



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

# Financial Stability Report

Number 14





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# Financial Stability Report

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**ABBREVIATIONS:**

ATM	Automated Teller Machines
BSSI	Banking Sector Stability Index
CAR	Capital Adequacy Ratio
CBK	Central Bank of the Republic of Kosovo
CEE	Central and Eastern Europe
CIS	Commonwealth of Independent States
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
FDI	Foreign Direct Investments
GDP	Gross Domestic Product
HHI	Herfindahl-Hirschman Index
IMF	International Monetary Fund
KAS	Kosovo Agency of Statistics
KCC	Kosovo Chamber of Commerce
KPST	Kosovo Pension Saving Trust
MFI	Micro Finance Institutions
MoF	Ministry of Finance
MTA	Money Transfer Agencies
NFA	Net Foreign Assets
NIM	Net Interest Margin
NPISH	Non-Profit Institutions Serving Households
NPL	Nonperforming loans
ODC	Other Depository Corporations
POS	Point of Sales
pp	Percentage points
TPL	Third Party Liability
PTK	Post and Telecommunications of Kosovo
RLI	Rule of Law Index
ROAA	Return on Average Assets
ROAE	Return on Average Equity
ROE	Return on Equity
RWA	Risk Weighted Assets
SDR	Special Drawing Rights
SEE	Southeastern Europe
VAT	Value Added Tax

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## 1. Governor's Foreword

The Central Bank of the Republic of Kosovo (CBK) has the pleasure to present to the public the 14<sup>th</sup> Financial Stability Report (FSR). From a perspective of risk-based analysis, the FSR's aim is not merely to inform the public on the financial system situation but rather to increase transparency and foster a professional debate on the developments and challenges of the financial system and its infrastructure.

External developments impacting Kosovo's financial stability have generally been stable, although the growth of uncertainties and added risks to the economic activity and financial sector of Kosovo's main trading partners have been reflected to some extent in the domestic economy.

The euro area economy, as the main trading partner of Kosovo and the region generating the highest level of remittances, suffered a setback in economic growth in 2018, while the prospects for 2019 do not appear to be optimistic. Western Balkans is considered to have increased its economic activity more compared to the previous year, while growth prospects for 2019 are more pessimistic as a result of reflection of global and political uncertainties in many of these countries.

Financial stability has been positively impacted by the economic growth in Kosovo, thus impacting the improvement of economic agents' financial position. Kosovo's economy marked a sustainable growth in 2018, which is expected to continue in 2019. However, growth prospects may be adversely affected by the growing external and internal risks during 2019 such as the persistent expansion of the fiscal deficit; increase of current expenditures influenced by pressures on social schemes and by the new law on salaries; the prices increase in the country as a result of the rise of the global prices and the decision for 100% tax on products imported from Serbia and Bosnia and Herzegovina as well as the growing trade deficit. As for 2019, initial projections suggested an average GDP growth rate of 4.2

per cent. However, the potential materialization of the risks mentioned above indicate for more pessimistic prospects for 2019.

The macroeconomic stability and a favourable financing environment have given a rise to the growth of lending to the private sector during 2018. Continuous improvement of loan portfolio quality, increased competition, strategic focus on certain market segments by banks, and the long experience in building customer relations were among other factors that continued to sustain fostering financial intermediation in the economy.

During 2018, the banking sector operated in a generally favourable environment with low risks and a satisfactory capacity to cope with possible shocks. Banking sector performance and health indicators are ranked at high levels, despite the slight decline in 2018.

In 2018, Kosovo's pension sector has significantly increased exposure to the domestic market by investing in Kosovo's Government securities, deposits in the banking sector and cash. Investment orientation in the domestic market was mainly attributed to increased political uncertainties and pessimistic prospects for global economic growth, which dynamics were reflected in external financial markets performance in 2018 and consequently in the negative financial performance marked by the pension sector in Kosovo.

The withdrawal of one of the life insurers from the market was reflected in the reduction of insurance sector assets in 2018. However, this sector closed this year with a positive financial result. The micro-finance sector has been characterized by an accelerated growth of activity and high performance.

In view of developing the financial sector and maintaining financial stability, during 2018, CBK continued marking progress towards advancing the regulatory framework and financial infrastructure. Additionally, the financial infrastructure continued the technological expansion and advancement, thus increasing its expansion and usage, with

a special emphasis on electronic and automated services.

Central Bank of the Republic of Kosovo continued its work for operationalizing the Macro-prudential Policy, which was adopted in 2016 to identify, monitor and assess the systemic risk in view of maintaining the

financial stability. In 2018, overall developments of macro-prudential indicators in Kosovo were stable, without any threat to the financial stability of the country.

Fehmi MEHMETI

Governor



## 2. Summary of main risks and developments of financial stability

*Developments in the macroeconomic environment continued to be favourable during 2018, supporting Kosovo's financial sector stability.* However, the second half of the year was characterized by growing uncertainties at global level. The

increased risks to the economy and external financial markets, mainly as a result of ongoing trade disputes, tightened financing conditions and BREXIT negotiations, are expected to continue, thus increasing the risk to the Kosovo's economic activity and to the financial sector of Kosovo's main trading partners, with a potential adverse impact on the economy and financial stability in the country.

**Table 1. Banking sector risks\***

Risks	First half 2017	Second half 2017	First half 2018	Second half 2018	Risk trend
Macroeconomic risk	Low risk	Low risk	Low risk	Low risk	↑
Financial position of the non-financial sector	Low risk	Low risk	Low risk	Low risk	↑
Credit developments	Low risk	Low risk	Low risk	Low risk	↑
Sustainability of the banking sector	Low risk	Low risk	Low risk	Low risk	↑
Negligible risk	Low risk	Medium risk	Over the average risk	High risk	

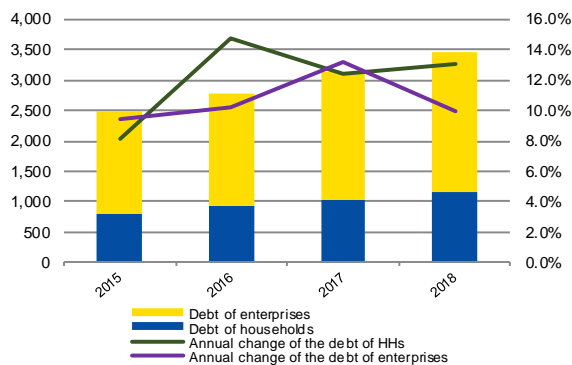
Source: CBK (2019)

\* The risk table generation methodology is based on the methodology of the Kosovo Financial Stability Map. Different from the former, the Credit Developments Indicator has been added in producing this table, including sub-indicators such as: lending-to-GDP gap, private sector loan growth, private sector loan to GDP ratio and growth in particular sectors such as enterprises and households. In calculating the sustainability of the banking sector, in addition to the mapping indicators such as Structure, Capitalization and Profitability, Liquidity and Financing, the Exposure Indicator is also added, which measures the banking sector's exposure to government securities, foreign currency loans, liabilities of non-residents as well as open

The euro area economy, as the main trading partner of Kosovo and the region generating the highest level of remittances, slowed down the economic growth. The continuous increased uncertainties reflected in the decline of businesses' and individuals' confidence, the expectations for the upcoming year are that the economic activity will continue to slow down. Western Balkans is considered to have increased its economic activity more compared to the previous year, while growth prospects for 2019 are more pessimistic as a result of the reflection of global and political uncertainties in many of these countries. Kosovo's economy marked a stable growth, which is expected to continue in 2019. However, growth prospects may be adversely affected by the growing external and internal risks such as the continued expansion of the fiscal deficit; increase in the current expenditures influenced by pressures on social schemes and by the new law on salaries; the rise of prices which marked the beginning of the growing

trend as of third quarter of 2018, as a result of rising global prices and the decision for 100% tariffs on products imported from Serbia and Bosnia and Herzegovina.

*Private sector debt continued to grow, supported by double-digit growth in domestic lending as well as growing of external debt.* Macroeconomic stability and continuous improvement of credit portfolio quality, in a favourable environment of financing conditions, has supported the growth of lending to the private sector. Increased competition, strategic focus on certain market segments by banks, and the long experience in building customer relations were among other factors that continued to sustain double-digit sector's lending. Loans granted by the banking sector to enterprises grew by 11.0 per cent, but the growth trend of new loans slowed down to 4.9 per cent, compared to 34.7 per cent in 2017.

**Figure 1. Debt of enterprises and households**

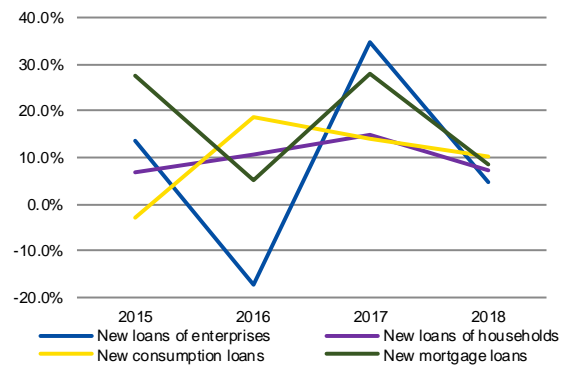
Source: CBK (2019)

Loans granted by other financial intermediaries to enterprises increased by 21.4 per cent, but they retain a small significance in the total enterprise debt at about 2.7 per cent. External debt of enterprises continued to grow and reached 21.5 per cent of total debt. The ratio of loans granted by banks to enterprises to GDP reached 26.9 per cent in December 2018 (compared to 25.4 per cent a year earlier).

Banking sector loans to households increased by 11.2 per cent, while loans granted by microfinance institutions increased by 31.2 per cent (reaching 12.1 per cent of the value of loans granted by banks). External debt of households increased by 13.1 per cent and amounted to 4.1 per cent of total debt. In December 2018, total household debt increased by 13.0 per cent and as a percentage of GDP it reached 16.7 per cent. Despite the growing trend, private sector's debt levels to GDP ratio remained the lowest in the region.

***The ratio of banking sector loans to the value of collateral, as well as the debt to income ratio, remain relatively low at 36.3 and 38.3 per cent, respectively. However, the banking sector's risk from private sector, albeit low, has shown a growing trend.*** The enterprise sector has been characterized by a slight decline in the volume of industrial production, while trade has increased. Business climate and business confidence indicators have declined in 2018, suggesting a weaker performance and more pessimistic expectations about enterprises' economic activity. On the other hand, the decision to impose a 100% tariffs on Serbia's and Bosnia and Herzegovina's products has shown uncertainty about the enterprises'

performance with sensitivity to imports from these countries, as well as other effects that may appear in the economy, such as price increase, etc.

**Figure 2. Annual change of new loans**

Source: CBK (2019)

The risk to banks from the household sector has also shown a growing trend. Labour market conditions have not shown any improvements; on the contrary, the labour market is also faced with the challenge of reduced workforce as a result of the high interest of the workforce to get work permit visas especially for the euro area countries. Remittances slowed down the growing trend and may slow down further as a result of the lower growth prospects in the euro area. Therefore, in such circumstances that do not suggest an increase in the sources of revenues, the high credit growth for the household sector may pose a risk of debt burden. In particular, the most vulnerable segment may be non-collateralised consumer loans and the consumer loans with longer maturity, which can be materialized with possible risks, especially in the event of materialization of increased political uncertainties or unfavourable macroeconomic conditions.

***Banking sector performance and health indicators stand at high levels, despite the slight decline in 2018.*** The banking sector's profit continued its growth, mainly driven by the increase in net interest income generated as a result of the increase in the volume of loans. Sector profitability pressures are expected to increase, taking into account developments in interest rates that are expected to increase pressure on narrowing the interest margin. Continued growth of competition will maintain the pressure to

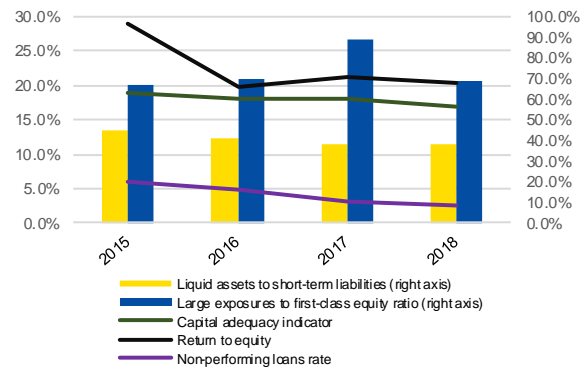
lower the interest rate on loans, although the sharp decline in the credit rate is considered to have matured. On the other hand, the struggle to withdraw deposits has been intensified, especially with lower-deposit banks and more difficult access to external sources of funding, affecting the rise in the cost of financing. The high credit growth during this period was largely influenced by the easing of standards through extension of maturity and lower rate, so the potential continuation of this trend may pose a challenge to profitability stability. The increase in the cost of financing, influenced by competition pressures on withdrawal of deposits or the possible increase of interest rates at the global level in the medium term, may have an impact on the further growth of pressures on sector's expenditures, as the main category of assets, loans, are contracted at a fixed interest rate and have a longer maturity. This situation will encourage the need for any possible changes in the sector's assets and liabilities structure for an effective risk management and is expected to further intensify efforts to increase cost efficiency and digitalization.

***The loan portfolio quality has continued to improve due to the process of repaying of non-performing loans from banks' balances, as well as other economic and structural factors that have improved the solvency and debt collection capability.***

The ratio of non-performing loans to total banking sector loans dropped to 2.7 per cent from 3.1 per cent in 2017. Growth in lending stock by 10.9 per cent yielded higher impact on the decline of the NPL ratio than the decline in the stock of non-performing loans by 4.6 per cent. The enterprise sector was characterized by the improvement of credit portfolio quality in almost all economic activities. On the other hand, households were characterized by the growth of non-performing loans stock, but which was not reflected in the NPL rate due to the higher growth of credit stock for this sector.

***The sector's capital position continues to reflect high sustainability.*** The capital adequacy ratio was reduced to 17.0 per cent from 18.1 per cent.

**Figure 3. Selected financial health indicators**



Source: CBK (2019)

This decline reflects the growth of risk-weighted assets as a result of the growth of lending activity, in addition to the slower growth of the regulatory capital that was also influenced by dividend distribution by some banks. The banking sector has a strong regulatory capital base, 91 per cent of which is Tier 1 capital, which mainly results from high generated and retained profits. Generating capital from domestic sources, profit, is an important element that continuously ensures the maintenance of a high level of capitalization.

***The main liquidity indicators give positive signals for the stability of the banking liquidity.***

Private sector deposits marked an accelerated growth of 7.5 per cent, mainly as a result of increased household deposits. At sector level, deposits surpass loans by 122.0 per cent. Despite the fastest annual growth of deposits in 2018, loans to deposits ratio declined by 2.5 percentage points, influenced by the effects of faster expansion of lending activity. Liquid assets marked an increase, which was also reflected in the increase of their ratio to short-term liabilities at 38.5 per cent, above the minimum regulatory of 25 per cent. The liquidity reserve of commercial banks in the CBK continues to exceed the required reserve by 49.7 per cent, despite the negative interest rate on the reserve surplus. The low interest rate environment has continued to encourage households to relocate their deposits in favour of short-term maturity, which in addition to the trend of accelerating long-term lending, resulted in highlighting the maturity discrepancies between assets and liabilities.

The steady increase in the share of transferable deposits and the expansion of the short-term gap increases the sector's exposure to financing risk in case of sudden withdrawal of deposits or their movement between banks. Such a situation could also pose a challenge to managing bank's liquidity, despite the current high level of liquid assets. This due to the non-developed financial market in Kosovo that may delay the conversion of these assets, such as securities into cash, and the lack of monetary policy instruments as a result of eurorization.

***Technological enhancements in the field of finances made, among others, have made the sector more sensitive to possible attacks and errors in systems, thus increasing the exposure to operational risk.*** Requirements for allocating capital for operational risk have increased, and the level of holding capital for operational risk in Kosovo's banking sector has marked steady growth over the years. Banks have established adequate systems, policies and appropriate procedures for managing operational risk, including the purchase of insurance policies to transfer this risk to third parties. Therefore, in spite of the continuous increase of this risk, which was manifested by the increase of robberies in branches of certain banks, the management of this risk in 2018 was adequate by isolating its consequences.

***The pension sector was characterized by a slowdown in growth as a result of negative returns on investments.*** The increase of political uncertainties, tightened funding conditions and pessimistic prospects for global economic growth, had an influence on the performance of external financial markets, in which the Kosovo pension sector has high exposure. The performance of these markets during the year was characterized by extreme volatility, closing the year with a sharp decline, which also influenced the Kosovo pension sector to close the year with losses. The uncertainties surrounding the developments in external financial markets have led Kosovo pension sector to increase its domestic market exposure to 27 per cent of its total assets compared to 10.2 per cent a year earlier, by investing in Kosovo's Government Securities, deposits in the banking sector and cash. A positive contribution of the sector's

assets in 2018 was recorded by the positive trend of contributions, which continued to mark a high positive difference between the new contributions versus the paid contributions.

***The insurance sector was characterized by a slight decline in assets, as well as by lower profit level.*** Insurance sector assets were adversely affected by the withdrawal of one of the life insurers from the market. Written premiums have continued to grow, but the lowest financial result in comparison with the previous year reflects the highest increase of the incurred damages. Securities sector assets continue to have a low share of 2.8 per cent in total assets of financial system. The sector continues to be concentrated mainly on non-life insurance, i.e. compulsory third party insurance. The penetration rate of 1.4 per cent (gross written premiums in relation to GDP) is estimated to be relatively low, especially compared to EU countries, reflecting the potential for further development.

***The activity of the microfinance sector has continued an accelerated growth, mainly driven by the sharp increase in lending, which is mainly financed by borrowings from the external sector. Despite its rapid growth, its weight at the level of financial intermediation remains low, at 4 per cent of total assets of financial system.*** Lending marked an annual growth of 27.7 per cent, more oriented to the household sector. The high interest rates characterizing this sector have marked a slight decrease on average, although there were large differences in the interest rate between institutions and products. The performance of this sector reached the highest levels recorded in the last six years as a result of increased interest income.

***The legal and regulatory framework and the financial infrastructure continued progress in view of developing the financial sector and maintaining financial stability.***

During 2018, the CBK continued to work on completing and advancing the legal and regulatory framework of the financial system in general and of the banking sector in particular, contributing to the alignment of the

regulatory framework with international standards with an enhanced function in maintaining financial stability. Also, the work on reviewing the regulatory framework for real estate valuation continued in order to improve the information in this area with a high weight on the stability of the financial sector as well

as the review of the payment system regulation to reflect the systemic importance of the payment system. Financial infrastructure continued its technological advancement by increasing its expansion and use, with particular emphasis on electronic and automated services.

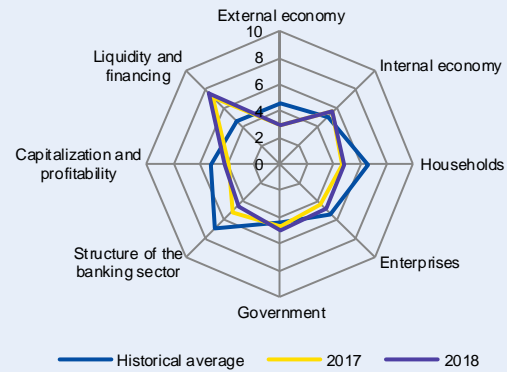
### Box 1. Financial Stability Map

Financial Stability Map<sup>1</sup> presents the developments in main indicators of risks to the stability of the banking sector (figure 4). On average, the 2018 was characterized by a similar level of risk to the financial stability from the macroeconomic environment, but with a trend of a risk increase from the external economy at the end of the year. The risk from the activity of economic agents such as enterprises, households, and governmental sector has increased slightly, a tendency identified in the last quarter of the year, excluding the sector of enterprises that marked a decrease of risk in Q4. Internal sustainability indicators of the sector reflected diverse developments. Capitalization and profitability of the sector has been characterized by a slight increase of the risk, but at the end of the year showed a decreasing tendency. Whereas the risk from banking sector structure has marked an increase during the year, showing a greater decrease tendency at the last quarter of the year. The position of liquidity and funding continued to increase the risk, but this tendency came to an end by the last quarter of 2018 where the risk scale marked a decrease compared to the same period of the previous year. Finally, most of indicators stand below or near the historic average risk level, excluding the liquidity and financing indicators.<sup>2</sup>

Accelerated economic growth of Kosovo trade partner countries in 2018, together with a decline in unemployment in countries with higher concentration of remittances, positively contributed to the decrease of the risk scale from the external macroeconomic environment. While developments to all other external economic indicators such as oil price, prospects for economic activity in Europe under the Organisation for Economic Co-operation and Development in Europe, and basic interest rates, were less favourable and had an impact to risk increase by neutralizing the positive effect of economic growth and unemployment. However, the last quarter of 2018 was characterized by a tendency of the increased risk to financial stability from external economy, affected mainly by the more pessimistic prospects for economic activity in Europe as well as the slowdown economic growth in euro area.

Kosovo's economy marked an accelerated growth and positive output gap in 2018, positively impacting the risk scale.

Figure 4. Financial stability map



Source: CBK (2019)

On the other hand, the higher trade deficit reflected in a higher negative current account balance to GDP ratio, along with the decrease of the real rate average of euro exchange in three first quarters of the year, contributed to risk increase. Other indicators of domestic economy were characterized by positive development in the context of financial stability and together with the accelerated economic growth has neutralized the risk increase effect from the abovementioned factors. External debt to GDP decreased as a result of lower debt stock and GDP growth. Inflationary pressures, on average, were lower in 2018 compared to the previous year, but the last quarter of the year indicated a growing tendency influenced by imposition of the tariff on goods imported from Serbia and Bosnia and Herzegovina.

Household and enterprise sectors were characterized by increased risk. Lending for households and enterprises continued the highest increase in relation to GDP. This affected the lending gap to GDP for these sectors to shift from negative to positive, which was also reflected with a slight increase in the risk scale.

On the other hand, the quality of credit portfolio continued the improving trend in both sectors, thus contributing to the decrease of risk to financial stability.

<sup>1</sup> The Financial Stability Map graphically presents the movement of the degree of risk to the main categories of risk to financial stability in the banking sector of Kosovo and enables comparison with the average historical risk note for relevant categories. The increase of distance from the centre of map for indicators reflects an increase of risk and decrease of the ability to cope with shocks to financial stability and vice versa. The whole

methodology of the model of Financial Stability Map for Kosovo, which has been subject to on-going revisions in the indicators and their manner of calculation, is presented in the CBK Working Paper No. 6.

<sup>2</sup> Progress of risk from indicators of Financial Stability Map and contribution of integral components at the relevant risk level is presented in Annex 1.

Another positive development for the household sector was the lower average rate of unemployment throughout 2018, but in the last quarter of the year showed an increasing tendency. Whereas, the indicator of the trend of remittances, which represent a significant source of sector revenue, was characterized by a decrease as a result of the lower annual increasing rate of remittances. Within the enterprise sector, the indicator of the industrial turnover index, the trade sector's value added to GDP, as well as the business confidence indicator, marked a decrease reflecting slowdown activity with the previous year. The only component that deteriorated besides the quality of the credit portfolio was the net balance of businesses registered and closed ones during this period.

Risk from government sector marked a slight increase. Main developments that have led to increased risk include the increase of sovereign risk premium, which reflects the increase of difference between the rate of treasury bonds of German Government and Kosovo Government, the increase of public debt size, as well as the increase of ratio of the negative budget balance to GDP. On the other hand, positive developments include the decrease of debt cost and the continuous increase of tax revenues, which is reflected among the highest level of the tax revenues to GDP ratio and is consequently characterized by low risk scale.

The structure indicator has been subject to the most significant change in the risk scale, which is characterized by a decrease as a result of positive developments in all integral components. The most significant improvement is recorded in the component of negative deviation from the average rate of the sector capitalization, which means that banks have converged towards the average rate of the sector capitalization. This as a result of the increase in the rate of capitalization of smaller banks, in addition to the decrease of the average rate of the sector capitalization. Other positive developments in the sector structure include a reduction of the concentration rate of three largest banks assets, reduction of concentration of enterprise credit portfolio, higher diversification of overall credit portfolio and bank funding sources.

The position of sector capitalization and profitability, although favourable throughout the year, has decreased compared to the previous year. The sector capitalization rate has decreased, decreasing the gap to the minimum regulatory rate. The report of net interest income to sector assets on the average has decreased, as a result of the higher increase of the sector's assets in relation to the

increase in net interest income. However, in the fourth quarter, the tendency of this indicator was positive. Similarly, sector profit before the tax has increased during this period at a slower rate than the assets, also giving a negative contribution to the risk scale. Large sector exposures in relation to Tier 1 capital, on average during 2018 were larger, but in the last quarter of the year, they marked a decrease. Components with a positive effect on the capitalization indicator were the increase of share capital ratio to sector assets, along with the continuous improvement of the credit portfolio.

Accelerated lending increase in relation to deposit increase and the expansion of the liquidity gap are among the main contributors to the increase of liquidity indicator risk and sector funding. The fastest lending increase has affected the increase of the loan indicator in relation to deposits, which is reflected at a higher risk rate. This, along with the low interest rate environment that impacted the migration of deposits to categories with lower maturity, contributed to the deepening of liquidity gap for assets and liabilities up to 3 months. The liquidity ratio, on average, in 2018 was lower than the previous year, but the ratio has increased in the last quarter of the year. The only component with mitigation effect to the indicator risk was the higher annual increase of deposits compared to the previous year, which is a positive development in the context of the sustainability of funding sources. It should be mentioned that the level of higher risk of liquidity indicator and funding in addition to historic rate reflects to a large extent the nature of components included in indicators, such as the household deposits increase rate that was high in the beginning of sector's operation and naturally followed a downward trend as a result of sector development and deposit increase maturity, as well as loans to deposits ratio, which also followed a naturally increasing trend since the beginning of the sector operation.

### 3. External environment and developments in the domestic economy

*The external economic environment has been characterized by an increase of uncertainties during 2018. The main risks to the economic prospects of developed countries, particularly in the euro area, are mainly related to increased*

*geopolitical uncertainties, strengthening of trade barriers and potential increase of fluctuations in international financial markets. In the region of Western Balkans, including the economy of Kosovo, mainly due to the low base of production and the weaker competitiveness, the high deficit of trade continues to be one of the main obstacles to economic developments. Economic growth in the region continued to rely heavily on internal demand.*

**Table 2. IMF estimates and forecasts for selected macroeconomic indicators of Kosovo's main trading partners**

Description	Real GDP			Unemployment rate*			Inflation			Public debt/GDP		
	2017	2018	2019	2017	2018	2019	2017	2018	2019	2017	2018	2019
Euro area	2.4	1.8	1.3	9.1	8.2	8.0	1.5	1.8	1.3	86.8	85.0	83.6
Germany	2.5	1.5	0.8	3.8	3.4	3.4	1.7	1.9	1.3	63.9	59.8	56.9
France	2.2	1.5	1.3	9.4	9.1	8.8	1.2	2.1	1.3	98.5	98.6	99.2
Italy	1.6	0.9	0.1	11.3	10.6	10.7	1.3	1.2	0.8	131.3	132.1	133.4
Bosnia and Herzegovina	3.0	3.1	3.1	20.5	18.4	18.0	1.2	1.4	1.5	39.0	37.0	36.3
Kosovo	4.2	4.0	4.2	30.5	29.6	n/a	1.5	1.1	2.2	16.3	17.0	19.7
Montenegro	4.7	4.5	2.8	16.1	15.2	n/a	2.4	2.6	0.9	66.3	72.1	70.6
North Macedonia	0.2	2.7	3.0	22.4	19.4	18.9	1.4	1.5	1.8	39.4	39.5	40.5
Serbia	2.0	4.4	3.5	14.1	13.7	13.4	3.1	2.0	2.0	58.7	54.3	50.9
Albania	3.8	4.2	3.7	13.8	12.2	13.7	2.0	2.0	2.0	71.9	68.6	65.1

Note: For Kosovo and Montenegro, data from relevant statistical agencies were used as they were missing in the IMF database.

Source: IMF Database, WEO, April 2019

**Closure of quantitative easing program within the framework of the monetary expansionary policy pursued by the ECB,** as well as the concerns raised about the potential escalation of trade tensions, are reflected in a slowdown of economic activity in the euro area by the end of 2018 and early 2019. However, the still favourable conditions for financing, salaries increase, the recovery of external demand and the easing to some extent of fiscal policies are expected to continue to support economic activity in 2019.

**The dynamics of economic growth in the Western Balkans during 2018 kept changing from country to country,** while the average growth turns out to be recovered compared to the previous year (table 2), mainly supported by investment increase. However, expectations for weaker dynamics of economic activity in the euro area are projected to be reflected in the countries of the Western Balkans, mainly through the weakening of external demand with negative effects on exports of the region, but also the potential reduction of remittances and foreign direct investments. Also, increased political

uncertainties in the countries of Western Balkans could be reflected in further decline in investor and customer confidence, thus directly affecting real growth and economic growth. Eventually, the potential tightening of monetary policy in the U.S.A and the euro area could affect the countries in Western Balkans in 2019, by increasing the cost of financing public debt and financial services.

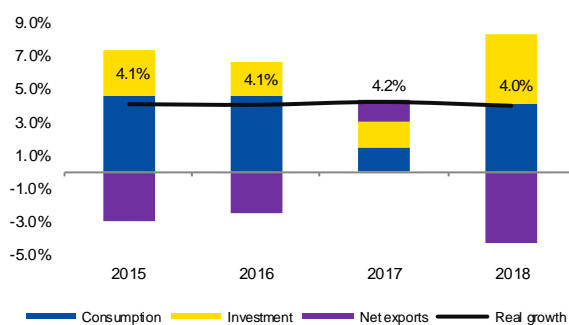
**The macroeconomic environment in Kosovo appears to have been stable in 2018 and the macroeconomic risk to financial stability, similar to the previous year, at an average level albeit at an increasing rate.** In 2019, estimates for the increase of external and internal macroeconomic risks could be reflected in the slowdown of economic activity in Kosovo mainly through the further increase of the trade deficit, increase of overall price level in the country and the decrease of external funding sources such as remittances, FDIs and compensation of employees.



### 3.1. Domestic economy

Increased uncertainties in the external environment during 2018 turn out to have also influenced the dynamics of the country's economy, although real GDP growth is estimated to have been similar to the previous year. Slower economic growth in the euro area and Kosovo's main trading partners in 2018 and dynamics in the domestic economy resulted in deterioration of the net export position of the country. Consequently, despite the fact that the macroeconomic environment appears to have been stable, real GDP growth, according to CBK estimates, results to have been 4.0 per cent (figure 5).

