BANKA QENDRORE E REPUBLIKËS SË KOSOVËS
CENTRALNA BANKA REPUBLIKE KOSOVA
CENTRAL BANK OF THE REPUBLIC OF KOSOVO

FINANCIAL SECTOR BULLETIN

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PUBLISHER Central Bank of the Republic of Kosovo
Office of the Chief Economist
33 Garibaldi, Prishtina 10000
Tel: ++381 38 222 243
Fax: ++381 38 243 763

WEB www.bqk-kos.org
E-mail research@bqk-kos.org

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ABBREVIATIONS:

BKT	Banka Kombëtare Tregtare
CBK	Central Bank of the Republic of Kosovo
DIS	Deposits Insurance Scheme
ECB	European Central Bank
FA	Financial Auxiliaries
FDI	Foreign Direct Investments
FED	Federal Reserve
GDP	Gross Domestic Product
IMF	International Monetary Fund
KEK	Kosovo Energy Corporation
KM	Komercijalna Banka
KPST	Kosovo Pension Saving Trust
MFI	Micro-Finance Institutions
MTA	Money Transfer Agencies
NFA	Net Foreign Assets
NLB	Nova Ljubljanska Banka
pp	Percentage Points
PTK	Post and Telecommunications of Kosovo
ROAA	Return on Average Assets
ROAE	Return on Average Equity
TEB	Türk Ekonomi Bankasi
TPL	Third Party Liability
VAT	Value Added Tax

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1. EXECUTIVE SUMMARY

The financial crisis in the international financial market in 2008 was one of the most serious crises in history and represented a big challenge for the governments and central banks in developed market economies. The crisis evolved in the mortgage market in the U.S. and was spread in banking systems elsewhere which were exposed to this market. Effects of the crisis were also transmitted into the real sector and many of countries have officially declared that their economies have entered into the recession.

Despite the difficulties in the international financial market, Kosovo financial system continued its normal operations, although the Kosovo Pension Savings Trust (KPST) recorded decline in the value of its assets that were invested in stock markets abroad. Banking sector, which represents the largest share of the financial market in Kosovo, was characterized with a significant growth in terms of financial intermediation. By the end of September 2008, loans extended by the banking sector reached euro 1.1 billion, representing a yearly growth of 37.0%, which is the highest growth rate since 2003. The structure of loans issued by the banking sector remained broadly the same with the largest share extended to the trading sector. Regarding maturity, longer term loans continue to increase their share to total loans.

A significant growth is noticed also in deposits reaching at euro 1.4 billion and representing a yearly growth of 32.1%. The main source of deposits remain households, while in terms of maturity, short-term deposits continue to dominate the deposit structure. The increase in the degree of financial intermediation, to some extent, is a result of competition in the banking sector which, among others, has been manifested with more favorable interest rates and higher quality services for clients. Kosovo banking sector continues to be profitable, liquid and solvent. The good liquidity and solvency position is shown also through results derived using the Stress-Test Model - which tests the banking sector sensitivity to various potential shocks.

Positive performance is noticed also in other sectors of the financial market. Insurance industry has shown that it is attractive sector for new investments since another insurance company joined the market during 2008. Moreover, during 2008 the insurance industry upgraded services by providing life insurance services. Insurance companies operating in Kosovo continue to be profitable and well capitalized. Micro-finance institutions continue to support the domestic economy through their lending activity. Loans issued by micro-finance institutions reached euro 89.1 million, a yearly increase of 26.3%.

2. INTERNATIONAL FINANCIAL ENVIRONMENT

International financial sector is experiencing one of the most serious crisis in the history. The financial crisis, which has already taken a global character, started in the U.S. and evolved during the period 2007-2008. Due to the high degree of integration of the financial systems, within a short period of time the financial crisis was spread also in Europe where problems emanated from banks exposed to the U.S. market. First signs of the financial crisis appeared in the sub-prime mortgage market in the U.S., which grew rapidly as a result of favorable credit conditions for banks and clients. The financial market liberalization in the previous years, increase in competition and sustained low interest rates enabled commercial banks in U.S. to increase substantially their lending by applying lower classification criteria for potential debtors. The increase was prevalent in the mortgage market, causing high increase in the demand for houses and housing prices. Inflationary pressures pushed FED to increase interest rates, which caused difficulties for sub-prime debtors to return their loans. Consequently, loan defaults were followed by a sharp decline in real estate prices which induced further defaults and deteriorated banks' loan portfolio quality.

In order to reduce the risk from the high level of lending, especially in the sub-prime market, banking institutions used a number of sophisticated financial instruments which were difficult to be controlled by regulators. The use of these instruments did not mitigate the risk but just hid and spread it away, having a negative impact on other financial sectors such as insurance companies and investment banks. Crisis culminated with the bankruptcy of some highly rated banks causing fast spread in the sector. Evolution of the crisis increased uncertainties and distrust in the inter-bank market, which was followed by the increase in interest rates for inter-bank loans and decrease in supply of liquid assets in this market. Consequently, access to funds through this market, both in the U.S. and Europe, became difficult and many banks faced serious liquidity problems.

Liquidity problems caused serious decline in the credit growth rates, implying that the financial crisis is being transmitted into the real economy. Credit crunch takes a short period of time to be transmitted into the real economy with negative effects for economic growth. In this context, some countries have already declared officially that their economies have entered into the recession. The difficulties in financing businesses through banking sector have caused a pessimist sentiment on economic activity and distrust in markets. As a result, share price indices such as Dow Jones Industrial Average marked a substantial decline, especially in the second half of 2008 (Figure 1). Weaker economic activity in economies affected by the financial crisis is being manifested with decline in aggregate demand, lower level of consumption and exports, decrease in industrial output and job cuts. This is also reflected in the substantial fall in demand for oil. For example, oil prices declined to USD 44 for barrel in December 2008 compared to USD 147 in July 2008.

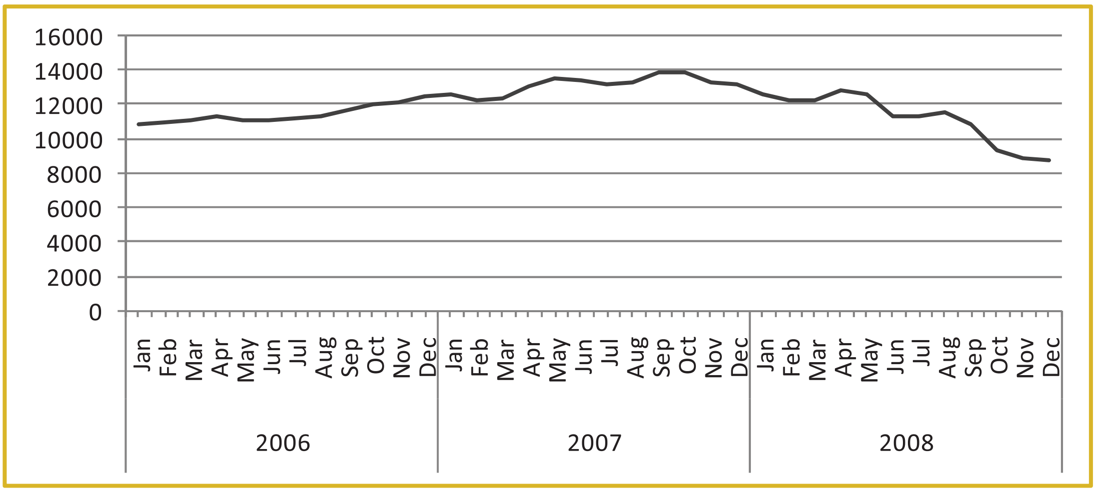

Figure 1. Dow Jones Industrial Average, 2006 – 2008

In reaction to the current situation, governments and central banks of almost all the countries that have been affected by the crisis intervened to minimize the negative impact on their economies. The measures that have been undertaken by central banks are mainly characterized by expansionary monetary policies through several cuts in key interest rates (see Figure 2), higher threshold for deposit insurance scheme and commitment for cash injections in the financial sector. Regarding cash injections, initially dominated the idea of purchasing non-performing loans from banks. However, later on it was considered that the capitalization of banks is more efficient, primarily because it will enable banks to continue and further expand their lending activity, thus, reducing the negative impact in the real economy.

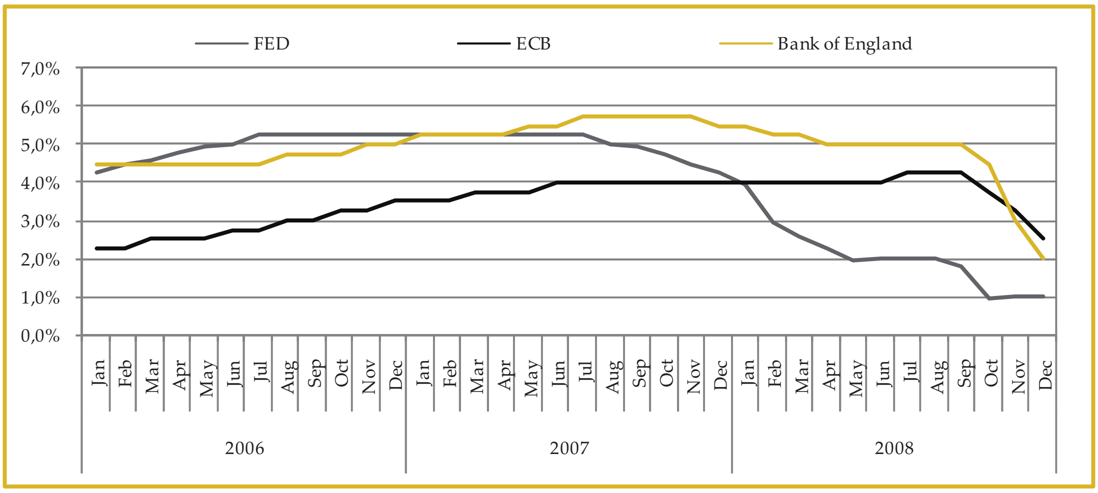

Figure 2. Key interest rates FED, ECB and Bank of England, 2006-2008

In order to stimulate aggregate demand, governments all over the world also considered to undertake expansionary fiscal policies. Apart from individual actions by the governments, another distinct feature of the current crisis is the initiative for a worldwide coordinated response to the crisis. This seemed as necessary action having in mind high degree of integration of the international financial markets. In the Summit on Financial Markets and the World Economy held in November 2008 in Washington D.C., G20 leaders agreed to undertake reforms in the following areas: strengthening transparency and accountability, enhancing sound regulations, promoting integrity in financial markets, reinforcing international cooperation and reforming international financial institutions.

