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INTEREST RATES IN KOSOVO, SOME COMPARISONS AND POSSIBLE DETERMINANTS

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Abstract

Kosovo banking system was established from scratch in 1999 and has undergone significant changes during five years of its operation. The intermediary role of banks in Kosovo has improved and is now comparable, and in some respects better, than in some other areas in the region. However, challenges are becoming apparent as to the availability and costs of external finance for firms. These are partly related to the assessed level of credit risk, partly to the banking sector itself, and partly to institutional factors, especially legal ones.

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I. Introduction

Developments in the banking sector in Kosovo have been significant in the last five years. They resulted in improvement of public confidence in the banking sector and strengthening of the intermediation function of banks in Kosovo economy. This took place without threatening the stability of the sector, and in comparison to other transition economies (TEs) - mainly in the region - the achievements are respectable. The banking sector in Kosovo is based on prudent regulatory and supervisory framework established in line with the best international standards and practices. The key building blocks of the market economy, especially the financial sector, are already in place. The intermediation costs and interest rate spreads, even though perceived as high at present, are not specific to Kosovo only. All countries in the region face challenges related to important factors that determine high costs and insufficient availability of external finance, some situated within the banking sector (competition, efficiency, etc.) but also some outside banking sector control (legal environment and institutional development in general).

The aim of this paper is not to provide a complete list of answers as to what determines particular cost or availability of external finance, but rather to shed some light on the most important determinants – such as legal aspects, and to suggest an agenda for future work as well as to stimulate a debate on the financial development issues.

The paper is organized as follows: key developments in the banking sector in Kosovo are described in section II, and section III describes the lending and deposit interest rates in Kosovo as well as some specificities of the market. Section IV compares the cost of intermediation with other TEs, mainly in the region, and describes the factors that influence cost of intermediation. Section V pays closer attention to the role of institutions, with special reference to legal framework and law enforcement, in determination of risk in the credit market. The role of credit registries as a remedy to institutional problems is briefly

described in section VI. Section VII gives some concluding remarks and an agenda for future work.

II. Key developments in the banking sector in Kosovo

One of the inherent characteristics of financial developments in TEs is that countries and territories are at different stages of development of their financial markets and institutions. Those in South-East Europe (SEE) and Kosovo have lagged behind. Almost all SEE countries have experienced severe financial crises with negative repercussions to their financial development, economic growth, and the whole process of transition.

Kosovo is a small-open economy that has lagged behind most of other TEs in financial sector development, although recent developments show that catch-up has become evident and the performance of the financial sector is now comparable with other areas in the region. Before the conflict of 1999, financial market system, in the sense of providing intermediation and payments system, was almost nonexistent. Therefore, Kosovo had to establish its financial system from scratch.

In 1999 the Banking and Payments Authority of Kosovo (BPK) was established to license, regulate and supervise the financial sector and establish a properly functioning payments system. The basis of two tier banking system was established. With technical assistance from the international agencies, BPK has adopted banking rules and regulations in line with international standards, including regulations in accordance with the Basel Accords. The banking sector in Kosovo, from the regulatory perspective may be labeled “liberal” as no interest rate controls, no directed credit programs and no capital account controls exist. Entry barriers and limits to branching are related only to prudential considerations applied by the BPK. It encourages banks to keep loan to deposit ratio below 70-75%, which limits rapid credit expansion and risk exposure, ensuring the liquidity position of the banking system, given that this market was developed from scratch. Poor, although improving, legal infrastructure is an

additional cause for cautious policies in the financial sector, in which there are no domestic inter-bank lending and borrowing facilities, nor deposit insurance and lender of last resort.

Kosovo banking system, now in its fifth year of operation, has undergone significant changes that justify the increase of public confidence in it. Several indicators show that Kosovo caught up with countries in the region and in most of the cases is performing better (see table below).

Table 1: Banking Intermediation Indicators in Transition Economies (TE) and the region (in %)

Country	Deposits to GDP		Private Credit to GDP		Non – performing loans to total loans	
	2002	2003 (2004)	2002	2003 (2004)	2002	2003
Albania	40.1	43.4	4.7	5.1	5.6	4.6
Bosnia and Herzegovina	39.6	43.0	11.2	14.6	11.4	8.3
FYR Macedonia	24.3	25.7	14.2	14.9	35.7	34.9
Serbia and Montenegro	-	24.2	16.3	15.7	28.5	23.8
Kosovo	24.6	28.6 (36.0)	5.0	13.0 (20.0)	2.5	1.6
Western Balkans (WB) average (without Kosovo)	**34.7**	**34.0**	**11.6**	**12.6**	**20.3**	**17.9**
Bulgaria	-	-	18.0	25.8	10.4	4.4
Romania	-	-	8.3	9.5	2.3	1.6
Croatia	70.6	-	44.0	48.5	11.6	9.4
CC- 3	-	**28.7**	**23.4**	**27.9**	**8.1**	**5.1**
NMS- 8	-	**44.5**	**31.5**	**33.6**	**13.0***	-

Source: EBRD (2004), European Commission (2004), World Bank (2004) and BPK (2005).