Figure 5. Real GDP growth rate and contributors to the growth



Source: KAS and CBK estimates for 2018(2019)

Growth of aggregate demand during 2018 is mainly supported by increased consumption and investment. Official quarterly data for 2018 published by KAS suggested a 3.7 per cent increase in overall consumption value, mainly supported by the increase in financial intermediation in the country. In addition to double-digit credit growth, other sources of consumer finance such as remittances and compensation of employees, and expenses for salaries in the public sector also increased, supporting the growth of overall consumption. During the reporting period, the increase of new investment loans and capital expenditures by the government impacted the increase of investments in the country by 14.4 per cent. In 2018, as a result of the weakening of external demand and lower metals prices in international markets, exports of Kosovo goods have decreased. At the same time, internal

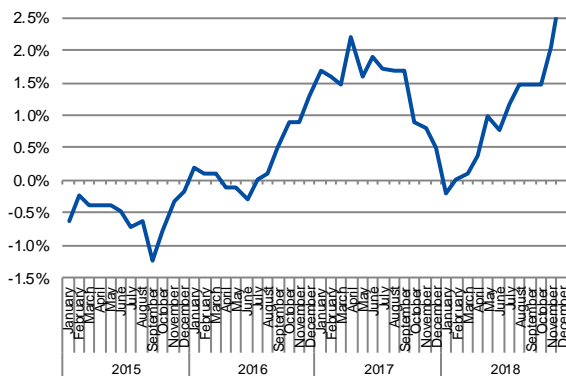
demand increase has impacted the increase in the value of goods import, resulting in a deterioration in the net export position (goods and services) by 14.7 per cent in real terms.

For 2019, the CBK forecasts suggest real GDP growth of 4.2 per cent, which is expected to be mainly supported by a strengthened fiscal incentive, as well as the increase of financial intermediation, inflows of external transfers in the form of remittances and compensation of employees, as well as FDIs.

CBK's forecasts for economic growth in 2019 are expected to be subject to review in the second half of the year, to reflect on the increase of perceived external and internal risks. The slowdown of growth in euro area, the not so optimistic prospects for the Western Balkans as well as the decrease in metals prices are expected to have an effect on the potential reduction of external funding sources (remittances, FDIs, compensation of employees), and consequently, in reduction of internal demand and exports of goods. Also, the increase of internal risks is expected to have an impact on the overall economic activity in 2019. Within the fiscal sector, pressures for further increase of budget expenditures compared to revenues, especially current expenditures (pressures on increasing transfers and the new law on salaries) in the next two years, will increase the risk of reducing capital expenditures and increasing the fiscal deficit beyond the fiscal rule. Also, the new Law on salaries is expected to affect the increase of salaries in the public sector, which, in addition to budgetary effects, could result in pressure on private sector salaries and consequently affect the competitiveness of Kosovo exporters.

**The slowdown of increase of prices of main goods in international markets led to a slower increase of prices also in Kosovo during 2018.** The average annual inflation rate, expressed through the consumer price index (CPI), marked an increase of 1.1 per cent in 2018 (a 1.5 per cent increase in 2017) (figure 6).

Figure 6. Inflation rate, annual change



Source: KAS (2019)

While the first half of 2018 was characterized by slower price increases, the second half and especially the last quarter marked an increase in prices. For 2019, CBK projections suggest that the average inflation rate is expected to be around 2.3 per cent. However, the country's inflation rate in 2019 is also subject to review, especially when we consider the general increase of prices, especially the food price increase of 7.6 per cent. Political decision taken to impose a 100 per cent tariff on products imported from Serbia and Bosnia and Herzegovina, which is still in force, influenced to some extent the internal price increase, with potential effects on disposable income and consumer purchasing power in 2019 and the purchasing power of consumers in 2019.

**In 2018, the dynamics that characterized the fiscal sector resulted in a higher increase of budget expenditures (10.3 per cent) compared to budget revenues (4.5 per cent).** The high increase in budget expenditures compared to the previous year, but also compared to revenues, has contributed to the increase of the primary budget deficit to EUR 162.7 million, namely 2.4 per cent of GDP. In 2018, with an increase of 9.7 per cent, **the public debt was also characterized, which has reached EUR 1.1 billion. As a percentage of GDP, public debt has reached 17.1 per cent, compared to 16.2 per cent in 2017.** Public debt increase is attributed to the internal debt increase by 17.8

<sup>3</sup> The source of data for the export and import of goods in Kosovo is the Kosovo Agency of Statistics.

per cent (which has reached EUR 676.6 million), while the external public debt has marked a decrease of 1.4 per cent, reaching EUR 416.1 million.

**Current account and capital account deficit amounted to EUR 575.0 million, which is 45.6 per cent higher compared to 2017. Current and capital account deficit to GDP ratio increased to 8.5 per cent, compared to 6.2 per cent in 2017.** The increase of deficit of goods and reduction of the positive balance of services were the main factors in the deterioration of the current and capital account position in 2018. On the other hand, the positive balances of the primary and secondary income account have marked an increase. The decline in exports of goods (2.8 per cent) and the significant increase in import (9.6 per cent) has caused the deficit in the trade of goods to increase by 11.3 per cent and reach about EUR 3.0 billion.<sup>3</sup> The trade deficit of goods to GDP ratio has reached 44.1 per cent, compared to 41.6 per cent as it was in 2017.

**The balance in the trade of services was characterized by an annual decline of 2.0 per cent, marking EUR 778.0 million.** Reduced balance of services is attributed to the much higher increase in the import of services (17.1 per cent) compared to the increase in exports (5.7 per cent). The structure of imported and exported services remained almost unchanged from the previous year.

**Within the balance of payments of Kosovo, net income from compensation of employees<sup>4</sup>, being the main category of primary income, marked an increase of 8.9 per cent. Also, the balance of secondary income was characterized by increase, mainly as a result of the higher level of remittances** which is also the largest category within the secondary income account. The inflow of remittances amounted to EUR 800.5 million in 2018 and marked an annual increase of 5.4 per cent.

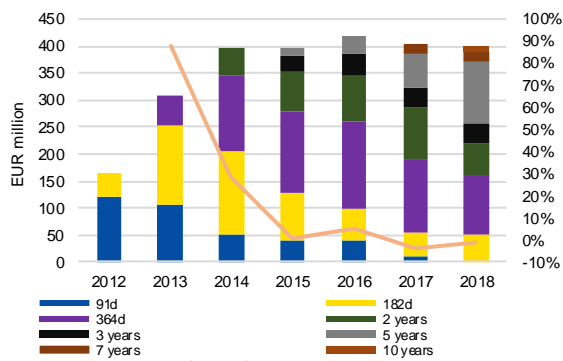
<sup>4</sup> Workers compensation includes salaries, wages and other benefits received by resident workers that work abroad. In this context, it includes seasonal workers or other short-term workers (less than one year) and border workers who have their economy as the centre of economic interest.

During 2018, FDIs received in Kosovo marked an annual decline of 9.3 per cent and amounted to EUR 231.7 million. The decline of FDIs was mainly noted in the financial services and construction sectors, while real estate, mining, energy, and trade sectors marked an increase.

### 3.1.1 Securities market

The internal securities market continues to be the main source for public debt financing.

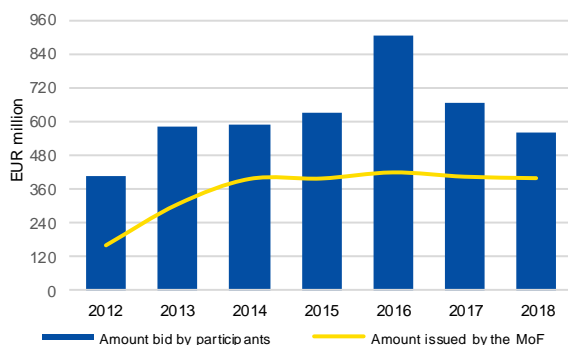
Figure 7. Amount of issued debt, annual difference



Source: CBK (2019)

In 2018, the Government of Kosovo has issued debt of an amount of EUR 399.8 million, which is 1.3 per cent lower than last year (figure 7). Despite the decline in the amount of securities issued, the demand to invest in these instruments continues to be high (figure 8).

Figure 8. The requested and issued amount of securities of the Government of Kosovo



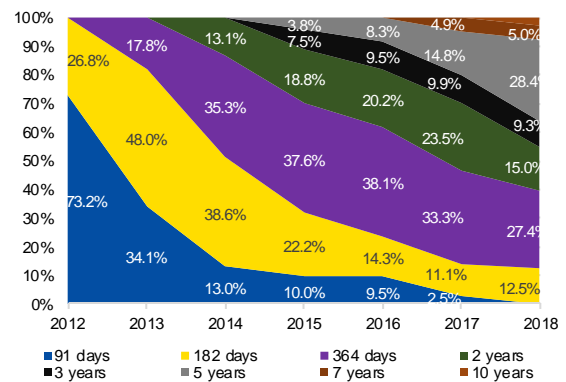
Source: CBK (2019)

The amount offered by the entities participating in the auction has exceeded the amount announced by the government in each

year. On average, bid to cover ratio was 1.40 (1.64 in the previous year).

The average maturity of the securities has continued to extend, reflecting in an increase of interest in longer-term debt. The structure of securities in the last two years has been dominated by government bonds. Treasury bills (with a maturity up to 1 year), which in the past dominated the securities structure, in 2018 reduced their share to 39.9 per cent (46.9 per cent in 2017) of total securities.

Figure 9. Securities share, by maturity

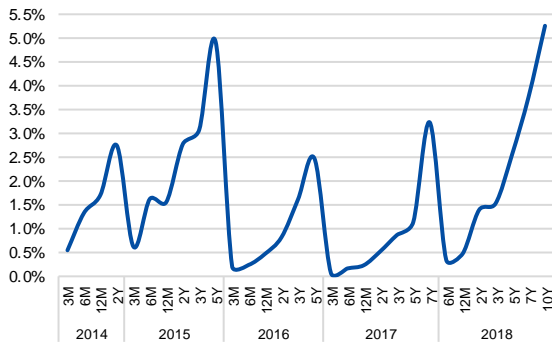


Source: CBK (2019)

Government bonds with a maturity term 'of 5 years' marked the highest annual growth (89.0 per cent), and dominated the structure of total securities (figure 9). A significant development in this period is the first execution of the auction for issuance of government bonds with a maturity of ten years. While, for the first time since the beginning of the issuance of securities, this year there was no treasury bills issuance with a maturity 'of 91 days'.

The average interest rate on securities of the Government of Kosovo has increased for all maturity categories, expressed more in bonds. Within bonds, those with a maturity of five years marked the highest increase of interest rate of 142 basis points. Whereas, treasury bills of 6 months maturity have marked the lowest increase of 18 basis points (figure 10).

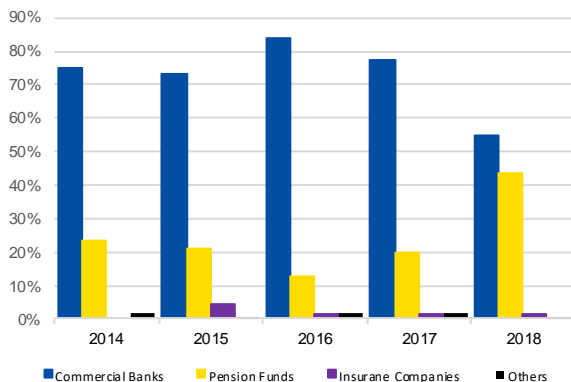
Figure 10. Average interest rate on securities of the Government of Kosovo, by maturity



Source: CBK (2019)

The main participants in securities auctions continue to be commercial banks, followed by pension funds which have considerably increased their share (figure 11 and 12). The share of commercial banks in auctions has decreased in recent years, which was reflected also in the decrease of the banking sector's exposure to the securities of the Government of Kosovo (from 6.6 per cent share of the securities of the government of Kosovo to the total assets of the banking sector in December 2016, exposure decreased to 6.2 per cent in December 2018). Pension funds have significantly increased their share in efforts to increase exposure in the country, at a time when the performance of their investments in foreign markets was negative.

Figure 11. Participants at securities auctions

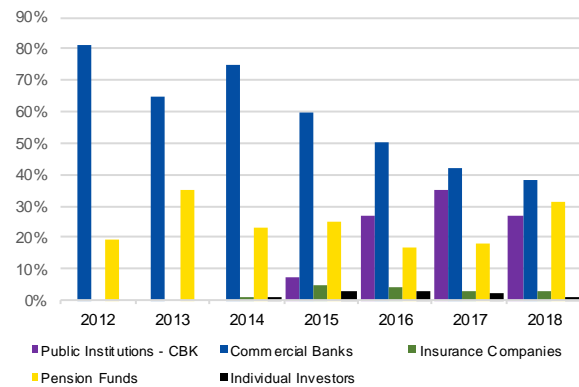


Source: CBK (2019)

Trading activities in the secondary market, considering the number of transactions, have increased, while the

volume has been characterized by a decline.

Figure 12. Holders of securities



Source: CBK (2019)

The annual number of transactions for 2018 was 81, which is 30.6 per cent higher compared to 2017, when 62 transactions were conducted. Whereas, the annual trading volume on the secondary market was EUR 78.6 million, an annual decline of 45.2 per cent. CBK is one of the key actors in the secondary market of securities. During December 2018, for the first time, transactions for the needs of short-term liquidity between commercial banks have been conducted, through agreements for the repurchase of government securities.

### 3.2. Financial position of enterprises

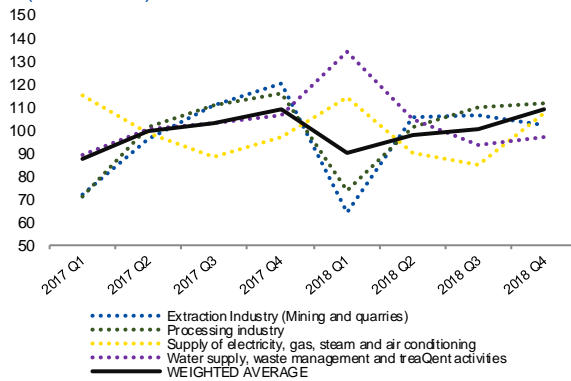
Developments in economic and financial indicators of enterprises suggest a slight decrease in the volume of industrial production and an increase of turnover in retail trade.

The weighted index of industrial production volume, which represents the performance of the production of enterprises in four sectors of industry, has been characterized by a slight decrease of 0.7 per cent compared to 2017. The decline in this index was higher in the extractive industry (-5.2 per cent), which is also noted by the decline of 6.1 per cent of value added in this sector.

In the processing industry and electricity supply, the decrease in the index was lower (-0.8 per cent in both sectors), while a 7.3 per cent increase was marked in water supply,

waste management, and treatment activities (figure 13).

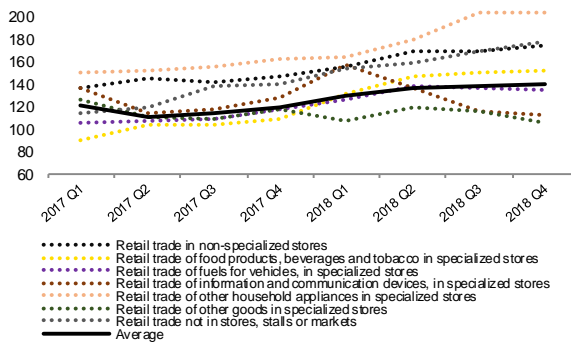
Figure 13. Industrial production volume index (2017=100)



Source: KAS (2019)

On the other hand, the average turnover index in retail trade has increased considerably (16.8 per cent) (figure 14), which was also noted by the 9.1 per cent increase in value added in this sector.

Figure 14. Retail trade turnover index (2013=100)



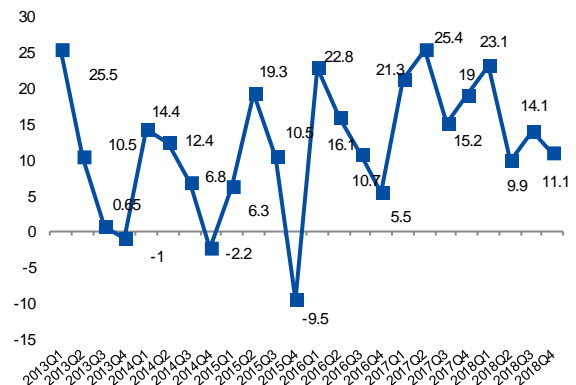
Source: KAS (2019)

**Business climate and confidence indicators have changed the increasing trend of 2017, marking a decrease in 2018.<sup>5</sup>** The business climate indicator, which assesses the current economic situation (profitability) of business and expectations for the next six-month period, was lower for 7.8 percentage points, while the business confidence indicator, which has a more general character of evaluating business status unlike the previous indicator which focuses only on

<sup>5</sup> The business climate indicator and business confidence indicator is compiled by the Kosovo Chamber of Commerce, as part of a regular quarterly study 'Business Climate in Kosovo' which surveys businesses in four sectors of the economy: manufacturing, construction, services and trade.

the financial performance of the business, was lower for 5.7 percentage points (figure 15).

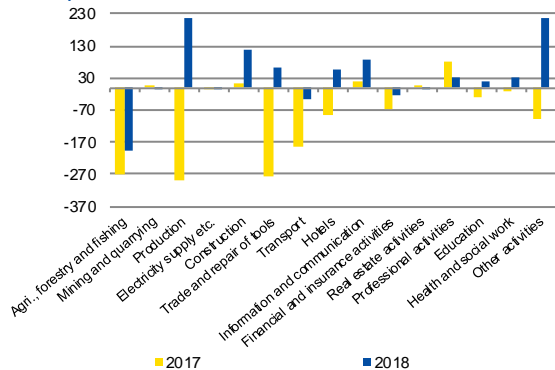
Figure 15. Business confidence index



Source: KCC (2019)

**Despite the decrease in business climate and business confidence indicators, the entrepreneurial initiative has increased in 2018 as a result of positive macroeconomic developments as well as the easing of procedures for starting a business.<sup>6</sup>**

Figure 16. Annual change of the number of new enterprises



Source: KAS (2019)

During 2018, 9,805 new enterprises were registered, which represents an annual increase of 6.3 per cent. The sectors that recorded the highest annual increase in the number of registered businesses were production and construction while in the agricultural sector the number of newly registered enterprises was significantly lower (figure 16).

<sup>6</sup> Kosovo has made further progress in regulatory reform in the field of business registration in 2018, and the World Bank in its 2019 Doing Business Report ranked Kosovo the 13th for convenience in starting a business from a total of 190 countries.

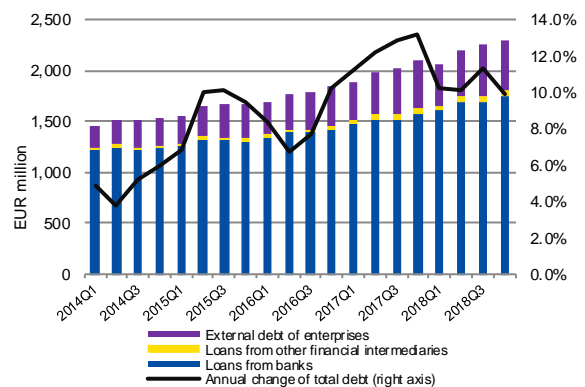
On the other hand, the number of enterprises that were closed during this period has declined to 1,426, compared to 1,623 in 2017. **In addition to the increase of the registered enterprises, the number of enterprises declaring turnover as well as the value of turnover of the declared enterprises in the Tax Administration of Kosovo have also increased.**

The number of enterprises declaring turnover above zero has reached 40,147 in 2018, compared to 39,506 last year, while the declared turnover for 2018 was EUR 11.1 billion, compared to EUR 10.1 billion in 2017. On average, turnover for enterprises that have declared turnover above zero has increased. Although the increase in turnover may reflect other developments such as increasing formal economy and such development may also suggest increased activity by the enterprise sector.

**Continued progress in the effective implementation of legislative and regulatory requirement reforms has contributed to reducing barriers to access to credit, but numerous challenges still remain.** Progress in the scope of private enforcement agents as well as changes to the Law on Enforcement Procedure that has to do with bank account sequestration and the accelerated procedure of selling collateral have had a positive impact on the credit offer and have made it easier to apply for collateral and reduce interest rates. Access to credit, among other things, is supported thanks to the advancement in the Credit Registry<sup>7</sup>, placement of the priority position in bankruptcy proceedings for secured creditors, and the adoption of the legal framework for corporate bankruptcy proceedings. However, numerous obstacles remain, that hinder business performance and access to finance. High level of informality, poor implementation of contracts, lack of cadastral data, coupled with lack of financial transparency and low

quality of financial reporting, continue to be a barrier to access to finances for enterprises.

Figure 17. Debt of enterprises



Source: CBK (2019)

**The debt of enterprises to domestic and foreign financial institutions has continued the increasing trend.** Domestic debt, namely the debt to the banking sector in the country has increased by 11.0 per cent. Enterprise loans from other financial intermediaries increased by 21.4 per cent, but remain of low weight to total corporate debt with around 2.7 per cent. External debt of enterprises continued to grow and reached 21.5 per cent of total debt. In December 2018, total corporate debt marked an annual growth of 10.0 per cent and reached 34.2 per cent of the GDP (figure 17).

**Increase of lending to enterprises from the banking sector has contributed to the process of approximation of the level of financial intermediation of enterprises towards countries of the region.** The enterprise loans from the banks to GDP ratio reached 26.9 per cent in December 2018 (compared to 25.4 per cent a year earlier). The faster increase of loans to GDP ratio has impacted the negative gap of 2017 to close and move to a positive territory in 2018.<sup>8</sup>

**As a result of the higher credit growth, even the net debt position of enterprises towards the banking sector marked an increase.** Enterprise deposits marked an

<sup>7</sup> In June 2017 was finalized the implementation of the project for advancing the Kosovo Credit Registry, which was supplemented with new information (interest rates, percentage covered by the Credit Guarantee Fund, business

size, etc.), which contribute, inter alia, to reducing the asymmetry of information and improving access to finance.

<sup>8</sup> Credit gap calculated with the Hodrick-Prescott filter.

accelerated annual growth and amounted to EUR 656.6 million.

However, the high credit growth for the enterprise sector, which reached EUR 1,747.1 million in December 2018<sup>9</sup>, has led enterprises to expand their debt position to the banking sector. In terms of currency, the enterprise sector has a net credit position vis-à-vis the banking sector as a result of the higher level of foreign currency deposits in comparison to loans. However, the currency position remains low as a result of the low share of loans and deposits in currency, to 0.1 per cent in currency to total loans, and 3.0 per cent for currency deposits to total deposits.

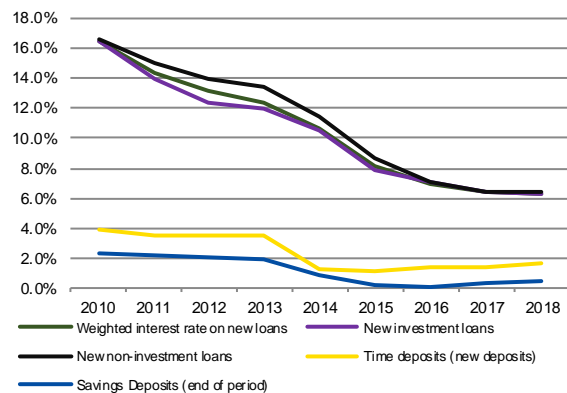
**The banking sector's willingness to lend to enterprises has marked a slower increase compared to the previous year. New loans increased by 4.9 per cent (34.7 per cent in 2017).** According to the purpose, new investment loans marked an increase of 21.2 per cent increasing their share in the structure from 59.6 to 65.1 per cent of total new loans to enterprises in 2018. New non-investment loans marked a lower increase rate of 4.3 per cent and decreased their share in the structure from 40.4 per cent to 34.9 per cent of total new loans to enterprises in 2018. In terms of maturity, 2018 was characterized by the growth trend of loans with longer maturity, where 27.1 per cent of new loans issued had a maturity from 5 to 10 years. The dominant category of loans continues to be of those with maturity from 2 to 5 years, with a share of 46.4 per cent to total new loans for enterprises.

**The borrowing of small and medium enterprises in 2018 was also supported by the Kosovo Credit Guarantee Fund (KCGF), whose use has marked a continuous growth trend.** KCGF, which aims to increase access to finance for SMEs by guaranteeing the credit portfolio of financial institutions, began to guarantee the first loans for SMEs in September 2016. By the end of 2018, the number of bank loans guaranteed by KCGF was 2,262, the total amount of which amounted to over EUR 41.7 million. The credit

guarantee structure is a representation of the overall structure of the banking sector loans, in which the loans for the wholesale and retail sector dominate, followed by the services sector and the manufacturing sector. The sector of agriculture, forestry and fishery had a share of 7 per cent from the total portfolio of guaranteed loans. Positive development prospects of KCGF, both in terms of capital growth and guaranteed amount of loans, as well as in focusing on supporting specific sectors with more difficult access to finance such as the agriculture sector, are expected to be reflected in facilitating lending conditions and further credit growth for SMEs in general, and specific sectors in particular.

**The lending cost for the enterprise sector has continued the downward trend.** In 2018, banking sector average interest rate for new loans to enterprises was 6.28 per cent, 0.2 percentage points lower than the previous year, and by half lower than in 2013 (figure 18).

Figure 18. Interest rates applied to enterprises



Source: CBK (2019)

This decline of interest rates resulted from the continuous competitive pressures, the improvement of the loan portfolio quality, the progress in structural reforms for reducing risks in collateral implementation and good access to financing.

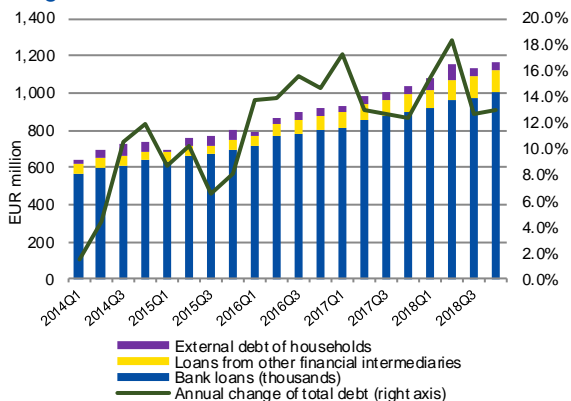
### 3.3. Financial position of households

**Households' debt continued the growing trend in 2018.** Domestic debt to the banking

<sup>9</sup> Including foreign currency loans, converted into equivalent value in euro.

sector has increased by 11.2 per cent, while the debt to microfinance institutions, which has reached 12.1 per cent of the debt to banking sector, has increased by 31.2 per cent.

Figure 19. Debt of households



Source: CBK (2019)

The external debt of households marked an increase of 13.1 per cent and reached 4.1 per cent of the total debt. In December 2018, total household debt increased by 13.0 per cent and as a percentage to GDP reached 16.7 per cent (figure 19).

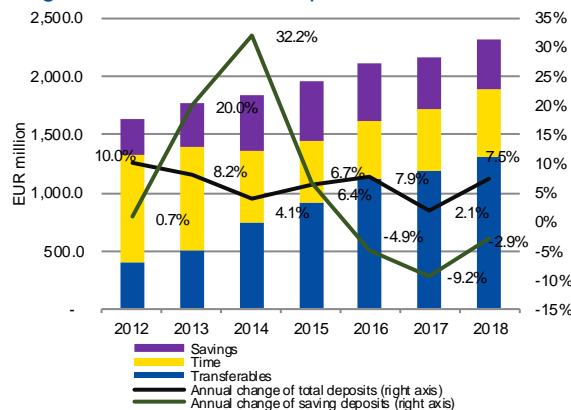
**New loans issued by the banking sector for households continued to grow but at a lower rate compared with the previous year.**

Total new debt to banks has increased by 7.1 per cent, in comparison to 15.0 per cent increase in the previous year. Concerning loans classified by purpose, an increase was more evident for consumer loans (10.4 per cent), while new mortgage loans marked an increase of 8.5 per cent. The higher increase of consumer loans affected the share of these loans to total new household loans to increase even higher reaching 74.0 per cent, an increase by 2.2 pp. New household loans are expected to continue growing in the following year in addition to expectations for higher demand and eased conditions and standards (increase of the approved amount and decrease of interest rates). **The net position of household loans to the banking sector increased as a result of higher volume of deposits compared to loans and the**

<sup>10</sup> Including the deposits in foreign currency, converted in equivalent value in Euro.

**higher growth rate of household deposits compared with the previous year.**

Figure 20. Household deposits

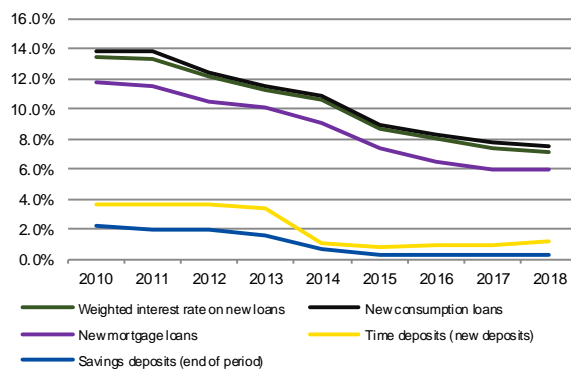


Source: CBK (2019)

Households' deposits amounted to EUR 2.3 billion<sup>10</sup>, representing an annual growth of 7.5 per cent (figure 20).

Loans, on the other hand, continued their double digit growth and amounted to EUR 1.0 billion, affecting in an increase of 4.9 per cent of the traditional lending position of households towards the banking sector.

Figure 21. Interest rates applied to households



Source: CBK (2019)

Regarding the net position of foreign currency, the household sector has increased its foreign currency lending position by 19.5 per cent as a result of foreign currency deposits growth, which reached 6.3 per cent of total household deposits (5.7 per cent in 2017), while foreign currency lending remains at a similar level under 0.3 per cent of total household loans.



**Household savings, in the form of time and transferable deposits, marked an increase during 2018.** This growth in deposits resulted from the gradual increase of the interest rate on deposits, which affected the reduction of the opportunity cost of holding savings and time deposits, namely the increase of household savings (figure 21).