Regarding the developments in the banking sector in Western Balkans, the recent IMF reports show that banking sectors in most of the countries are solvent, liquid and profitable.[1] However, governments and central banks have already planned different measures aiming at overcoming negative impact of the current crisis in their economies. Projections for the impact of the financial crisis in the economy in Western Balkans are mainly directed towards implications for the real sector that may be reflected from the recession in developed economies. The impact of this recession in economies in the region may be manifested with a decline in exports, reassessment of risk by foreign investors and, consequently decline in FDI. Another important channel of the impact of crisis is decline in remittances, which continue to be a very important source of finance in many countries in the region As a result, many countries in the region have revised their growth estimates and projections for 2008 and 2009, which resulted to be lower than initially projected. However, the economic growth in Western Balkans is expected to be positive.

3. FINANCIAL SECTOR IN KOSOVO

3.1 General characteristics

The financial sector in Kosovo continues to grow, increasing its contribution to the economic development as well as the range and quality of products offered to clients. In September 2008 total assets of the financial sector reached euro 2.2 billion, which represents an annual growth of 25.2%. This growth is mainly attributed to the banking sector with its assets growing by 30.9% y-o-y.

The financial sector in Kosovo is largely dominated by commercial banks, whose assets represented 79.2% of total assets in September 2008. The remainder consists of pension funds (12.7%), micro-finance institutions (4.5%), insurance companies (3.4%) and financial auxiliaries (0.2%). The structure of the financial

[1] http://www.imf.org [accessed on 1st December 2008].

sector assets remained broadly unchanged compared to the previous year, with a slight increase of banking sector participation and a decrease of pension fund and insurance companies' participation (Figure 3).

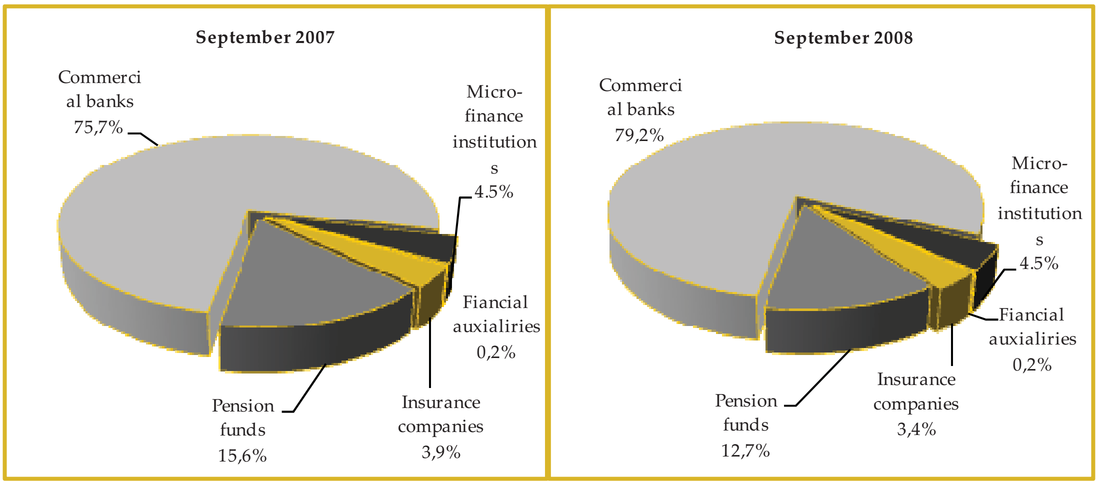

Figure 3. Structure of the financial system

The banking sector activity remains mainly basic and relies on lending to the domestic economy, while its main source of finance remain deposits collected in Kosovo. While for insurance companies the main activity remains compulsory insurance TPL policies, the activity of micro-finance institutions is mainly concentrated on lending to the domestic economy (mainly agriculture and households) and is financed from credit lines received from abroad. This structure of the financial sector has enabled normal operations despite the global financial crisis, except for the pension system with KPST marking a decline in the value of its assets invested in shares in international stock markets.

Financial sector in Kosovo is characterized with a large presence of foreign capital. This is mainly prevalent in the banking and insurance market where 91.0% and 72.1% of total assets are managed by foreign companies, respectively. The presence of foreign financial institutions in Kosovo has contributed in the modernization of the financial system by bringing more advanced practices in finance and stimulating competition.

Net Foreign Assets (NFA) of Kosovo financial sector (including CBK) continued to grow in 2008. In September 2008, NFA amounted euro 1.8 billion which represents an annual growth of 10.8% (Figure 4). In September 2008 claims on nonresidents recorded an annual growth of 13.1%, amounting euro 1.9 billion. Claims on nonresidents are mainly represented by deposits accounting for 65.9% of total assets, which is for 6.6pp higher compared to the previous year. This is a result of the orientation of investments towards deposits, which are considered to be safer, compared to shares and securities which are experiencing a considerable decline in their value due to the global financial crisis. Liabilities to nonresidents marked an annual increase of 60.3%, which represents a higher growth rate compared to previous periods. In September

2008 liabilities to nonresidents amounted euro 128.0 million, and despite the recorded growth, remain lower compared to claims on nonresidents. Liabilities to nonresidents are mainly composed of credit lines from the external sector (69.4% of total liabilities) and deposits of nonresidents (30.6% of total liabilities).

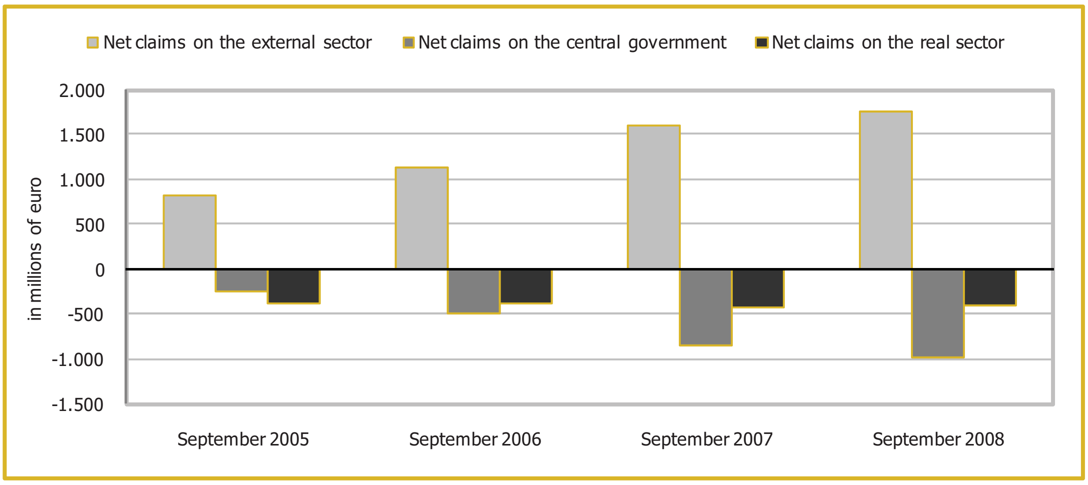

Figure 4. Financial corporations survey

In September 2008 financial sector liabilities to the government amounted euro 998.3 million (euro 850.2 million in September 2007), comprised mainly from government deposits at the CBK, while financial sector continues having no claims to the government. In September 2008, financial sector claims to other sectors (mainly private corporations and households), amounted euro 1.2 billion and are mainly composed of loans extended by financial institutions. Meanwhile, liabilities to the real sector reached euro 1.6 billion (euro 1.3 billion in September 2007), composed mainly from the real sector deposits in commercial banks.

3.2. Structure of the banking sector

During the second half of 2007 the banking sector of the Republic of Kosovo was characterized with new entries. In third quarter of 2007, the license for operating in the Kosovo banking market was granted to Banka Kombëtare Tregtare (BKT) from Albania and Komercijalna Banka from Serbia. At the end of 2007, Türk Ekonomi Bankasi (TEB) from Turkey joined the Kosovo banking system and in January 2008 started its operations. Also NLB Prishtina which took over and merged Kasabank (KSB) and Banka e Re e Kosovës (BRK) started operations in January 2008.

In September 2008, Kosovo banking sector consisted of eight commercial banks, of which six in foreign ownership and the remaining two in domestic ownership. The dominance of banks with foreign ownership is shown through the share of foreign bank assets comprising 91.0% of total assets of the banking sector in September 2008 (Figure 5).

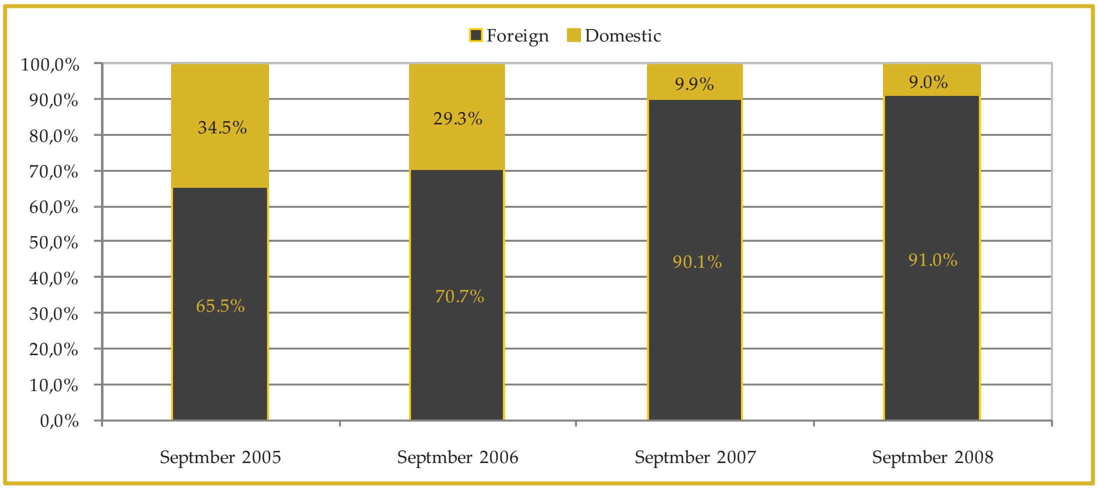

Figure 5. Commercial banks by ownership structure

The market structure of the Kosovo banking system is highly concentrated. In September 2008 three largest banks represented 86.3% of total assets, an increase of 2.1pp compared to the previous year. This is mainly attributed to the merger of KSB and BRK, which represented the third and fourth largest bank. Three largest banks attain a similar share in loan and deposits market, representing 88.0% and 88.5% of total, respectively. Concentration in the Kosovo banking system can be expressed also by the Herfindahl-Hirschman Index (HHI), but due to the new bank entries, this index shows a slight decrease compared to the previous year (Figure 6). In September 2008 the HHI for assets recorded 2,887 points compared to 2,896 points in the same period of the previous year, while HHI for loans and deposits recorded 3,014 and 3,016 points, respectively.