Notes: *Only Czech Republic, Poland and Hungary; CC-3 (EU Candidate Countries: Croatia, Bulgaria and Romania); NMS-8 (EU New member states: Hungary, Slovenia, Slovakia, Czech Republic, Poland, Estonia, Latvia, Lithuania)

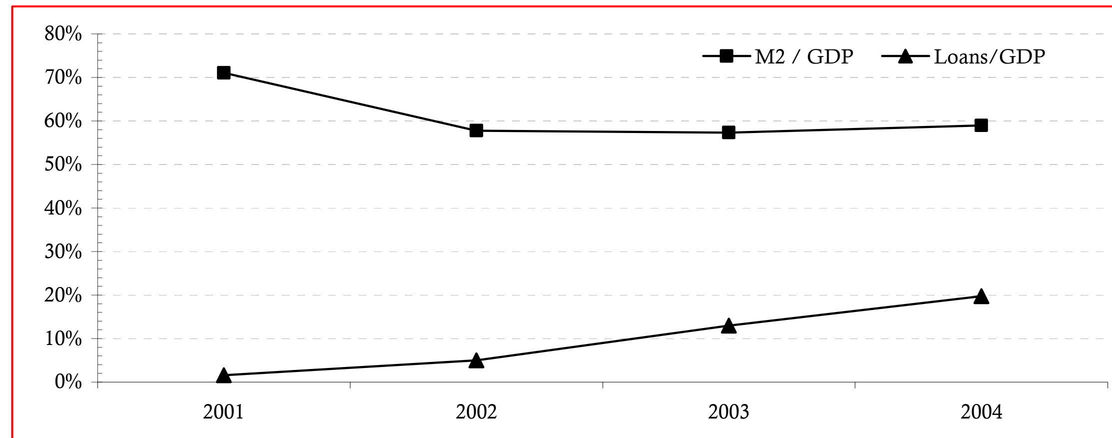
Prior to 2000, Kosovo was almost entirely a cash-based economy whereas in 2004 50% of broad money liabilities was channeled through the banking system. Deposits increased from less than 10% of GDP[1] in 2000 to 36% in 2004. Although the gap between monetisation and intermediation remains high (see figure 1), the intermediation role of the banking sector to the real economy has improved significantly.

The volume of outstanding credit to the private sector has been growing rapidly, rising from 2% of GDP in 2001 to 5%, 13%, and 20% in 2002, 2003 and 2004

[1] IMF estimates, November 2004.

respectively. This is higher than the WB average of 12% and higher than in some other TEs. In addition, it should be noted that non-performing loans (around 2% of total loans)[2] show that the loan portfolio of the banking system remains of high quality compared to other TEs i.e., WB average is 17%, CC-3 average is 5%, and in 2002 NMS-3 average stood at 13%.

Figure 1. Monetisation and intermediation



Source: BPK

Key stability indicators reveal that the banking sector remains well capitalized, liquid and profitable. Capitalization (17% in 2004) is well above Basel minimum requirements. Liquidity of the banking sector, measured by loan to deposit ratio (53% in 2004), remains high from an international perspective[3]. The total banking sector performance ratios, e.g. profitability as measured by ROA at 2% and ROE at 22% in 2004, show improvement from 2002 onwards. Profitability was lower and one bank reported losses in 2001, because 6 out of 7 banks had been recently licensed and their market entry was accompanied by large initial investments. On the other hand, change in the composition of banking sector balance sheet in favor of domestic credit has been an additional factor contributing to the increase in profitability of the banking sector as a whole.

[2] This may be a sign of hard budget constraints.

[3] Average loan to deposit ratio in Western Balkans in 2003 was 76.2% (European Commission 2004), so crediting potential may have not been fully utilized. The lack of short-term liquidity instruments, the lack of lender of last resort, and lack of correct assessment of core deposits may be partial explanations for this.

III. Interest Rates in Kosovo

Deposit rates

New data on effective interest rates in Kosovo[4] reveal some characteristics worth of discussion. Firstly, the table below shows that interest rates on deposits range from 1.7% to 4.1% and are positively correlated with maturity and amount.

Table 2. Commercial Banks Effective Interest Rates (in %) Average (June-December 2004)

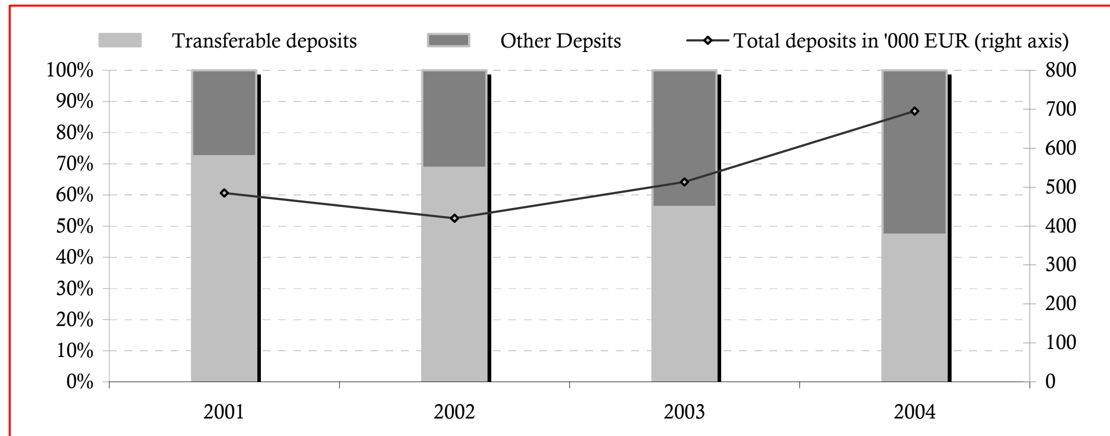
Description			Interest Rates
DEPOSITS			
	Non-financial corporations		
	Less than 250.000 EUR	<= 1 month	1.66
		> 1 month and <= 3 months	2.24
		> 3 months and <= 1 year	2.89
	Equal or more than 250.000 EUR	> 3 months and <= 1 year	3.5
	Households		
	Time deposits	<= 1 month	1.69
		> 1 month and <= to 3 months	2.23
		> 3 months and <= 1 year	3.01
		> 1 year and <= 2 years	3.79
		> 2 years	4.11
LOANS			
	Non-financial corporations		
	Business investment loans	<= 1 year	16.11
		> 1 year and <= 3 years	14.65
	Other business loans	<= 1 month	15.59
		> 3 months and <= 1 year	15.69
		> 1 year	14.73
	Credit lines		15.36
	Households		
	Consumer Loans		12.73

Source: BPK

Banks encourage longer-term savings by offering higher interest rates for longer maturities, and this is also becoming the preference of the clients (see figure 2) who increasingly favor term deposits over transferable deposits.