Households' total deposits increased by 7.5 per cent in 2018 (2.1 per cent increase in 2017). Time deposits increased by 10.0 per cent, while the interest rate reached 1.21 per cent or 0.28 percentage points higher than the previous year.

On the other hand, the new savings deposits marked an annual decline of 4.9 per cent, despite the slight increase of the interest rate from 0.26 to 0.28 per cent. **The cost of new household debt continued to decline, influenced by competitive pressures and favourable financing conditions.** Consumer loans marked an average interest rate of 7.2 per cent or 0.24 percentage points lower compared with 2017, while the interest rate of 5.9 remained similar to 2017. Interest rates for households are expected to remain at a similar level, under the positive prospects of economic growth and the quality of the credit portfolio.

**Table 3. Indicators of debt to banks and performance of households**

Description	2010	2011	2012	2013	2014	2015	2016	2017	2018
Households' debt to banks (in millions)	434.2	514.6	546.3	567.7	639.0	697.7	799.5	900.6	1,001.1
of which in foreign	-	3.7	3.8	3.9	3.7	3.4	2.9	3.0	2.6
Households' Deposits in Banks (in millions)	1,299.3	1,490.5	1,640.1	1,775.0	1,848.3	1,965.8	2,120.5	2,164.2	2,326.3
of which in foreign	93.3	117.0	104.7	116.2	97.2	102.2	100.8	122.6	145.5
Net Position to Banks (Credit Position) in millions	865.2	975.9	1,093.8	1,207.2	1,209.3	1,268.1	1,321.0	1,263.5	1,325.1
Debt to income ratio								26.3% *	38.3%
The average credit value for employees			1,804.3	1,677.7	1,975.2	2,349.8	2,409.5	2,522.6	2,901.0
Rate of economic dependence					266%	301%	274%	250%	268%

Source: CBK (2019)

\* The household debt-to-income indicator began to be reported on a regular basis and with consistent methodology from banks as of 2018, including 2017.

Household income sources indicated an increasing trend, where remittances increased by 5.4 per cent while compensation of employees marked an annual increase of 11.2 per cent.<sup>11</sup> The level of salaries for the period 2012-2017 marked an increase of 22.7 per cent, reaching EUR 471 in 2017 compared to EUR 384 in 2012. For 2018, the monthly net salary of employees, according to the Labour Force Survey, on average continued to range between EUR 400 and EUR 500. The labour market was characterized by not very favourable developments. The labour force participation rate in 2018 was 40.9 or 1.9 percentage points lower than in the previous year, so the rate of non-activity increased by 1.9 percentage points to 59.1 per cent. The employment rate, which in 2018 recorded the level of 28.8 per cent of

the working age population, was 1.0 percentage points lower than in 2017. On the other hand, the unemployment rate in 2018 was 29.6 per cent or 0.9 percentage points higher lower than in 2017. **The burden of households with debt, measured through the debt-to-income ratio, increased to 38.3 per cent in 2018 (26.3 per cent in 2017).** This indicator does not present the full debt burden as it considers debt only by a banking institution, not considering multiple borrowing in banks and other financial institutions as well as external debt. However, the economic dependence indicator, which represents the ratio of total inactive population (over 15 years old) and employment has declined to 68 per cent in 2018 compared to 250 per cent in 2017.<sup>12</sup>

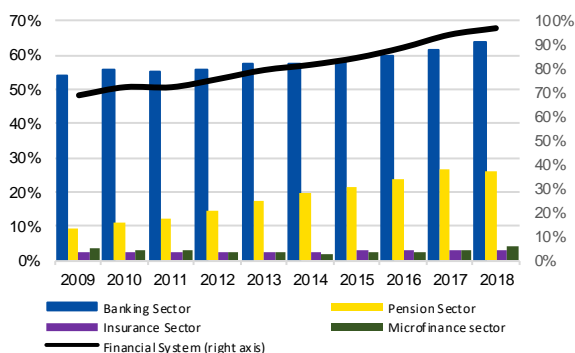
<sup>11</sup> Income from compensation of employees - income of seasonal employees abroad as well as Kosovar employees working abroad for a period of less than one year.

<sup>12</sup> According to KAS, the projected economic dependency rate in the EU will increase to 122.2 per cent in 2023.

#### 4. Developments in the financial system

The financial system continued its growth trend also during 2018, albeit at a slower rate. Almost all sectors of the financial system, with the exception of insurance and financial intermediation, increased their assets in the reporting period, reaching a value of EUR 6.32 billion, representing an annual growth rate of 6.9 per cent. Positive developments of the financial system contributed to a higher extent of access to financial services by the public, especially by the banking and microfinance sector, which also suggests increased market competition pressures for financing and providing financial services. The level of financial intermediation, expressed as a ratio of financial system assets to GDP, increased by 2.7 percentage points, thus reaching a 96.7 percentage at the end of 2018. The assessment of financial intermediation for the integral components of the financial system indicates an increase in intermediation, especially for the banking and microfinance sectors (figure 22).

Figure 22. The weight of the financial system sectors to GDP



Source: CBK (2019)

The growth of banking and microfinance sector assets is mainly attributed to the readiness of these two sectors to expand their lending activity, supported by continuous

Table 4. Number of financial institutions

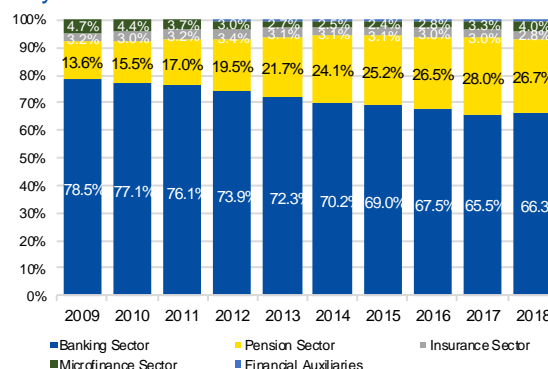
Description	2010	2011	2012	2013	2014	2015	2016	2017	2018
Commercial Banks	8	8	9	9	10	10	10	10	10
Insurance Companies	12	13	13	13	14	15	15	15	14
Pension Funds	2	2	2	2	2	2	2	2	2
Financial Auxiliaries	28	34	38	39	42	44	48	52	51
Microfinance and non-bank financial institutions	17	20	17	17	18	18	16	18	22

Source: CBK (2019)

improvement of credit quality, increased competition and improved access to finance. The growth of the pension sector's assets was made possible by the increase of the contributions received while the return on investment was negative during this period. The insurance sector marked a marginal decline, which was affected by the withdrawal of one of the life insurance providers in 2018.

The structure of the financial system has not undergone any significant changes during 2018. Within the financial system structure, the number of commercial banks and pension funds remained unchanged compared to the previous year, while the number of microfinance institutions marked an increase. Financial auxiliaries continue to have the largest number of financial institutions, despite their share of 0.2 per cent to total financial system assets (figure 23).

Figure 23. Share to total assets of financial system

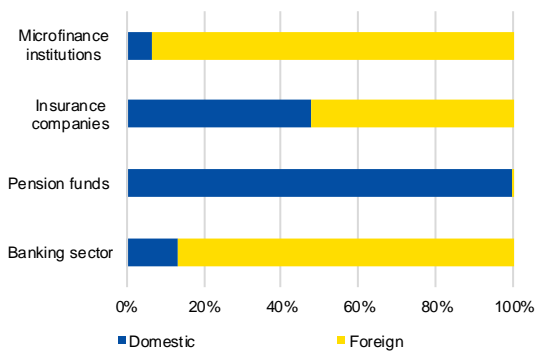


Source: CBK (2019)

Foreign capital dominates the majority of the financial system segments. The banking, microfinance and insurance sectors have a high share of foreign capital, while the pension sector relies almost all the funding in domestic contributions. On the other hand, the equity of the insurance sector is almost equally divided between domestic and foreign shareholders (figure 24).

**EU banking groups have the largest share of the banking sector in Kosovo, however banks from other countries, mainly Turkey, are gradually increasing their presence.** Banks originating from EU countries account for 57.3 per cent of banking sector assets.

Figure 24. Ownership of constituent segments of the financial system, December 2018



Source: CBK (2019)

With a more proactive approach for the purpose of market penetration, Turkish-origin banks gradually increased their presence to 7.5 per cent of the sector's assets and at the same time, contributed to lowering concentration and increasing competition in the sector. Expressed as a ratio of assets of the three largest banks to total assets of the sector, the level of banking concentration decreased to 57.3 per cent compared to 2010 when there was a concentration rate of 77.8 per cent. The insurance sector underwent significant changes in ownership over the years where this sector is dominated by domestic companies, followed by companies originating from Albania. Domestic insurance companies account for 47.7 per cent, compared to 45.7 per cent in the previous year and compared to 2010 where the share was 25.2 per cent, while companies from Albania account for 26.1 per cent of the insurance sector assets.

**The financial system in Kosovo has a simple structure, with regard to its non-advanced stage of development, and there is minimal linkage between the segments of the system.** Major links include deposits that non-banking sectors (insurers, pension funds and other non-banking institutions) have in the banking sector.

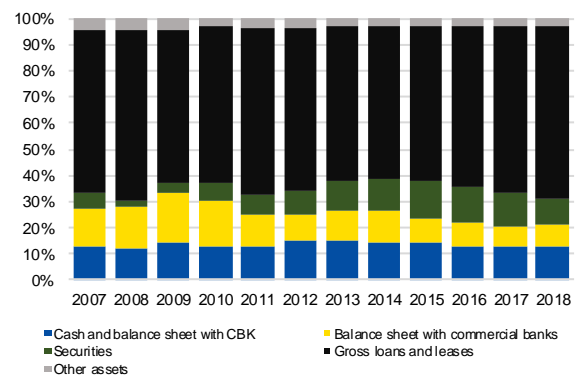
The insurance sector and financial auxiliaries hold 49.6 per cent, respectively 29.3 per cent of their assets as deposits in commercial banks, significantly influenced by limited alternatives for investing their assets. In this context, the stability and liquidity of the banking sector has an emphasized weight on the operation and stability of other sectors. Excluding this transmission channel (the high share of deposits held by the other sectors in the banking sector), other options for transferring problems between the segments of the system remain limited.

#### 4.1. Banking activity

**Banking sector activity during 2018 was expanded further, driven by credit supply.** Banking sector assets were 8.2 per cent higher compared to the previous year and reached a value of over EUR 4.0 billion, namely EUR 4.19 billion. The increase of this sector's assets during 2018 is mainly attributed to the positive dynamics which characterized credit activity (figure 25), supported by the improvement of funding by banks and the increased credit demand.

The credit supply side was influenced, among other things, by the competitive pressures, the favourable liquidity position and the continuous improvement of the loan portfolio quality. Within assets, annual growth of 8.5 per cent was recorded by cash and bank reserves held at the CBK.

Figure 25. Share to assets structure



Source: CBK (2019)

Despite the continued negative interest rate applied by the CBK on the exceeded level of the

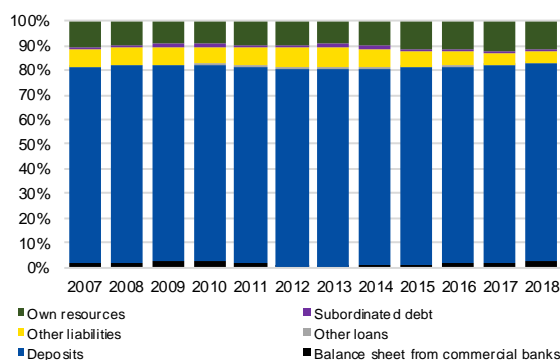
obligatory reserve that commercial banks hold at the CBK, this sub-category marked an annual growth of 3.8 per cent.

Assets have not undergone major structural changes over the years, except for the sub-category of securities that expanded since 2012 as a result of the launch of the domestic securities market and the active participation of banks in this market. Investments in these instruments grew rapidly, taking into account attractive return rates, zero risk that these instruments bear, and new investment opportunities at a time when lending needs to take care of the risk it carries. However, for the second consecutive year the stock of securities was characterized by annual decline (11.5 per cent in 2018). Consequently, the exposure of the banking sector to the Government represented in securities formally reduced slightly to 6.2 per cent of total assets from 6.3 per cent in the previous year.

The banks' strategy to focus on lending rather than in securities investment in the last two years is mainly attributed to the decline of credit risk.

**Higher increase of activity by domestic banks and new banks in the market has affected the decline of concentration in the banking sector.**

Figure 26. Share to the structure of liabilities and own resources



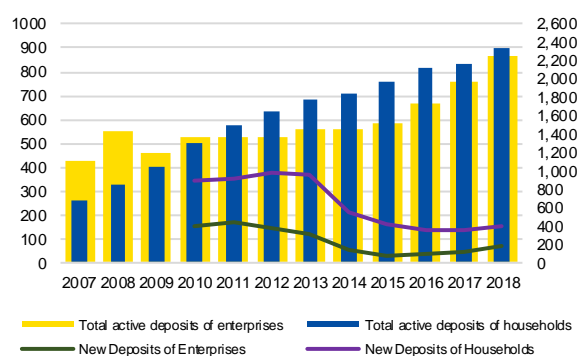
Source: CBK (2019)

The ratio of assets of the three largest banks to total assets of the sector decreased to 57.3 per cent from 61.0 per cent as it was in the previous year.

**The banking sector activity continues to be mainly financed by household and enterprise deposits (80.3 per cent of total liabilities and own resources) (figure 26).**

In 2018, deposits marked an increase of 8.7 per cent compared to the previous year, reaching a level of EUR 3.36 billion. Household deposits recovered their growth rate, which in the previous year marked the lowest increase ever recorded standing at 2.1 per cent, while in 2018 they marked an increase of 7.7 per cent. The recovery of interest rates on deposits during 2018 may have affected the withdrawal of deposits by households (figure 27).

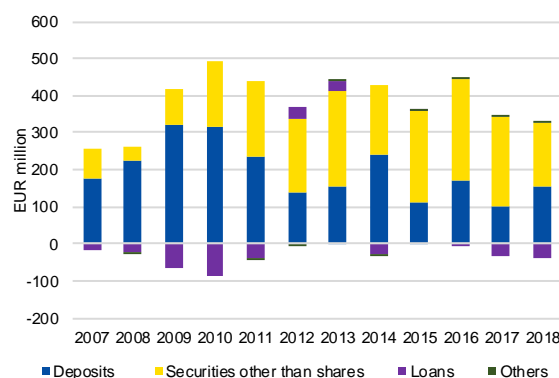
Figure 27. Stock of total deposits and new deposits, in millions of euro



Source: CBK (2019)

Enterprise deposits were 14.1 per cent higher compared to the previous year. A more significant increase was marked by time deposits, followed by transferable deposits and saving deposits.

Figure 28. Net position to non-residents



Source: CBK (2019)

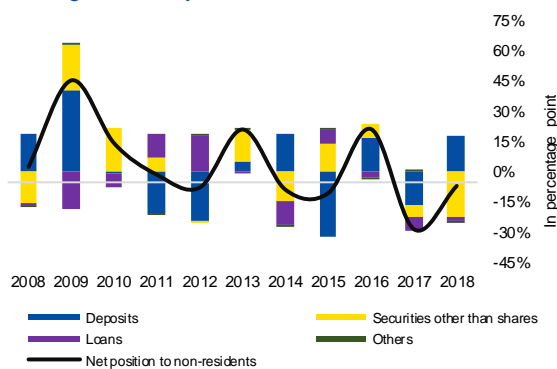
**Exposure of the banking sector to the external sector has decreased, mainly due to the decline of deposits in foreign banks**

and the decline of investments in securities. Net lending position to non-residents decreased by 7.1 per cent, declining to EUR 289.4 million (figure 28 and 29).

Claims on non-residents account for about 11.8 per cent of total banking sector assets, where the majority of them are invested in securities and held as deposits, and together represent about 88.4 per cent of total external demand.

On the other hand, banking sector liabilities to non-residents account for 4.9 per cent of total banking sector liabilities and consist mainly of non-resident deposits held in local banks and credit lines used by banks, which together account for 98.3 per cent of total liabilities to the external sector.

Figure 29. Contribution of items to annual change of activity with non-residents



Source: CBK (2019)

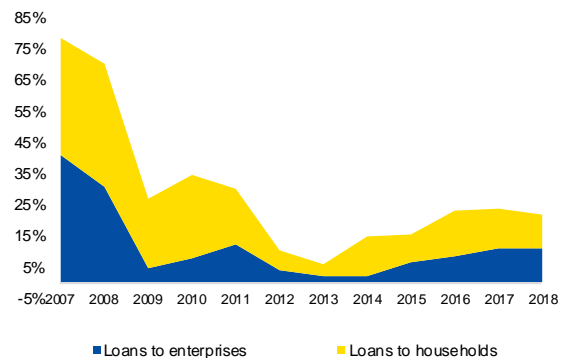
In general, the banking sector has a low exposure to non-residents in terms of external demand and liabilities to the external sector. Moreover, the banking sector has a very low level of foreign currency exposure, which avoids possible losses from changes in the exchange rate to the Euro currency.

#### 4.1.1 Credit developments

The banking sector loans maintained the double digit growth trend. The stock of active loans in domestic banks amounted to EUR 2.76 billion, representing an increase of 10.9 per cent (figure 30).

The factors that contributed to the increase in lending in 2018 were the increase in demand for loans by both enterprises (most notably SMEs) and households (for consumer and mortgage loans).

Figure 30. Annual growth of loans to enterprises and households



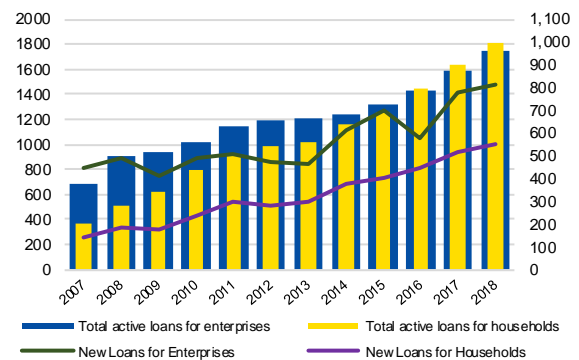
Source: CBK (2019)

Moreover, the improvement of credit supply by banks, mainly through the reduction of the average interest rate on loans and the extension of maturity of loans, has resulted in an increase of the total stock of loans.

Other factors influencing lending dynamics were the continuous improvement of loan portfolio quality, sufficient liquidity and bank competition played a key role in expanding bank lending activity over the last three years.

Enterprise loans grew by 10.8 per cent and amounted to EUR 1.75 billion. In 2018, new enterprise loans increased by EUR 37.9 million and reached EUR 816.4 million (figure 31). Moreover, investment loans rose by EUR 90.9 million to EUR 518.8 million, followed by non-investment assets, whose value at the end of 2018 reached EUR 277.6 million, namely EUR 12.6 million less than in the previous period.

Figure 31. Stock of total loans and new loans to enterprises and households, in millions of euro



Source: CBK (2019)

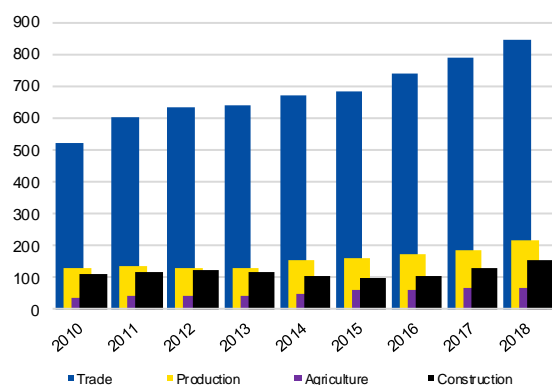
**Banking lending has increased for most sectors of the economy, with special**

### emphasis on construction and manufacturing.

Loans for the manufacturing and construction sectors recorded the highest annual growth of 16.3 and 20.7 per cent, respectively. However, the share of these sectors in the total loan portfolio remains low.

The trade sector, which dominates the structure of total loans, recorded a 7.6 per cent credit growth. Meanwhile, the mining sector was characterized by an annual decline of 54.4 per cent, and the agriculture sector with a slight decrease of 0.1 per cent (figure 32).

Figure 32. Stock of loans by economic sectors



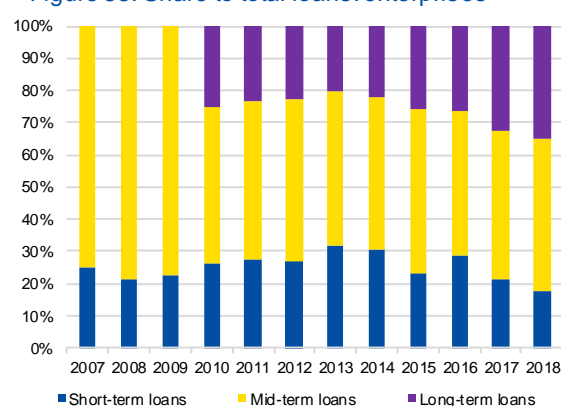
Source: CBK (2019)

Among the factors that supported lending to small and medium-sized enterprises, in 2018, was the Kosovo Trust Fund, whose use has marked a steady growth trend. The cumulative number of banks' loans to SMEs guaranteed by the KCGF amounted to 2,262 at the end of 2018 (785 at the end of 2017). The total amount of guaranteed loans in 2018 marked EUR 87.2 million, an increase against the guaranteed value of EUR 30 million in the previous year. The guaranteed credit structure is a representation of the overall structure of banking sector loans, whereby loans to the wholesale and retail trade sector are dominated by services and manufacturing sectors. The agriculture, forestry and fisheries sector represented 7 per cent of total guaranteed loan portfolio. Positive growth prospects of KCGF and focus on supporting

specific sectors with more difficult access to finance such as the agriculture sector are expected to be reflected in further credit growth for SMEs in general and certain sectors in particular.

**Loans to households, which in recent years have increased the share of total loans stock structure (about 36 per cent), marked a significant increase for the fifth year in a row.** By the end of 2018, the value of loans intended for households amounted to EUR 998.5 million, or 11.2 per cent higher than in the previous year.

Figure 33. Share to total loans: enterprises



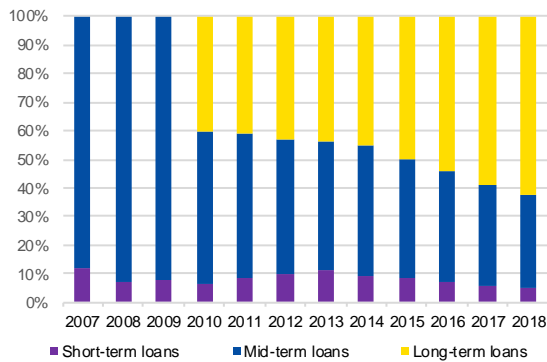
Source: CBK (2019)

However, compared to last year, there was marked a slowdown increase of loans to households. This slower pace of loans growth for this category may be attributed to the slower growth of new loans during this period, which increased by 7.1 per cent in 2018 against the annual growth of 15.0 per cent marked in 2017. The value of the new loan amounted to EUR 550.7 million (figure 33). The majority of the new loans was intended for consumption (74.0 per cent) and home purchase (18.0 per cent).

**For the first time, long-term maturity loans managed to dominate the structure of total loans, with a share of 44.9 per cent.<sup>13</sup>**

<sup>13</sup> The short-term period includes maturity up to 1 year, medium-term includes maturity from 1 to 5 years, and the long-term period includes maturity over 5 years.

Figure 34. Share to total loans: households



Source: CBK (2019)

Long-term maturity loans marked an increase of 18.7 per cent and amounted to EUR 1.23 billion, followed by medium-term maturities, which increased by 9.9 per cent and amounted to EUR 1.15 billion.

Medium-term maturity loans (1 year to 5 years) are more pronounced for enterprises (figure 34), whereas for households, this category has gradually reduced its share in the recent years (figure 34).

According to the Bank Lending Survey (Box 2), households' orientation towards long-term loans was mainly driven by banks' credit policies, driven by competition, through the facilitations applied to loans for house purchase, enterprise investment loans, and long-term loans in general. Such credit structure in economy coincides, in one hand, with financing needs for liquidity enterprises in meeting short and medium-term business obligations, and on the other hand with the needs of financing long-term investments such as the need for financing housing for households.

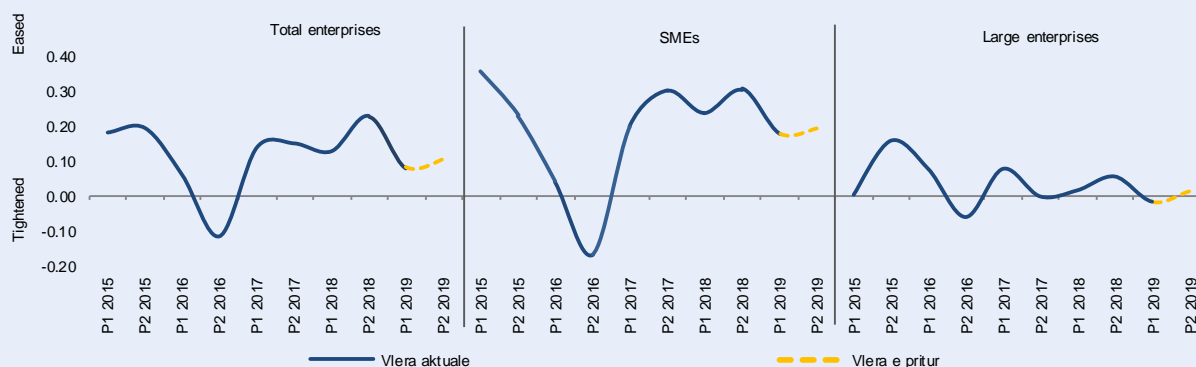
### Box 2. Bank Lending Survey<sup>14</sup>

The latest results of the Bank Lending Survey<sup>15</sup> reflect the developments in bank lending activity during the period of September 2018 – February 2019 (referred as P1 2018)<sup>16</sup> and expectations for lending activity for the period of March - August 2019 (referred as P2 2019). The dynamics of lending activity to **enterprises** during this period, based on the bank lending survey, results to be affected positively by credit supply side. Within the credit supply conditions, banks have reported to have eased standards applied during the

process of assessing the enterprises' applications for loans.

Within loans to enterprises, credit standards for SMEs eased while credit standards for loans to large enterprises remained unchanged, with the exception of one of the smallest banks in total sector loans which declared tightening up to a certain extent. For the period of March – August 2019, banks stated an expectation for further ease of credit standards for SMEs. Similar to the past six months, banks stated that they expect ease of credit mainly for SMEs (figure 35).

Figure 35. Credit standards applied when assessing credit applications of enterprises



Source: CBK (2019)

The main factors, stated by banks that impacted the facilitation of credit supply, were the increase of competition in credit market, improvement of credit quality and banks' favourable access to finances, in particular the internal funding from deposits. Within the credit offer, banks also reported to have facilitated the terms and conditions for lending to enterprises. Both for SMEs and for large enterprise loans, banks facilitated lending conditions, mainly through lowering the average interest rate, extended maturity of

approved loans and facilities for required collateral (figure 36).

For the period March-August 2019, banks expect an overall ease of lending conditions but at a much lower rate than in the previous six months. More specifically, the average interest rate on loans for both categories is going to follow a declining trend. While only one of the banks has stated that they expect increased collateral requirements for large enterprises to some extent. During the reporting period, banks have stated a decrease in credit demand by enterprises.

<sup>14</sup> Bank Lending Survey is conducted by the Central Bank of the Republic of Kosovo with banks that operate in Kosovo. The survey is conducted twice a year, conveying the period of March-August and September-February.

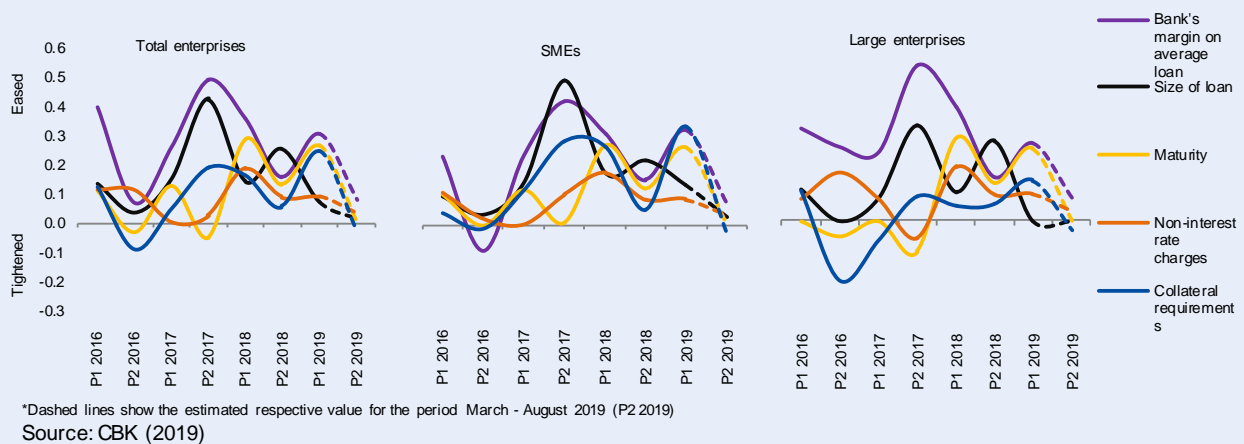
<sup>15</sup> Replies of individual banks were aggregated by using the appropriate weight of each single bank to total credit portfolio of the banking sector. Positive values of the index of credit standards show ease of lending

whereas negative values are characterized by a tightening of lending. Also, positive values of the index of demand show an increase of demand and the negative values show a decline.

<sup>16</sup> The period of September-February of each year is referred as "the first period"-P1, while the period of March-August of each year is referred as "the second period" – P2.