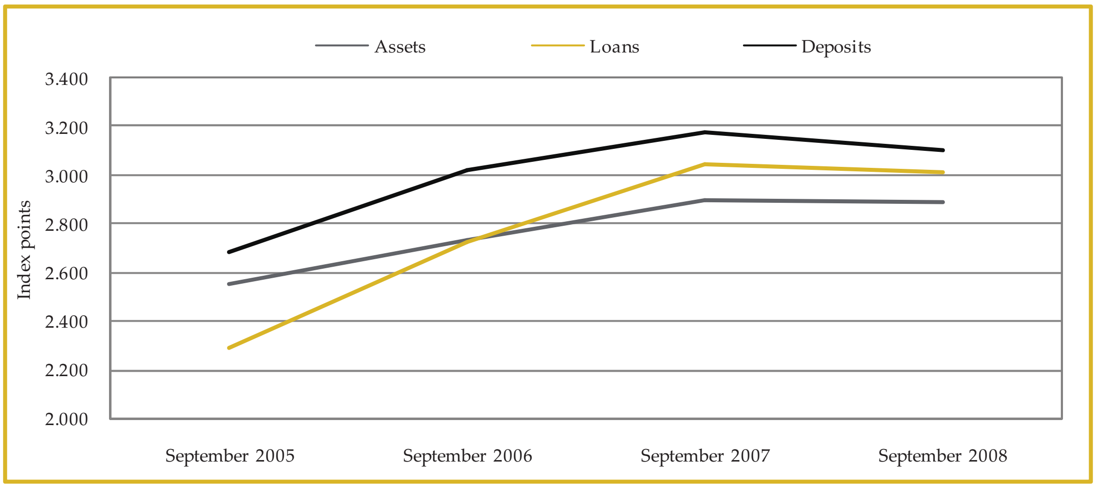

Figure 6. Herfindahl-Hirschman Index for the banking sector

The new entries in the banking market, which led to a decline in the concentration rate, positively affected the competition in this sector. The increased competition may be noticed by the sharp increase in loan and deposit volumes, as well as by the decrease in the interest rate spread (difference between interest rates on loans and deposits). Moreover, commercial banks have been more active in providing new products for clients.

The increased competition in the banking sector is also expressed through the rapid expansion of the banking network. In September 2008 total number of banking units (branches and sub-branches) reached 276 units from 231 in the previous year (Table 1). The increased number of banking units resulted mainly from the entry of new banks into the market as well as by the increased effort of the existing banks to expand their presence in the market. Moreover, the total number of ATMs recorded a considerable growth in 2008 reaching 240 from 155 in the previous year, thus, improving clients' access to banking services. Being closer to their clients seems to be an important priority for the banking sector. In this context, the number of Points of Sale (POS) and e-banking accounts recorded a considerable growth reaching 3,246 (2,554 in September 2007) and 13,051 (4,742 in September 2007), respectively.

Table 1. Banking sector network

	Septmber 2005	Septmber 2006	Septmber 2007	Septmber 2008
Number of branches and subbranches	232	219	231	267
Number of ATM	102	116	155	240
Number of e-banking accounts	412	2,872	4,742	13,051
Number of Point of Sales (POS)	1,138	1,767	2,554	3,246

3.2.1. Financial intermediation of the banking sector

In September 2008 banking sector assets reached euro 1.7 billion, representing an annual growth of 30.9%. In relation to GDP, banking sector assets accounted for 45.7% of GDP compared to 39.0% in the previous year. The growth of the banking sector assets is mainly generated by the growth in loans extended by the banking sector.

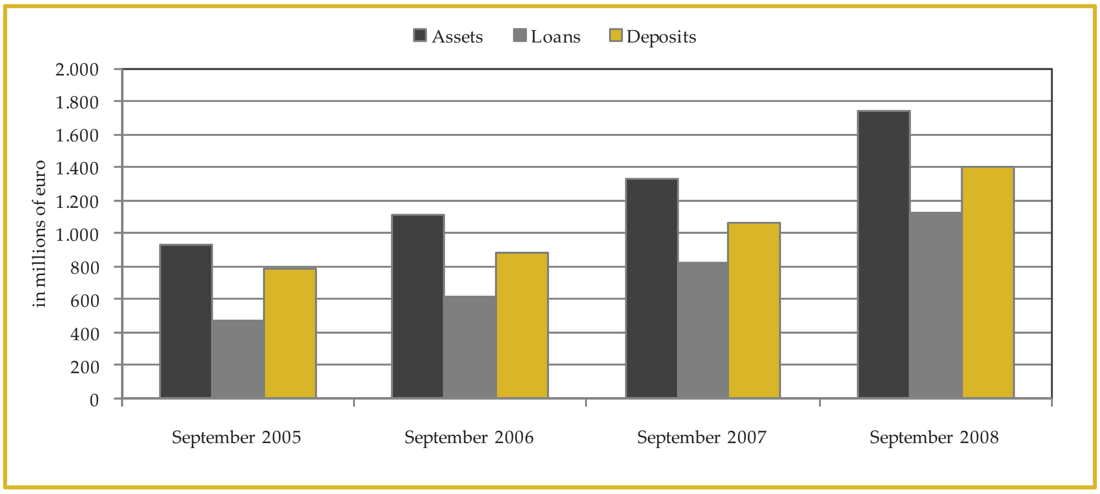

Figure 7. Assets, loans and deposits of the banking sector, in million of euro

In September 2008 the level of financial intermediation of Kosovo banking sector, expressed as ratio of loans to GDP, was 29.5% compared to 24.1% in the previous year. In September 2008 loans amounted to euro 1.1 billion, an annual increase of 37.0%. The credit growth was an outcome of the expansion of the economic activity and the increase in competition of the banking sector what drove banks extending their portfolios in order to ensure a higher market share. The credit growth is of a high importance for the Kosovo economy, especially in this period when the financial crisis is being reflected in credit contraction elsewhere and, as a consequence, the economic activity is slowing down (see Box 1).

Box 1. Recession in developed market economies and its possible impact in Kosovo

The recent financial crisis in the international financial market is having impact also in the real sector in economies more exposed to the crisis. Due to the high level of economic integration, it is expected that the impact of the recession will be evident also in economies not directly affected by the financial crisis. Kosovo economy, as an open economy, might absorb some consequences of the potential recession in the region and EU. Nevertheless, the IMF and Ministry of Economy and Finance projections for 2008 suggest a real economic growth of 6.6% and 5.2%, respectively. In addition, there has been no revision to these projections, while revised projections in some countries in the region suggest a lower economic growth than initially projected. An initial impact of the financial crisis in the real sector was through the decline in aggregate demand (mainly domestic consumption and exports). Regarding Kosovo economy, there is no evidence that the crisis has had an impact on the level of exports, given that until September 2008 the recorded level of exports was higher than in the previous year. Moreover, even in case of a drop in exports, the consequences for the economy would not be large, given that the level of exports is low anyway.

The recession in other countries may be transmitted in the Kosovo economy through its impact on remittances, which represent an important source of finance for the economy. The level of remittances was not affected during the year 2008, with preliminary estimates suggesting an increase compared to the previous year. However, having into the consideration that the recession in EU is becoming deeper, reflected in considerable job cuts, it may be expected that this will be reflected in the level of remittances in 2009. The possible decline in remittances would negatively affect consumption and investments leading to a contraction in economic activity. In this context, continuous increase in lending by the banking sector aligned with a proper risk management is a very important factor in supporting economic activity. The credit growth in Kosovo was very encouraging compared to the last year. Possible credit crunch would pose a negative effect for the economic growth with negative implications for the banking sector soundness later on.

A very important instrument for stimulating the consumption and investments in Kosovo is prudent fiscal expansion. For 2009, government increased the planned budget to euro 1.4 billion, while from January 2009 the cut in personal income and profit tax rates will be implemented. This will stimulate consumption – though some offsetting effect will have the increase in VAT – as well as investments, including foreign direct investments (FDI) as an important component for the economic activity. The FDI level is directly related to economic developments in the external sector, i.e., its level in Kosovo might drop as a result of the recession in countries affected by the financial crisis. However, the level of FDI in Kosovo highly depends on structural reforms of the economy, such as the privatization process which so far has attracted considerable amount of FDI. Progress in the privatization process and the possible privatization of Post and Telecommunications of Kosovo (PTK) and a few sectors of Kosovo Energy Corporation (KEK) may increase substantially FDI in Kosovo. Moreover, additional investments in infrastructure and tax cuts represent very important elements for attracting FDI.

The credit growth is supported by the increase in banking sector deposits, to a large extent, reaching euro 1.4 billion in September 2008 (36.7% of GDP) or 32.1% higher than in the same period last year. The growth rate of deposits registered during this period represents the highest annual growth rate since 2003. To some extent, this reflects the increase of competition in the Kosovo banking sector, which stimulated the increase of interest rates on deposits, attracting a higher amount of deposits in commercial banks. Moreover, increased competition encouraged banks to be more active in providing new products in the market, thus attracting more deposits in the banking sector.

