainty in the banking sector over the financial stability of borrowers. As a result, lending decreased while commercial banks' sources of finance, mostly deposits, continued to increase in a pattern similar to earlier eras. By mid-2010, loans from Kosovo's banking sector totaled 1.4 billion euros, showing 9.6% annual growth compared to 17.5% growth in June 2009. The banking sector's stricter lending policies have had a greater impact on loans to businesses, resulting in much slower growth compared to earlier eras. During the first half of 2010, loans given to businesses increased by 2.3% annually, a significant drop from the growth rates of 13.9% in June 2009 and 38.5% in June 2008. In contrast, it doesn't seem as though the credit restrictions have had an impact on the growth rate of loans given to consumers.

In June 2010, loans given to households rose by 31.4%, compared to 30.4% in June 2009. The proportion of loans allocated to firms has decreased to 70.9% from 75.7% in June 2009, while loans for family economies have climbed to 29.1%.

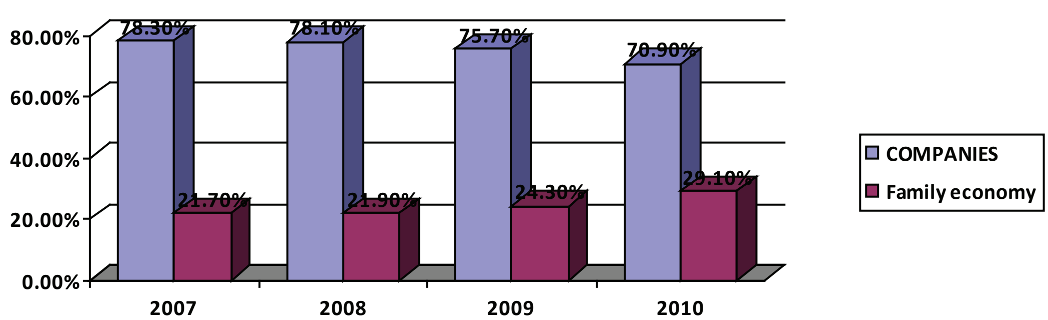

Fig. 2. Structure of loans in percentage

Obligations

Due to the majority of its funding coming from domestic sources, Kosovo's banking industry has been less impacted by changes in the external financing environment during the financial crisis. Deposits acquired within the country remain the primary financial source for banks, accounting for 79% of the total liabilities in the banking system.

Description	JUNE 2009	JUNE 2010
Balance from other banks	2.2	2.2
DEPOSITS	78.5	79.0
Other loans	0.0	0.0
Other obligations	7.9	7.5
Interdependent debt	0.9	1.1
Own tools	10.5	10.1
Total liabilities	100 %	100 %

Table 3. Structure of banking sector liabilities

DEPOSITS

Deposits in June 2010 amounted to 1.8 billion euros, showing a 15.8% yearly rise. Despite a lower yearly growth rate of deposits compared to 2009, it can be inferred that deposits were less affected by the crisis due to the dominance of deposits made within the year in the banking sector of Kosovo. The rise in the banking sector's total deposits is primarily due to the increase in deposits from households, which amounted to 1.13 billion euros in June 2010, thereby boosting overall deposits. Household deposits account for 65% of total deposits, with company deposits following at 17.5%. 12.7% of the remaining component consists of government deposits and deposits from other financial institutions.

3.3. The performance of the banking sector

In June 2010, the banking sector of Kosovo saw a turnaround in profits, generating a net profit of 19.4 million euros, marking a 56.8% yearly increase following a period of decline. The banking sector's profit increase is primarily due to cost reduction measures implemented by commercial banks to maintain efficiency during a slowdown in financial intermediation activity, while revenue growth remained slower than in previous periods. Following two years of declining profitability in the banking sector, there was a rise in profitability metrics, including the average return on average asset (ROAA) and the average return on average equity (ROAE), due to the increase in net profit. The rise in the average return on assets and the average return on capital was primarily due to the profit growth of the country's three major banks.

A significant 80% decline in other income in June 2010 further reduced the banking sector's revenues in the first half of 2010. Conversely, the banking sector's investments in securities increased in 2010, leading to a favorable impact on total revenues.