Figure 36. Terms and conditions applied for loans to enterprises

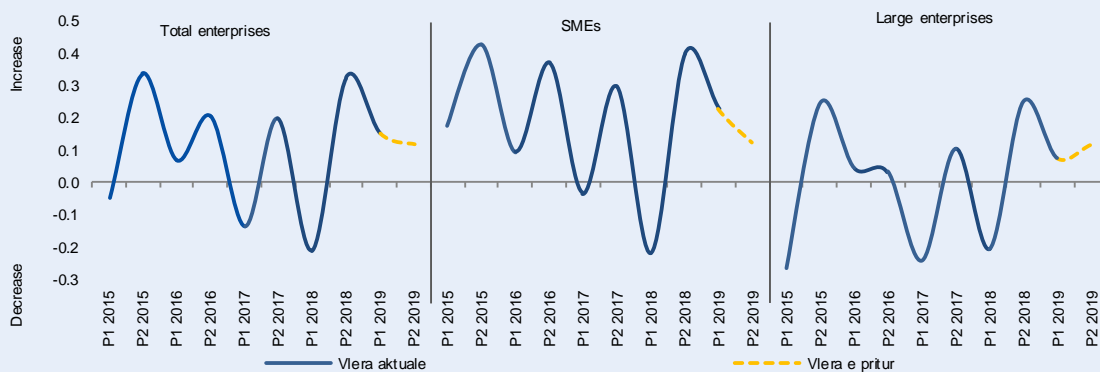


However, the index showing the demand for loans was significantly higher for SMEs than for large enterprises, which showed a marginal increase (figure 37). Banks reported for the improvement in the quality of applications received from SMEs. Within enterprises' credit demand there was an increase in demand for fixed investments, while banks indicated a lower demand for financing inventories and working capital and for debt refinancing. For the period March - August 2019, banks expect credit demand to increase slightly compared to

the previous six months. The dynamics of the activity of lending to **households** during the reporting period, according to the survey, were positively influenced by the favourable credit offer as well as by the demand of households for loans.

Unlike the preliminary survey results, when credit standards applied during the review of household loan applications were eased in particular for house purchase loans, in this survey, banks reported that the facilities were concentrated on consumer loans (figure 38).

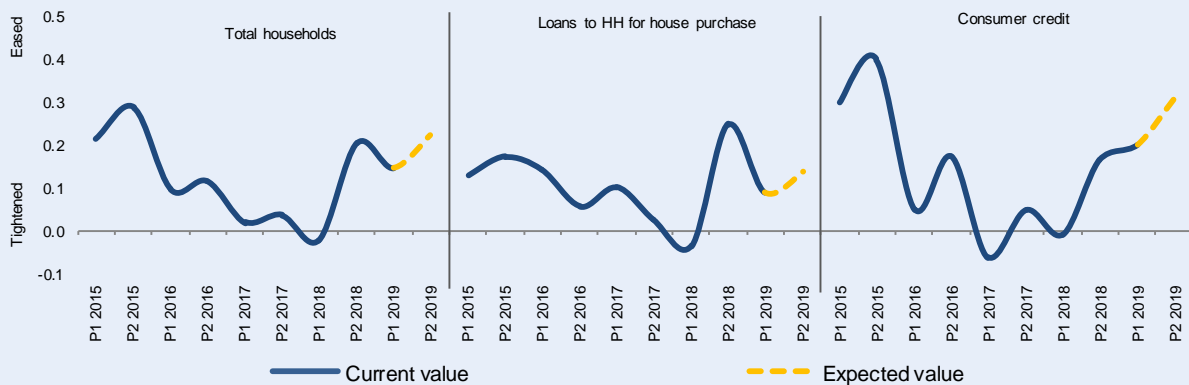
Figure 37. Enterprises demand for loans



In the next six months (March-August 2019), banks expect further ease of consumer credit and also further ease of house purchase loans. Improvement of credit conditions for households, during the reporting period, for house purchase was done through the decline of interest rates, the increase of size of approved loans and the decline of collateral requirements (figure 39).

Conditions for consumer loans were mainly improved through the decline of average interest rate, extension of maturity and increase of the amount approved to some extent. For the six upcoming months, banks declared that they expect an ease of lending conditions for households for both categories.

Figure 38. Credit standards applied in assessing households credit applications



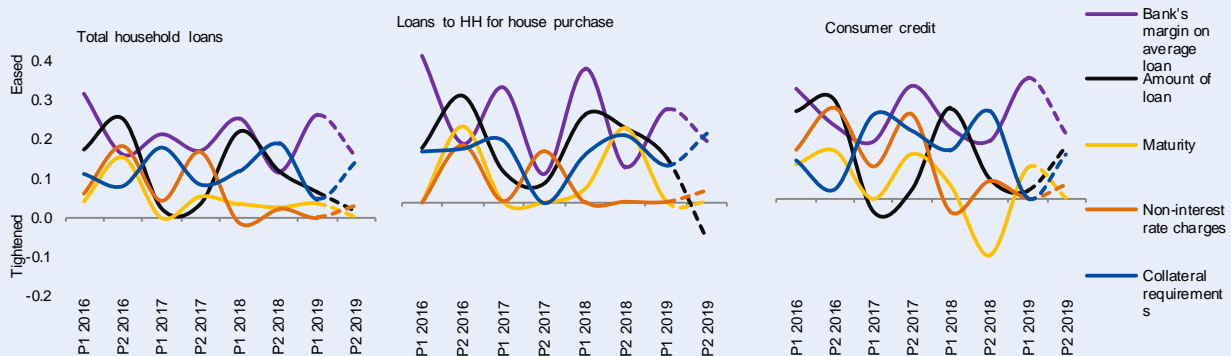
Source: CBK (2019)

The conditions for home purchase loans are expected to ease through lower interest rates and smaller collateral requirements, while the conditions for consumer loans are expected to be positively affected mainly by lowering the interest rate, increasing the size of the approved amount and smaller collateral requirements. Banks reported an increase in demand for household loans. Both credit categories for households had an increase in demand for loans, but the demand for

consumer loans was higher than the demand for home purchase loans (figure 40).

The increase in demand for household loans is largely attributable to increased customer confidence in their credit return capabilities and increased demand for financing other expenditures besides the house purchase. While banks stated that positive developments in the real estate market positively contributed to the demand for house purchase loans.

Figure 39. Terms and conditions applied for household loans



\*Dashed lines represent the respective expected value for the period March-August 2019 (P2 2019)

Source: CBK (2019)

Also, the quality of the applications received, both for home purchase loans and consumer loans, has improved. Banks still expect a rise in demand for loans in the upcoming six months, but unlike the previous six months, the demand for home purchase loans is expected to have a higher growth. Regarding the maturity, the survey results show that the greatest demand during this period was for short-term loans, while long-term loan demand

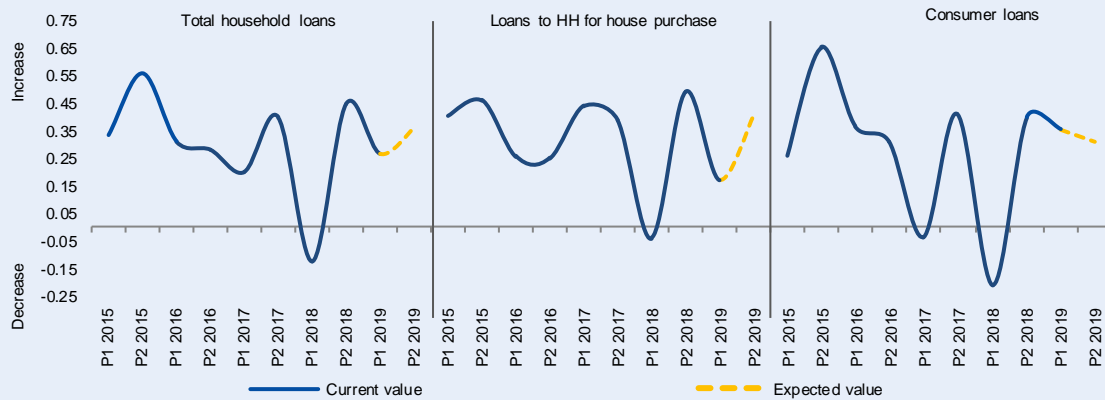
decreased to some extent. The credit offer divided by maturity of the loans results to be without major changes. Short-term loans remained unchanged, with the exception of a small-size bank in total sector lending, which stated tightening up to a certain extent for the category in question. While, for long-term loans, a marginal ease was declared. In the next six months, banks expect ease to a degree of credit standards for both categories on one

hand, and the demand largely similar for the two categories on the other hand.

Banks have stated an increase to a certain extent of total funding in the reporting period,

more specifically as deposits of the main source of financing, especially short-term deposits from households.

Figure 40. Households demand for loans



Source: CBK (2019)

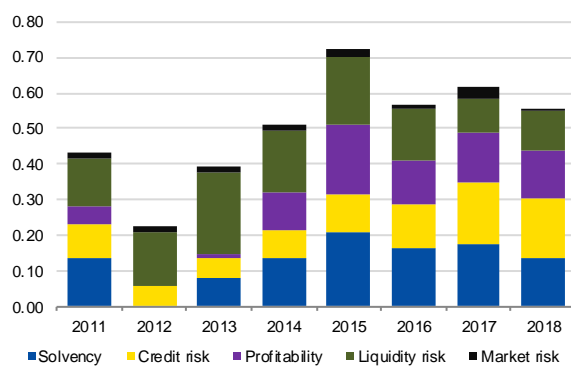
Also, the growth of credit activity results to have been positively influenced by the increase in financing from international financial institutions. Unlike the results of the preliminary survey, financing by parent banks during this reporting period declined. Although the financing by banks through long-term maturity funds marked an increase during the reporting period, the short-term one continued to dominate.

Similarly, banks expect increased access to financing through household deposits, but unlike the past six months, banks expect financing growth also from parent banks. Also, funds from international financial institutions are expected to support the financing of banks' activity in the upcoming six months. As for the maturity of funds, short-term financing is expected to dominate the fund structure.

## 5. Risks of the banking sector

During 2018, the banking sector operated in a generally favourable environment with low risks and a satisfactory capacity to cope with possible shocks. In order to measure and evaluate the internal conditions of the banking sector that reflect the stability of the sector, the banking sector's stability index has been established. The index is built on the underlying financial stability indicators of the banking sector, taking values in the range from 0 to 1, where the highest values pose a declining risk and vice versa.<sup>17</sup> According to the aggregate risk index, the banking sector on average has marked a decreased risk exposure compared to the previous year, mainly driven by the credit risk dynamics of solvency and to a lesser extent than market risk and profitability.

Figure 41. Banking sector stability index, by risk criteria



On the other hand, we have improved the level of liquidity of the banking sector, further reducing the risk that may arise from the lack of liquidity in the banking sector.

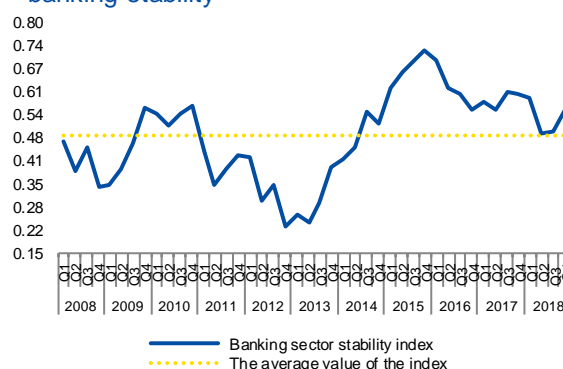
Profit growth was more slowed mainly as a result of increased provision expense. The risk of profitability is considered to be growing as the banking sector is challenged by market developments that tend to narrow the margins of interest. Increased banking competition will continue to pressurize

interest rates on loans and increase interest rates on deposits in order to attract deposits.

These interest rate developments are also reflected in increased market risk. This is due to differences in the mismatches between maturity terms between assets and liabilities. The increase of interest rates may further increase the pressure on the cost of financing in the conditions when long-term lending is increasing and dominated by fixed interest rate contracting while the financing has mainly short-term maturity.

Consequently, the sector's exposure to solvency risk has increased. Slower growth of profit affected the lower return in the capital of the sector. Also, the growth of risk-weighted assets was influenced by the growth of long-term lending, creating pressure on increased capital requirements.

Figure 42. Aggregate index of the banking stability



However, in general, the aggregate financial stability index stands above the average level (figure 42) and has an upward trend in most of 2018, indicating a stable and healthy banking sector.

<sup>17</sup> For further information on the methodology of building the banking sector stability index, refer to the Financial Stability Report no.9

Table 5. Risks of the banking sector

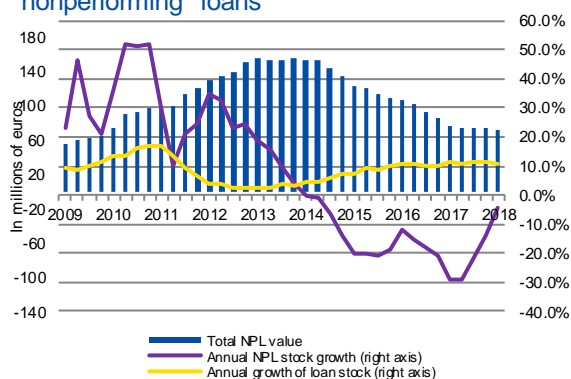
Risks	Indicators	2015	2016	2017	2018	Risk direction	Interpretations
Credit Risk	Non-performing loans (NPL) ratio to total loans (%)	6.2%	4.9%	3.1%	2.7%	↓	<p>Credit risk declined further as a result of the higher increase of the loans, in addition to the decline of non-performing loans. Improvement in the quality of the loan portfolio was affected by the loan repayment process lost from banks' balances. Similarly, the drop in the stock of the NPLs has affected the increase of provision coverage ratio.</p> <p>The concentration of large credit exposures was reduced further, despite its low level (below the maximum level of 300%). The decrease in the ratio came as a result of the decrease in exposures, mainly by banks with the highest weight in the banking sector.</p>
	Coverage of NPLs with provisions (%)	115.1%	127.6%	149.7%	152.1%		
	Large credit exposures/First tier capital (%)	67.3%	69.5%	88.9%	68.7%		
Profitability Risk	Net interest income (in million euros)	163.3	160.3	159.7	171.0	↑	<p>The positive impact on profit growth this year was yielded by net interest income as a result of increased loan volume. While the highest repayment level of non-performing loans contributed to the increase of provisioning expenses during 2018, thus increasing the pressure on sector profitability, which caused the pace of growth to slow down. The risk direction is considered to be growing based on the ongoing pressure of the increase of the cost of financing.</p>
	Net non-interest income (in million euros)	47.5	17.7	41.7	32.6		
	Expenditures/revenues	60.3%	67.3%	64.6%	65.1%		
	Return on average equity (ROE)	29.1%	19.7%	21.3%	20.4%		
Market Risk	The gap between interest rate sensitive assets and liabilities (in million euros)	1,740	1,538	1,735	1,684	↑	<p>The gap between sensitive assets and liabilities towards the interest rate has narrowed. Shifting to some extent towards long-term financing, in addition to the previous years as a result of the increase in deposit rates, contributed to the improvement of this indicator. However, the continued growth of fixed-rate long-term lending led to the increase of the interest rate risk in the future.</p> <p>The aggregate net open position in foreign currencies increased during the year, causing the to some extent the exposure to grow, even though it stands far from the regulatory minimum.</p>
	Open positions in foreign currency to first tier capital (%)	1.9%	4.6%	1.2%	1.3%		
Solvency Risk	Regulatory capital/Riskweighted asset (%)	19.0%	17.8%	18.1%	17.0%	↑	<p>Regulatory capital ratio marked a decline as a result of a higher increase in the risk-weighted assets, driven by credit growth. In the wake of continued lending growth, as a result of increased capital requirements, increased pressures on profitability due to decrease in interest rates on loans and increase in interest rates on deposits, as well as dividend division, the capital adequacy ratio is expected to be under pressure in the future.</p>
	First tier capital/Riskweighted asset (%)	16.6%	15.8%	16.2%	15.5%		
	Equity/Assets	11.7%	12.1%	12.6%	12.3%		
Liquidity Risk	Loan/deposit ratio (%)	74.7%	77.0%	80.3%	81.9%	↓	<p>Liquidity indicators point to a good financial position of the banking sector, as well as the potential for expansion of lending activity. The ratio of liquid assets to short-term liabilities increased as a result of the increase in liquid assets (influenced by the increase of deposits and balances with banks, cash and investment in government bonds of Kosovo).</p> <p>The liquidity gap was further expanded as a result of the discrepancies of the deadlines between assets and liabilities, which was highlighted in the category 'over 5 years' of maturity deadline. This situation reflects the increase of long-term lending during this period.</p>
	Liquidity assets ratio to shortterm liabilities (%)	44.9%	41.5%	37.9%	38.5%		
	Liquidity gap (in million euros)	398.1	405.1	463.8	494.4		
			Growing risk	Low risk	Unchanged risk		

Source: CBK (2019)

### 5.1. Credit risk

The quality of credit portfolio at the banking sector level continued to be improved, supported by the decline in non-performing loans of the enterprise segment. Regulatory changes for the write offs of loans categorized as 'loss' from banks' balances within defined deadlines<sup>18</sup>, was among the factors influencing the reduction of non-performing loans. Although the current situation provides positive signals for sector exposure to credit risk, the trend of lending growth and largely the orientation towards increased household loan can increase the risk of facing the banking sector with the solvency of this segment, which in the future may weaken if the labour market conditions deteriorate and other economic factors shift the current direction of development. Therefore, in an attempt to improve credit quality and maintain financial stability, banks should be more prudent towards lending levels, credit standards for households that have been declared by banks that will be alleviated in the following period and consequently affect the level of debt worthiness of households.

Figure 43. Annual growth of loans and nonperforming loans



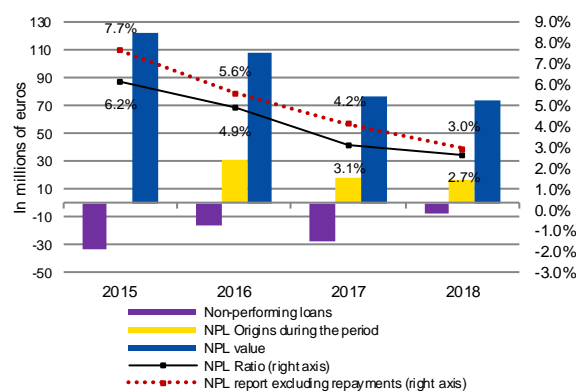
Source: CBK (2019)

The ratio of non-performing loans to total banking sector loans declined to 2.7 per cent from 3.1 per cent in 2017. The increase in non-performing loans stock by 10.9 per cent had the

highest impact on the decline in the NPL's ratio that the decline of non-performing loans stock by 4.6 per cent (figure 43).

Only during 2018, the repaid loans amounted to 8.3 million euro, which, in absolute terms, has affected the reduction of total non-performing loans by 10.6 per cent. Likewise, the repayment of loans classified as non-performing contributed with a deductible contribution of 17.9 per cent, while the non-performing loans' origins had an upward effect of 21.8 per cent on total non-performing loans stock (figure 44).

Figure 44. The effect of write-offs



Source: CBK (2019)

Other factors, such as the growth of the economic activity and the continuous improvement of the structural factors, have also influenced the improvement of the loan portfolio quality. A part of the declining effect in NPLs is also attributable to other factors such as the good financial performance of the enterprise sector<sup>19</sup> during this year, based on the increase in the turnover value stated in TAK, which may have contributed to the solvency of these borrowers. The activity of Private Enforcement Agents has also facilitated and accelerated the process of credit repayment, whilst advancement of structural reforms to facilitate collateral enforcement has had an impact on increasing bank confidence and consequently increasing the volume of loans issued by banks. These factors have been reflected in lower origins of

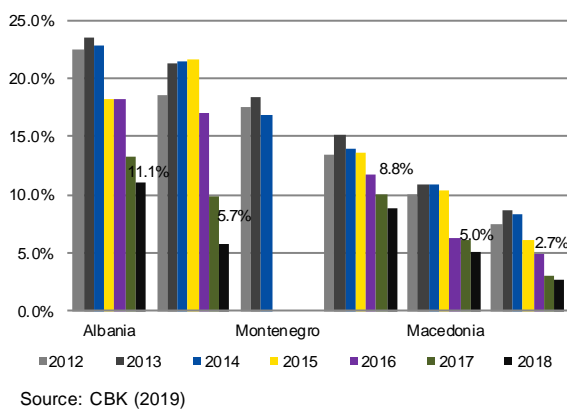
<sup>18</sup> CBK 2017, Regulation on Credit Risk Management, Article 18.

<sup>19</sup> For further information, see Chapter II, Enterprises, and the section on Bank Lending Survey.

non-performing loans and their recovery over the period.

**The quality of Kosovo's credit portfolio remains at the best level in the region.** Over the years, Kosovo has had the lowest ratio of non-performing loans compared to the countries of the region (figure 45). Improved quality of the loan portfolio in 2018 has further improved the position, where the NPL ratio in December 2018 was half lower than in Macedonia, the second highest ranked country in the region regarding credit portfolio.

Figure 45. NPL to total loans ratio in the the region countries

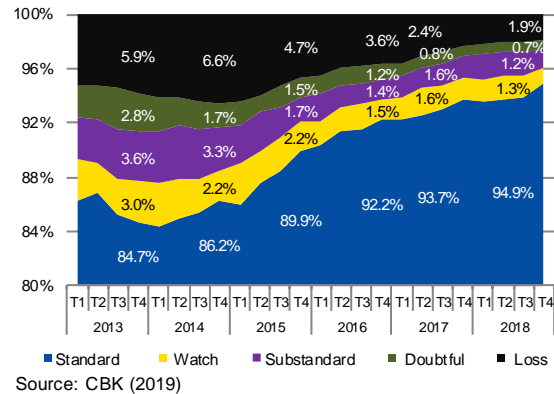


**Credit exposures with higher credit rating and standard loans have followed the trend of increased share to the credit portfolio and, by the end of 2018, represented 94.8 per cent of total loans.**

Standard loans, which include credit exposures without difficulties, with delays of less than 30 days or fully covered by collateral, have continuously increased participation, where, in December 2018, they increased their weight by 1.1 percentage points, in favour of lowering the weight of low-rated loans classified as “doubtful” and “loss” by 0.01 and 0.4 percentage points (figure 46).

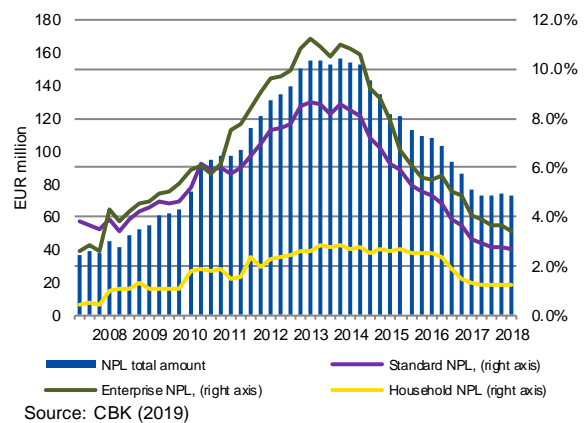
**The most credited and, at the same time, the most burdened segment by non-performing loans is the segment of enterprises, although their credit quality has improved during 2018.**

Figure 46. Structure of loans classified by overdue payments



This segment represents about 63.6 per cent of total credit portfolio for 2018. The ratio of non-performing loans to enterprises decreased to 3.4 per cent from 4.1 per cent in the previous year, as a result of the decline of non-performing loans by 5.6 per cent (figure 47).

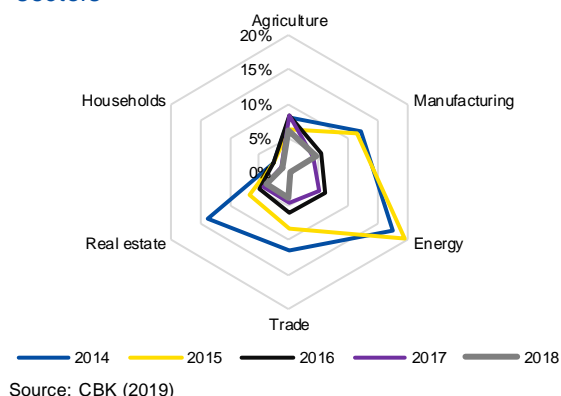
Figure 47. Nonperforming loans



**By economic activity, almost all sectors have been characterized by the improvement of the credit portfolio. The agricultural sector continues to have the highest rate of non-performing loans.** The ratio of NPLs to the trade sector, which represents the most credited sector, in 2018 dropped to 3.7 per cent from 4.5 per cent in the previous year. While the sector with the highest NPL rate is the agriculture sector with 6.0 per cent, which is 2.2 percentage points lower than in the previous year. This sector, which represents the most strategic sector of the economy, is one of the least credited sectors, where only 2.4 per cent of total credit stock is destined for agriculture, followed by the production sector with a NPL’s ratio of 4.6

per cent and real estate with 3.7 per cent (figure 48).

Figure 48. NPL ratio to credit stock, by sectors



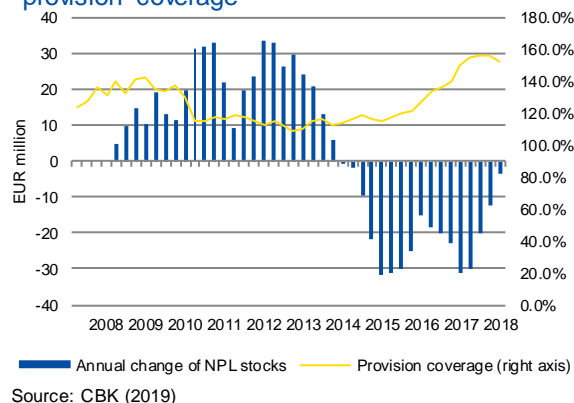
The enterprise loan portfolio quality has improved, suggesting lower levels of non-performing loans and their recovery during the period as a result of the best economic performance of the enterprises.<sup>20</sup> Increasing the use of KCGF which guarantees up to 50% of the principal of loans to SMEs, thus facilitating access to finance and covering part of their credit risk, is expected to be reflected in credit growth for the least credited sectors due to higher credit risk.

**Although lending to households, especially consumer ones, has upward trend, the credit quality of this segment remains low.** Households recorded a slight increase of the non-performing stock of 0.6 per cent, however, the growth of the lending base affected the marginal decline of NPL ratio by 0.1 per cent, from 1.2 per cent (figure 49). In improving the quality of the loan portfolio contributed the regulatory factors such as the process of repayment of loss loans from bank balances according to established maturity terms. The financial position of households is considered at adequate levels based on the ratio of non-performing loans of this segment, therefore in this period this segment does not carry high credit risk to the banking sector. However, the risk may increase or even materialize in the future if lending continues at an accelerated pace and labour market

<sup>20</sup> Net non-performing loans represent the value of non-performing loans that remain after deducting provisions for these loans.

conditions deteriorate, remittances reduce the growth rate and economic activity declines, factors that would be reflected in increased debt to households and weakening of their solvency.

Figure 49. Annual change of NPL stock and provision coverage



**The sector provisioning level has further increased despite the decline in the value of provisions, as a result of the more pronounced improvement of the loan portfolio quality.** The decline of non-performing loans stock in recent years is reducing the level of provisions that must be allocated to cover possible loan losses. In 2018, the non-performing loans stock recorded a significant decline of 4.6 per cent, whilst the value of provisions for possible loan losses declined by 3.0 per cent. Consequently, the provision coverage ratio increased to 152.1 per cent from 149.7 per cent in 2017 (figure 49).

The banking sector maintains a high level of provisions, which exceed the regulatory requirements, where surplus provisions accounted for 36.5 per cent of total retained provisions stock. As a result of the decrease in the value of the provisions, the ratio of 1.5 per cent of net non-performing loans coverage from provisions for loan losses<sup>21</sup> to regulatory capital this year was higher than in the previous year of 1.2 per cent.

**Exposure to credit risk has decreased in this period, due to the quality improvement in all sectors and the**

<sup>21</sup> Net non-performing loans represent the value of non-performing loans remaining after deducting provisions for these loans.

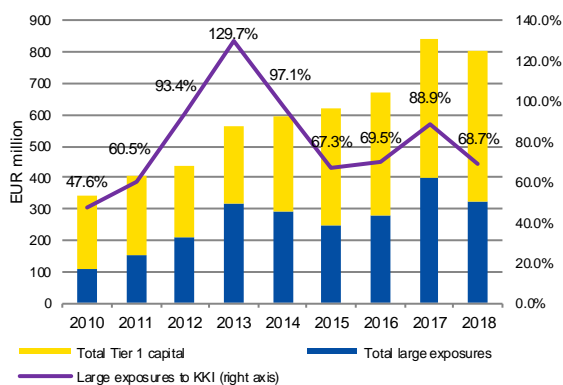


**increase in provision coverage.** Favourable macroeconomic conditions reflected in the better performance of the enterprise and household sectors as well as the regulatory measures undertaken for repayment of loan losses have strengthened the sector's credit position and have contributed to the decline in exposure to credit risk. The decline in exposure to credit risk is expected to be positively manifested in lending dynamics in the upcoming period, in addition to positive prospects for economic growth in the country. **The maintenance of the low level of credit risk would be facilitated by individual banks' initiatives for changes in credit standards in line with the dynamics and economic situation in the country and closely following the developments in the financial performance of enterprises and mainly households.**

### 5.1.1 Large credit exposures

**The credit exposure rate has dropped to 68.7 per cent from 88.9 per cent in the previous year, and is significantly below the maximum regulatory level.<sup>22</sup>** The annual decline in the value of large exposures by 17.9 per cent and the increase in the value of large exposures by 6.3 per cent influenced the increase of the exposure level. (figure 50).

Figure 50. Credit risk concentration



Source: CBK (2019)

<sup>22</sup> Ratio of total large credit exposures to Tier I capital; Large credit exposures, as defined by the CBK Regulation on Large Exposures, are considered any exposure to a single person or related group of persons whose value exceeds 10% of the Tier I capital of the bank. While all large credit exposures together cannot exceed more than 300% of Tier I capital.

<sup>23</sup> Ratio of total exposure to the number of exposures.

**The concentration of credit risk, expressed as a ratio between the large exposures value to the number of these exposures, has been reduced.** The average value of large exposures<sup>23</sup> increased to EUR 5.3 million from EUR 6.2 million as a result of the decline in the value of large exposures. The ratio of the three largest exposures to total exposures increased to 57.2 per cent from 53.7 per cent. The level of large credit exposures of the total banking sector is largely increased by banks operating as banking branches in Kosovo, which also have higher sensitivity to the analysis of sustainability against possible shocks to large credit exposures. The outcomes of the failure scenario of three and five largest borrowers in each bank show that the sector would remain at the cap of the regulatory capital requirement, while one branch of foreign bank and a bank of systemic importance which during 2018 was transformed from a branch into an independent bank would result to be undercapitalized in case of failure of the five largest borrowers. This proves that the sector, despite being under the maximum regulatory level of credit exposures, is vulnerable to possible shocks to these positions. This situation is especially stressed at foreign bank branches.<sup>24</sup>

### Box 3. Alignment with International Financial Reporting Standards (IFRS) 9

During 2018, the CBK has finalized the regulation, which aligns the country's framework with the International Financial Reporting Standard (IFRS) 9<sup>25</sup> and the same is in the process of approval and it is foreseen to enter into force by 1 January 2020.