[4] Prior to June 2004 only nominal interest rate statistics were available. The loan/deposit interest rate spreads were around 11% - 12% according to World Bank (2004) and European Commission (2004). Of course, nominal and effective rates may differ to some extent. This paper will rely on effective rates for the period from June 2004 onwards.

Figure 2. Term structure of deposits in banking sector



Source: BPK

The level and structure of interest rates are, however, also linked to the market structure. Banks may compete in deposit taking in order to increase their deposit base, and subsequently their lending activity, once they approach the recommended loan to deposit ratio. Competition in deposit taking currently may seem to be less important than in loan extension, as overall banking sector loan to deposit ratio (53% at the end of 2004) remains well below the limit set by the implicit rule (70-75%). This low overall banking sector loan to deposit ratio is distorted however by the fact that the largest bank holds its loan to deposit ratio at around 35%, whereas the rest of the sector approaches the limit. This “leakage” - lower backflow from deposits to loans - may give rise to more competition among the banks, and hence potentially higher interest rates on deposits. Up to now, increased lending was possible because of steady increase in deposits, however any further significant increase in deposits may be questionable. Therefore, lending potential of the banks may soon reach its upper limit, unless other sources of funds become available. Capital inflows are at present questionable due to political uncertainty and lack of credit ratings for domestic banks as well as Kosovo itself.

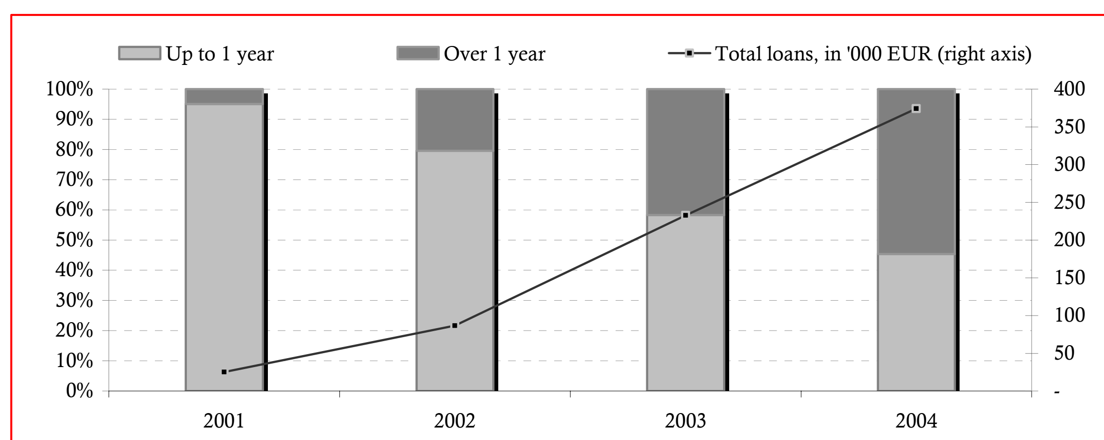
Another driving force of the increase in deposit rates may be attributed to the concentration of large depositors in the total banking sector deposits. Public non-financial corporations’ share in total deposits is around 20%. This may push the

interest rates on the deposits upward, due to a better bargaining position of large depositors.[5]

Lending rates

Interest rates on business loan vary from 14.7 % to 16.1 % depending on the maturity.[6] In general, interest rates on longer-term loans are lower than for loans with shorter-term maturities. One possible explanation is that banks use more advanced screening technologies or apply more strict criteria for longer-term loans. Those loans are provided to the most creditworthy borrowers with longer business history and/or longer client relationship with particular bank. The banks may require more guarantees for longer term credits reducing the risk, and hence the interest rate. Consumer loans are less expensive than business loans, being a peculiarity, probably due to the less risky nature of those products related to lower amounts and simpler procedures. Overall, apart from significant increase in the intermediary role of banks in Kosovo the maturity structure towards longer-term loans improved as well (see figure 3).

Figure 3. Maturity structure of loans (in %)



Source: BPK

In order to evaluate whether the lending rates and the spreads are high (around 12%), we will try to reflect on some issues that may influence costs of external finance for firms.

[5] Recent introduction of tax on incomes from interest earnings may further push interest rates on deposits upwards.
[6] No interest rate data are available by amount.

IV. Intermediation costs and comparisons with countries in the region

In a Modigliani-Miller context, where capital markets are perfect, firms are indifferent between what sources they use (internal or external) to finance their investment. But when transaction costs (TC), information asymmetries (IA) and agency problems are severe, firms may face high costs in raising external finance. The crucial dimensions of financial development in terms of reducing those imperfections[7] are the increased efficiency of financial intermediaries accompanied by improvements in other determinants, i.e. legal framework, legal enforcement, regulations and the macroeconomic environment.

One of the remedies to these markets is well functioning institutions, be it regulatory institutions or courts. Examples of the role of institutions are manifold. Financial markets are strictly regulated. Banks are required to hold proper capital structure, liquidity and risk exposure. Otherwise, excessive risk taking behaviour due to competitive pressure and/or deposit insurance will prevail (moral hazard problem). Also there are regulatory requirements for firms to disseminate information i.e., in order to be listed in the stock exchange. Without that information, company evaluation by the market participants will be hard and incomplete.