The majority of the banking sector's income comes from interest on loans, accounting for 79.3% of the overall income. The income composition of the banking industry mirrors the composition of its balance sheet, with loans making up the majority of the sector's assets. The sector's significant reliance on one source of revenue increased its susceptibility to changes in certain market segments. In the past two years, a decrease in lending has led to a noticeable slowdown in the rate of income growth. Fees and commissions from banking products account for 16.8% of total revenues in the first half of the year, which is a significant contribution to the banking system's income.

For the first time since the establishment of Kosovo's banking system, expenses in this sector decreased in the first half of 2010. The banking sector's expenses in June 2010 amounted to 83.8 million euros, showing a 6.5% yearly drop. The banking sector's expense reduction is mostly focused on decreasing operating costs to uphold sector efficiency. In June 2010, the banking sector's general and administrative expenses experienced an annual decline of 11.6%.

3.4. Interest rates

The average loan interest rate has remained consistent at 14.3% in June 2010, which is somewhat lower than the rate of 14.4% in June 2009. Business loans typically have higher interest rates compared to loans for individuals. Banks may have adopted a more conservative attitude towards businesses due to the enterprises' increased vulnerability to economic shocks and the higher risk associated with their initiatives.

The average interest rate for corporate loans in June 2010 was 16.7%, and for home loans, it was 12.2%. The highest interest rates within enterprise loans are seen in loans designated for investment.

Interest rate differentials on deposits typically decrease due to lower interest rates on loans and higher interest rates on deposits.

Numerous factors, primarily the interaction between the market's supply and demand for loans and deposits, affect interest rates in Kosovo.

Interest rates, particularly on loans, are influenced by factors within and outside the control of banks. The Central Bank's power through monetary policy instruments is significantly restricted due to the Euroization of the economy, which has removed the traditional tools central banks use to impact interest rates.

The cost of financing in Kosovo can be reduced by improving the efficiency of the banking sector, which will lower banks' expenses and lead to decreased prices for banking products.

3.5. The risks of the banking sector

Liquidity risk

Deposits continue to be the primary source of funding for Kosovo's banking sector. Deposits accounted for 79% of the banking sector's total liabilities in June 2010. The remaining financing for banking activities includes 10% from own resources and 1.1% via interdependent debt. Most banks in Kosovo mostly obtain their funds from local sources and are not reliant on foreign funds. The global crisis did not significantly affect Kosovo's banking sector due to the limited liquidity in the international financial markets.

The liquidity in Kosovo's banking system has consistently maintained a respectable level. Every bank in our country has shown enhanced liquidity indicators, signaling a favorable advancement for the soundness of the banking system. The loan-deposit ratio has decreased due to the faster growth rate of deposits in comparison to the growth rate of loans. The loan-deposit ratio was 80.2% in June 2010 and 84.7% in June 2009.

Solvency Risk

In June 2010, the capital adequacy ratio (CAR) in the Kosovo banking sector rose to 18.7% from 17.4% in the previous year. This number is good, as it is obviously above the Central Bank's minimum rate of 12%.

The rise in CAR was mostly due to the accelerated expansion of capital in comparison to the growth of risk-weighted assets (RWA). The annual growth rate of capital was 12.8%, whereas RWA only showed an annual growth rate of 4.8%. The decrease in the growth rate of risk-weighted assets (RWA) mirrors the decrease in the growth rate of loans, which are the primary component of RWA.

Capital

By June 2010, the capital in the banking sector had risen to 259.3 million euros, marking 12.8% annual growth from the previous year.