The main change in this regard is related to the provisioning of credit exposures based on the expected loss model. The qualitative application of IFRS 9, due to its complexity, requires changes and has an impact on the processes, systems and governance of banks themselves, including the need to develop human resources in the field of

<sup>24</sup> Operating in the capacity of a foreign bank branch, these banks are not subject to the regulation of limiting the ratio of exposures to the Tier I capital of the bank but to the Tier I capital of parent banks, so the value of large credit exposures is higher in these banks.

<sup>25</sup> <https://www.bis.org/fsi/ifs/summaries/ifrs9.htm>

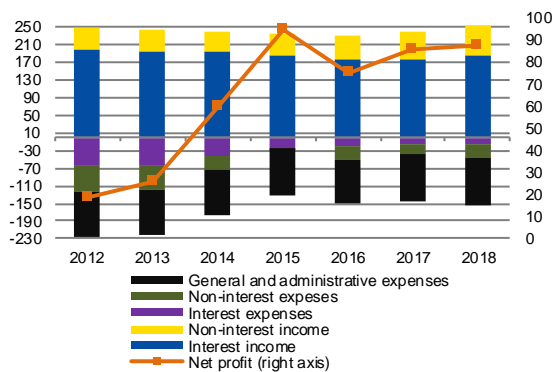
construction and validation of models. In this context, CBK is in close communication with banks following the process and challenges towards alignment with IFRS 9 in order for the process to be easier and more efficient. The sector has generally developed adequate models and has built up capacities for effective implementation of IFRS 9, gradually preparing for the entry into force of the regulatory framework. Full application of IFRS 9 will enable more advanced and more predictable approach to credit risk assessment and recognition of credit losses. Due to the high level of provisions that banks have generally held as a safeguard against low collateral enforcement rates, the implementation of IFRS 9 is not expected to have any significant effect on level of provision at sector level.

### 5.2. Sustainability of profit and interest rate risk

**Kosovo banking sector's profit marked an annual growth of 3.0 per cent, influenced by the increased interest revenues.** The net profit amounted to EUR 88.0 million (figure 51).

Net interest revenues marked a significant increase compared to the previous year, marking a growth of EUR 11.3 million. Interest revenues on loans recorded an annual growth of 5.0 per cent, and were among the main drivers of profit growth in addition to increase of revenues from fees and commissions.

Figure 51. Profit structure of the banking sector, in millions of EUR

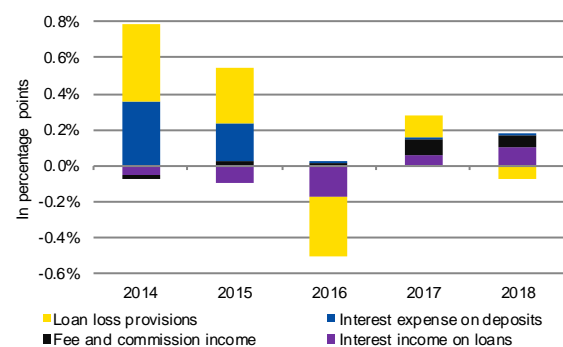


CBK: Source (2019)

The latter increased by EUR 11.1 million, amounting to EUR 61.6 million in December 2018 (figure 52).

On the other hand, expenditures increased as a result of provision expenses that consequently slowed down the profit growth. The increase in provision expenses is in line with the process of write-off of the non-performing loans from balances within the defined time limits.

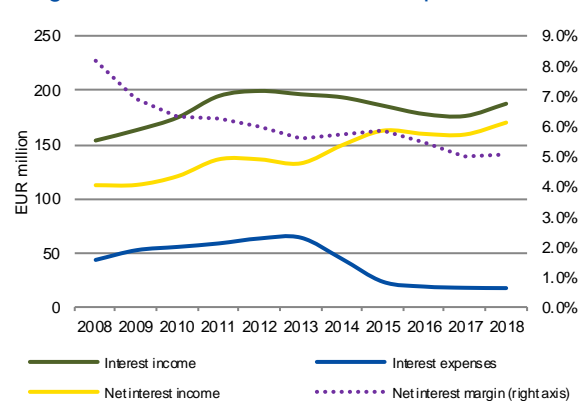
Figure 52. The main contributors to profit increase/decrease



Source: CBK (2019)

**Although the cost of financing through deposits increased, profit growth was offset by revenues from credit activity that recorded the highest increase, affecting net interest income this year to increase after two years of decline.** However, compared to the decline of 0.4 per cent in the previous year, this year, the increase in net interest revenue was 7.1 per cent (figure 53).

Figure 53. Interest income and expenses

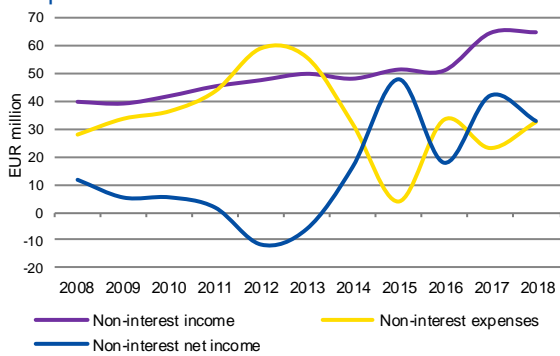


Source: CBK (2019)

The average interest rate on loans declined to 6.6 per cent, a decline of 0.2 percentage points,

while that on deposit slightly increased to 1.3 per cent, an increase of 0.3 percentage points.<sup>26</sup> Despite the competitive pressures reflected in lower interest rates on loans, the expansion of lending activity during 2018 led to an increase of EUR 11.0 million (or 6.2 per cent) of interest revenue.

Figure 54. Non-interest income and expenses

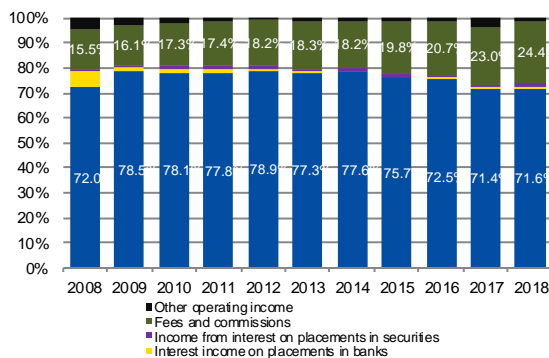


Source: CBK (2019)

Despite the increase in banks' pressure to expand the deposit base, interest expenditures, unlike the previous year, continued to decline, marking a marginal decline of EUR 0.3 million (or 1.8 per cent).

**Net interest margin increased to 5.1 per cent, by 0.1 percentage points, because the increase in the volume of lending on one hand resulted in annual growth of interest income versus the decline in interest expense.**

Figure 55. Income structure of the banking sector



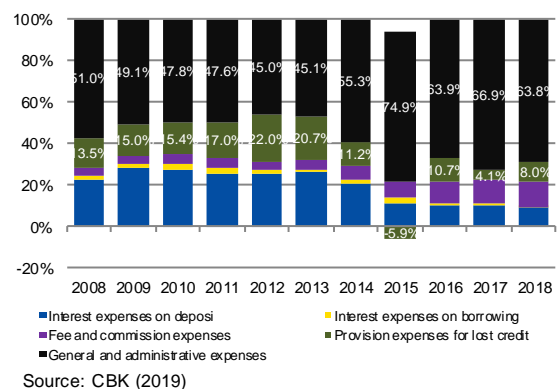
Source: CBK (2019)

Despite positive developments in deposit growth as a result of the increase in the average interest rate on deposits, the higher growth of lending versus deposits contributes to the increase in net interest income. Consequently, the growth of the latter dominates the increase in the average of interest-bearing assets, resulting in a slightly higher net interest margin.

**The sector's profit is expected to face the pressure of narrowed space to reduce the financing cost through deposits and the on-going competition pressures to reduce the mediation cost.** The already low interest rate on deposits and the high share of transferable deposits (about 60 per cent of total deposits) that do not have interest expense make the opportunities for positive effects on profit realization by managing interest expenses to be limited. Therefore, given this and bank statements in the bank lending survey signalling the possibility of a further decline in interest rates on loans, the current high profitability position will face downward pressures that may prompt banks to explore new ways of generating profits.

**Efforts of banks to increase efficiency in managing general and administrative expenses, as well as to adopt the business model to market needs are expected to intensify due to competitive pressures.**

Figure 56. Expenses structure of the banking sector



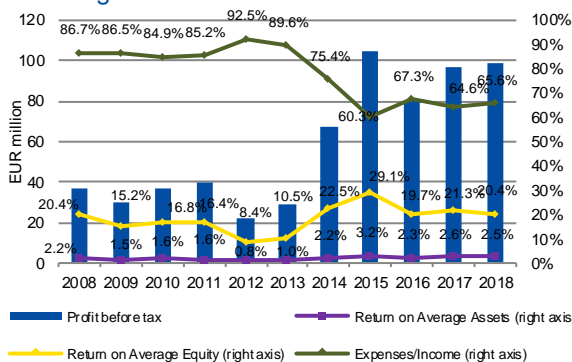
Source: CBK (2019)

<sup>26</sup> As about 90 per cent of interest income and expense is realized by intermediary activity, net interest income is directly affected by changes in interest rates on loans and deposits (figure 51 and 52).

Narrowing of interest margins and the technological advances in the finance sector will increase the pressure to banks in Kosovo to advance their business processes and models in order to increase efficiency in cost management and provision of new sources of income generation. Banks have already increased the efforts to reduce operating costs by rationalizing activities and reducing branches, along with undertaking strategic actions to encourage increased use of automated and electronic services (figure 56). The latter may have been one of the factors that have affected the rise in prices for fees and commissions, especially for services performed within the bank.

**Profitability indicators declined easily as a result of marginal profit growth, but still remain at the highest level in the region.** Kosovo's banking sector average return on assets and return on equity dropped to 2.5 per cent and 20.4 per cent respectively from 2.6 per cent and 21.3 per cent respectively in the previous year (figure 57). These levels are well above the region's average, which recorded a return on assets of 1.7 per cent and a return on equity of 12.8 per cent.<sup>27</sup>

Figure 57. Profitability indicators of the banking sector



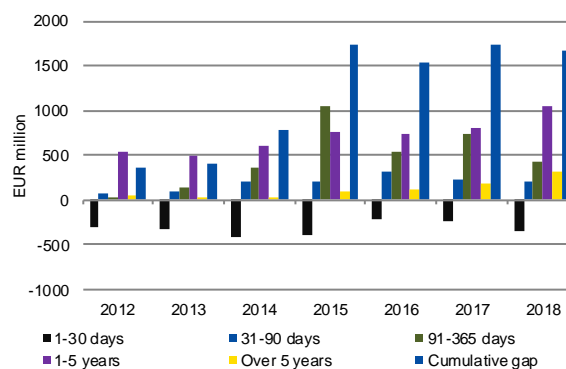
Source: CBK (2019)

### 5.2.1 Risk of interest rate fluctuations

**The continued growth of lending by banks, on the one hand, and the increase in the share of transferable and short-**

**term deposits, on the other hand, increased the exposure of the banking sector to the risk of interest rate fluctuations.**

Figure 58. Cumulative gap between assets and liabilities sensitive to interest rates

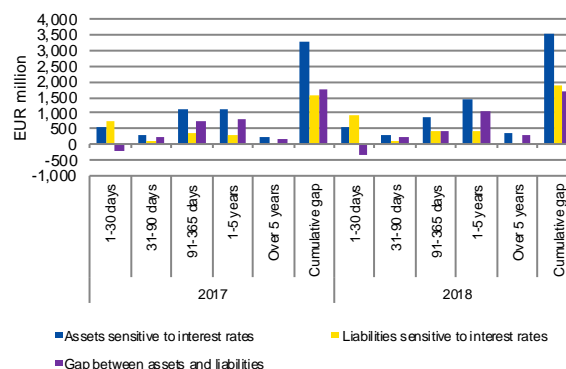


Source: CBK (2019)

Risk is manifested in the sense of income generation from reinvestment of assets and the creation of expenses for refinancing activities when the discrepancies between maturity terms of assets and liabilities are large (figure 58).

Kosovo banking sector's balance is mainly characterized by fixed interest rates, thus, the sector is affected by interest rate movements mainly at maturity of these positions.

Figure 59. Assets and liabilities sensitive to interest rates



Source: CBK (2019)

The increase in the financing cost, influenced by the pressure of competition in the withdrawal of deposits or the possible increase of interest rates at the global level in the medium term, may affect the increase of sector

<sup>27</sup> Countries in the region include Albania, Serbia, Bosnia and Herzegovina and Macedonia. Montenegro is not involved due to the lack of data.

spending pressure, as the main asset category, loans, are contracted at a fixed interest rate and have longer maturity.

This situation will prompt the need for eventual changes to the structure of assets and liabilities of the sector for effective risk management.

**Compared to the previous year, the gap was extended to all maturity terms, except in the terms of '31-90 days' and '91-365 days' where it shortened.** The positive gap for maturity over 1 year was further extended, while it deepened to a negative value for the maturity term '1-30 days', due to the increase of long-term maturity assets along with the increase of short-term maturity liabilities (figure 59). This means that the short-term maturity sector would face the risk of potential interest rate hikes that would affect the refinancing cost. Cumulative positive gap contraction implies that a signal for falling interest rates in the market would increase the risk of revenue generation from re-investing assets that mature, but at the same time would be conducive to coping with refinancing costs. It should be noted that the possible decline in interest rates may have a direct negative effect on interest income from investments in securities and other instruments, while assessment of the effect of the increase in the financial intermediation rate is more problematic as it affects the loan demand and may imply an increased burden on the borrower.

**The analysis of sector's sensitivity to potential interest rate hike suggests low banking sector exposure to this risk.** Results suggest that a possible increase in interest rates on balance sheet positions, which are sensitive to interest rates, would not result in losses to the sector. This is because interest sensitive assets are higher than the liabilities for a period of one year and, under the assumption that the same maturing instruments could be reinvested at a higher rate, the sector results in positive income effects.

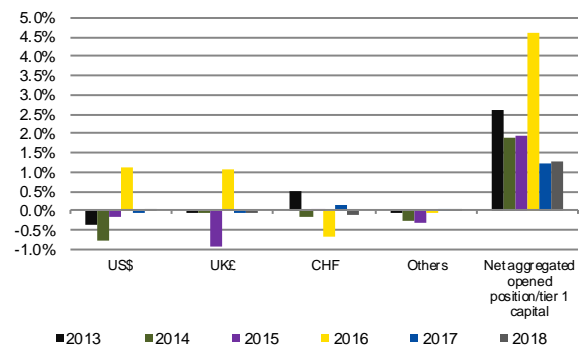
### 5.3. Risk from the position in foreign currencies

**The aggregate net open position in foreign currencies increased during the year, by further increasing exposure to the risk of currency change.**

The aggregate net open position in all foreign currencies increased to EUR 6.0 million equivalent to EUR 5.6 million, which is 1.3 per cent of Tier I capital (1.2 per cent in 2017) (figure 60).

Banking sector's exposure has increased slightly in terms of currency mismatches, where the rise in foreign currency denominated foreign currency liabilities prevailed in foreign currency assets equivalent in euro. These movements affected the gap between assets and liabilities in foreign currency to be negative at 0.01 per cent of total sector assets, compared to 0.1 per cent last year.

Figure 60. Opened positions in foreign currency to tier 1 capital

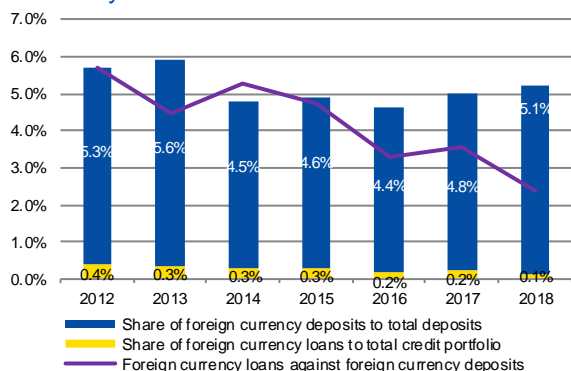


Source: CBK (2019)

**By special currencies, the net disaggregated position to Tier I capital declined for the British Pound, Swiss Franc and other aggregate currencies, while it increased for the US Dollar.** Liabilities in the British Pound and Swiss Franc increased sharply, thus surpassing assets in these currencies. This means that the banking sector is more exposed to the potential risk of euro depreciation against these two currencies at maturity since the value of liabilities equivalent in euro would result to be higher and would, therefore, increase the cost of currency financing. While assets positions in

the US Dollar exceeded the liabilities in this currency, the opposite was in the previous year.

Figure 61. Loans and deposits in foreign currency



Source: CBK (2019)

The ratio of net open positions for each individual currency to Tier I capital remains below the maximum level of 15 per cent permitted under the relevant regulation. Therefore, currency fluctuations have a marginal impact on the sector's financial position, given the very low level of positions in foreign currencies. This is also evidenced by the stress test that suggests a low level of sensitivity of the sector's capital position to exchange rate fluctuations.

The indirect foreign exchange risk from currency exposure remains low, as foreign currency loans remain negligible. Foreign currency loans account for only 0.1 per cent of total loans, despite the decline of EUR 1.2 million in foreign currency lending portfolio compared to the previous year. Foreign currency deposits also have low share, 5.1 per cent, despite the increase of EUR 22.9 million this year (figure 61).

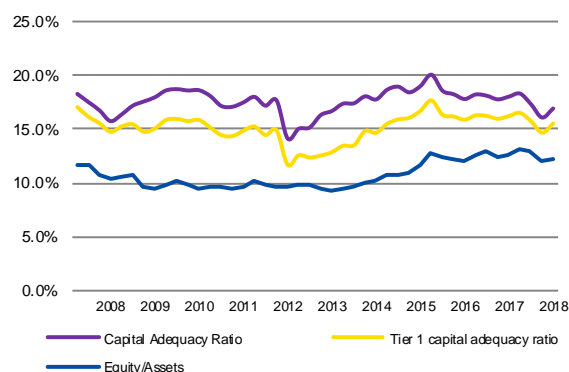
#### 5.4. Capital

The sector's capital position continues to reflect high sustainability. Capital adequacy ratio decreased to 17.0 per cent from 18.1 per cent (figure 62).

This decline reflects the growth of risk-weighted assets as a result of the growth of credit activity, in addition to the growth of the regulatory capital. Despite the decline, the

banking sector has a strong regulatory capital base, 91 per cent of which is Tier I capital, which largely results from high realized and retained profits and which, at the same time, indicates that banks are oriented towards creating capital mainly within their activity (retaining profit as equity).

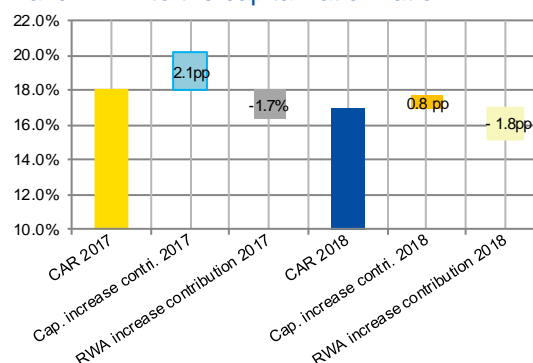
Figure 62. Banking sector capitalization



Source: CBK (2019)

Regulatory capital marked an increase of 4.3 per cent, contributing to the increase of capital adequacy ratio by 0.8 percentage points (figure 63). Regulatory capital growth was recorded as share capital and retained earnings from previous years. While the distribution of dividends from banks that affect capital through reduction of undistributed profits was the only factor with a reducing effect on regulatory capital.

Figure 63. Regulatory capital contribution and RWA to the capitalization ratio



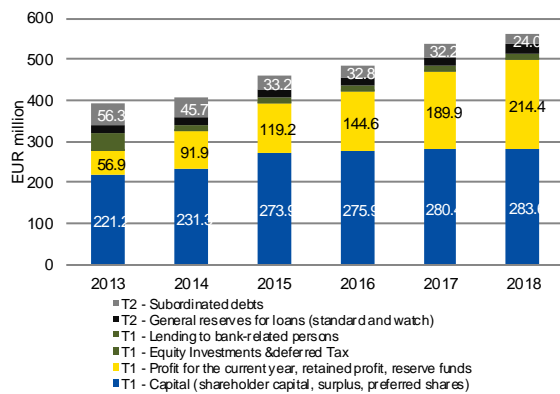
Source: CBK (2019)

The credit growth this year has led to increased sector exposure to risk-weighted assets. The increase of 11.0 per cent in risk-weighted assets contributed to the decline of the capital adequacy ratio by 1.8 percentage points. Consequently, the higher effect of the

increase in regulatory capital than that of risk-weighted assets increased the capital adequacy ratio by 1.1 p.p. (figure 63).

By individual banks, some of the banks that have expanded their credit activity have faced a decline in capital adequacy ratio as a result of the higher growth of risk-weighted assets. At the same time, these banks also faced an increase in the risk profile, expressed through the ratio of assets with a risk to total assets.

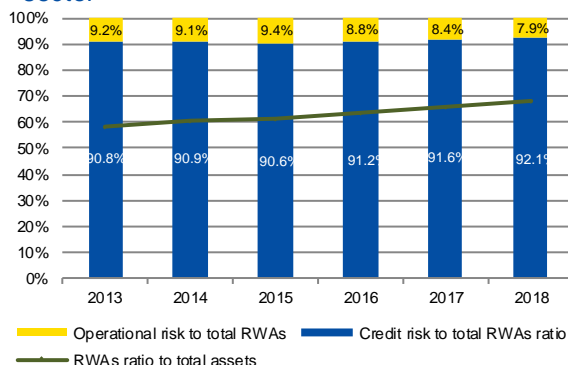
Figure 64. Regulatory capital structure



Source: CBK (2019)

The financial leverage also declined as a result of higher asset growth versus equity. The financial leverage ratio (equity-to-assets ratio) dropped to 12.3 per cent, compared to 12.6 per cent last year, suggesting reduction of activity financing through the share capital in relation to debt financing (figure 64).

Figure 65. RWAs ratio to total assets of the sector



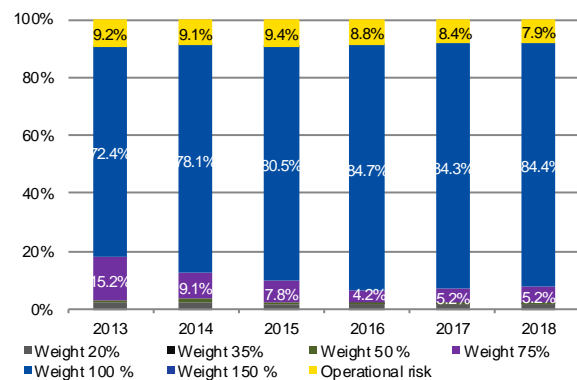
Source: CBK (2019)

In the context of risk-weighted assets, growth was recorded for both risk-weighted assets for credit risk and risk-weighted assets for operational risk. As

the banking sector's business model is predominantly the credit activity, 92.1 per cent of risk capital requirements are for credit risk, while 7.9 per cent for operational risk (figure 65).

In 2018, risk-weighted assets for credit risk increased by 296.0 million (or a 11.7 per cent annual growth), reaching EUR 2.8 billion. All categories increased, but the largest contribution to the increased risk weighted assets was given to 100% risk-weighted assets which recorded an annual growth of 11.2 per cent, which also dominate the total RWAs (figure 66).

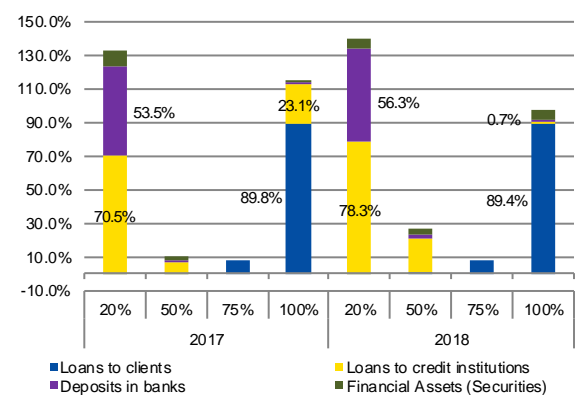
Figure 66. RWA structure by risk weight



Source: CBK (2019)

These movements are in line with developments in the balance sheet of long-term lending growth (loans with maturity term 'over 5 to 10 years' expanded their share to total loans by 1.8 percentage points).

Figure 67. Assets classification by risk weight



Source: CBK (2019)

Almost 89.4 per cent of total loans to customers for 2018 are weighted at 100% risk, while 78.3

per cent of loans to other financial institutions are weighed at 20% risk (figure 67).

**The level of holding capital for operational risk has marked a steady increase over the years along with the continuous increase of exposure to this risk.** The digital revolution has affected every aspect, including the impact on the financial system, encouraging the ever-increasing adaption of advanced technology systems and the creation of infrastructure for the provision of digitized services. Banks in Kosovo have also been exposed to these developments, which have invested heavily in the provision of electronic banking services in recent years. Ever-increasing reliance on digitized services is increasing the risk of errors in information technology systems or potential cyber-attacks. The banking sector during 2018 was also affected by another type of operational risk, a large number of bank robberies in Kosovo. This phenomenon has increased the operational risk and has raised the attention of competent bodies, including the CBK, to take measures to address this issue. Such events, besides causing material losses, create uncertainty and loss of customer confidence towards banks and the financial system in general. Therefore, oversight and assessment of operational risk is a very important issue in terms of financial stability since operational risk may, at the same time, pose a systemic risk due to losses and panic that may spread. In 2018, the demand to keep capital for covering possible operational losses stood at EUR 241.0 million, which is 4.0 per cent higher than in the previous year. However, operational risk management is assessed as appropriate, having no cases of its materialization, and keeping capital to cover this risk in accordance with regulatory requirements.

**The stress test results suggest that the banking sector remains stable in all supposed scenarios of shocks to the capital position.**

#### Box 4. Regulatory framework on capital requirements

The 2008 global financial crisis has prompted the review and advancement of the international and local regulatory framework for the protection of the financial system from systemic risk. CBK is in the process of gradually aligning its regulatory framework with the Basel international standards and the European Union directives and regulations.

From September 2014, a specific project for the adaption and implementation of the regulatory framework known as the Basel Capital Framework has commenced. Currently, the CBK is at the end of the process of fully adapting the requirements of the First Pillar of Basel, and at the same time, the CBK is in the on-going process of advancing the adaption of the requirements of the Second Pillar and of the Third Pillar. The full alignment of the existing regulatory framework on the supervision and regulation of banks with the Basel Capital Framework, as well as the EU Regulation 575/2013 and the EU Directive 2013/36, according to the CBK strategy, is foreseen to be finalized during 2015-2019.

During 2018, as part of this project, the following regulations have been finalised:

- *Regulation on Bank Capital Adequacy;*
- *Regulation on the Leverage Indicator; and*
- *Regulation on the Internal Capital Adequacy Assessment Process.*

These regulations have been approved by the CBK's Board on 29 November 2018, and they will enter into force on 1 January 2020. Pursuant to the Regulation on Bank Capital Adequacy and Regulation on the Leverage Indicator, draft guidelines and reporting forms have been drafted, which are expected to be finalized and approved during 2019, whereas they will enter into force on 1 January 2020.

The amendment of the **Regulation on Bank Capital Adequacy** will redefine regulatory capital and will set the requirements on capital for credit risk through the application of the standardized approach for weighing the risk of exposure to credit risk. It will also define the requirements for adapting credit risk mitigation techniques, as well as the requirements on capital for market and operational risks.

These amendments mainly include the review of capital requirements and components of capital in order to increase capital quality, which will enable banks' exposures to be covered by higher quality



capital through financial instruments that have stronger loss-absorbing capacities. The capital definition is given under the Basel III Framework.<sup>28</sup> The overall level of regulatory capital to be required remains the same, i.e. at 12% of the total risk-weighted assets, but its composition has changed. Tier 1 capital is classified into the Common Equity Tier (CET 1), which at all times should be at least 4.9% of risk-weighted assets. In the Tier 1 capital is also added the Capital Conversation Buffer which, together with the Common Equity Tier, should at all times be at least 9% of risk-weighted assets. This implies that Tier 1 capital requirement increases to 9% of risk-weighted assets, as opposed to the current 8%.

**Regulation on the Leverage Indicator** sets up leverage indicator, which is a simple risk-free capital indicator. Through this indicator, which will serve as additional measure for the risk-based capital requirements, it is aimed to limit the exposure to the eventual risk of increasing bank balance and off-balance sheet exposures through the excessive emission of debt instruments that may destabilize the financial sector and the economy. According to the Regulation on the Leverage Indicator, banks are obliged to maintain this indicator, which includes the ratio of the capital level<sup>29</sup> against the exposure level, to a minimum of 3%. Currently, the CBK obliges banks to maintain the leverage indicator at a minimum level of 7%, but the calculation method varies. The current leverage ratio is equal to total equity against total assets. The leverage indicator change impact analysis shows that despite the changes in the calculation method, the current level of the sector's leverage remains similar, with a slight decrease of the indicator according to the new calculation methodology.

**The Regulation on the Internal Capital Adequacy Assessment Process**, which is a requirement of the Second Pillar of the Basel Capital Framework, has defined the process of internal capital adequacy assessment of the bank in order to manage risk, define risk strategies and plan the capital. Adapting this regulation will have an impact on building the banks' capacities for conducting a risk assessment themselves as well as on building the supervisor's capacities to monitor the risk and capital requirements, thus having an impact on advancing the process of maintaining financial stability.

Assessment of impacts that these regulations may have for each individual bank as well as on banking sector in general suggest that banks have adequate capacities to adopt the changes without any adverse impact on the respective indicators and their financial performance. Also, during 2018, work has been done on capacity building to ensure the effective implementation of regulations, which are expected to enter into force in the beginning of 2020. The entry into force of these regulations is expected to contribute to the growth of the stability of financial sector by enabling more prudent banking supervision, increasing capital quality, and increasing the capability of the sector to protect against risks. Also, the entry into force of the regulations will be accompanied by a review of the minimum requirements on information disclosure by banks, which will help in increasing market transparency and discipline.