One important element in the credit market is the ability of financial intermediaries (FIs) to use non-price terms in debt contracts i.e., collateral. The use of collateral and other restrictive covenants directly depends on the efficiency and effectiveness of law. In other words, degree to which creditor rights are secured by written law and extent to which these laws are enforced properly will influence the ability of FIs to use collateral and other contractual agreements to secure the debt and overcome moral hazard behaviour by borrowers.

Interest rate spreads in countries in the region (SEE) appear high compared to NMS-8[8]. There are many possible explanations for such comparatively high rates.

[7] We will refer hereinafter to information asymmetries.

[8] Interest rate spread in 2003 was 2.6% (European Commission (2004)).

One element important to note is that loan interest rates are high and in many cases higher than in Kosovo (except in Bulgaria and Croatia[9]). However, spreads are lower mainly due to higher interest rates on deposits. This may be a reflection of the currency denomination of deposits[10], inflation premia in some countries or market peculiarities of the particular country.

Table 3. Interest Rate Spreads in Selected Countries (in %)

Country	Description	2002	2003
Albania	Deposit rate (1year)	9.3	7.6
	Lending rate (1 year)[1]	16.0	10.5
	Interest rate spread	**6.7**	**2.9**
Bosnia and Herzegovina			
	Interest rate spread	**9.8**	**6.8**
FYR Macedonia	Deposit rate	9.2	6.7
	Lending rate [2]	17.7	14.5
	Interest rate spread	**8.5**	**7.8**
Serbia and Montenegro	Deposit rate	2.6	-
	Lending rate	19.2	-
	Interest rate spread	**16.6**	-
Bulgaria	Deposit rate (1 month)	2.8	2.8
	Lending rate (< 1 year)	9.4	9.1
	Interest rate spread	**6.6**	**6.3**
Romania	Deposit rate (average)	18.4	10.8
	Lending rate (average)	36.7	26.2
	Interest rate spread	**18.3**	**15.4**
Croatia	Deposit rate[3]	1.6	1.7
	Lending rate [3]	10.9	12.0
	Interest rate spread	**9.3**	**10.3**
Kosovo[4]	Deposit rate[3]	-	2.8
	Lending rate [3]	-	14.8
	Interest rate spread	**-**	**12.0**

Source: EBRD (2004), European Commission (2004), World Bank (2004) and BPK

Notes: 1) The figures show the weighted average monthly rate for new credit in leks for maturities between 6 months and 1 year in December each year; 2) Mid-point rates for short-term lending to all sectors; 3) Weighted average over all maturities; 4) Data for 2004.

Zahler (2004), referring to Kosovo case, points out that high interest rate spreads are the result of "… credit risk, high operational costs (of small banks), high loan-loss provision, high ROE, high reserve requirements, and quasi monopolistic rents of larger banks (foreign banks are the largest and more efficient than domestic banks, however this greater efficiency has not been reflected in smaller

[9] As we will see later, Bulgaria and Croatia are among most advanced SEE countries that have made a significant progress in their institutional reforms which seemingly contributed to lower loan interest rates.

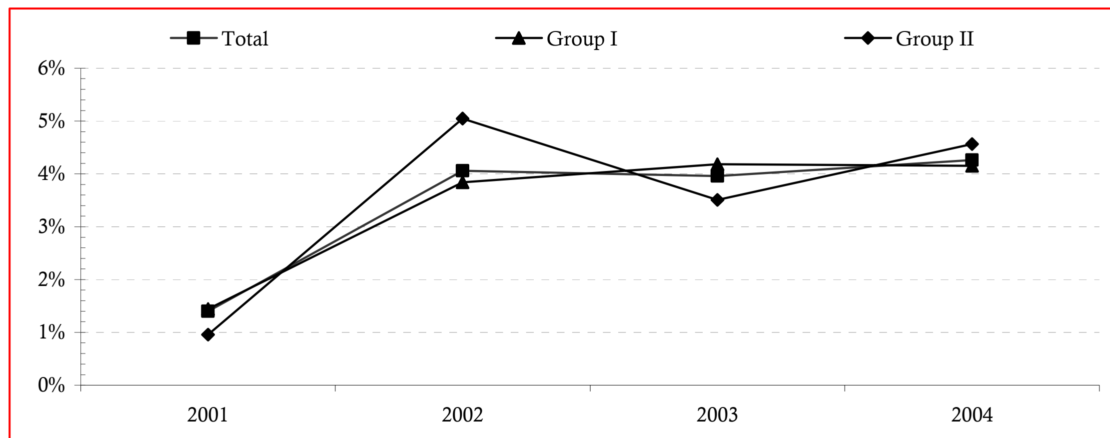
[10] To the extent that foreign currency loans are larger in share relative to foreign currency deposits.

margins because, apparently, competition from domestic banks is not strong enough)."

These observations and explanations are partially correct, however these must in some respects be amended. The situation has changed in the meantime and the degree of intermediation in Kosovo is similar to, or well above, some countries in the region. Secondly, Zahler (2004) compares degree of intermediation in Kosovo with early transition period in other TEs, which may not be appropriate. In period 1990-1995, in many transition economies (TEs) soft budget constraints were still in place, bad loan portfolios were inherited from the past, and bank restructuring did not take place yet. This resulted in banking crisis in many TEs in 1995-2000. So during that period, disintermediation rather than financial intermediation was apparent in TEs. Secondly, Zahler (2004) points out that high loan-loss provisioning of around 3.5% of total assets, and given that largest part of assets are invested abroad in secure investments, appears too high.

But the 3.5% provisioning applies only to loans provided to domestic economy and, as such, provisioning may not be considered as high.