3.2.2. Balance sheet structure

The banking sector assets continue to be dominated by loans in the domestic economy, implying that the banking system is minimally exposed to the external sector (Figure 8). This makes the Kosovo banking sector less sensitive to the developments in international financial market and not exposed to any serious threat for the financial sector stability.

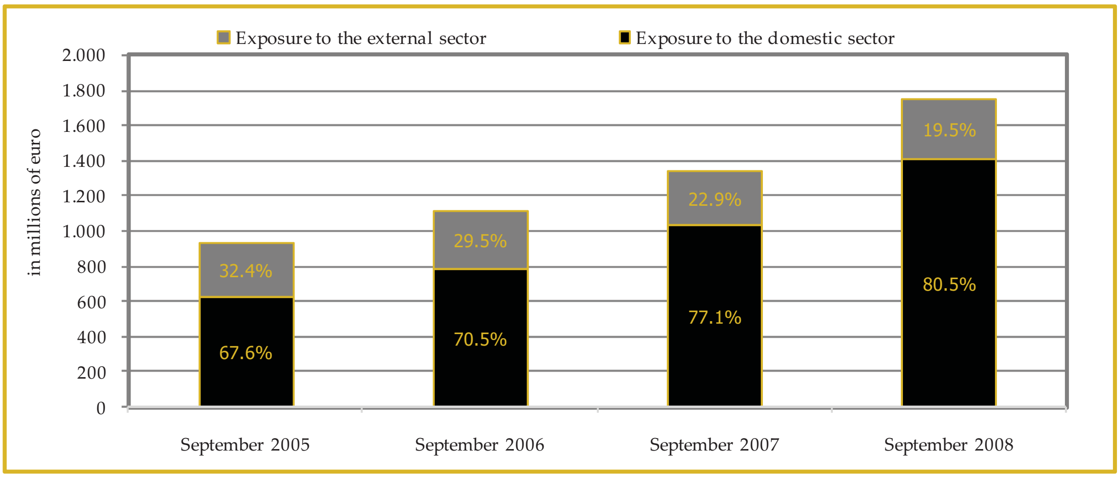

Figure 8. Exposure against the domestic and foreign sector

In September 2008, loans issued by the banking system represented 64.6% of total assets, which is for 2.9pp higher compared to the previous year (Figure 9). On the other hand, balances with commercial banks recorded a decline as a share to total assets from 18.5% in September 2007 to 17.1% in September 2008. Similarly, investments in securities recorded a decline as a share to total assets from 5.4% to 2.4%. The decline in the share of investments in securities and balances with banks abroad, and the continuous growth of loans issued in the domestic economy shows that the domestic market is becoming more attractive for banks' investments.

Regarding the change in asset components, a considerable increase is recorded in the volume of loans with y-o-y growth of 37.0%. This increase resulted mainly from the increase of loans issued to enterprises. Loans to enterprises represent the largest share of total loans issued by the banking sector representing 76.7% of total in September 2008, while loans to households participated with 23.2% in the total portfolio (Figure 10).

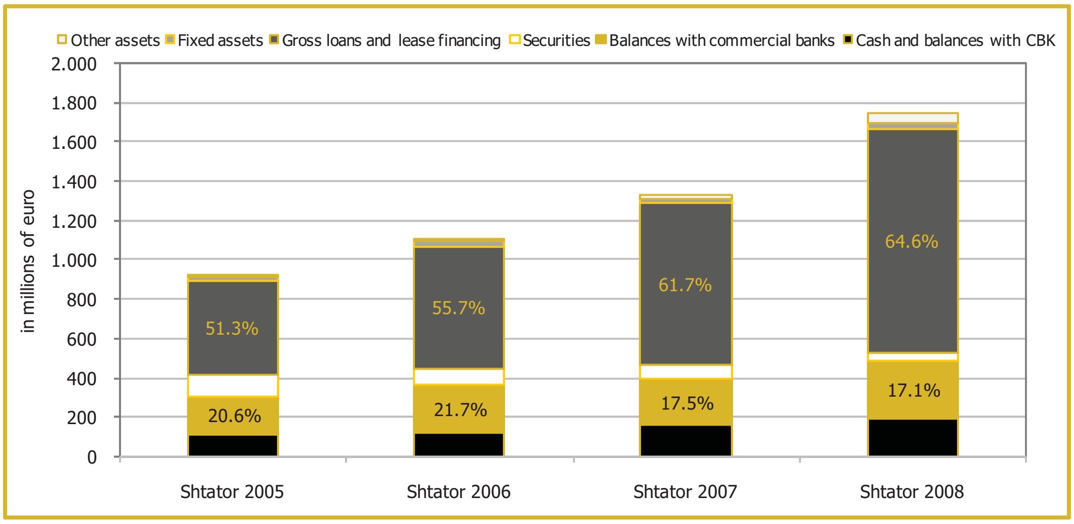

Figure 9. Structure of assets

The share of household loans to total loans in Kosovo remains lower compared to other countries in the region. The main explanation for this is high unemployment, high informal employment, low wages and relatively short maturity of loans. The increase of mortgage loans is very important for household lending. However, mortgage loans remain low, mainly as a result of deficiencies in the legal infrastructure.

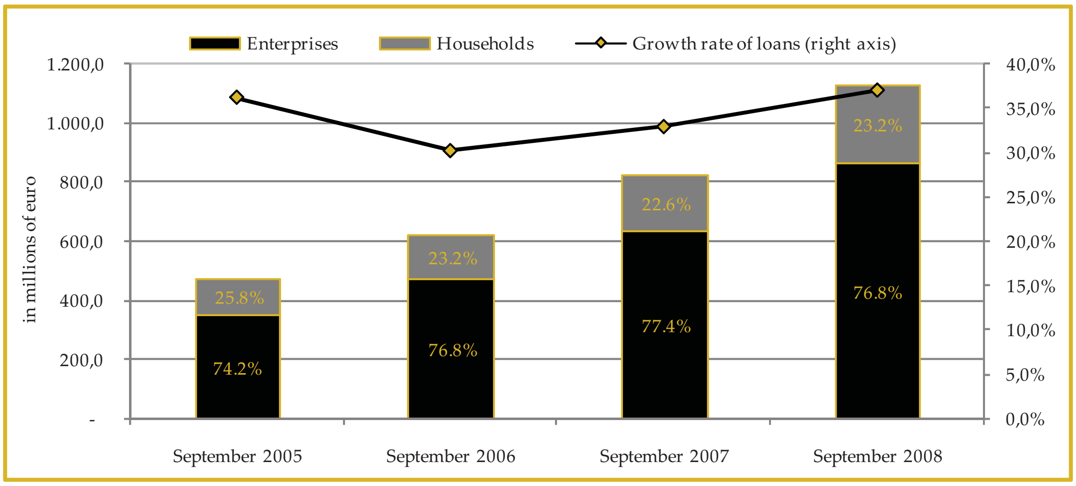

Figure 10. Structure of loans by sector

The structure of loans issued to enterprises continues to be dominated by the services sector composing 76.4% of total loans. Loans issued to the trade sector represent the largest share (57.4% of total loan issued to enterprises), what reflects high dependence of the Kosovo economy on this sector (Figure 11). Loans issued to the industry, energy and construction sector represented 19.2% of total loan to enterprises, while the agriculture sector was represented with 4.3%. The structure of loans issued to enterprises shows that banking sector is highly exposed to the trading sector. However, the growth of credit towards other sectors, such as agriculture, industry, etc., will take place as projecting capacities of potential borrowers will be developed. Consequently, banking sector could directly contribute to the development of these sectors.

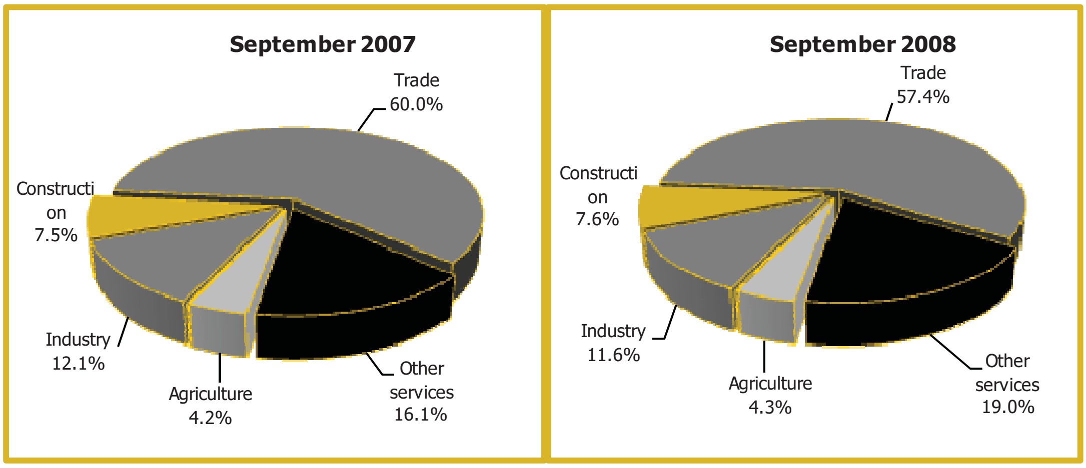

Figure 11. Structure of loans to enterprises

Continuous growth of the banking sector loans supported the economic activity in Kosovo increasing the absorption capacity of the businesses. This increased the trust of the banking sector towards the business environment in Kosovo, what can also be explained by continuous increase in the maturity of loans. For example, in September 2008 loans with maturity of over two years represented 68.1% of total loans compared to 45.0% in 2005 (Figure 12).