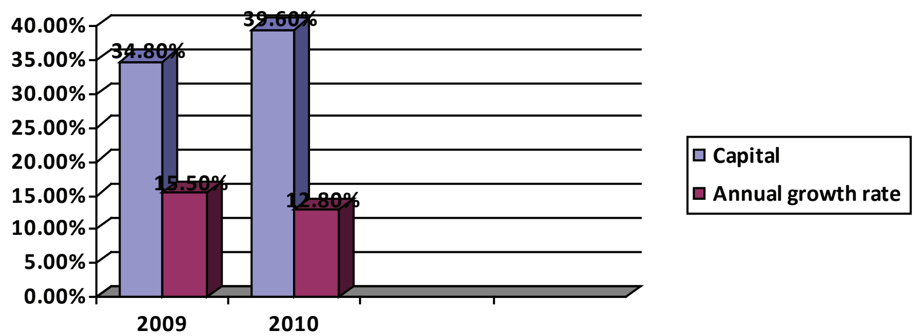

Fig. 3. Total capital of the banking sector

Figure 3 shows that over the past three years, the capital of the banking industry has consistently increased, while its growth rate has been declining. Kosovo's banking sector primarily funds its regulatory capital through banks' share capital and retained profits. Recently, banks have started utilizing foreign financing methods to increase capital, including incorporating additional subordinated debt as part of Tier 2 capital. Banks have yet to adopt hybrid financial instruments, which could pose a greater danger.

3.6 . Stress-test analysis

The stress-test study assesses the banking system's stability when subjected to severe negative shocks in the industry. Stress tests are crucial tools for risk management in individual banks, and central banks also use them to assess systemic risk. The primary goal of the stress test is to demonstrate how the financial system reacts to changes in different risk factors. Stress tests can be conducted on both the asset and liability sides of banks' portfolios. The system's sensitivity can be assessed by conducting stress-test analysis to evaluate its resilience against different risks, including credit risk, liquidity risk, interest rate risk, and exchange rate risk.