Figure 4. Cost inefficiency[11]



Source: BPK

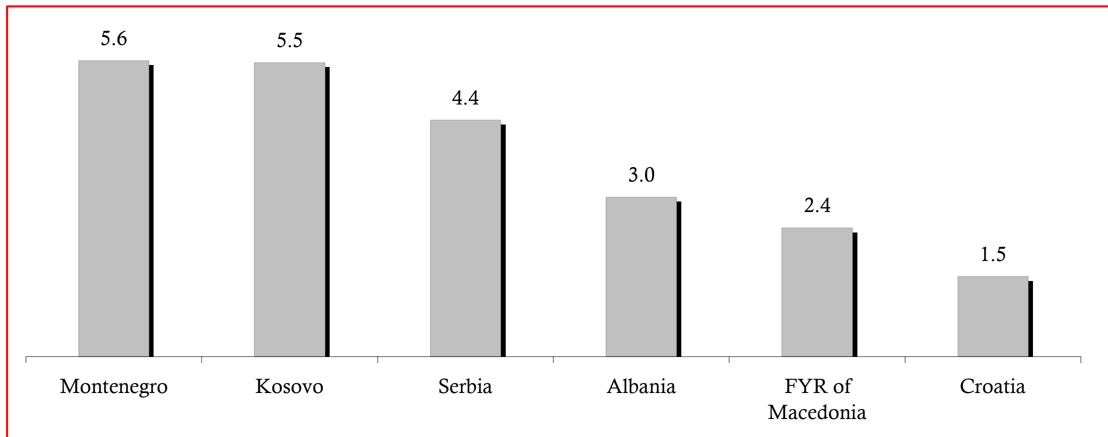
Regarding the operational costs of the banking sector, empirical evidence hardly supports a distinction between large and small banks. As it can be seen from figure 4, there was an increase in costs especially in 2001-2002 (due to positioning

[11] This is the ratio between general and administrative expenses to total assets. Group I consist of three largest banks.

of banks in the market, increase in branching accompanied by increase in numbers of staff), and afterwards these costs remained stable. There is rather a small gap between groups of banks and it continues to converge. Furthermore, overheads in Kosovo banking system (4.8% to total assets in 2004) are lower than in many TEs (17.8%, 5.5%, 6.2%, and 7.3% in Bulgaria, Croatia, Macedonia, and Romania, respectively).[12]

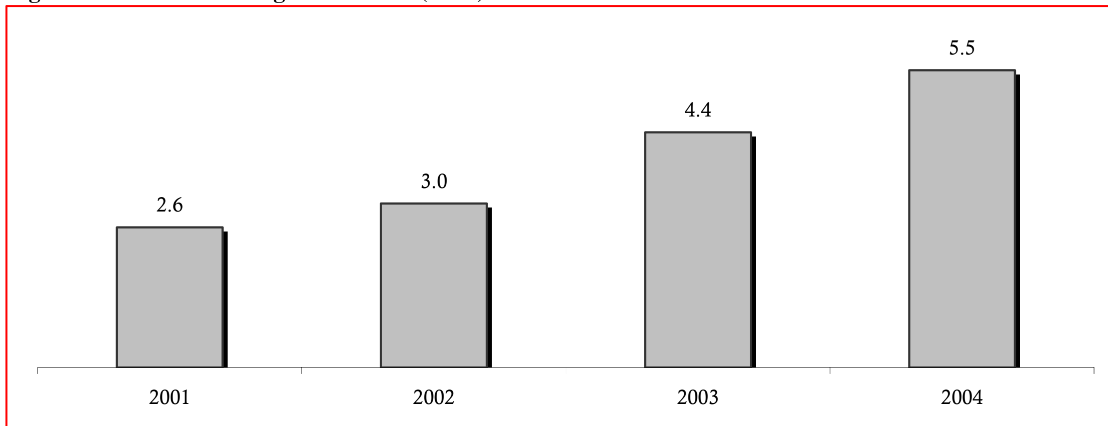
Regarding the ROE, it is true that it is the highest compared to WB countries (average for 2003 was 9.3% and in Kosovo in 2004 it stood at 22%). High reserve requirements of 10% may be high by international practices, but not unusual in the region.

Figure 5. Net interest margin in selected countries (in %)



Source: Central banks in respective countries

Figure 6. Net interest margin in Kosovo (in %)



Source: BPK

[12] Averaged over the 1994-2001 period in the sample of banks in respective countries (Fries and Taci 2004).

Interest rate spreads are an ex ante measure of intermediation efficiency. Ex post measure is net interest margin[13] (NIM), which provides information on how efficiently banks intermediate. NIM, being a profitability and intermediation efficiency measure, shows the ability of management to find the cheapest sources of funds, the optimal portfolio management, etc. Interest rate spreads may be too high, but extent to which banking sector undertakes risk, degree of non-performing loans (NPL), etc. may influence ex post intermediation efficiency. One explanation for the increase in NIM in Kosovo (see fig. 6) is the shift towards crediting the domestic economy[14] characterized by high interest rate spreads. Even though volume of deposits has increased and hence interest expenditure, interest income from crediting the domestic economy more than offsets the increase in interest expenditure, and as a result, data reveal increase in NIM.

Lower NIM in Albania may be a result of low degree of intermediation to the domestic economy. In Macedonia, apart from low intermediation to the domestic economy, lower NIM is a reflection of high NPL (see table 1). For Croatia it may be said that lower interest rate spreads are reflected in lower NIM implying higher intermediation efficiency.