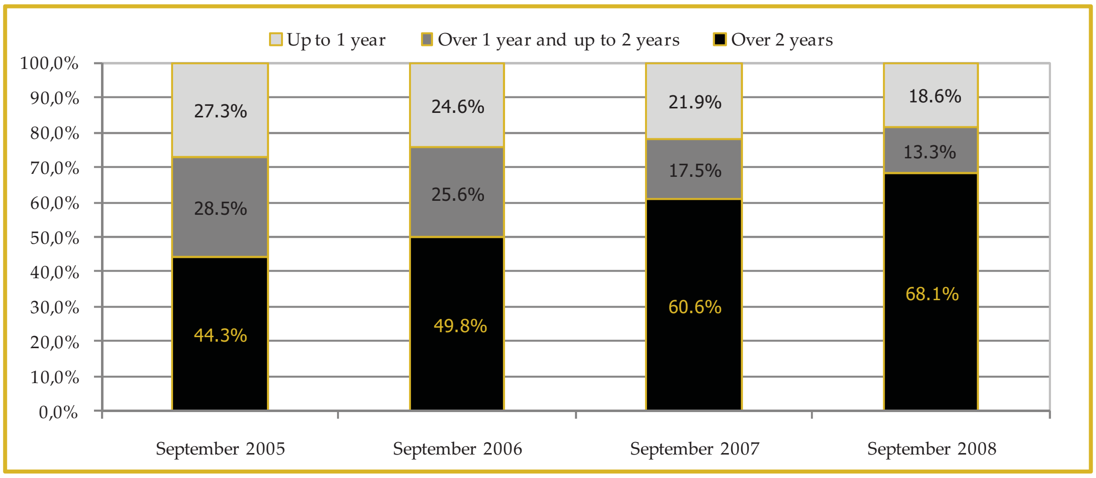

Figure 12. Structure of loans by maturity

Loan portfolio in the Kosovo banking sector remains of good quality. Despite the fast credit growth, in September 2008 the share of non-performing loans (NPLs) to total loans (which include loans classified as 'doubtful' and 'loss') declined to 3.5%, compared to 4.3% in the same period last year. The condition of the loan portfolio seems even better when taking into consideration that loan loss provisions cover around 170.9% of NPLs, suggesting that the actual level of NPLs does not represent any threat for the stability of the banking sector (see Box 2). Regarding breakdown by sector, households have the lowest level of NPLs.

Box 2. Credit risk is analyzed using the Stress-Test Model with two main scenarios: (i) assumption on the increase in the volume of NPLs as a share to total loans and (ii) assumption on the loan migration from one category to a lower category. Both scenarios assess the impact of assumed shocks in the Capital Adequacy Ratio (CAR) as an indicator of banking sector solvency. In the first scenario, results suggest that banking sector is capable of maintaining CAR in levels above the regulatory minimum of 12% even in the case when the assumed NPL growth rate is 50%, 100% and 150%. CAR declines slightly below regulatory minimum only when NPLs grow by 200%.

In the second scenario, key assumption is that 75% of loans from category 1 migrate to category 2 and 25% in category 3, while categories 2, 3 and 4 migrate to one classification below. Loan quality categories are: standard (1), watch (2), substandard (3), doubtful (4), loss (5). Results suggest a stable banking system also under this scenario, where CAR declines from 16.8% (the original level) to 12.8%, which is again above the regulatory minimum.

In September 2008, deposits as the main financing source of the banking sector assets represented 80.3% of total liabilities (Figure 13). The high reliance of banking sector on deposits collected in Kosovo has resulted in a minimal vulnerability of the commercial banks to fluctuations in the supply and cost of funds in international markets. However, to maintain the actual trend of growth in loans necessitates faster growth in deposits. This can partially be achieved by further advancing the payment system and educating the businesses and households to develop their activity through the banking system. Also reducing informal economy and a higher channeling of emigrants' remittances through the banking sector could significantly contribute to the increase of deposits. Furthermore, the introduction of Deposit Insurance Scheme (DIS), which is expected to be approved by the Kosovo Assembly in 2009, represents an important step contributing to the increase of deposits, given that it strengthens safety. The main goal of DIS is to protect small depositors, attain harmonization with the EU standards and to support the CBK in advancing banking system soundness and liquidity.[2]

[2] The financing of DIS is expected to be financed initially by a donation from the German government through KfW and later on all banks will be obliged to pay the initial fixed amount in the respective agency for deposit insurance (0.3% of capital) and continue with the regular payment of premiums (from 0.3% to 1.5% of insured deposits, depending on the evaluation by the agency).

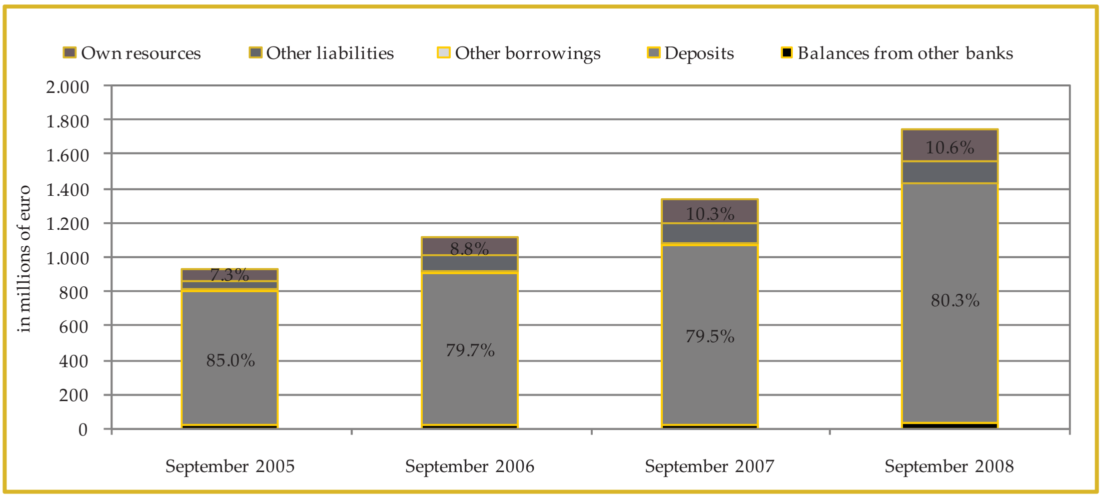

Figure 13. Structure of liabilities

The main source of deposits for the Kosovo banking sector are households, generating 60.6% of total deposits as of September 2008, while enterprises (public and private) represented 32.1% (Figure 14). Public enterprises generated 17.7% of total deposits, whereas private ones were represented with 14.4%.

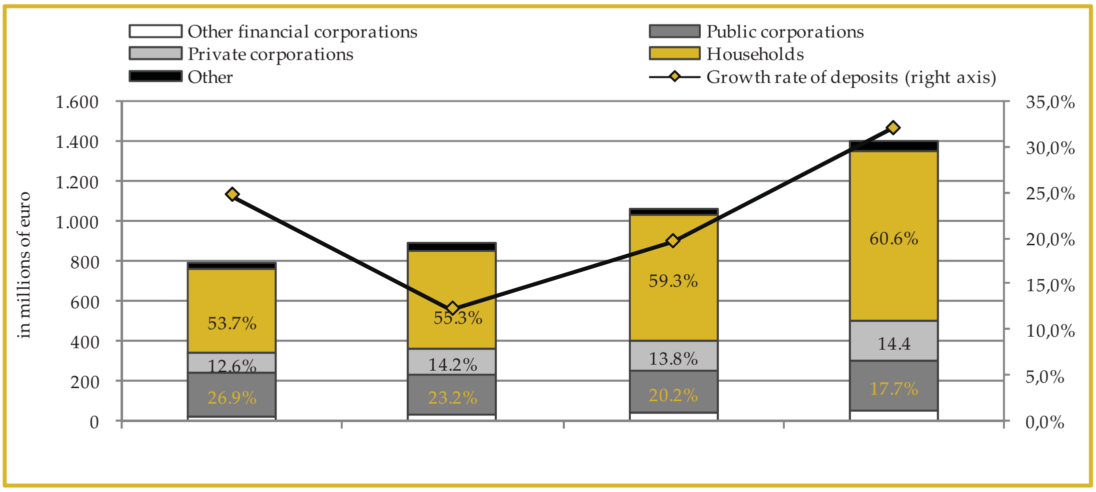

Figure 14. Structure of deposits

The structure of deposits by maturity remains similar to previous periods, where 34.4% are transferable deposits and 65.6% are time and saving deposits. The structure of time and saving deposits continues to be dominated by those with maturity of less than one year, which represented 82.5% of deposits that belong to this category (Figure 15).

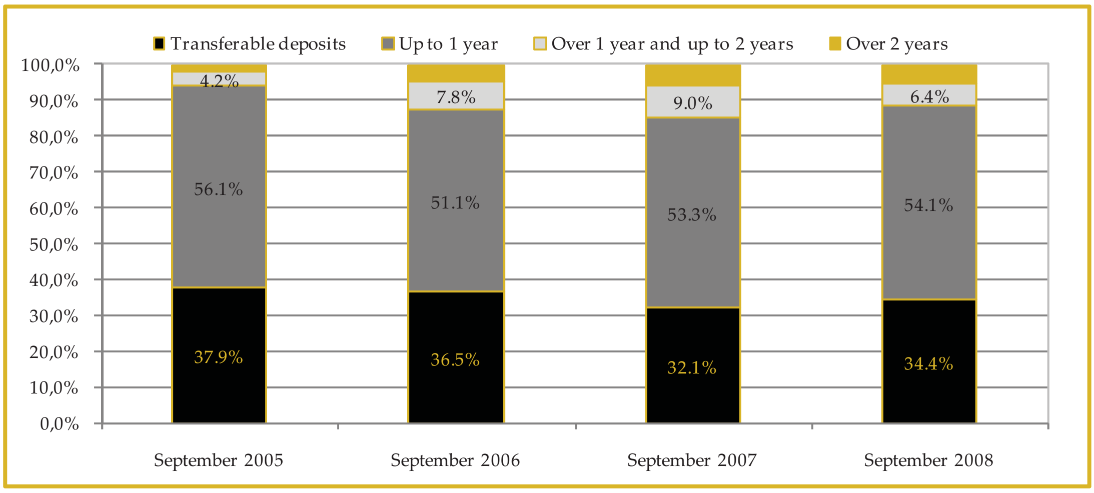

Figure 15. Structure of deposits by maturity

3.2.3. Income Statement

Kosovo banking sector was profitable since its establishment. In September 2008, the banking sector net income for the year reached at euro 29.4 million, an annual increase of 19.0%. This increase mainly resulted from the growth in lending and consequently from the increase in interest income from loans, which recorded an annual increase of 39.0%.