## 5.5. Financing and Liquidity Risk

The main source of bank activities financing continues to be represented by deposits which marked an increase, mainly from households deposits. Under the influence of low interest rates, the share of transferable deposits increased, which, in combination with the increase in long-term depositing, contributed on the accentuation of maturity mismatches of these items. This may create uncertainty on the stability of sector funding in the sense that immediate withdrawal of transferable deposits is less predictable and the likelihood of converting other liquid cash assets is limited and uncertain in non-favourable economic situations. However, the main liquidity indicators give positive signs for the current situation of banking liquidity, where the high level of bank liquidity reserves held by the CBK, but also of total liquid assets, makes the sector more resistant to the potential adverse effects that may result from the discrepancies of maturity time limits between investments and financing.

<sup>28</sup> In the Common Equity Tier, or retained profit, it is also possible to include year-end profits under the condition that they are verified by an external auditor or by CBK during examinations.

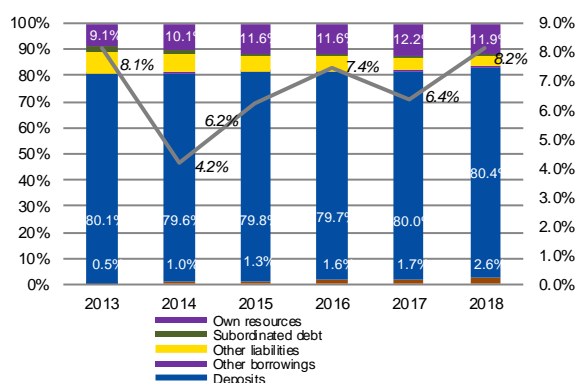
<sup>29</sup> Capital level includes Tier 1 capital under the new Regulation on Capital Adequacy, while the exposure level includes balance sheet exposures, derivative exposures, security transactions exposures, and off-balance sheet items.

### 5.5.1 Bank financing

The bank sector's financing structure is dominated by non-bank sector financing, mainly deposits that continued to increase.

In 2018, deposits accounted for 80.5 per cent of the financing, while only non-bank sector (enterprises and households) deposits accounted for 88.7 per cent of total deposits, indicating that inter-bank financing is at a very low level and that banks are very little exposed to external sector financing (figure 68).

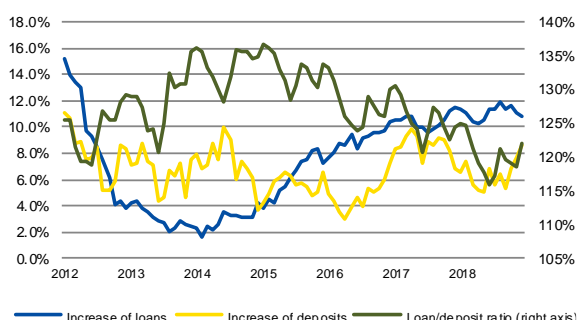
Figure 68. Financing structure



Source: CBK (2019)

Deposits recorded an annual increase of 8.7 per cent, reaching the amount of EUR 3.4 billion. While, only non-bank sector deposits amounted to EUR 2.95 billion, and increased at an annual rate of 7.5 per cent.

Figure 69. Increase of banking sector loans and deposits



Source: CBK (2019)

Banks continue to finance increased lending activity, mainly from deposits. This year, the deposits surpassed loans by 122.0 per cent, an indicator that decreased by 2.5 percentage points from the previous year, under the

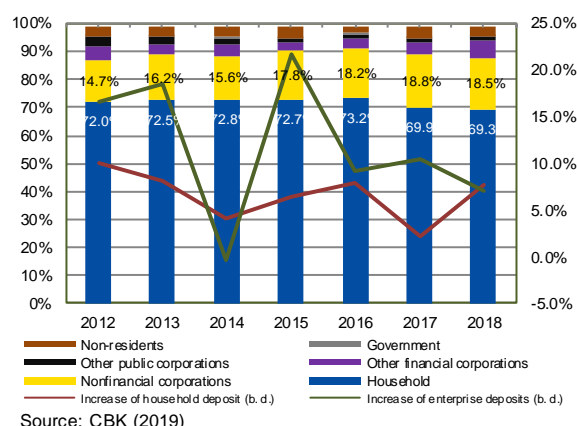
influence of the expansion of lending activity (figure 69).

Households' deposits, which represent the main source of financing, continued to increase despite the prevailing low-interest rates in the market.

The trend of increase continued this year as well, with an accelerated rate of 7.7 per cent, compared to 2.1 per cent in 2017 (figure 69). The household deposit stock amounted to EUR 2.3 billion.

Most of them were transferable deposits which, with their annual increase of 10.5 per cent, contributed to the increase in household total deposits (figure 70).

Figure 70. Structure of deposits

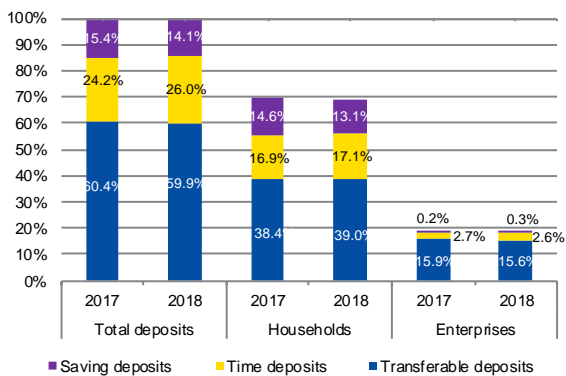


Source: CBK (2019)

Enterprise deposits continued with the increase trend, with a 7.0 per cent annual increase compared to the previous year. Enterprise deposits were supported by positive enterprise financial performance, as well as by the slight increase of average interest rate in these deposits during 2018.

The enterprise deposit stock amounted to EUR 622.1 billion, with a share of 18.5 per cent in total deposits. The increase of enterprise deposits was mainly driven by the increase of transferable deposits by 7.0 per cent, due to the effect of the base. Time deposits were characterized by an increase of 4.0 per cent, which could be influenced by the slight increase of 0.20 percentage points of the average interest rate on these deposits during 2018, which amounted to 1.63 per cent.

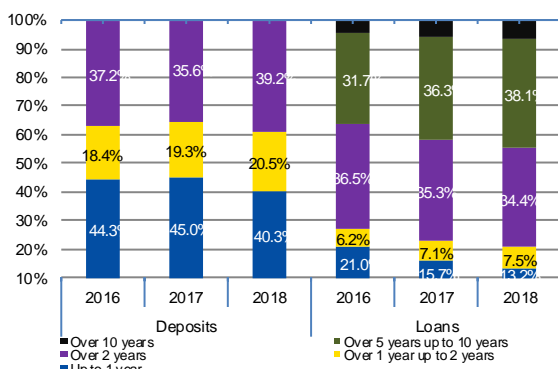
Figura 71. Structure of deposits by maturity



Source: CBK (2019)

**The structure of total deposits by time of maturity is dominated by transferable deposits, which increased even this year, at an annual rate of 7.9 per cent.** Transferable deposits amounted to 60.0 per cent of total deposits in 2018 (figure 71), while, 39.7 per cent of total deposits is composed of household transferable deposits. Total time deposits recorded a significant annual increase of 17.4 per cent, while savings deposits recorded an annual decrease of 0.6 per cent. The prevalence of low interest rates on saving deposits is reflecting discouragement of households to save money in banks, while the opposite is happening with time deposits where it is reflected the effect of interest rate increase in these deposits, albeit in low level.

Figure 72. Maturity structure of deposits and loans



Source: CBK (2019)

**Deposits and loans maturity terms emphasize structural discrepancies between them, which are expressed in time periods of ‘up to 1 year’ and ‘over 1**

**to 2 years’** Deposits with maturity of ‘up to 1 year’, although with a decreased share from 45.0 per cent to 40.3 per cent, dominated the structure of time deposits. Whereas loans with maturity time period of ‘over 5 to 10 years’ are the ones with the highest share (38.1 per cent) in total loans and which expanded their share in 2018 (figure 72).

The high share of transferable deposits and their increase over the years, on one hand, and the increase of long-term lending, on the other hand, have increased the pressure for a stable financing of banks, which may be manifested in pressure for competition in the banking system in terms of movements of interest rates.

Pressures of competition to reduce interest rates on credit to stimulate credit activity may also create pressures to increase interest rates on deposits by some banks in order to stimulate savings to ensure a more stable financing.

### 5.5.2 Liquidity risk

**The banking sector continues to maintain a satisfactory liquidity position. Liquid assets remain at high levels and are increasing, which was reflected also by increasing their ratio to short-term liabilities during the year. The ratio higher than the regulatory minimum<sup>30</sup> indicates the potential for expansion of lending activity.** In 2018 the ratio of liquid assets against short-term liabilities increased to 38.5 per cent, compared to 37.9 per cent in 2017.

This result was driven by the increase of liquid assets which was higher than the increase of short-term liabilities of 9.4 per cent and 7.7 per cent respectively.

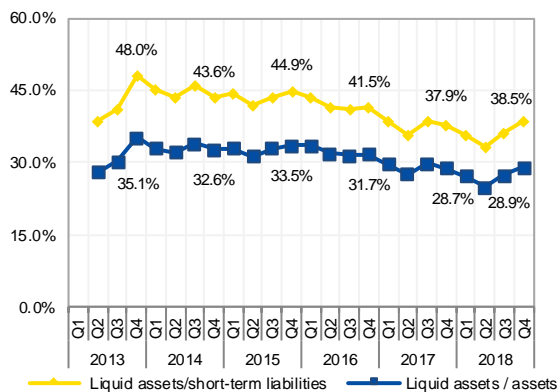
Likewise, the ratio of liquid assets to total assets increased to 28.9 per cent (28.7 per cent in 2017), as a result of higher increase of liquid assets against total assets (figure 73).

Growth of liquid assets during this period resulted from the increase of deposits and

<sup>30</sup> The ratio of liquid assets to short-term liabilities is defined in the Regulation on Liquidity Risk Management of 25% (Article 17. Liquidity rate)

placement in local banks of EUR 25.7 million with a maturity of up to 30 days and of deposits and placements in non-financial institutions of 4.5 per cent, increase of 18.0 per cent of cash and a 4.1 per cent increase in the balance of reserves with the CBK.

Figure 73. Liquidity indicators<sup>31</sup>



Source: CBK (2019)

Also, securities of the Republic of Kosovo recorded an annual growth of 33.5 per cent. Meanwhile, the securities of international financial institutions, bonds issued by foreign governments and treasury bills of the Republic of Kosovo have recorded a decline. Liquidity reserves with the CBK constitute around 29 per cent of liquid assets, being the second major category after the securities.

**The level of liquidity reserves of commercial banks continue to be high, exceeding the required reserve held at CBK by 49.7 per cent.** As of August 2016, CBK applied a negative interest rate on the required surplus reserve that commercial banks in the country hold at the central bank, in line with international developments and the ECB's decision to apply negative deposit rates.

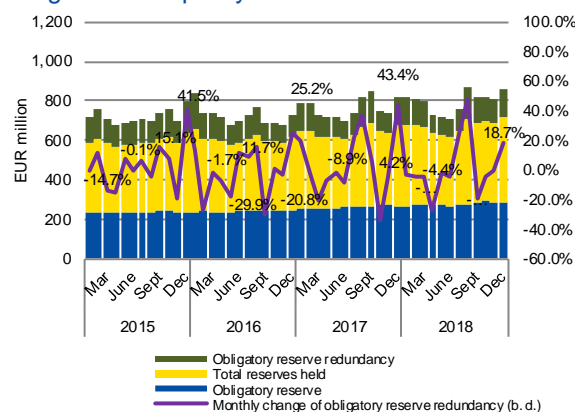
The application of the negative rate affected the reserve surplus immediately in the following month, where in September 2016 the surplus was reduced by 29.9 per cent (figure 74).<sup>31</sup> However, no long-term effects of the negative rate measure at the level of the reserve surplus have been observed,

<sup>31</sup> Liquidity surplus is characterized by seasonal effects. The tendency to increase the level of excess liquidity reserves is observed during the third quarter months and in December of the respective years. Reserve surplus

potentially due to the limited scope for saving or even investing assets as a result of low interest rates.

**The low interest rate environment is stimulating households to relocate their deposits in favour of short-term maturity, which, in addition to the trend of accelerating long-term lending, resulted in the emphasis on maturity mismatches between assets and liabilities in 2018.**

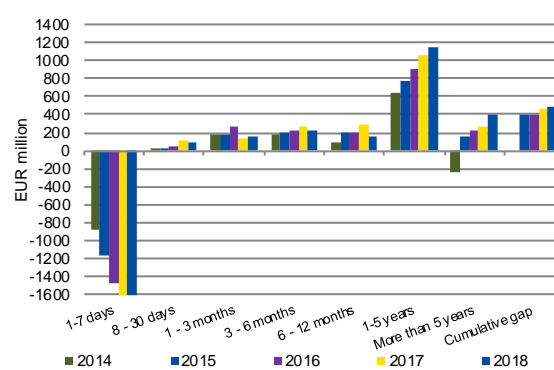
Figure 74. Liquidity reserves



Source: CBK (2019)

Deposits of enterprises and especially of households are the source of financing of the increased credit activity of banks. The discrepancies between maturity terms between investments and financing are increasing in the conditions when transferable deposits have increased and loan maturities are prolonged, a movement that increases exposure to liquidity risk.

Figure 75. Liquidity gap\*



\*As of 2015 there is a methodological change in calculation; equity not included  
Source: CBK (2019)

in the third quarter of this year was 49.0 per cent higher than in the second quarter, while in December the surplus was 18.7 per cent higher than in November.

The cumulative liquidity gap expanded to EUR 494.4 million from EUR 463.8 million a year earlier. This result was mainly driven by the more pronounced expansion of the positive gap between assets and liabilities of maturity periods over 5 years. Positive gap expansion was also recorded in categories with a maturity period of 3-6 months and 1-5 years. Approximately 38.6 per cent of total assets are categorized within the term '1-5 years' in relation to the liabilities of this term, which account for only 11.6 per cent of total liabilities.

The negative gap results only in the maturity term '1-7 days', worth EUR 1.7 billion. In this category of maturity are included 71.0 per cent of total liabilities, while assets consist of 20.2 per cent. Consequently, discrepancies in the maturity terms of the balance sheet items are most pronounced in the maturity categories '1-7 days' and '1-5 years' (figure 75). This situation poses a challenge to bank liquidity management and may, in the future, limit opportunities in favour of long-term lending.

## 5.6. Shock Absorption Capacity – stress-test analysis<sup>32</sup>

According to credit portfolio shock test results, the banking sector's capital position appears to be generally stable, with little sensitivity to the severe scenario where an extreme economic situation is assumed (table 6). However, the banking sector turns out to be profitable and with sufficiently separate provisions to cover the losses resulting from the growth of non-performing loans under the alleged situations of shocks in the economy.

In the moderate and severe scenario where interest rates are assumed to increase, and which would mainly affect loans and deposits (due to their high share to the balance sheet), only a few small banks would suffer losses, while the sector would be stable. However, there is a risk that in times of crisis the possibility for re-investment of matured assets is limited and at the same time the risk of overcharging higher interest borrowers increases, but this risk is not taken into account in stress test analysis.

**Table 6. Assumptions on credit risk**

Indicators	Baseline scenario	Adverse scenario	Severe scenario
	<b>Assumptions</b>		
GDP (real growth rate, %)	4.2	0.5	-2.5
Loans (lending growth rate, %)	10.0	5.0	0.0
Change in the interest rate on net positions of IR-sensitive balance sheet (pp.)	n/a	+ 1 pp.	+ 2 pp.
Devaluation of EURO against other currencies (pp.)	n/a	10	20
Profit shocks: Profit * (1 - reduction margin %)	n/a	50	60

Source: CBK (2019)

The results from the liquidity position shock test suggest that the banking sector possesses financial capacity to cope with the alleged

situations of withdrawing a significant deposit amount. In all supposed scenarios, the liquidity position of most banks is stable (table 9).

<sup>32</sup> The stress-test does not represent a forecasting model, but contains supposed scenarios of macroeconomic and financial shocks in order to

measure the banking sector's resistance to these negative shocks without prejudice that such situations may or may be expected to occur in the future.

### 5.6.1 Assessing the sustainability of macroeconomic and financial shocks in the credit portfolio and capital position

The stress test analysis on credit risk assessed the stability of the banking sector for the upcoming one-year period towards potential shocks in the credit portfolio as well as in the capital position that may arise from unfavourable macroeconomic developments. The analysis was conducted through the application of three scenarios: baseline, moderate and severe scenarios (table 6). The

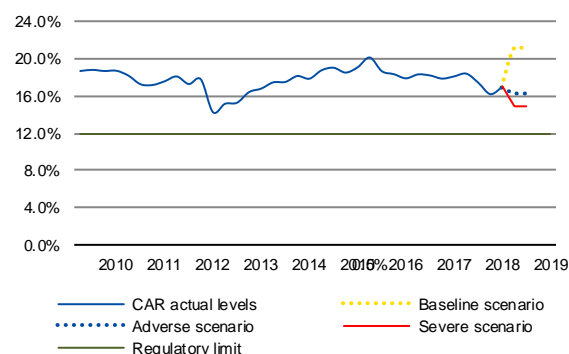
baseline scenario is based on the expected macroeconomic developments. In this scenario, economic activity in the country is projected to have a positive growth of 4.2 per cent. Economic growth is assumed to be accompanied by high double-digit lending growth<sup>33</sup> and at the same time will affect the improvement of the credit portfolio<sup>34</sup> (table 6 and 7). Also, these developments are expected to further improve the performance of the banking sector in terms of capitalization.

**Table 7. Elasticity coefficient of the NPL rate**

Description	Elasticity	NPL rate reactions		
		Baseline scenario	Adverse scenario	Severe scenario
GDP real growth (%)	-0.56 pp	-2.35 pp		
Expansion of production gap	0.80 pp		2.80 pp	5.20 pp
Growth in loan interest rate (pp)	0.20 pp		0.20 pp	0.40 pp

Source: CBK (2019)

**Figure 76. Capital Adequacy Ratio, by scenarios**



Source: CBK (2019)

However, profit is assumed to remain almost the same with the current year profit on the grounds that interest income on loans may be increased by the effect of increasing loan value, but this effect may be limited by the constant pressure for the decrease of interest rates on

loans, while non-interest income is not expected to continue to grow due to limited space for further tariff and commissions increase. On the other hand, non-interest expenses are expected to decrease due to the reduction of the need for additional provisions as a result of the improvement of the loan portfolio, but interest expenses may increase due to competitive pressures on increase in interest rates on deposits. Consequently, the effects of the growth and decline of profit components will exclude each other by letting us assume that profit remains close to the current year level. This scenario does not include the risk coming from the market. This is based on bank statements that interest rates on loans are expected to decline easily<sup>35</sup>, while interest rates on other assets, mainly affected by ECB decisions, such as interest on deposits

<sup>33</sup> According to banks' forecasts for 2019, the annual growth of lending to the banking sector will be 10.4 per cent, provided by the Banking Supervision Department

<sup>34</sup> The effect of economic growth on the quality of the credit portfolio will be calculated through a coefficient of non-performing loan elasticity to

**GDP of 0.56 percentage points.** The coefficient was measured based on the Vector Error Correction empirical model, with a time series from 2006 to December 2017. The output of the model suggested that a real GDP growth of 1% would reduce the non-performing credit ratio by 0.56 percentage points.

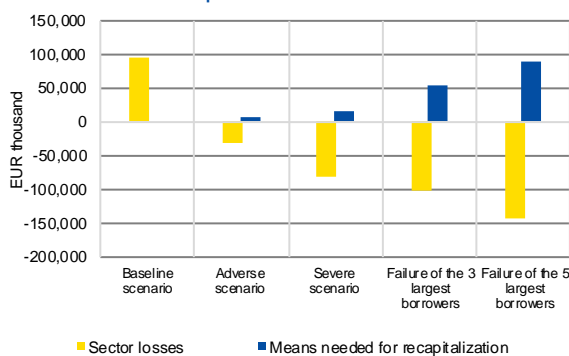
<sup>35</sup> Bank Lending Survey.

held in European banks, have given signals that they will not be decreased further. Therefore, under these conditions it is assumed that interest rates will be kept the same as the current year.

Results based on these assumptions suggest a further improvement of the credit portfolio's quality. Non-performing loans ratio would drop to 0.3 per cent from the current level of 2.7 per cent. Capital position would also be strengthened as a result of credit growth and credit performance, where the CAR (Capital Adequacy Ratio) of the sector will rise to 21.0 per cent from the current level of 16.9 per cent (figure 76 and Table 8).

In the moderate scenario it is assumed that in 2019 there will be economic growth of 0.5 per cent, much slower compared to 2018 (table 6). The slowdown in economic growth is thought to have discouraging effects, causing non-utilization of capacity, and consequently expansion of the output gap.<sup>36</sup> Slow economic growth will be accompanied by narrowing of lending growth, devaluation of the Euro currency towards other currencies applied to net foreign currency positions and increase of interest rate applied in the balance sheet gap of the interest rate sensitivity ( $\Delta \text{Net interest income } i = \text{Gap } i \times \Delta \text{NI}i$ ).

Figure 77. Credit risk stress test results - losses and recapitalization



Source: CBK (2019)

These developments will aggravate to a certain extent the quality of the credit portfolio and

sector performance. Under the influence of these assumptions, the ratio of non-performing loans to the sector will increase by 3.0 percentage points or at 5.7 per cent from the current level of 2.7 per cent. Sector losses would amount to EUR 31.3 million (figure 77).

These losses will be directly charged to the capital, which would result in the capital adequacy ratio at 16.3 per cent for 2019 (table 8).

At the level of individual banks, two banks would face capitalization problems, whose CAR would drop to 10.3 per cent and 10.1 respectively, below the regulatory minimum. Additional funds needed to increase capital at the required minimum level will reach the value of EUR 7.5 million (table 8). One of two banks has no general systematic importance and acts as a branch of a parent bank, for which, according to the regulations in force, the minimum capital requirements are limited based on the capital of the respective parent banks, so the interpretation of the results for this bank should not be taken for granted. Whereas the other bank has systematic importance, furthermore, it has changed status from a foreign bank branch to an independent bank during 2018 and consequently the CBK has granted to it a one-year period to adjust its capital in line with the relevant regulatory requirements.

In the severe scenario it is assessed the sensitivity of banking sector against extreme macroeconomic and financial negative developments, which is typically characterized by investment deterioration, domestic demand discouragement, decline in income, weakening of the solvency of borrowers. This scenario is implemented by applying the assumption that the economic decrease will be 2.5 per cent, and this decline would be reflected in the deterioration in the credit portfolio's quality, calculated on the basis of the NPL rate response coefficient to the output gap.<sup>37</sup> As a

<sup>36</sup> The impact of these developments on the quality of the loan portfolio is calculated through the non-performing loan elasticity coefficient to the output gap of 0.8pp. IMF unpublished research material, 'CESE Bank Loss Projection and Stress Testing Exercise', July 2009.

<sup>37</sup> Since the sensitivity of non-performing loans to GDP has been calculated based on data when the country has only had periods of economic growth, it does not mean that the same magnitude would react to the rate of NPLs in the context of the economic decrease. Therefore, in the severely adverse

result of shocks in the real sector, it is assumed that lending will not increase in the following year. The depreciation of the Euro currency against other currencies is assumed to be higher than in the adverse scenario. This scenario also assumes higher interest rates increase in balance sheet positions compared to the adverse scenario (table 7). Practices show that in times of crisis, the initial reaction of creditors would be the increase of interest rates due to increased risk. Whereas, as a response, the borrowing requirement would be reduced due to the uncertainty created to invest, and subsequently, at a later stage, would create pressure to reduce interest rates in order to stimulate economic activity. However, the assumption of interest rate growth in this scenario is based on the current situation of the already limited opportunities of the banking sector for further reduction of interest rates in the sources of financing and based on the fact that the monetary authority of the European Union has signalled that the possibility of further interest rate reduction is too small. The analysis is based on a 1 year static balance sheet state, therefore it is considered that the same instruments maturing within one year will be reinvested and refinanced at the interest rates assumed in this scenario. The analysis does not consider the possibility of collateral realization, reprogramming of loans or raising capital from other sources, as the efficiency and the possibility of carrying out these actions is very uncertain in times of crisis.

The profit is assumed to be subject to shock as a result of the non-increased lending and increased degree of the failure of loans. These assumptions are reflected in the calculation of profit for 2019 thus the net profit after taxation for 2018, has served as a basis, towards which a shock (reduction margin) of 60 per cent was applied and the incomes (which would be realized, if NPLs would not increase) were reduced.<sup>38</sup>

In the severe scenario, the credit portfolio will deteriorate, and thus the share of non-performing loans to total loans will increase by 5.6 percentage points, namely to 8.3 per cent. Sector losses would amount to EUR 80.9 million (figure 77). However, the high level of provisions held by individual banks makes the sector more resistant to the assumed shocks in this scenario with regard to the capital position. The level of capitalization after the shock results to be 14.8 per cent for 2019, which is far above the regulatory requirements (table 8). Moreover, the assumption of having an increased interest rate has had positive effects on net interest income, due to the fact that the sector has a positive balance gap of interest rate-sensitivity and assuming that the same positions will be re-invested, then, as a result, the sector revenues will be higher despite the other negative effects that this assumption may have (e.g. increased cost for borrowers). The effect of Euro devaluation on sector revenues is presented at a low but positive level due to the positive net open position of the sector during the current year. This means that the potential devaluation of the Euro against other currencies would bring higher incomes because the net equivalent value in Euro would be higher.

At the level of individual banks, two banks that are not of general systemic importance and act as branches of foreign banks would face capitalization problems, whose CAR would drop to 8.3 per cent and 8.2 per cent, respectively. Additional funds needed to increase capital at the minimum required level would be a total of EUR 14.7 million (figure 77, table 8).

The risk scenario from the failure of large credit exposures: in this scenario, it is estimated the banks' sustainability to the potential failure of three and five major creditors. The assumption of the failure of three major creditors would have the sector level capitalization drop to 14.0 per cent and

scenario where economic decline is assumed, the sensitivity of the NPLs is based on the coefficient of response to output gap and not to the GDP.

<sup>38</sup> The assessment of the 'lost' revenues as a result of the increase of the NPLs was initially conducted by calculating the ex-post general interest rate

on loans for each bank, which was then multiplied by the added value of the NPLs.



the loss reach to EUR 102.7 million (figure 77 and Table 8). The two abovementioned banks would face again high losses, where the one being a branch of a foreign bank<sup>39</sup>, would have its CAR fall to negative levels. This means that these two banks need to provide EUR 54.1 million to reach capital at the required level. The failure of the five largest borrowers would further aggravate the situation in these two banks as well as one bank of general systemic importance would be presented as under-capitalized. The losses would reach a total of

EUR 142.8 million and the CAR sector would drop to the regulatory limit at 12.5 per cent. All three under-capitalized banks would need additional EUR 88.7 million to increase the capital (figure 76 and table 8). The outcomes of this scenario suggest that the sector does not have a high concentration of credit exposures, but it can be said that the branches of foreign banks significantly influence the increase in the level of large credit exposures of the total sector.

**Table 8. Results of stress test scenarios for credit risk**

Description	Number of banks with CAI <12%	Capitalization rate			NPL rate			Additional means needed for recapitalization (in thousand Euros)
		higher level	lower level	sector's level	higher level	lower level	sector's level	
Current levels (before shocks)		117.6	11.8	16.9	4.3	0.2	2.7	
Scenario results								
Baseline scenario: Decrease in NPL for 2.35 pp, increase in lending for 10%		112.8	14.9	21.1	2.0	-2.2	0.3	
Adverse scenario: Increase in NPL for 3.00 pp, slow down in annual lending growth for 5.9 pp., interest rate growth for 1 pp. applied in the IR-sensitive balance gap, adjustment of positions in foreign currency based on EUR depreciation for 10 pp.	2	120.6	10.1	16.3	7.3	3.2	5.7	7,539
Severe adverse scenario: Increase in NPL for 5.60 pp, lending stagnation, interest rate growth for 2 pp. applied in the IR-sensitive balance sheet gap, adjustment of positions in the currency based on EUR devaluation for 20 pp.	2	130.0	8.2	14.8	9.9	5.8	8.3	14,675
Failure of the three largest borrowers	2	132.6	(20.8)	14.0	39.7	0.3	9.2	54,092
Failure of the five largest borrowers	3	132.6	(33.0)	12.5	53.7	0.3	10.9	88,738

Source: CBK (2019)

### 5.6.2 Assessing the stability to shocks in the liquidity position

The stability test of the banking sector's liquidity position aims to assess banks' financing ability to withstand liquidity shortages caused by extreme situations.

The test is based on two hypothetical scenarios that assess the adequacy of liquid assets of banks to withstand withdrawals of a deposit value within 5 days and to cope with the risk of the failure of concentrated deposits. The scenarios are quite conservative due to the fact that banks are unable to meet part of the liquidity needs through external funding sources.

### Scenario 1: Withdrawal of deposits on daily basis

In this scenario, the withdrawal of deposits by structure and entities is considered at different levels of withdrawals on a daily basis (table 9) for five consecutive days. After each day, 5% of deposits from the remaining deposits are allocated for the purposes of bank operation in the following days. This implies that, under the assumed scenarios, the obligatory reserve of 10 per cent will decrease by 50 per cent. The scenario was also built on the assumption that during this period the possibility of converting liquid assets into cash would be 80 per cent of total liquid assets, while the possibility of converting non-liquid assets in cash would only reach 1 per cent of these assets within a day.

<sup>39</sup> Operating in the capacity of a foreign bank branch, these banks are not subject to the regulation to limit the ratio of exposures to the Tier I equity of

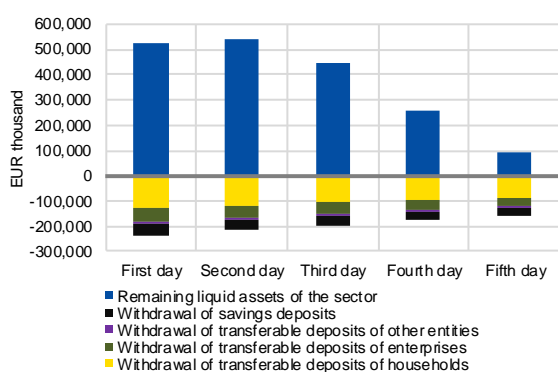
the banking branch, but to the Tier I capital of parent banks, hence the value and the rate of large credit exposures is high at these institutions.