Zahler (2004) estimated the cost of financial intermediation (due to high overheads, high ROE, high loan-loss provision) at 13.5% for banks in Kosovo. The high cost of financial intermediation reflects the interplay between large inefficiencies and high-risk premia in an overly concentrated sector (IMF 2004). In the remainder of this article we will reflect on some issues regarding the concentration of the banking sector and risk due to the institutional performance related to credit market.

Competition

Regarding the concentration (C3: the 3 largest banks by total assets) of the banking sector in countries in region and particularly in Kosovo (74% in 2004) it

[13] Measured as the ratio between net interest income and total assets.
[14] Loans to domestic economy represented 18% of balance sheet total in 2002 and increased to 40% and 47% in 2003 and 2004 respectively.

can be said that in WB and CC-3 concentration remains high (55.8% and 58.8% respectively). This may be the result of prudent regulatory requirements due to entry and consolidation of the banking sector in countries in the region after several crises in most of the countries (Kosovo being an exception). C3 being only a crude measure (i.e., takes into account only large banks) of the degree of competition[15] in the banking sector there is not much to say on the nature of competition and implications on efficiency and decrease in intermediation costs. However, for instance in the U.S. markets, an Herfindahl-Hirschman Index (HHI) above 1800 is considered as a sign of highly concentrated market that would be submitted to antitrust laws.[16]

Theoretically, in concentrated markets banks may have a collusive behaviour (or leader-follower model of market competition) and have a good performance where the market power hypothesis holds (Bain 1951). Nevertheless, concentration may be the result of superiority in efficiency of larger banks, hence efficiency hypothesis holds (Shaffer 1994). Lastly, even monopolists may behave competitively when the market is contestable (Baumol et al. 1983). Allen and Gale (2001) provide a theoretical framework where smaller number of banks with well-developed banking network (branching) provide more competitive environment than greater number of unit banks.

It is difficult to say whether market in Kosovo is contestable. Firstly, since the market is closed and not integrated in international financial markets,[17] interest rates are determined by domestic factors and in this respect contestability of the market might not hold. In relation to this, even though banking sector is highly concentrated, differences in efficiency scores[18] among the banks in Kosovo tend to diminish, although they were higher in 2001-2002.

So, the efficiency hypothesis may partly hold in favor of large banks. Also market power hypotheses may hold with leader-follower behavior hence maintenance of

[15] This heavily depends on the market size, number of banks, barriers to entry etc.
[16] HHI in Kosovo in 2004 was 2536.
[17] For example in new member states of EU banks face now competition from other countries i.e., cross-border lending increases.
[18] Measured by Data Envelopment Analysis which is subject to ongoing research at the BPK. For the comprehensive description of the DEA methodology see Favero and Papi (1995).

higher spreads makes possible profit efficiency even for smaller banks which free-ride from such scenario. Lower concentration may increase efficiency and decrease intermediation costs. However, this may deteriorate profit margins and market power, and may induce banks in excessive risk-taking. Advanced regulatory and supervisory capacity should be in place to deal with this trade-off. However, this requires more in-depth empirical analysis in defining the nature of competition in the banking sector in Kosovo, which is on our agenda of future work.

High spreads may be a reflection of within banking sector efficiency, in that case reflecting low competition and/or low efficiency, or factors outside banking sector control i.e., perception of poor protection of creditor rights among lenders. The legal aspect (or institutional aspect in general) ex ante might be perceived as too inefficient that increases the spread and ex post, given low NPLs, enables higher profit margins.

Basing himself on interviews with bankers in Kosovo, Zahler (2004) points out that, even though the legal, regulatory, and supervisory frameworks are in line with international standards and recognized best practices, banks and judges are not sufficiently aware on the advances in law. Most courts have not implemented them, and moreover courts are perceived as being slow and tending to favor borrowers vis-à-vis the lenders. Of course, perception among bankers on the protection of creditor rights may be biased. However, BEEPS survey (1999 and 2002) reveals that in the countries in the region even entrepreneurs perceive legal effectiveness and efficiency as poor.

V. The role of legal framework and law enforcement in credit market

The most important factors that determine financial development, apart from factors within FIs efficiency, are those related to law and finance nexus and macroeconomic environment i.e., institutions that support the functioning of markets. Legal and regulatory system characteristics influence the degree to which FIs can acquire information about borrowers, make contract agreements,

and enforce contracts. This will fundamentally influence the ability of FIs to identify the most productive firms, and screen, monitor and manage risk.

The EBRD and World Bank have conducted a Business Environment and Enterprise Performance Survey (BEEPS) in TEs. This is the most comprehensive survey regarding the problems that firms face in their day-to-day operations, in an environment that is under transformation to the market economy. Regarding the financial sector, in general, companies perceive that cost of financing and difficulties in obtaining loans are one of the major constraints in doing business. Some results of the survey in the countries of the region are described in Box 1.

Box 1. The Business Environment and Enterprise Performance Survey (1999 – 2002)

- Business environment in SEE appears to have improved across almost every category between 1999 – 2002
- Areas that seem to show the largest improvement are infrastructure, *access to finance* and crime
- Problems associated with access to finance are perceived as particularly severe (relative to other barriers) in Bulgaria, BiH, SCG and Moldova
- On average, 54% of enterprises in the region said that it was either fairly difficult or impossible to obtain short-term working capital while 70% long-term loans
- Internal funds were the main source of finance (except Croatia)
- Expensive loans, time needed to process a loan and collateral required by banks are problems that firms face
- For Kosovo (World Bank 2004): factors which prevent businesses for starting new or investing in existing one: 70 % respond lack of capital

Source: EBRD (2004).

Previously we have seen some explanations of possible determinants of high interest rates (spreads) related to within banking sector characteristics. There are also factors outside banking sector control that influence the credit market.