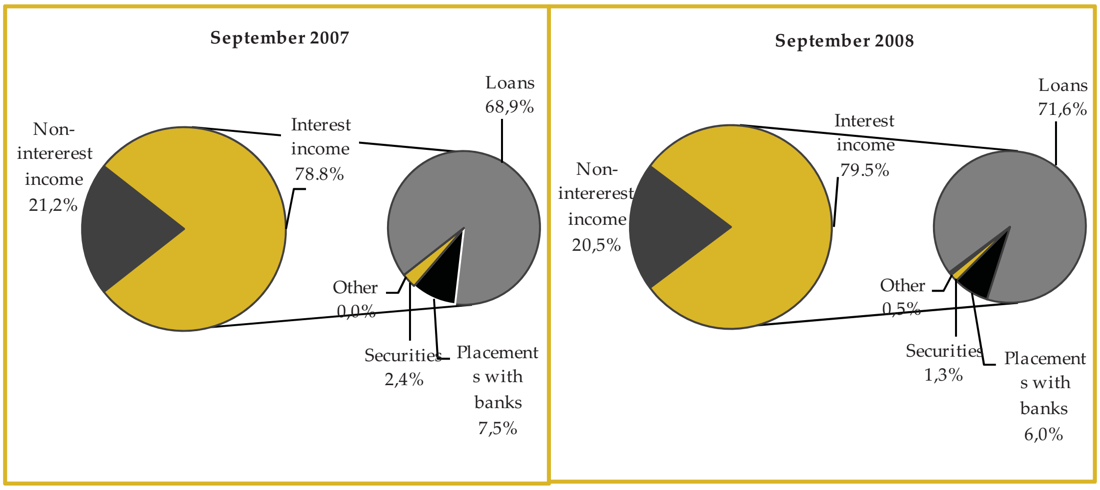

Figure 16. Structure of income

In September 2008, banking sector income reached euro 142.3 million, which is an increase of 33.7% compared to the previous year. The banking sector income largely depends on interest income from loans accounting for 71.6% of total income (Figure 16). The high dependence of total income on interest income from loans makes the banking sector earnings highly sensitive to potential fluctuations in lending rates. This becomes more important when taking into account that lending rates may decline as a result of continuous increase in competition in the banking sector. However, results from the Stress-Test Model (interest rate risk) suggest that Kosovo banking sector is capable to withstand adverse fluctuations in interest rates (see Box 3).

Box 3. Interest rate risk analyzes the sensitivity of capital adequacy ratio (CAR) to changes in interest rates with implications on financing costs and earnings of the banking sector. In this analysis it is considered decrease/increase in interest rates on loans/deposits and the impact of this shock on CAR. A particular characteristic of Kosovo banking sector is the low level of variable interest rates accounting for 2.4% of total loan portfolio, while no bank in Kosovo offers variable interest rate on deposits. Therefore, with the intention to consider a more conservative scenario, all loans and deposits with maturity up to one year were considered having variable interest rates.

The results from the analysis suggest that the banking sector remains stable with respect to assumed interest rate shocks. Assuming a drop in lending rates by 1.5pp and an increase in deposit rates by 1pp, results show that banking sector is able to maintain the capitalization level well above the minimum required. Even under the most conservative assumption of a drop in loan interest rates by 5pp and increase in deposit interest rates by 1pp, CAR remains above the minimal regulatory requirement. Under such scenario, a considerable drop in interest income would occur (about 45%), but without serious consequences for capital adequacy ratio.

In September 2008, banking sector expenditures increased by 35.2% reaching euro 104.0 million. The largest share of the banking sector expenditures consisted of general and administrative expenses accounting for 57.6% of total (Figure 17). Compared to the previous year, this category increased its share by 1.5pp, mainly as a result of the continuous expansion of the banking network. Expenses related to interest on deposits increased their share to total expenditures from 24.1% in September 2007 to 25.6% in September 2008, reflecting to some extent the increase in interest rates.

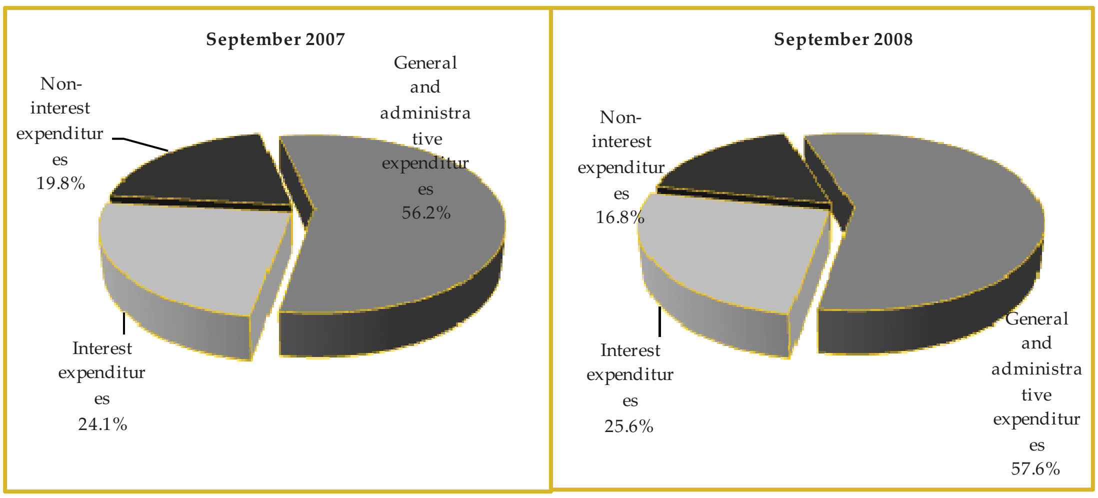

Figure 17. Structure of expenditures

3.2.4. Interest Rates[3]

The increase of the number of banks increased competition in the Kosovo banking sector and resulted in more favorable interest rates for clients. During the period January-September 2008, effective interest rates for deposits averaged at 4.13% compared to 3.11% in the same period last year (Figure 18). Increased competition also affected loan interest rates averaging at 13.80% in the period January-September 2008 compared to 14.68% last year[4].

As a result, the average interest rate spread decreased to 9.67pp from 11.56pp last year.

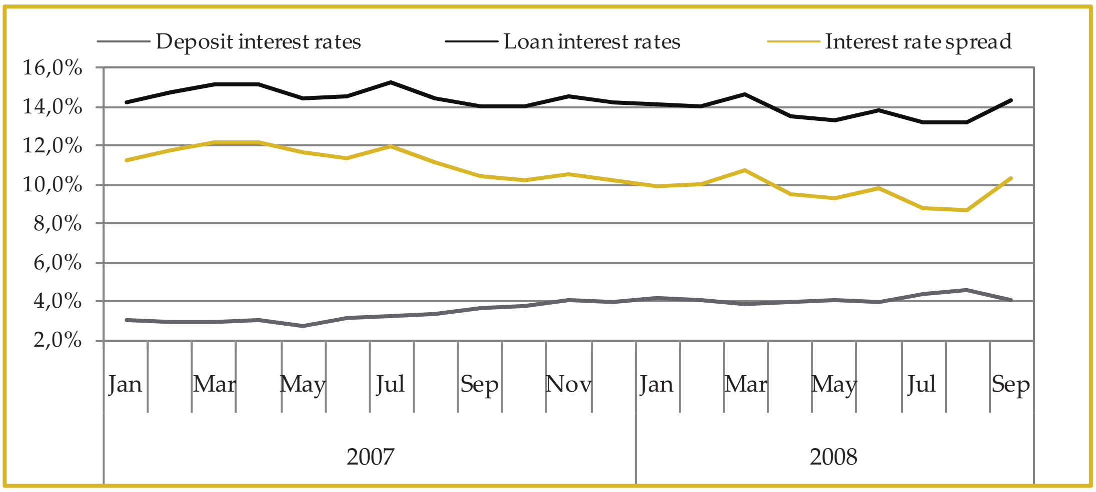

Figure 18. Interest Rates

Lending rates in the Kosovo banking sector are considered as high, but are expected to continue the decreasing trend due to the increased competition and efficiency improvement in the banking sector. The decline in loan interest rates can be facilitated also by the businesses themselves, where appropriate projecting capacities would increase the feasibility of projects. In addition, a higher quality financial reporting by businesses and a more efficient judicial system would play an important role in decreasing lending rates.

3.2.5. Banking sector performance indicators

Kosovo banking sector continues to be profitable. Return on Average Assets (ROAA) in September 2008 remained at around 2.5% (Table 2). However, in September 2008, Return on Average Equity (ROAE) marked

[3] Weighted average interest rates of different products and maturities.
[4] From January 2008, lending rates include disbursement fee applied by the banks on loan contracts. In order to be methodologically consistent with previous periods, lending rates in this section do not include disbursement fee.

an annual decrease of 4.0pp, standing at 22.2%. The decline of ROE is mainly attributed to the faster increase in the shareholders capital in the banking sector.

Table 2. Performance Indicators, in percent

	December 2005	December 2006	December 2007	September 2008*
ROAA	1.5	1.9	2.6	2.5
ROAE	20.1	22.4	26.2	22.2
NIM	6.7	6.4	7.1	7.3
Inefficiency indicator	5.5	5.1	5.4	5.1

*Annualized data.

Net Interest Margin (NIM), which is the difference between interest income and interest expenditure as a share to average assets, stood at 7.3% in September 2008 compared to 7.1% in the same period of the previous year. The inefficiency indicator, which shows the share of general and administrative expenditures to average assets, declined from 5.4% in December 2007 to 5.1% in September 2008 suggesting a slight improvement in the efficiency of the banking sector. On the other hand, the number of employees for one banking unit suggests a slight decline in efficiency, reaching 13.4 in September 2008 compared to 12.3 in September 2007.