**Table 9. Assumptions for liquidity risk scenarios**

Deposit withdrawal	Assumptions for time withdrawals	Deposit withdrawal level
Households - transferable deposits	Every day, for 5 consecutive days	10.0%
Enterprises - transferable deposits	Every day, for 5 consecutive days	9.0%
Other entities - transferable deposits	Every day, for 5 consecutive days	8.0%
Savings deposits	Every day, for 5 consecutive days	10.0%
Time deposits	Every day, for 5 consecutive days	8.0%
Five largest depositors	Within the day	100.0%
Twenty largest depositors	Within the day	100.0%

Source: CBK (2019)

**Figure 78. ST results for liquidity risk -Scenario 1**



Source: CBK (2019)

These assumed levels of daily withdrawals are based on the experience of the banking sector of the countries of the region, which have experienced situations of significant withdrawals of deposits, due to massive uncertainties caused by political instability and other financial crises occurring in different periods. Therefore, since Kosovo has no history of such occurrences, based on the practices of the countries of the region it is assumed that this level of withdrawals could materialize in situations of crisis.

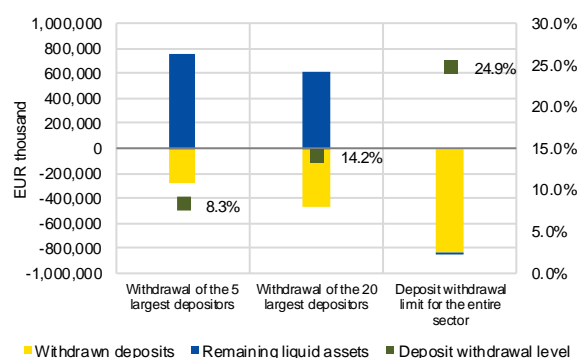
Scenario results suggest that banks could withstand withdrawal of deposits at defined levels on a daily basis until the fourth day. On the fifth day, liquidity problems would appear in four banks, including three banks of general systemic importance. The value of lacking liquid assets of these four banks would reach EUR 40.0 million (figure 78). The level of total deposit withdrawal in the banking sector on

the fifth day would reach 32.7 per cent (table 9).

**Scenario 2: Withdrawal of deposits by the largest depositors**

The bank's liquidity position turns out to be able to withstand losses under the scenario's assumptions on potential deposit withdrawals by the five largest depositors in each bank.

**Figure 79. ST results for liquidity risk - Scenario 2**



Source: CBK (2019)

Under the assumption that the twenty largest depositors of each bank will withdraw their deposits within the day, the liquidity situation would weaken in two banks. The lack of funds for these two banks would amount to EUR 6.3 million (figure 79, table 10). The results of this scenario generally suggest that the Kosovo banking sector does not have a significant concentration of the source of funding, which are the deposits as the main component of liabilities.

### 5.6.2.1 The capable level of total withdrawal of deposits before the liquidity position reaches critical levels

Liquidity problems for the entire banking sector would arise in case of withdrawal of 24.9 per cent of deposits within one day, which implies that the banking sector may be able to withstand close to one quarter (1/4) of total

deposits without needing extra liquid assets (figure 79 and table 10). Meanwhile, at bank level, the bank with the lowest withdrawal threshold stands at 14.9 per cent, while the highest stands at 45.4 per cent (as a result of the high level of liquid assets owned by this bank).

**Table 10. Stress test scenario results for liquidity risk**

The results of the credit risk scenarios	Number of banks with a lack of liquid assets	The level of a withdrawal deposits	Additional liquid assets needed (in thousand of euros)	Loan/deposit ratio
<b>Scenario 1:</b> Withdrawal of deposits on a daily basis at the end of the fifth day	4	-32.7%	(39,976.8)	121.4%
<b>Scenario 2.1:</b> Withdrawal of deposits from the largest 5 depositors	0	-8.3%	-	89.1%
<b>Scenario 2.2:</b> Withdrawal of deposits from the largest 20 depositors	2	-14.2%	(6,293.7)	95.2%
<b>Threshold</b> - Withdrawal of deposits to the critical level of liquidity		-24.9%	(3,069.8)	108.8%

Source: CBK (2019)

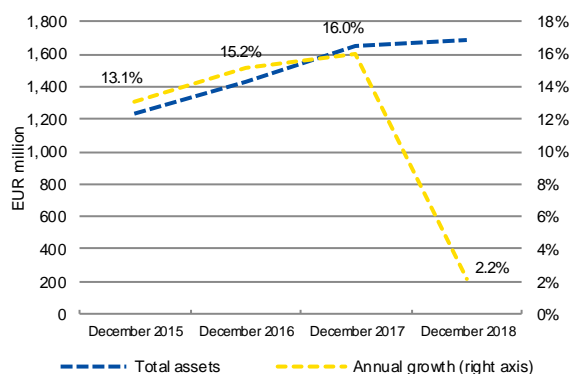
## 6. Non-bank financial institution

### 6.1. Pension sector

#### Pension sector activity

The positive performance of new contributions affected the growth of this sector in 2018, but with a slower pace.

Figure 80. Pension sector assets



Source: CBK (2019)

The value of assets of the pension sector was characterized by an annual growth of 2.2 per cent, amounting to EUR 1.69 billion (figure 80). The Kosovo Pension Savings Trust (KPST) represents the largest part of the sector's assets (99.6 per cent), while the remaining part is managed by the Slovenian-Kosovo Pension Fund (SKPF). New collected contributions marked an annual increase of 8.1 per cent, whose value reached EUR 172.7 million from around 34.9 thousand new contributors this year.

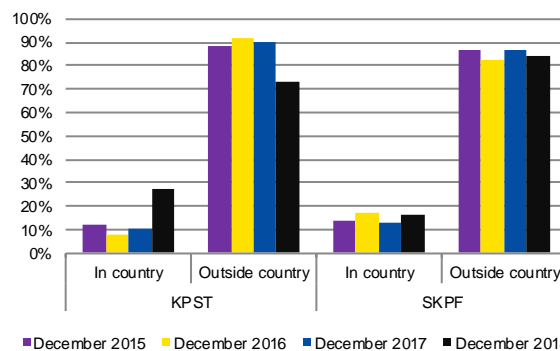
**Structure of assets of KPST continued to be dominated by investments at external markets, which are mainly held in the form of joint funds diversifying the risk through investing in shares and treasury bills of foreign governments.**

By December 2018, the investment portfolio in foreign markets decreased by 17.0 per cent, mainly as a result of performance and negative return in investment during the most part of 2018.

Investments abroad slightly decreased their share to 73.0 per cent (89.8 per cent in December 2017), while investments in Kosovo

increased their share to 27.0 per cent (10.2 per cent in 2017) (figure 81). Within domestic investments, the share of government securities of Kosovo continues to be the category with the greatest weight, followed by that of deposit certificates and cash held in the country.

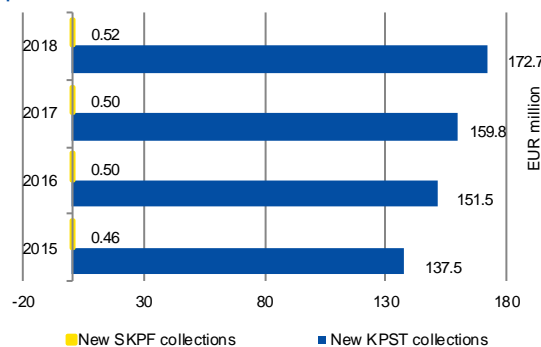
Figure 81. The structure of pension sector investment



Source: CBK (2019)

The weight of securities decreased to 46.0 per cent (56.8 per cent in December 2017), whereas the weight of certificate deposits decreased to 26.3 per cent (30.2 per cent in December 2017). Dynamics of investments in Kosovo's Government securities depends on the demand and offered amount by the Government along with the competitiveness at auctions.

Figure 82. Collected contributions , by pension funds



Source: CBK (2019)

It is worth mentioning that within domestic investments in the cash category it appears an amount of EUR 120.0 million, but which is dedicated for investments abroad (transit money).

In December 2018, the value of total assets of SKPF amounted to EUR 7.0 million, marking

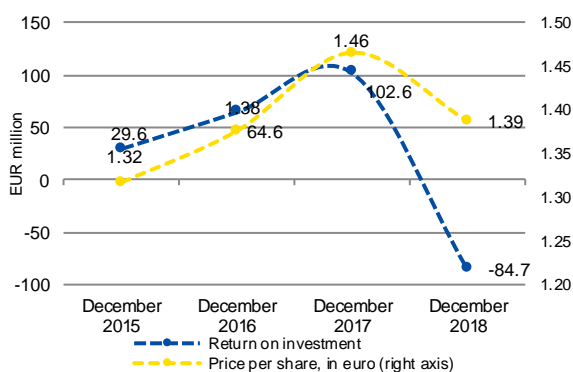
an annual increase of 6.0 per cent (growth of 9.8 per cent in December 2017). The new collected contributions amounted to EUR 515.3 thousand up to December 2018, which corresponds to an annual growth of 2.6 per cent, which constitutes a higher growth than the one marked in previous year of 2.6 per cent (figure 82).

**Vast majority of SKPF assets continue to be invested abroad, with 84.0 per cent of total assets.** The investment strategy abroad focuses mainly in the form of shares (80.1 per cent), securities (19.3 per cent), and in cash (0.6 per cent). On the other hand, investment in Kosovo reached their share to 16.0 per cent, from 12.9 per cent in the same period of the previous year. Investment opportunities in the domestic market are somewhat limited so investments are also distributed in securities of the Government of Kosovo (71.1 per cent), deposits (21.5 per cent) and cash (7.4 per cent).

**6.1.1 Financial performance of pension sector**

**The pension sector marked a negative financial performance in 2018 as a result of the negative return on investment, while new contributions continued to increase.** KPST had negative return on investment of EUR 84.7 million during 2018 compared to return on investment of EUR 102.6 million in 2017 (figure 83).

Figure 83. Financial Performance of Kosovo Pension Savings Trust



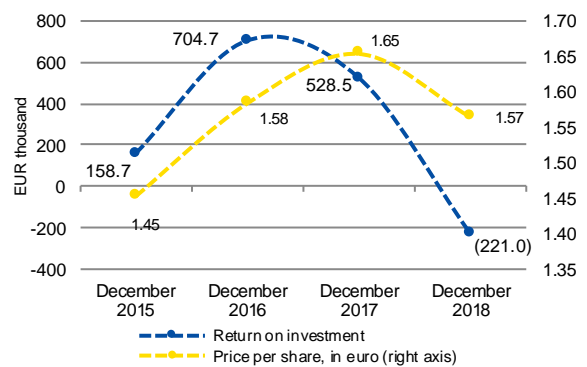
Source: CBK (2019)

Consequently, KPST closed the last day of 2018 with the lowest share price compared to the previous year. Specifically, the share price dropped to EUR 1.39 compared to EUR 1.46 in

December 2017. Year 2018 was considered as a year of extreme fluctuations in the USA financial markets. Key indexes were characterized by positive performance throughout the year, especially in September and October, when they marked a record return on investment. However, in the last two months of the year, key indexes marked a significant drop, affecting the year to close with an overall decline.

This decline at the end of the year was affected by the huge sale of financial instruments by investors and securities of traders, driven by uncertainties as a result of trade disputes between the USA and China, indications of global economic slowdown, further growth in the base rate from the Federal Reserve, the uncertainties surrounding the potential increase in inflation and the political situation within the United States and abroad (the impact of BREXIT in Great Britain and Europe and China's economic slowdown). High pension sector exposure to external dynamics as a result of high share of foreign investment was translated into gross negative return in investment by the end of 2018.

Figure 84. Financial Performance of Slovenian-Kosovo Pension Fund



Source: CBK (2019)

Similarly, the SKPF also marked a negative return on investment during 2018. In December 2018, gross return on investments amounted to EUR -221.0 thousand, compared to positive return on investment of EUR 528.5 thousand up to December 2017 (figure 84). Whereas, in the last day of 2018, the share price of SKPF marked a drop to EUR 1.21, compared to EUR 1.26 in 2017.

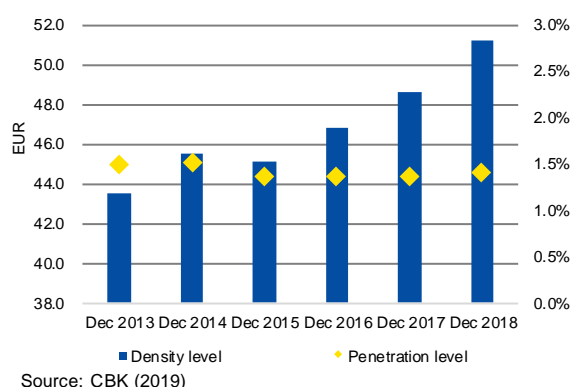
## 6.2 Insurance sector

### 6.2.1 Activity of the insurance sector

In the insurance sector, the year 2018 was characterized by a poorer profitability and lower asset value compared to the previous year. However, the positive developments within the gross written premiums gave this sector absorbing capacity against poorer performance during this year. Moreover, they also influenced the modest growth of the intermediation sector, reflecting the potential for further development.

With a share of 2.8 to total financial system assets, which is almost an unchanged share in the last five years, the insurance sector is the fourth largest sector by size. Sector intermediation level (gross written premiums in relation to GDP) results to have been at the level of 1.41 per cent, which is considered as relatively low, although with a marginal increase compared to 2017. Also, the density level, which represents written premiums per capita, have marked an increase in years, reaching EUR 51.2 in 2018 (figure 85).

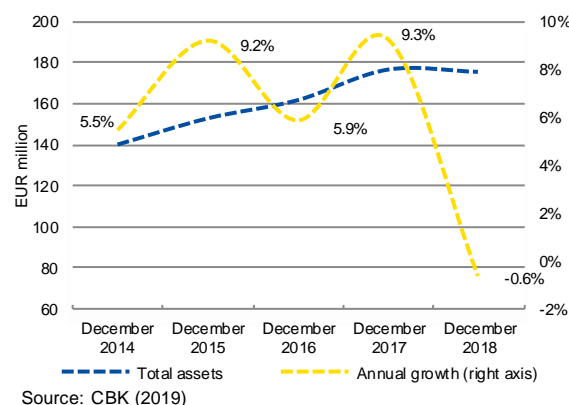
Figure 85. Insurance sector development indicators



The interconnection between the insurance sector and other segments of the financial system is still at a low level, which minimizes the possibilities of distributing the risks in other segments of the financial system of Kosovo. Insurance sector has higher exposure to banking sector, considering that almost half of the assets of this sector are held in commercial banks in the form of deposits. In

this context, the stability and liquidity of the banking sector is of particular importance in the operation and stability of the insurance sector and other sectors in the country's financial system.

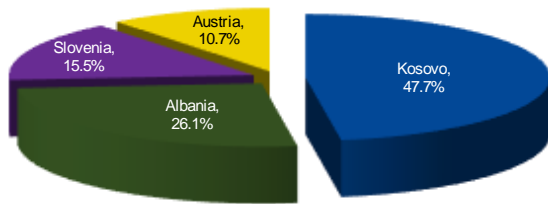
Figure 86. Insurance sector assets



The structure of the insurance sector continues to be dominated by 'non-life' insurance services, which represent 90.8 per cent of the insurance market assets, while the remainder consists of the assets of the 'life' insurance companies. In 2018, the number of insurance companies decreased as a result of withdrawal from the market of one of 'life' insurance companies. Consequently, the number of insurance companies decreased from 15 to 14 insurance companies, out of which 12 are 'non-life' insurance companies and 2 'life' insurance companies.

Unlike the previous year, the insurance market appears to have had an equal share of the number of insurance companies by ownership, although foreign-owned insurance companies continue to have the highest share of total assets of the sector. In 2018, the withdrawal from the market of one of the 'life' insurance companies resulted in a decline in the share of assets managed by foreign-owned insurance companies to 52.3 per cent (54.3 per cent in 2017). Albania had the highest share in total insurance sector assets in 2018, while Austria and Slovenia reduced their share in total sector assets (figure 87).

Figure 87. Structure of insurance sector assets, by ownership (December 2018)



Source: CBK (2019)

**Insurance market in Kosovo is characterized by a low concentration, which is a precondition for functioning of a greater competition in the market.** Herfindahl<sup>40</sup> index, calculated for gross written premiums in 2018 results to 870 points (in 2017 it was 875 points). While the same index calculated on the basis of the insurance market assets shows lower values, namely 808 points for 2018, compared to 765 points in 2017. Similarly, the CR5<sup>41</sup> index for 2018, calculated in relation to the GWP for the insurance sector, results with 52.8 per cent (2017 - 53.2 per cent), while calculated in relation to assets ratio results with 49.8 per cent (2017 - 47.7 per cent). By sectors, the concentration is higher in the 'life' insurance sector, as a result of the smaller number of insurance companies in this sector.

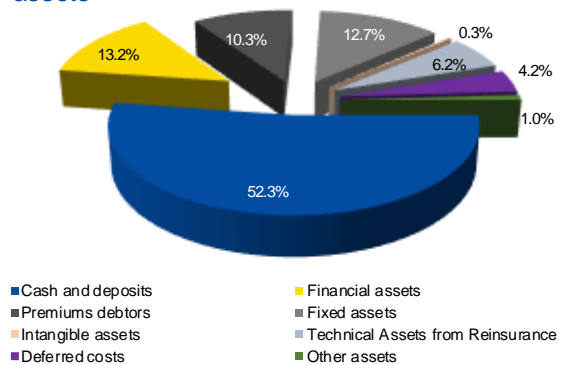
Insurance sector assets in December 2018 decreased to EUR 175.7 million, marking a marginal annual decline of 0.6 per cent (figure 88). Assets of 'non-life' insurance companies increased by 2.7 per cent, while 'life' insurance assets marked an annual decrease of 24.8 per cent.

The decrease of the insurance sector assets was affected by the withdrawal from the market of one of the 'life' insurance companies in 2018. In terms of the assets, investments in securities of the government of Kosovo and collectables from the insured entities marked an increase,

while deposits held in commercial banks decreased.

Cash and deposits held in commercial banks and the CBK remain the dominant category in the balance sheet of the insurance sector with a share of 52.3 per cent. This asset structure suggests that the assets of the insurance companies contain a high percentage of high liquid assets. While the investment structure of insurance companies, which continues to be conservative, consists of investments in securities of the government of Kosovo, which have increased the weight to 13.2 per cent in December 2018, compared to 11.9 per cent in the same period last year (figure 88).

Figure 88. Structure of insurance sector assets



Source: CBK (2019)

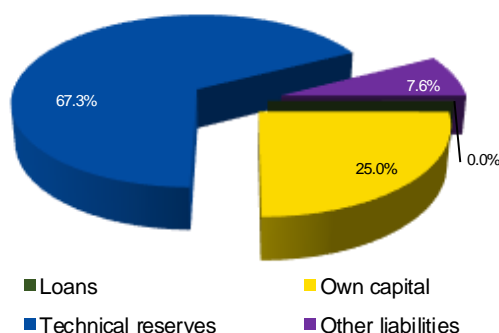
Within its own liabilities and own resources, technical reserves lead over the general structure. Technical provisions, which constitute majority of the liabilities of insurance companies during 2018, recorded an annual growth of 4.0 per cent. Mainly, the increase in technical reserves was positively influenced by the annual growth of 5.6 per cent of provisions for 'non-life' insurance sector premiums. Also, mathematical reserves recorded an increase of 17.8 per cent compared to 2017 (figure 89).

<sup>40</sup> Herfindahl index is calculated by the following formula:  $HI = \sum_{i=1}^n (s_i)^2$ , where  $s_i$  is the share of the company in total assets (gross written premiums) of the insurance market,  $n$  is the total number of institutions in the respective sector. If the index ranges between 1,000 to

1,800 units, the level of concentration in the insurance sector is considered acceptable.

<sup>41</sup> The CR5 index combines the market share of 5 companies with the highest assets values in relation to total sector assets and GWP in relation to total GWP of the sector.

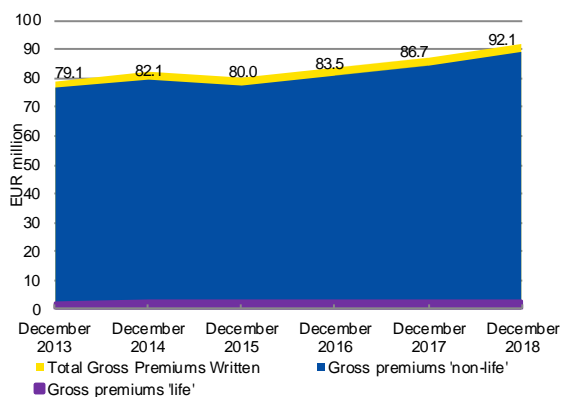
Figure 89. Capital and liabilities of the insurance sector (December 2018)



Source: CBK (2019)

The value of the total capital of insurance companies decreased by 6.1 per cent and dropped to EUR 44.0 million.

Figure 90. Collected gross premiums



Source: CBK (2019)

The decrease in capital is attributed to the decrease in the capital of insurance companies due to the withdrawal from the market of one of the insurance companies of this profile and the worst performance during 2018, which was reflected in own source revenues through the lowest net profit realized during this year. While the accumulated losses (negative value of retained earnings) decreased by 11.9 per cent.

During 2018, the value of premiums written by insurance companies amounted to EUR 92.1 million, an annual growth of 6.2 per cent (figure 90). The structure of written premium is driven by 'non-life' insurance premiums representing 96.8 per cent of total written premiums.

In December 2018, these premiums amounted to EUR 89.1 million, an annual growth of 5.8 per cent. The remainder of the total written premiums consists of 'life' insurance premiums, which amounted to EUR 3.0 million, representing the higher value for 16.6 per cent.

**The product that dominates the insurance market continues to be that of Third Party Liabilities.** During 2018 compulsory insurance products increased by 1.3 per cent, while their share in total gross written premiums decreased to 61.7 per cent, compared to 64.4 per cent in 2017 (table 10). The decrease of the share of compulsory insurance products was affected by “MTPL” and “Border insurance” products. Meanwhile, voluntary insurances recorded an increase by 14.1 per cent, while their share in total gross written premiums increased 38.3 per cent from 35.5 per cent as it was in 2017. The increase in voluntary insurance contributions to total gross written premiums was influenced by increased premiums for products such as "Loans and Guarantees", "Casco", "Property Insurance", "Accident and Health" and other products that recorded a slight increase (table 11).

Damage claims paid by the insurance sector, which include damages of insurance companies and Kosovo Insurance Bureau (KIB), marked a slowdown in annual growth to 5.0 per cent (17.9 per cent in 2017), amounting to EUR 48.3 million in 2018.

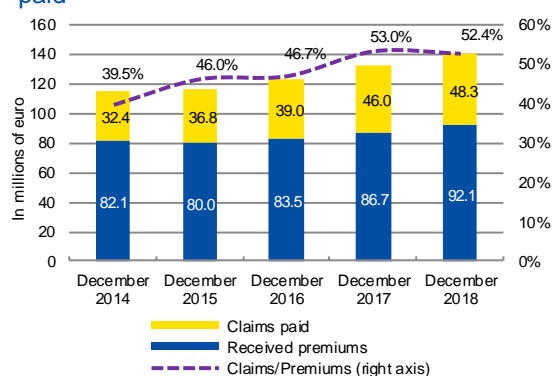


**Table 11. Gross written premiums by business classes (EUR million)**

Aktiviteti	2017	2018	Difference	Share 2017	Share 2018
Accident and health	17.0	18.0	6.1%	19.6%	19.6%
Border insurance	7.2	7.4	2.7%	8.3%	8.1%
Casco insurance	3.9	4.5	16.4%	4.4%	4.9%
Loans and guarantees	2.5	3.6	43.7%	2.9%	3.9%
Property insurance	4.6	5.4	16.3%	5.3%	5.8%
Insurance for financial losses	0.8	1.0	17.8%	1.0%	1.1%
Liability insurance	1.1	1.6	42.6%	1.3%	1.7%
Marine and transport	0.0	0.1	191.2%	0.0%	0.1%
MTPL	44.9	45.3	0.9%	51.7%	49.2%
TPL+	2.2	2.3	4.8%	2.5%	2.5%
Total non-lifa	84.2	89.1	5.8%	97.1%	96.8%
Total life	2.5	3.0	16.6%	2.9%	3.2%
Total market	86.7	92.1	6.2%	100.0%	100.0%

Source: CBK (2019)

The increase in the level of damage claims paid in 2018 was mainly due to the payment of damage claims on behalf of other voluntary insurance products. Only during 2018, the amount of damage claims paid by voluntary insurance amounted to EUR 16.0 million, or 8.3 per cent more compared to the previous year of 2017.

**Figure 91. Received premiums and claims paid**


Source: CBK (2019)

Unlike voluntary insurance, damage claims paid by compulsory insurance, although with a larger share in total portfolio, during 2018 recorded an increase by 2.6 per cent. This increase in damage claims paid by compulsory insurance was influenced by “internal motor liability” product.

Meanwhile, the amount of damage claims paid by insurance has decreased to EUR 552

thousand from EUR 777 thousand as it was in 2017, marking an annual decrease of 28.9 per cent.

The higher increase of written premiums during this period, parallel to the smaller increase of paid damage claims, resulted in a decrease in the ratio of total damages paid against written premiums (figure 91).

### 6.2.2 Financial performance of the insurance sector

Despite the increase in claims incurred, the increase in net income from premiums and efficient expenditures management resulted in the improvement of the insurance sector's situation, characterized by a positive financial result, albeit lower compared to the previous year. The profit recorded in 2018 was EUR 1.6 million, compared to the profit of EUR 6.4 million in 2017. This financial result reflects the highest increase of the claims incurred (39.5 per cent) against the increase in net income from premiums (5.8 per cent), and similarly, the annual decrease in sector expenditures by 3.4 per cent. Within this realized profit, non-life insurance companies have operated with a profit of EUR 1.0 million, while life insurance companies with a profit of EUR 0.6 million.

Another indicator showing the slowdown in profit during 2018 is the combined ratio at the level of 97.7 per cent compared to 89.6 per cent in 2017, meaning that the insurance market for 1 euro won has spent 0.98 euros compared to 0.90 euros in the previous year. This ratio contains the ratio of claims to net income from premiums of 50.6 per cent and the ratio of operating expenditures to net income from premiums of 47.1 per cent, excluding incomes from investment interests.

Pursuant to Regulation on the Investment of Assets in covering technical and mathematical provisions and the investment of the basic capital of insurance companies, insurers are obliged to hold sufficient assets in covering the technical and mathematical provisions not less than the gross value of the technical and mathematical provisions, respectively. This Regulation determines the time limits for achieving full implementation of the regulation within the three year period for the maintenance of assets covering the technical provisions: “a) from 1 January 2017 to 31 December 2017 - 70 per cent b) from 1 January 2018 to 31 December 2018 - 85 per cent, and c) from 1 January 2019 to 31 March 2019 - 100 per cent”. The indicator of technical provisions coverage with liquid assets in 2018 for non-life insurance companies was at the rate of 100.6 per cent (120.6 per cent in 2017), meeting the regulatory requirement of 85 per cent set for 2018. While the indicator of technical provisions coverage with liquid assets in 2018 for life insurance companies was at the rate of 137.4 per cent.

The annual decrease in liquid sector assets (cash and cash equivalents) of 3.1 per cent, in addition to the 4.0 per cent increase in technical reserves of the insurance sector, contributed to the decline in the liquidity level. The ratio between liquid assets to reserves decreased to 97.2 per cent in 2018 compared to 104.3 per cent in 2017, and the ratio between liquid assets to total liabilities decreased to 87.3 per cent (91.3 per cent in 2017).

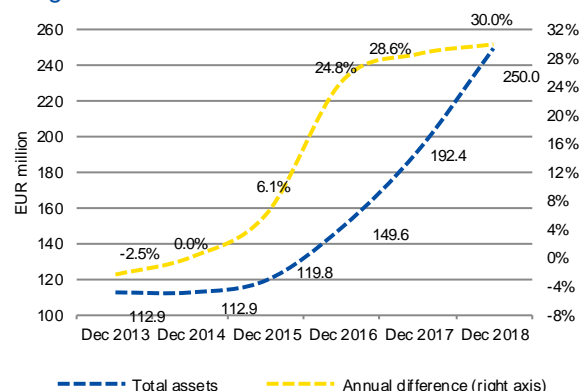
<sup>42</sup> In here are included five non-bank financial institutions that carry out lending, leasing and factoring activities

### 6.3. Microfinance sector and financial auxiliaries

#### 6.3.1 Activity of microfinance sector

**Increase of assets of microfinance sector is mainly attributed to increase of gross loans, an activity financed by loans from auxiliaries sector.** Sector assets amounted to EUR 250.0 million in December 2018, corresponding to an annual growth of 30.0 per cent (figure 92).

Figure 92. Microfinance sector assets



Source: CBK (2019)

22 microfinance institutions<sup>42</sup> operate in the domestic market, of which 14 have foreign ownership and represent 93.6 per cent of total sector assets.

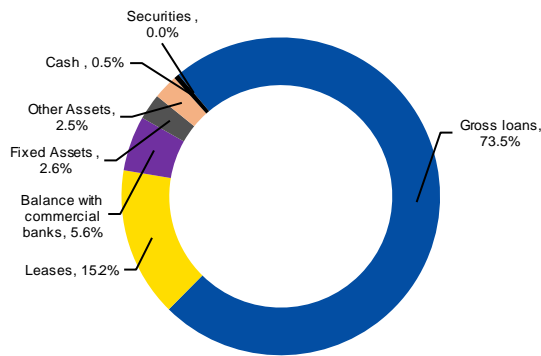
Herfindahl-Hirschman's index on assets resulted in 1,376 points in December 2018, reflecting a decline in concentration from the same period of the previous year (1,489 points). While the share of assets of the three largest institutions in total sector assets decreased to 53.1 per cent from 55.9 per cent as it was in December 2017.

**The structure of microfinance sector assets is dominated by loans constituting 73.5 per cent of total sector assets.** The second most important category by weight consists of leasing with a share of 15.2 per cent (figure 93).

Compared to the previous year, the weight of leasing in total assets in the sector increased, while the weight of loans slightly decreased.

Regarding liabilities, the activity of the microfinance sector is mainly financed by borrowings which account for 75.2 per cent of total liabilities and equity, whereas only financing from the external sector accounts for 67.3 per cent of total liabilities and equity.