If we take into account weak information infrastructure of companies, than this problem remains one of the most important obstacles for banks providing credit

to the businesses. One element worth mentioning is information infrastructure of companies in Kosovo. In regulation (UNMIK Regulation 2001/30) regarding the financial reporting of business organizations, which stipulates that companies with annual turnover of more than 100,000 EUR or total assets in excess of 50,000 EUR must submit their financial statements to the business registry, and companies with total assets in excess of 250,000 EUR should have their financial statements audited. It is hard to say whether this is being followed in practice. This severely worsens the information asymmetry problem, which is reflected in the increase of costs due to more expensive screening technologies for the banks and lower quality of screening.[19] As we will see later, proper design and functioning of credit registry may increase the quality of screening process.

Jappelli, et al. (2002) in a model of opportunistic debtors and imperfect courts, argue that the degree of law enforcement will effect the borrower future willingness to pay (degree of moral hazard) which in turn would determine the ex ante willingness of creditors to lend and the terms of lending. One proxy for judicial efficiency is collateral-to-loan ratio and the fraction of collateral that lenders can expect to recover from default borrowers. The higher the expected fraction of recovery is, that is the more efficient are the courts, the lower collateral-to-loan ratio will be required from the borrowers. This will increase the pool of potential borrowers, which previously could not qualify even if they had projects with positive net present value and, by assuming efficient and competitive financial markets, terms of loans will improve and credit rationing will decrease.

The relevance of laws and law enforcement was experienced to a great extent in TEs. One of the drawbacks in TEs in their transformation process was weak institutions. With this in mind, European Bank for Reconstruction and Development (EBRD) every year publishes the Transition Report in which “state of the art” in TEs is described. The great attention is paid to institutional developments in these countries. One of the elements of interest to us is the degree to which the law, as it appears on the books (extensiveness) and law

[19] Here should be mentioned also the lack of risk assessment skills among banks.

enforcement (effectiveness), has been improving in TEs. In the Legal Indicator Survey (LIS), EBRD provides rating for each country in the transition scaled from 1 to 4+ [20] both, for law extensiveness and effectiveness. These ratings are based on surveys conducted with local experts and institutions regarding the commercial laws i.e. bankruptcy laws, company law, secured transactions, financial regulations etc. LIS was conducted by EBRD in 1995-2002.

Table 4. LIS Commercial Law Indicators

Country	1997 Overall	1998 Overall	1999 Overall	2000 Extensiveness	2000 Effectiveness	2000 Overall	2001 Extensiveness	2001 Effectiveness	2001 Overall
Albania	2	2	2	3+	2-	2+	2+	2	2+
Bosnia and Herzegovina	1	1	2-	3	1	2+	1+	2	2-
Bulgaria	3	4	4-	4	4-	4-	4	4-	4-
Croatia	4	3	3+	4	3+	4-	4-	4-	4-
FYR Macedonia	2	3	4-	3-	2+	3	3+	4-	4-
FR Yugoslavia	-	-	-	-	-	-	3+	3	3+
Romania	3	4	3+	4-	3	3+	4	4	4

Source: Ramasastray (2002)

Table 5. LIS Financial Regulations Indicators

Country	1998 Overall	1999 Overall	2000 Extensiveness	2000 Effectiveness	2000 Overall	2001 Extensiveness	2001 Effectiveness	2001 Overall
Albania	2-	2+	2	1	2-	2	2-	2
Bosnia and Herzegovina	1	1	1	1	1	1+	1	1+
Bulgaria	3	3-	3	2+	3-	3	3	3
Croatia	3	3-	3+	3-	3	3	3	3
FYR Macedonia	2	2+	3	2-	2+	3+	2	3
FR Yugoslavia	-	-	-	-	-	3+	2	3
Romania	3-	3-	4	3	3+	4	3	3+

Source: Ramasastray (2002)

As indicated in the table those countries that in general have better institutional performance have better scores and here Bulgaria, Croatia, Romania and Macedonia are better performers. This is also an indication that they better complied with EU requirements in functioning of institutions and are accession countries or started negotiations with the EU.

In 2003 the EBRD conducted the New LIS. The effectiveness of laws in TEs was assessed by empirical case studies by combining local expert perceptions and EBRD legal expertise. The main focus of NLIS was on secured transactions. This

[20] 1 (little or no progress in reform); 4+ (standard of advanced market economies).

is because the secured transactions decrease the risk of the lenders to credit the economy and this increases their expected profit by increasing the expected recovery value from collateral. This in turn may improve the availability and terms of lending.

In NLIS the greater attention is paid to law enforcement because, as we can see from data in table 5 and 6, there is almost always a gap between extensiveness and effectiveness of laws, law enforcement being almost always less developed than law in books.

One of the characteristics of the TEs is that these countries adopted the most comprehensive laws of the western world. Pistor, et al. (2000) by applying LaPorta, et al. (1997) propositions argue that in TEs shareholder and creditor rights index is higher than the world average and almost average of all law families, but law enforcement remains a great obstacle of the transition. They argue that law is a necessary but not sufficient condition for the financial development. Law enforcement - which depends on voluntary compliance and effectiveness of legal institutions - should at least be credible. Hence, law and law enforcement are necessary and sufficient conditions. Written law, also referred to as law in the books, can be of high quality. There may exist comprehensive legislation but those laws may not be enforced properly. It is easy to write (copy) the most comprehensive laws using the developed countries laws as a model but whether these are suitable and enforceable (for example in TEs) is another question.

Table 6. NLIS: Enforcement of charged assets

Description	Law enforcment
Bulgaria	24
Croatia	23
FYR Macedonia	21
Serbia and Montenegro	19
Romania	18
Albania	18
Bosnia and Herzegovina	4

Source: EBRD (2003).