3.2.6. Liquidity and Solvency

Despite the fast growth of the banking sector assets and credit, liquidity of the banking sector in Kosovo remains strong. Faster credit growth compared to deposit growth was reflected in a relatively high loan-to-deposit ratio, reaching 86.2% in June 2008. However, in September 2008 loan-to-deposit ratio stood at 80.5% – which is within the margin recommended by the CBK – as a result of slower credit growth and faster deposit growth (Figure 19).

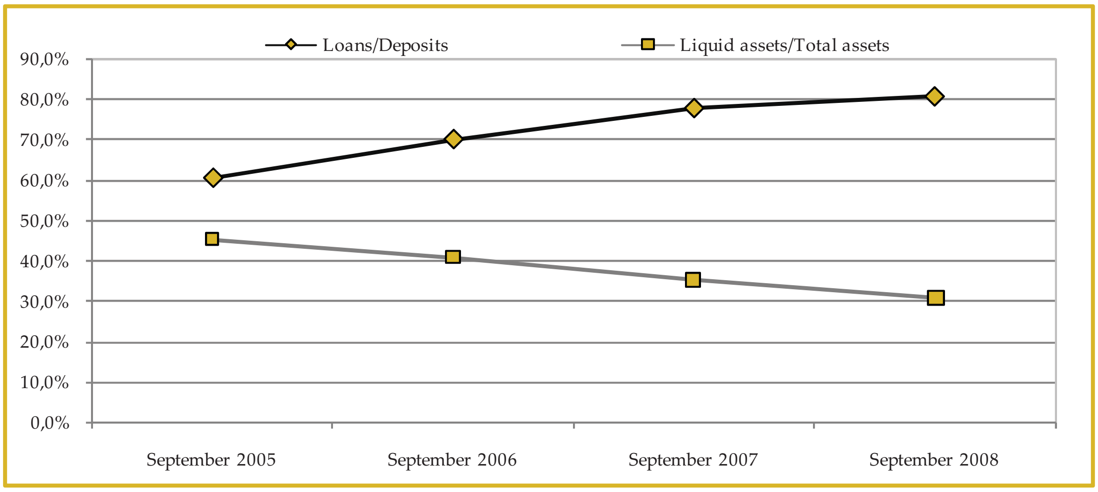

Figure 19. Liquidity indicators

The fast credit growth was reflected in the share of liquid assets to total assets reaching 30.7% in September 2008, which is for 4.3pp lower than in September 2007. Assessment of the liquidity risk through the Stress-Test Model indicates that banking sector of Kosovo is liquid (See Box 4).

Box 4. Liquidity Risk assessment analyses the ability of banks to withstand a considerable withdrawal of deposits. Results of the Stress-Testing exercise indicated a satisfactory liquidity in the banking sector. The analysis was conservative in its assumptions, considering as liquid assets only the cash and the amount of banks' reserves that exceed the minimum required by the CBK (based on the regulation on minimum reserve requirements). Different assumptions were considered about the degree of liquidity of other assets such as deposits in banks abroad and securities. In addition, in order to keep the scenario more conservative, it was not taken into account any opportunity of banks to use credit lines as a source of liquidity.

Under the assumption that placements and securities abroad are 100% liquid, banking sector may withstand a withdrawal of up to 24% of total deposits without additional liquidity support. Even with more conservative assumption, i.e., banks would not have access to their placements and securities abroad, banking sector remains liquid. In this case, banking sector is able to withstand a withdrawal up to 6% of total deposits without the need for additional liquidity support. Therefore, it can be considered that the banking sector is liquid even in the case of substantial withdrawal of deposits.

Banking sector of Kosovo remains solvent. In September 2008 Capital Adequacy Ratio (CAR), which is the ratio between capital and risk-weighted assets, stood at 16.8% which is well above the minimum level of 12.0% required by the regulator. Moreover, all commercial banks that operate in Kosovo exceed this minimum capital requirement. Compared to the same period of last year, CAR recorded a slight decline (1pp), which is mainly due to a higher growth in risk-weighted assets, resulting from higher credit growth, compared to the growth recorded by capital. Nevertheless, as shown in the analysis of the credit and interest rate risk (Box 2 and 3), CAR is higher than the minimum capital requirement even in cases of different conservative scenarios and shocks considered throughout the analysis.

3.3. Insurance Companies

Insurance industry is another very important sector of Kosovo's financial system. In May 2008, the number of insurance companies operating in Kosovo reached 10 after ELSIG entered the market. The new company was initially domestically-owned whereas in October 2008 changed the ownership becoming foreign- owned. This shows that the insurance industry in Kosovo remains an attractive sector for foreign investors, what is also explained by the fact that seven out of 10 insurance companies operating in Kosovo are foreign owned and manage 72.1% of total insurance sector's assets. In April 2008, CBK allowed a controlled liberalization in setting the tariffs for TPL insurance policies. This action has stimulated competition in the insurance market and it is expected to have an impact in the increase of efficiency and improvement of quality services in this sector. During 2008, insurance industry in Kosovo introduced new products such as life insurance services, which represent a very important segment of insurance activity.

In September 2008, total assets of insurance companies reached the amount of euro 74.8 million, which represents an increase of 9.9% compared to the same period of last year. The largest part of assets is composed of deposits composing 70.1% of total assets. The main item in the liability side continues to be shareholders capital representing 47.1% of total. The expansion of Kosovo's insurance industry activities can also be explained through premiums received amounting euro 43.8 million in September 2008, which is for 9.4% higher than in September 2007 (Figure 20). Activity of the insurance industry in Kosovo continues to be concentrated mainly on the insurance of motor vehicles through TPL policies - generating 64.5% of total premiums received. The remaining part of premiums received is generated from border insurance and non-TPL policies which in September 2008 represented 19.9% and 15.6% of total premiums, respectively. On the other hand, in September 2008 damages paid by insurance companies reached the amount of euro 12.9 million, which shows an annual increase of 32.4%. As a result, the damages - to - premiums ratio reached 29.5% in September 2008 (24.3% in September 2007).

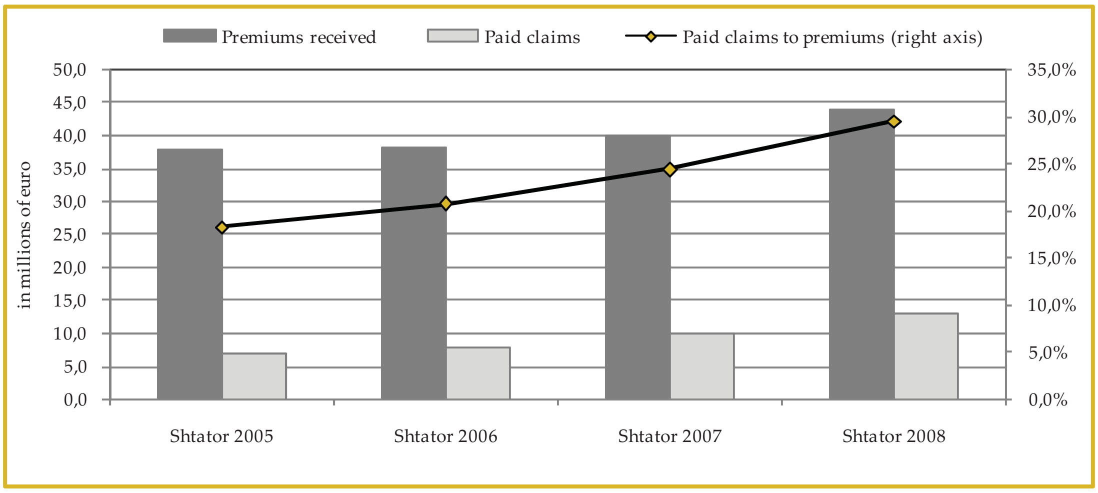

Figure 20. Activity of insurance companies

Share of capital to total assets, which shows the capitalization level of the industry, recorded an annual decrease of 1.8pp, standing at 47.1% in September 2008. The capitalization level shows the ability of the sector to withstand eventual losses. Another important indicator for evaluating the health of the insurance industry is the capital to technical reserves ratio which stood at 114.1% in September 2008 (112.0% in September 2007).

3.4. Pension funds

Pension funds represent the only sector of the Kosovo financial system affected from the international financial crisis. Since the beginning of the year until September 2008, the value of savings at KPST has decreased for 16.7% (49 million euro) and has continued to decrease also during the fourth quarter of the year. This is due to the decline in the value of KPST shares invested abroad, which have followed the global trends at international stock markets. Nevertheless, the value of shares is expected to increase as a result of the measures undertaken by governments in developed market economies, aiming at returning stability and trust in financial markets.

The impact of the crisis in KPST, which represents the largest pension fund in Kosovo, has considerably affected the amount of Kosovo's pension system total assets. In September 2008 total assets of pension funds which operate in Kosovo reached the amount of euro 280.7 million, which represents an annual increase of only 2.0% compared to the annual increase of 38.0% in September 2007. The largest part of assets is invested in shares and other forms of capital which comprise 56.7% of total assets (61.8% in September 2007). Investments in securities other than shares represent 31.8% of total assets, whereas 11.5% of assets are invested as deposits. Compared to the same period of last year, investments in deposits as a share to total assets increased by 7.0pp, which is mainly a result of the increase in pension fund deposits in CBK and in commercial banks operating in Kosovo.

3.5. Micro-Finance Institutions

The activity of Micro-Finance Institutions (MFI) in Kosovo is focused in crediting the domestic economy. In September 2008, total assets of these institutions reached the amount of euro 99.0 million, which is for 19.4% higher than in the same period of last year (Figure 21). Assets of MFIs consist of loans, with share to total assets at 90.0% (85.1% in September 2007). The volume of loans issued by MFIs increased annually by 26.3%, reaching the amount of 89.1 million euro. However, share to total loans issued by financial corporation decline to 7.3% of MFI loans because of a higher increase in loans issued by commercial banks.