Table 4. Simplified presentation of the stress-test model methodology

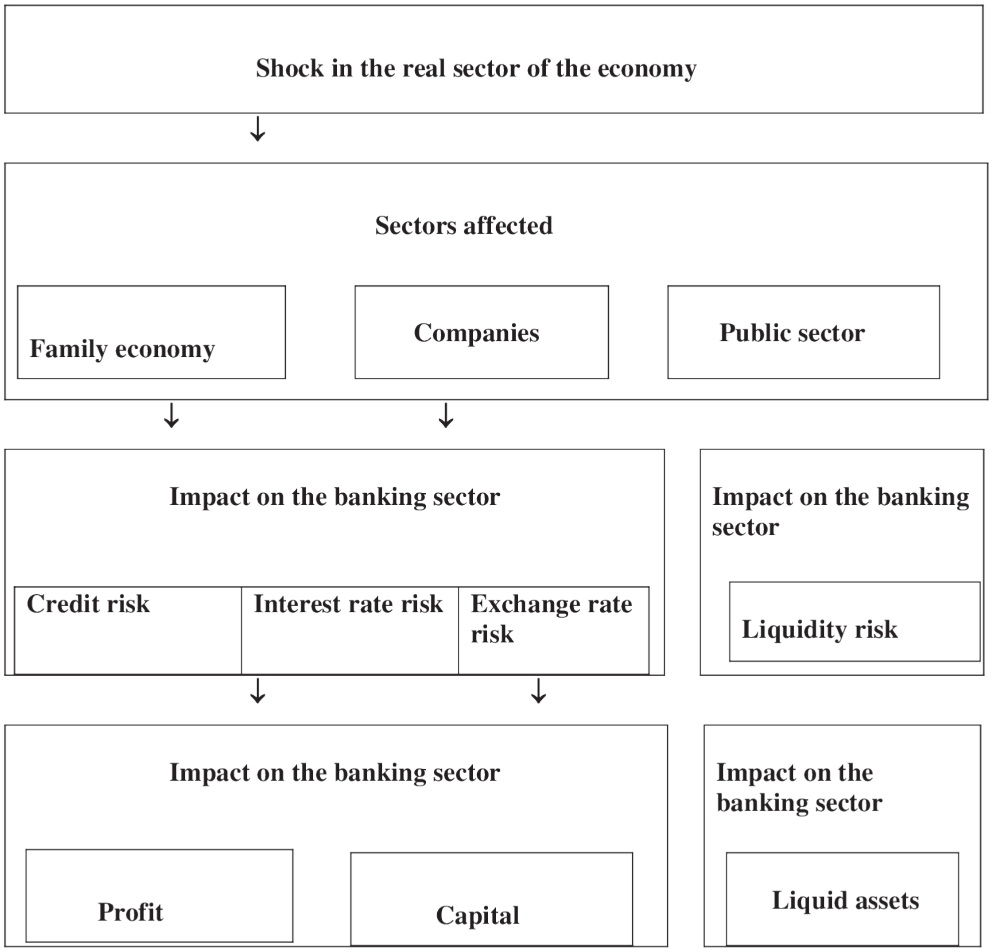

Table 4 illustrates the pathways through which an economic shock might impact the performance and stability of the banking system. For instance, a negative shock in the real economy sector could impact firms' performance and consequently hinder their loan repayment capabilities. Therefore, Non-performing loans in the banking sector would rise, leading to a decline in profit, an increase in provisions for loan losses, and ultimately a reduction of capital. The decrease in the banking sector's capital has adverse effects on its sustainability by diminishing banks' ability to withstand shocks. The stress-test analysis provides an opportunity to link macroeconomic trends in the country with the banking system's performance, allowing for the evaluation of how the banking sector responds to different macroeconomic shocks. This allows for the monitoring and prediction of the stability of the banking system. The Central Bank of the Republic of Kosovo (CBK) utilizes stress-test analysis to evaluate possible risks in individual banks and at the systemic level. The CBK's stress test assesses banks' sensitivity to various risk factors like credit risk, liquidity risk, and interest rate risk. The goal is to improve the correlation between these risk factors in the banking system and macroeconomic trends in the country. The anticipated disruptions in the banking system's portfolio mostly rely on previous trends in banks' portfolios and their way of assessing potential future changes. This analysis focuses on the current state of the banking system at a certain moment. Efforts have been made to incorporate dynamic aspects to improve the ability to predict future changes regarding the stability of the banking system. We analyzed the banking industry of Kosovo in the Stability Report using stress-test analysis based on June 2010 data.

This analysis tested the banking system of Kosovo for sensitivity to credit risk, interest rate risk, exchange rate risk, and liquidity risk. The majority of the portfolio is in euros, resulting in minor exchange rate risk.

4.Discussion

Insurance is a method of safeguarding against financial losses caused by various risks. Insurance plans provide compensation for losses resulting from traffic accidents, property theft, fire and storm damage, medical bills, and loss of income due to disability or death. The insurance fund generates compensation for losses. Insurance is justifiable when the occurrence of insurance events (risks) results in a substantial financial requirement. Insurance, as an economic concept, encompasses economic relationships, the establishment and utilization of insurance funds, and their role in compensating for insured events and assisting individuals during specific life occurrences. Aleksandrov A. (1998) outlines the features of the economic category of insurance as follows:

Redistributive relations, insured risk and evaluation criteria, organization of the insurance community by signatories and insurers, combination of individual and group insurance interests, joint responsibility of signatories for damage, limited spread of damage, redistribution of damage in space and time, return of insurance payments, and self-sufficiency of insurance activity.

Recommendations

In the first half of 2010, the insurance business in Kosovo saw steady growth and maintained stable operations. As of June 2010, insurance companies' assets amounted to 90 million euros, reflecting a yearly growth rate of 20.1%. Insurance businesses in Kosovo mostly possess assets. 65.2% of total assets are held as deposits in commercial banks. In June 2010, there were 11 insurance companies operating in the Kosovar market, with 8 being foreign-owned and 3 being locally owned. In terms of the ownership composition of the assets, domestic investors own 20.1% while foreign investors own 79.9%. By June 2010, insurance companies had sold 241,000 policies, reflecting an annual growth rate of 8%. The insurance companies received 34.8 million euros in premiums by June 2010, showing an annual growth rate of 5.4%. Insurance businesses in Kosovo primarily focus on providing third-party liability (TPL) insurance. In June 2010, the premiums from selling PPT plans accounted for 61.2% of the total premiums received. Conversely, the damages paid by June 2010 had doubled compared to the previous year's similar time, amounting to 13.2 million euros. PPTs contribute the majority of the total damages paid, 74% of the total. The premium-to-claims ratio rose to 38% by June 2010, up from 24.2% in June 2009.

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