From the table above we can see the ratings from 0 to 30 on how successfully law is being enforced in SEE. This is based on the threefold rating: 1) how much; 2) how fast the creditor can recover the loan and 3) how simple is the recovery procedure. Each of these three criteria is assessed from the survey with relevant parties in each transition country and EBRD legal experts and are assessed on the scale 0 (worst) to 10 (best). For example maximum score can be achieved if the loan is recovered in full amount (no recovery worst case), within one month (24 months worst case) and with clear, not complex and simple enforcement procedures.

The best performers are Bulgaria and Croatia. If we recall that the lowest interest rates (on loans) were in these countries, then we have some indication of the importance of law (enforcement) in the credit markets.

Regarding the legal framework in Kosovo, many laws are in place regarding the functioning of market economy and explicitly related to financial sector development, and these laws are in line with good practices. Here worth mentioning are:

- regulation on pledges and the establishment of a pledge filing office
- regulation on mortgages
- regulation on bankruptcy
- regulation on business organizations
- regulation on financial reporting of business organizations etc.

However, World Bank (2004) has made an evaluation of 'laws in action' in Kosovo and it points out that there are many deficiencies in court procedures, unpredictability of the judgment, length of the process, complexity and lack of clarity in procedures, which are considered as constraints in enforcing creditor rights and which may encourage a culture of non-payment. Referring to World Bank study, two banks have never taken any legal action against borrower. However, remainder of the banks has taken 300 legal actions. For half of the lenders, the percentage of legal cases completed is less than 1% and the average time required to complete a case was about 18 months. This point out to poor developments in legal aspect related to finance, which puts a high wedge to

external finance. So, this leads to the problem of functioning of the institutions that support the financial markets.

Better information flows between banks and borrowers will improve access to finance, increase the quality of screening technology, and improve the credit risk management of banks. This in turn reduces the costs of intermediation and may increase the volume of lending to the domestic economy. One institutional solution to the improvement of information flows in the market is credit registry.

VI. The role for Credit Registries

Screening process may be too costly and difficult, taking into account cases of lack or limited experience in commercial credit, poor information disclosure (standards), track record, lack of scoring techniques, etc. Banks may allocate too many resources to studying historical data and requiring collateral to back loans. This is time consuming and results in high fixed costs, making especially small business loans too costly to undertake. So credit registries may reduce these costs due to screening which in turn may decrease interest rates. Also, lower interest rates may result in reduced moral hazard problem. Since lower interest rates increase incentives to perform then borrower will be left with more net return from good performance.

Berglof, et al. (2000) in a model with incomplete contracts and imperfect renegotiation, where firm can pledge up to the full amount of available assets to multiple creditors, argue that this would increase its debt capacity (may increase over-leverage) and provide it with incentives to default strategically.

Even though this may seem strong assumption, in an environment without a credit registry and improper functioning of property and pledge registry, this problem becomes apparent.

Once information is shared among lenders, it has an impact on credit market by improving the pool of borrowers and in this way reducing adverse selection

problem, decreasing default rates, decreasing interest rates, decreasing per loan costs, and possibly increasing volume of lending. Credit registries increase the efficiency of financial system by improving risk assessment of loan applicants, improving portfolio quality by reducing arrears and lower the cost of capital for the borrower. Moreover, given the information which is shared among banks, credit registries may increase competition among banks in competing in more advanced screening technologies not shared among the lenders.

Jappelli and Pagano (1999) empirically assessed the role of credit registries in access to credit and default rates. Their results show that the longer the period that credit registries are in place firms face less financial constraints (credit markets are more developed) and nonperforming loans are less pronounced (default rates are lower). Similarly, Miller (2000) in conducting wide range survey on credit registries around the world finds out that credit registry presence improves time of loan processing, decreases costs related to loan extension and has positive influence in lower default rates.

The Banking and Payments Authority of Kosovo is establishing a credit registry for credit providers in Kosovo. The proper design and functioning of the registry may reduce information asymmetry problems, improve screening technology and increase the competition among the lenders with positive impact on the cost, volume and the quality of intermediation. This is another institutional response to information asymmetry problems that are considered to be severe in SEE. In many countries in the region the credit registry is either not in place, or it does not function properly.

VII. Concluding Remarks

Kosovo banking system has undergone significant changes during five years of its operation. Developments in the banking sector in Kosovo led to strengthening of their intermediation function in Kosovo economy and significant improvement of public confidence in the banking sector. This took place without threatening the stability of the sector. The intermediary role of banks has improved and is now comparable, and in some respects stronger, to some countries in the region. Widespread perception of high costs of intermediation and low availability of credit is characteristic not only for Kosovo, but also for the region as a whole. Challenges remain in the field of availability and costs of external finance for firms that are partly related to banking sector itself and partly to institutional factors, especially legal ones, not to mention the possible lack of bankable projects.

Financial reporting of firms, better performance of courts in enforcing legal framework already in place, and proper functioning of institutions in general, may improve availability of credit in terms of amount and longer term maturity, and reduce costs of external finance. Other institutional responses, such as credit registries, are partial solutions to these problems.

More in depth analysis of the efficiency and competitiveness of the banking sector, supply and demand factors of credit market, and law enforcement in Kosovo shall prepare ground for better understanding of how the local credit market functions. These research topics, which are ongoing work at the BPK, may also become helpful in policy guidelines formulation.

With publication of this paper, the Banking and Payments Authority of Kosovo starts a working paper series in which its research results will be published and made available to the interested audience. Of course, as a first attempt in this direction, this paper may have its shortcomings, and its

findings are not presumed to be comprehensive nor conclusive. It rather aims at stimulating a debate among researchers and practitioners interested in topics related to the developments in Kosovo economy.

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