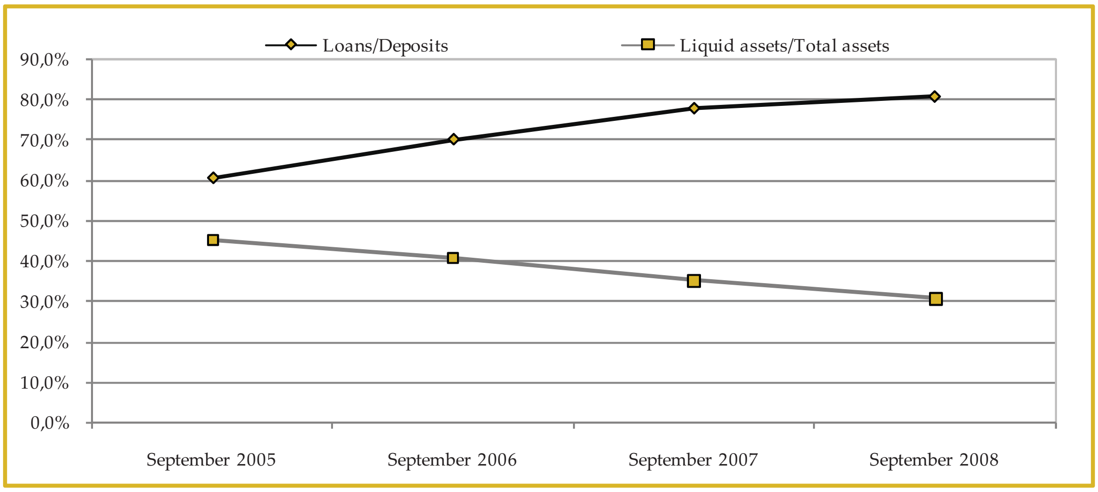

Figure 21. Credit activity of micro-finance institutions

The main source of finance for MFI activity are credit lines from abroad which represented 54.9% of total liabilities. In September 2008, credit lines from abroad reached euro 54.4 million, which represents an annual increase of 76.5%.

3.6. Financial Auxiliaries

Financial Auxiliaries (FA) that operate in Kosovo are mainly represented by exchange bureaus and Money Transfer Agencies. In September 2008, the value of money transfers abroad (incoming and outgoing) through financial institutions has shown a considerable growth (31.5% compared to 19.3% in September 2007) reaching euro 3.6 billion. A higher increase is registered in outgoing transfers, which reaching the value of euro 2.1 billion (1.5 billion euro in September 2007), whereas incoming transfers reached at 1.5 billion euro (1.3 billion in September 2007). However, the share of transfers through FA in total money transfers through financial institutions has shown a decreasing trend. Until September 2008, 10.3% of total incoming transfers came through FA compared to 11.2% in the same period last year, whereas only 0.7% of outgoing transfers were transferred through FA (0.9% in September 2007). In Kosovo, transfers with abroad are mainly made through commercial banks.

4. LIST OF FINANCIAL CORPORATIONS IN KOSOVO

Banking sector

(As of September 2008)

PROCREDIT BANK

Address: Nëna Terezë Street, Prishtina

Phone: ++381 38/ 555 777

Fax: ++38138/ 248 777

E-mail: info@procreditbank-kos.com

Website: www.procreditbank-kos.com

Balance Sheet

(Outstanding amounts, end of period, in thousands of euro)

Assets	Amount	Liabilities	Amount
Cash and balances with CBK	78,585	Balances from other banks	4,574
Balances with commercial banks	84,723	Deposits	575,728
Securities	40,417	other borrowings	...
Loans	434,118	Other liabilities	32,012
Fixed assets	15,121	Subordinated debt	7,010
Other assets	12,340	Own resources	45,980
TOTAL ASSETS	**665,304**	**TOTAL LIABILITIES**	**665,304**

RAIFFEISEN BANK

Address: UÇK Street, No.51, Prishtina
Phone: ++381 38/ 226 400, 401
Fax: ++38138/ 226 408
E-mail: info@raiffeisen-kosovo.com
Website: www.raiffeisen-kosovo.com

Balance Sheet

(Outstanding amounts, end of period, in thousands of euro)

Assets	Amount
Cash and balances with CBK	58,581
Balances with commercial banks	129,477
Securities	...
Loans	412,056
Fixed assets	6,610
Other assets	5,284
TOTAL ASSETS	**612,008**

Liabilities	Amount
Balances from other banks	17,094
Deposits	493,966
Other borrowings	...
Other liabilities	31,143
Subordinated debt	...
Own resources	69,805
TOTAL LIABILITIES	**612,008**

NLB PRISHTINA

Address: Rexhep Luci Street, No.5, Prishtina

Phone: ++381 38/234 111

Fax: ++381 38/246 189

E-mail: info@nlbprishtina.com

Website: www.nlbprishtina.com

Balance Sheet

(Outstanding amounts, end of period, in thousands of euro)

Assets	Amount
Cash and balances with CBK	20,776
Balances with commercial banks	53,336
Securities	1,100
Loans	147,943
Fixed assets	4,770
Other assets	4,153
TOTAL ASSETS	**232,078**

Liabilities	Amount
Balances from other banks	10,495
Deposits	172,574
Other borrowings	...
Other liabilities	22,001
Subordinated debt	...
Own resources	27,008
TOTAL LIABILITIES	**232,078**

BANKA EKONOMIKE

Address: Migjeni Street, No.1, Prishtina

Phone: ++381 38/244 396

Fax: ++381 38/243 828

E-mail: bek@ekonomike.com

Website: www.bekonomike.com

Balance Sheet

(Outstanding amounts, end of period, in thousands of euro)

Assets	Amount
Cash and balances with CBK	7,694
Balances with commercial banks	15,041
Securities	...
Loans	47,623
Fixed assets	1,708
Other assets	1,760
TOTAL ASSETS	**73,826**

Liabilities	Amount
Balances from other banks	...
Deposits	60,050
Other borrowings	...
Other liabilities	2,036
Subordinated debt	...
Own resources	11,740
TOTAL LIABILITIES	**73,826**

BANKA PËR BIZNES

Address: UÇK Street, No.41, Prishtina

Phone: ++381 38/ 244 666

Fax: ++38138/ 243 656, 243 657

E-Mail: info@bpbbank.com

Website: www.bpbbank.com

Balance Sheet

(Outstanding amounts, end of period, in thousands of euro)

Assets	Amount	Liabilities	Amount
Cash and balances with CBK	7,465	Balances from other banks	...
Balances with commercial banks	14,742	Deposits	42,777
Securities	...	Other borrowings	...
Loans	29,487	Other liabilities	3,317
Fixed assets	1,433	Subordinated debt	...
Other assets	767	Own resources	7,800
TOTAL ASSETS	**53,894**	**TOTAL LIABILITIES**	**53,894**

KOMERCIJALNA BANKA

Address:	Kralja Petra Prvog Street, No.33, Mitrovica
Phone:	++381 38/423 822
Fax:	++ 381 28/425 295
E-Mail:	posta@kombank.com
Internet:	www. kombank.com

Balance Sheet

(Outstanding amounts, end of period, in thousands of euro)

Assets	Amount	Liabilities	Amount
Cash and balances with CBK	9,565	Balances from other banks	...
Balances with commercial banks	...	Deposits	29,461
Securities	...	Other borrowings	...
Loans	4,708	Other liabilities	194
Fixed assets	...	Subordinated debt	...
Other assets	21,232	Own resources	5,850
TOTAL ASSETS	**35,505**	**TOTAL LIABILITIES**	**35,505**

TÜRK EKONOMI BANKASI

Address:	Agim Ramadani Street, No.15, Prishtina
Phone:	++381 38/230 000
Fax:	++ 381 38/224 699
E-Mail:	info@teb-kos.com
Internet:	www. teb-kos.com

Balance Sheet

(Outstanding amounts, end of period, in thousands of euro)

Assets	Amount
Cash and balances with CBK	4,272
Balances with commercial banks	2,532
Securities	...
Loans	25,244
Fixed assets	3,043
Other assets	222
TOTAL ASSETS	**35,313**

Liabilities	Amount
Balances from other banks	...
Deposits	23,236
Other borrowings	...
Other liabilities	887
Subordinated debt	...
Own resources	11,191
TOTAL LIABILITIES	**35,313**

BANKA KOMBËTARE TREGTARE

Address:	Garibaldi Street, Prishtina
Phone:	++381 38/246 180
Fax:	++ 381 38/543 699
E-Mail:	infoBktKosova@bkt.com.al
Internet:	www. bkt.com.al

Balance Sheet

(Outstanding amounts, end of period, in thousands of euro)

Assets	Amount
Cash and balances with CBK	7,667
Balances with commercial banks	...
Securities	...
Loans	3,345
Fixed assets	787
Other assets	734
TOTAL ASSETS	**12,533**

Liabilities	Amount
Balances from other banks	...
Deposits	6,008
Other borrowings	...
Other liabilities	163
Subordinated debt	...
Own resources	6,362
TOTAL LIABILITIES	**12,533**

Other financial corporations

	Other Financial Intermediaries	FINCA, KEP, Gramen Trust, Agency for Finance in Kosovo, Cordaid, Besëlidhja Micro Finance,Kreditimi Rural i Kosovës, Kosinvest World Vision, Mështekna, Centro Laici Italiani per le Mission, START, Perspektiva 4, AgroBusinees Development Unit, Kosova Aid and development, Atlantic Capital Partners, Vllesa - Co, Crimson Finance Fund, Islamic Word Committee, KLM Enterprises.
	Pension Funds	Kosovo Pension Saving Trust (KPST), Fondi Sloveno Kosovar i Pensioneve.
	Insurance Companies	Croatia Insurance, Dardania, Dukagjini, Insingu, Kosova e Re, Sigal-Drini, Sigkos, Sigma, Siguria, Elsig.
	Financial Auxiliaries	**Assets Manager:** Slovenian Kosovar Fund.
		Money Transfer Services: DMTH, PCB Western Union, RZBK Western Union, Union Financiar Prishtina, E&S Efikasiteti Siguria Llc.,Post and Telecommunications of Kosovo (PTK).
		Exchange Bureaus: Agimi, Agoni, Beni, Euro, Euro Eki, Euro Exchange, Euro-Cufa, NBS, Gipa, Indriti, Monedha, Prizreni, Valuta, Xeni, Ximi,E-Bani, Te Gazi, Pëllumbi, Hamza, Veli, Mena.