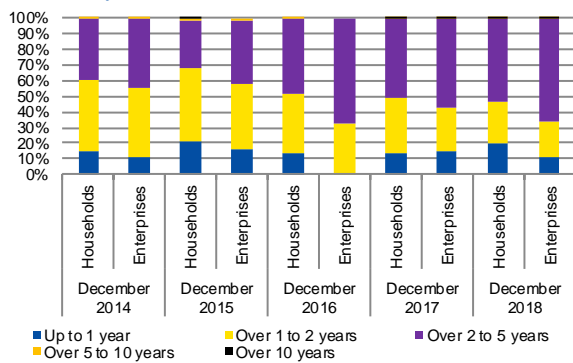
Figure 93. Structure of microfinance sector assets in 2018



Source: CBK (2019)

During 2018, external sector borrowings continued with the same trend as in the last year. The value of external sector borrowings amounted to EUR 168.3 million, indicating an annual increase of 28.6 per cent (30.6 per cent in 2017).

Figure 94. Loans to economic sectors, by maturity



Source: CBK (2019)

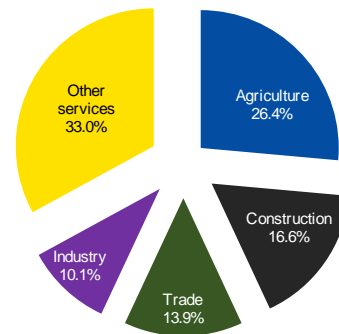
The value of total microfinance sector loans in December 2018 amounted to EUR 183.8 million, which represents an annual increase of 27.7 per cent along with the increase of 32.1 per cent in the previous year. This is the fourth consecutive year of double-digit increase of lending activity by microfinance institutions. This significant increase in lending was supported by the increase in the source of financing of microfinance institutions, mainly

by the external sector and by the growth of own capital influenced by the profit of the year and retained profit.

**During this year, microfinance institutions were oriented more towards lending to households, although lending to enterprises increased as well.** Specifically, loans to households in December 2018 accounted for 66.0 per cent of total loans of the microfinance sector and marked an annual increase of 31.7 per cent. According to the maturity term, household loans with maturity term 'over 2 to 5 years' have continuously increased their share and in 2018 they account for 53.4 per cent of total loans to households.

Loans to enterprises account for 34.0 per cent of the total loan stock. In 2018, loans to enterprises were characterized by an annual increase of 20.6 per cent, although this increase is halved compared to the previous year (an annual increase of 44.1 per cent in 2017). Similar to household loans, loans issued to enterprises continue to have a maturity of "over 2 to 5 years" (figure 94).

Figure 95. Structure of loans to enterprises, by economic sectors, December 2018

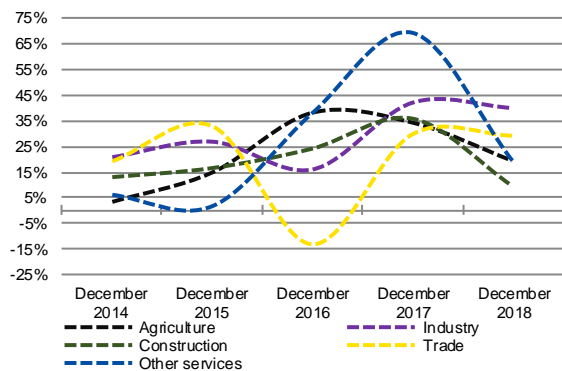


Source: CBK (2019)

**The structure of enterprises loans according to economic activities remains similar to previous periods.** Unlike the banking sector, where loans to agriculture represent the category with the lowest share, agriculture has the largest support of microfinance institutions, representing 26.4 per cent of total loans to enterprises. Other categories with high access to microfinance financing are loans destined for other services and loans to the construction sector (figure 95).

Regarding performance, loans to the industry sector recorded the highest annual growth. A significant increase in lending was also marked by the sector of trade, services and agriculture, albeit with weaker dynamics of increase (figure 96).

Figure 96. Growth rate of microfinance sector loans to enterprises, by economic sectors



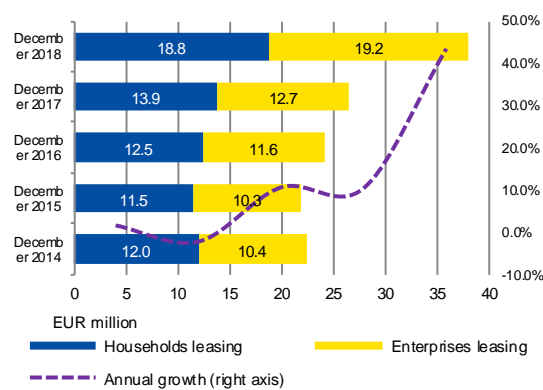
Source: CBK (2019)

Leasing activity in microfinance institutions marked a significant increase. The value of leasing in the microfinance sector reached EUR 38.1 million, an annual increase of 43.2 per cent (figure 97). The largest contribution in the total increase of leasing was leasing to enterprises, being for the first time the dominant category, the value of which was by 51.7 per cent higher than in December 2017.

Leasing to households have a share of 49.4 per cent in the general structure of total leasing.

Within leasing to households, mortgage leasing, which comprises the dominant category, marked an increase of 25.9 per cent compared to the increase of 8.0 per cent in the previous year. Other leasing also marked an annual increase of 52.0 per cent compared to the increase of 44.4 per cent in the previous year. Leasing to households continues to be dominated by long-term leasing “over 10 years” which have a share of 49.2 per cent, followed by leasing with maturity “over 5 up to 10” years with a share of 32.0 per cent.

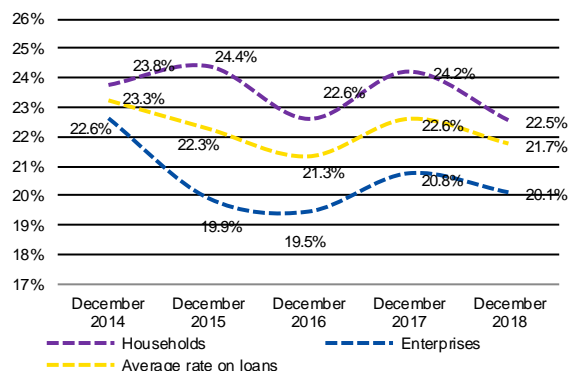
Figure 97. Microfinance sector leasing



Source: CBK (2019)

Within leasing to enterprises, other leasing, which dominate leasing of enterprises, were characterized by an increase of 37.7 per cent, which contributed to the increase of total leasing of enterprises. Leasing for equipment also marked a significant increase from EUR 0.3 million in 2017 to EUR 2.3 million at the end of 2018. Mortgage leasing continued to decrease, namely 25.1 per cent, mainly due to the small value. As regards the maturity of leasing to enterprises, the majority of them is comprised by mid-term leasing ‘over 2 up to 5 years’ with a share of 89.7 per cent, followed by leasing with a maturity of ‘up to 1 year’ with a share of 5.5 per cent.

Figure 98. Average interest rate on loans to microfinance sector

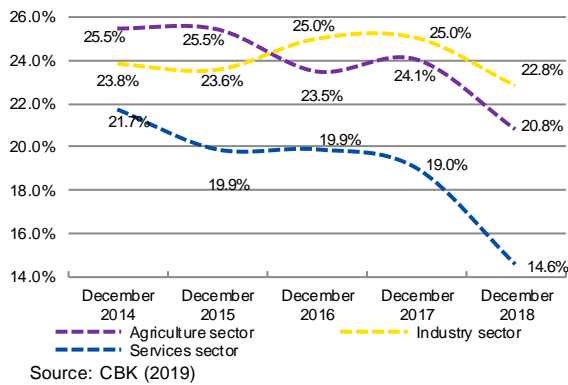


Source: CBK (2019)

The average interest rate on microfinance sector loans increased during the year, reaching 21.7 per cent in December 2018 (figure 98). Both household and enterprise sectors were characterized by a decrease in the average interest rate on loans.

The average interest rate on loans to households decreased to 22.5 per cent in December 2018. While the average interest on loans to enterprises remained to 20.1 per cent (figure 98). Within the loans to enterprises, the service sector has the lowest average interest rate of 14.6 per cent, a decrease of 4.5 percentage points compared to the same period last year. The average interest rate on loans to the industry sector decreased by 2.2 percentage points, remaining at 22.8 per cent in December 2018. Whereas, the average interest rate on loans to the agricultural sector decreased by 3.3 percentage points (figure 99).

Figure 99. Average interest rate on loans, by economic sectors



### 6.3.2 Performance of the microfinance sector

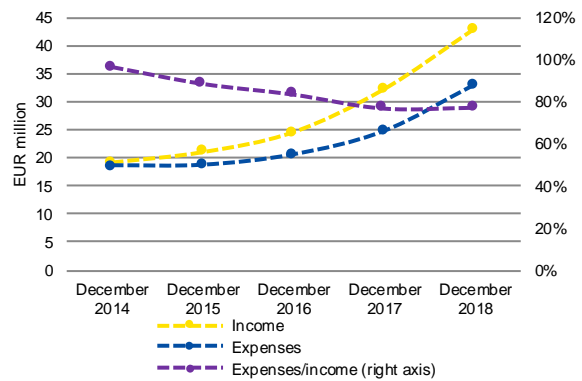
**Microfinance sector was characterized by the greatest financial performance in the last six years, which also reflected in profit growth.** In December 2018, the realized profit amounted to EUR 9.7 million, compared to the EUR 7.4 million profit of the previous year. The profit increase was a result of a higher increase in income than the increase in expenditures.

Microfinance sector income marked an increase of 33.1 per cent compared to 28.8 per cent in December 2017, mainly affected by an increase in interest incomes. Expenditures also increased by 33.7 per cent, unlike the 17.9 per cent increase in December 2017 (figure 100).

All expenditure categories were characterized by increase, but the largest contribution to the increase of total expenditures was from

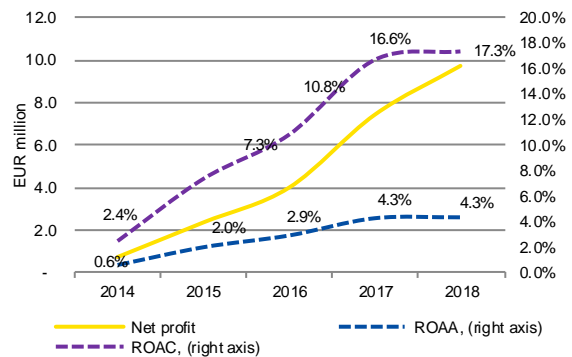
personnel and administrative expenditures, which marked an increase of 23.5 per cent.

Figura 100. Income and expenses of microfinance sector



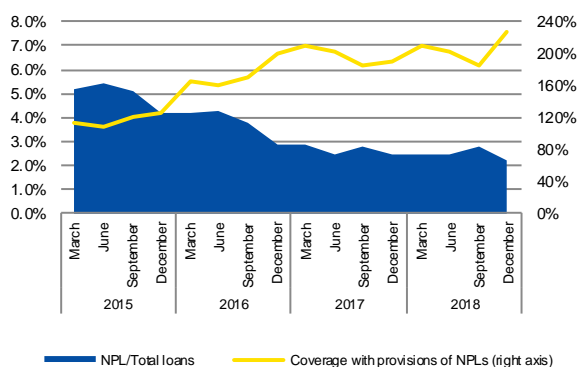
Expenditures to income ratio of the microfinance sector has marked a marginal increase of 0.4 percentage points as a result of a higher increase in expenditures compared to incomes during this period. In December 2018, this indicator stood at 77.3 per cent from 76.9 per cent in the previous year.

Figura 101. Profitability indicators of microfinance sector



The profit realized until December 2018 had an impact to some extent on the improvement of profitability indicators where the Return on Average Assets (ROAA) remained at the same level as in the previous year (4.3 per cent in 2017), whereas Return on Average Equity (ROAE) reached 17.3 per cent (16.6 per cent in 2017) (figure 101).

Figure 102. Loans portfolio quality indicators



Source: CBK (2019)

**The microfinance sector continues to be characterized by a relatively low level of nonperforming loans and a satisfactory level of coverage of nonperforming loans by provisions.** In December 2018, the share of nonperforming loans to total loans declined to 2.2 per cent, compared to the 2.5 per cent rate in December 2017. Coverage by provisions improved by 35.7 percentage points, reaching a level of 226.0 per cent compared to the level of 190.3 per cent in December 2017 (figure 102).

**The sector of financial auxiliaries comprises the largest number of financial institutions in the country but manages the smallest share of financial system assets (0.2 per cent in December 2018).** This sector consists of exchange bureaus and money transferring agencies (MTAs). The value of financial auxiliaries' assets in December 2018 amounted to EUR 15.8 million, representing an annual decrease of 0.3 per cent. Furthermore, financial auxiliaries' income marked an annual increase of 2.2 per cent, reaching EUR 7.7 million. The income structure of financial auxiliaries is dominated by incomes from transfers (share of 72.7 per cent in December 2018), which were characterized by an annual increase of 3.6 per cent. On the other hand, expenditures marked an annual increase of 2.2 per cent, reaching EUR 4.6 million. Consequently, the net profit realized by these financial institutions during 2018 amounted to EUR 3.1 million, similar to last year.

## 7. Financial infrastructure in Kosovo

### 7.1. Payments system

**Payment systems have an important role in the financial system of a country's economy, taking into account that their efficient and safe operation represents a very important factor in maintaining and promoting financial stability. In Kosovo there is only one payment system for interbank payments, Interbank Payment System (IPS), being operated and supervised by Central Bank of the Republic of Kosovo (CBK).**

The number of transactions processed by ATS in 2018 totalled 11.5 million (11.7 million in 2017), marking an annual decrease of 2.1 per cent. While, in the same period, the total value of transactions reached EUR 13.0 billion (EUR 11.6 billion in 2017), representing an annual increase of 11.3 per cent. Priority massive

payments and regular massive payments in 2018 had an equal share in the total number of realized interbank transactions (table 12). Priority massive payments represent 4.6 million realized transactions (or 40.2 per cent of the total number of transactions) and are mainly payments from governmental institutions (such as wages and pensions). Similarly, regular massive payments represent 4.6 million realized transactions (or 40.2 per cent of the total number of transactions) and are mainly payments received by governmental institutions and account for tax payments, fees, customs etc., while 0.6 million transactions account for Giro payments mainly being composed by public utilities (bills of public utility companies, governmental institutions such as Customs Services and Kosovo Property Agency (KPA) (table 12).

**Table 12. The share of payment instruments to total transactions of IPS, in percentage**

Description	Number of total transactions		Value of total transactions	
	2017	2018	2017	2018
Regular	12.1%	13.4%	11.2%	11.3%
Priority	0.9%	1.0%	35.0%	36.6%
Regular - massive	36.0%	40.2%	5.9%	5.7%
Priority - massive	42.7%	40.2%	8.1%	8.1%
GIRO payments	7.8%	5.0%	10.2%	9.1%
Securities	0.0%	0.0%	6.8%	6.4%
Direct debit	0.2%	0.0%	0.1%	0.0%
Bank-bank	0.1%	0.1%	22.8%	22.7%
Returned	0.3%	0.1%	0.1%	0.1%

Source: CBK (2019)

Regarding the value of transactions, priority payments are the category with the highest share of realized transactions, amounting to EUR 4.7 billion, followed by the bank-to-bank category, amounting to EUR 2.9 billion in 2018. The number of total valid bank accounts<sup>43</sup> in December 2017 was 2.05 million,

representing an annual increase of 4.4 per cent.

The virtual infrastructure is developing at a fast and safe pace. E-banking accounts, by which are processed online banking services, have steadily been increased. In December 2018, the number of total e-banking accounts reached 250.7 thousand<sup>44</sup> (table 13).

<sup>43</sup> The number of total bank accounts comprises: the number of current accounts, saving and other accounts at a bank.

<sup>44</sup> Upon the entry into force of the 'Regulation on Reporting Payments Instruments Statistics' in 2018, the methodology of reporting the number of

accounts accessible by the internet has also changed. This number represents the number of current accounts that have access to e-banking, whereas, according to the previous methodology, all accounts have been reported, including current, saving and term deposit accounts.

The number of total transactions realized through E-banking accounts in 2018 reached 4.4 million, while the value of total transactions realized through E-banking accounts amounted to EUR 9.04 billion.

The structure of E-banking accounts continues to be dominated by individual bank accounts with a share of 83.1 per cent of all E-banking

accounts, followed by business accounts with a share of 16.9 per cent.

The number of total cards (debit and credit cards) that provide services of cash withdrawal and various payments increased by 8.7 per cent in 2018. As regards cards, the number of debit cards reached 1,011,888 while credit cards reached 173,471.

**Table 13. Banking sector network**

Description	December 2015	December 2016	December 2017	December 2018
Number of bank branches	45	45	45	47
Number of bank sub branches	210	207	183	165
Number of ATMs	540	522	512	491
Number of POS	9,705	10,589	11,501	13,183
Number of 'e-banking' accounts	187,297	230,905	301,841	250,733

Source: CBK (2019)

The number of debit cards was characterized by an annual increase of 9.3 per cent, while credit cards marked an annual increase of 5.3 per cent. The highest share within debit and credit cards according to the operators was marked by Visa Cards (67.0 per cent), followed by Master Cards (31.4 per cent), while the local cards had a share of 1.7 per cent.

Banking infrastructure in the country was expanded in the context of Point-of-Sales (POS) network, whereas the number of Automated Teller Machine (ATM) decreased compared to December 2017 (table 13). Despite the decrease of ATM number, the number of withdrawals through them increased to 15.2 million (13.8 million until December 2017), with an amount of EUR 2.4 billion (EUR 1.9 billion until December 2017) (table 13).

**Table 14. The share of the value of card transactions by terminals to total value of card transactions, in percentage**

Description	December 2015	December 2016	December 2017	December 2018
ATM withdrawals in cash	70.8%	63.4%	61.9%	58.9%
ATM deposits	10.5%	26.5%	29.3%	30.9%
Credit transfer through ATM	0.0%	0.0%	0.0%	0.1%
Cash withdrawals at POS terminals	1.2%	0.3%	0.2%	0.2%
Card payment at POS terminals	17.5%	9.9%	8.5%	9.8%

Source: CBK (2019)

The value of cash withdrawals through ATM to total transactions processed by bank cards reached 58.9 per cent in 2018, showing a high level of cash usage. Increase of the number of ATMs which enable clients to deposit cash into clients' accounts had an effect on the depositing value to increase its share to 30.9 per cent to total value of card transactions through terminals, from 10.5 per cent as it was

three years ago (table 14). At the same time, the number of payments through points of sales using cards at POSs reached 10.9 million with an amount of EUR 393.8 million. The value of payments through POSs to total transactions by bank cards reached 9.8 per cent in 2017.



### Box 5. Regulatory framework in the function of financial stability

#### Regulation on Factoring Activity

With the aim to advance the financial sector and its activities and to enhance the access to finances, the CBK has engaged in drafting a relevant regulation on the financial activity of factoring. The Regulation on Factoring has been approved by the CBK Board on 29 October 2018. All banks operating in Kosovo have been licensed / registered for performing the factoring activity, including a non-banking financial institution licensed in Kosovo. Exercising of factoring activity is expected to contribute to access to finance in the segment of small and medium enterprises, which faces numerous challenges in this regard. By enabling enterprises, mainly trading enterprises, to have access to finances based on their expected incomes, factoring will increase the opportunities of these enterprises to access short-term financing to meet their short-term liquidity needs, and consequently will be able to contribute to their financial stability.

#### Legal and Regulatory Framework for Bank Recovery, Settlement and Liquidation

In 2018, the CBK has drafted the legal and regulatory framework for the bank recovery and settlement process. The regulation has initially been made within the framework of the Law on Banks, which, in a separate chapter, addresses the regulation of recovery and liquidation process. In parallel to the work on regulating bank recovery and liquidation process through the Law on Banks, which is expected to be adopted during 2019, it has also been worked on drafting the regulations deriving from the new section in the Law on Banks on regulating the bank recovery and liquidation process. The drafting of the new regulatory framework, based on the relevant European Directive, will adequately define the entire recovery and liquidation process of problematic banks that could have negative effects on the stability of the financial sector. The CBK is also in the process of preparing tertiary legislation - Operational Manual of Recovery, Settlement and Liquidation - to facilitate operationalization at the technical level of this process. The full Regulatory Framework for Bank Recovery, Settlement and Liquidation advances banking regulation at the level of regional and European countries, and will serve the CBK as an additional instrument in maintaining the country's financial stability.

#### Regulatory framework for appraisal of immovable properties

The appropriate valuation of immovable properties is a very important factor for monitoring credit risk in the banking sector given that immovable property is the dominant form of collateral for issued loans, as well as the existing potential for increasing mortgage loans. Therefore, adequate information on the value of immovable properties is a key aspect of the banking sector activity with significant implications for the sector's development and its financial stability. During 2018, CBK has continued its work on the project started a year ago on reviewing the regulatory framework for immovable property valuation, in order to update the requirements to improve the immovable property valuation practices by financial institutions in line with the new European Standards (European Valuation Standards - EVS 2016). Within this project, the CBK is working on the new Regulation on Immovable Property Valuation, which will replace the current regulation by advancing the regulation of this area. The regulation of the program licensing immovable property evaluators, as well as the definition of the minimum requirements and standards to be applied by financial institutions licensed by the CBK during the valuation of immovable property used as collateral for issued loans, will contribute to the development of the necessary framework in order to improve the quality of immovable property valuation.

The development of the regulatory framework for immovable property valuation and regulation of the profession of property evaluators in compliance with international standards is expected to affect the improvement of the quality of property valuation as well as the provision of information on credit risk monitoring and the evaluation of potential accumulation of systemic risk.

#### Regulatory framework for systemically important payment systems

The sustainability of financial infrastructure is a very important component of securing financial stability. Within the financial infrastructure, the attention focuses particularly on overseeing the systemically important financial infrastructure due to its potential to promote systemic crises and potential effects on the failure of both financial and economic system as a whole.

In 2018, the CBK has approved the Methodology on Evaluation of Systemically Important Payment

Systems. This document has been prepared based on the Principles on Financial Market Infrastructure published by the Bank for International Settlements<sup>45</sup> and the International Organization of Securities Commissions in 2012, as well as on the relevant regulatory documents of the European Central Bank for the oversight and evaluation of systemically important payment systems. Implementation of the methodology on the evaluation of systemically important payment

systems for compliance with the abovementioned principles is foreseen to begin in 2019. The advancement of the regulatory framework and infrastructure of systemically important payment systems contributes to increasing the sustainability of the payment system by guaranteeing efficient structures in managing the risks of financial market infrastructure in general and the payment system in particular.

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<sup>45</sup> Bank for International Settlements and International Organization of Securities Commissions. *Principles for financial market infrastructures*. April 2012, <https://www.bis.org/cpmi/publ/d106.pdf>

## 8. Macro-prudential framework

In 2016, the Central Bank of the Republic of Kosovo, pursuant to the Law No. 03/L-2009 on the Central Bank which empowers the CBK to draft the implementation of the policies to maintain the financial stability in the country, has compiled the Macro-prudential Policy, which is already published on the CBK official website.

In order to strengthen the CBK's legal base in exercising its mandate for macro-prudence, the new draft law on banks that is expected to be approved in 2019 defines the CBK as the only authority responsible for macro prudential oversight of banks. The new law also grants to CBK the authority to issue relevant regulatory instruments.

### 8.1. Summary of developments in selected macro-prudential indicators

In 2018, overall dynamics in selected macro-prudential indicators in Kosovo were characterized by sustainability, resulting in parameters above the regulatory requirements.

Despite the expansion of financial intermediation, namely the double-digit lending growth, the credit quality of the banking sector continued to be high and with an upward trend. The share of non-performing loans (NPL) to total loans continued to decline, being the lowest level at the regional level and below the European Union average. In addition to the improvement of the loan portfolio quality, the non-performing loans coverage ratio has been increased with credit loss provisions, indicating good sector protection against possible loan losses.

The banking sector as a whole and the systemic banks in particular continue to remain well-capitalized and liquid in 2018. Capital adequacy ratios for the banking sector and systemic banks stand high above the regulatory requirements. The good banking sector capitalization is also supported by the analysis of additional capital allocation in relation to the systemic importance of banks.

Similar to capital adequacy ratios, the leverage ratio of the whole banking sector and systemically important banks continued to remain high above the minimum legal requirements. Liquidity indicators were at a satisfactory level, in particular the ratio of liquid assets to short-term liabilities, which was above the regulatory requirements. The concentration of large exposures to the banking system stood at an adequate level with a downward trend.

Profitability indicators, in particular the Return on Average Equity (ROAE) remained at a high level, while the credit to GDP gap signals that the banking sector in Kosovo has room for further expansion of lending activity within the framework of the macro-financial environment in which it operates. In December 2018, the banking sector appears to have five systemically important banks, while the stress test results for these banks consistently suggest satisfactory banking sector abilities to cope with extreme situations of exposure to market risk or liquidity risk.

Even the general analysis of health indicators of the insurance sector, as potentially important indicators for macro prudence, suggests that Kosovo's financial stability is not threatened by the insurance sector, given the small share of the sector in the financial system. In addition, the interconnection between the insurance and microfinance sectors and other segments of the financial system is still at a low level, which minimizes the opportunities for risk-sharing between different segments of the Kosovo financial system.

### 8.2. Countercyclical Capital Buffer

Countercyclical Capital Buffer aims to strengthen financial stability by protecting the banking sector against losses that may be caused by cyclical systemic risk accumulation in an economy as well as by the impact on insuring the sustainability of credit supply throughout the financial cycle. Countercyclical Capital Buffer is a part of the Basel III regulatory and also one of the major macro

prudential policy instruments to address the cyclical dimension of systemic risk.

By increasing capital requirements at a time when lending is in the growth phase beyond the fundamentals of the economy (increases faster than Gross Domestic Product and perceived as excessive lending growth), this instrument aims to increase the sector's sustainability (solvency of banks) to cope with financial stress situations that may result from accumulation of risk as a result of excessive lending growth. At the same time, the instrument, through the release of accumulated capital reserves at the growth stage, contributes to the stimulation of credit growth in periods of financial stress, in order to avoid the transfer of negative consequences of the decline in lending to the total financial sector and the economy of the country.

For calculation of Countercyclical Capital Buffer, the guidelines of Basel Committee on Banking Supervision<sup>46</sup> suggest monitoring of several assessing parameters if lending is growing beyond sustainable fundamentals and consequently is affecting the accumulation of systemic risk. In addition to assessing the parameters according to the relevant guidelines, relevant authorities shall assess the relevance of applying countercyclical capital requirements.

The CBK in the Macro prudence policy<sup>47</sup> lists the countercyclical capital requirements as a potential instrument of the macro prudential policy intermediate objective for reducing and preventing excessive credit and leverage growth. According to Basel Guidelines, the main parameter for defining the CCR rate is stated to be credit to GDP gap in Kosovo, in addition to other relevant indicators that will inform the final decision on the possible activation of the instrument.

Below is presented the so-called model for assessing the cyclical capital requirements for Kosovo banking sector. Deviation of the credit

to GDP gap from its long-term trend is the main parameter of the model. Calculation of credit to GDP gap is conducted based on Basel guidelines and unified practices based on recommendations, through one-sided Hodrick–Prescott filter ( $\lambda$  400,000).

The lending gap is calculated in line the Basel Committee guidelines and the unified practices of the calculation method from most countries in the world, based on recommendations from empirical research. In lending were included loans to the private sector<sup>48</sup> by banks as well as non-banking financial institutions. The latter albeit in a lower share of total lending, are growing at a higher growth rate and expanding its share in certain sectors. Therefore, the involvement of non-banking sector loans despite low share, and currently without any effect on the lending gap, provides consistency in calculation method with other countries, and ensures the inclusion of effects of the possible increase of lending weight to the private sector by non-banking financial institutions.

Lending gap outcomes at the end of 2018 suggest that the private sector in Kosovo has never gone through an “over-lending” period. This coincides with the fact that the financial sector in Kosovo is still at a stage of development and Kosovo's economy is in the phase of increasing financial intermediation and convergence with other countries.

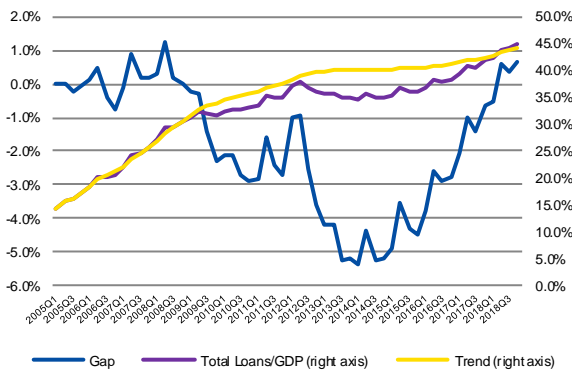
However, faster lending growth in relation to GDP in recent years resulted in the credit to GDP ratio moving slightly to a positive balance in 2018 (figure 103). The private sector credit to GDP ratio in Kosovo in December 2018 stood at 44.6 per cent, while the average of this ratio in the region is at over 50 per cent.

<sup>46</sup> Bank for International Settlements (2010). Guidance for national authorities operating the countercyclical capital buffer, The Basel Committee on Banking Supervision, December.

<sup>47</sup> CBK (2018). *Macro-prudential Policy*, Prishtina, June.

<sup>48</sup> Not including public sector loans and loans to financial enterprises in the calculation of the lending gap ensures that lending dynamics are not affected by possible changes in lending to the public sector or the financial sector.

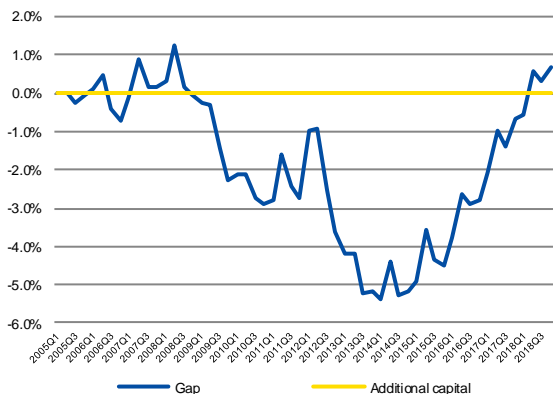
Figure 103. Lending gap



Source: CBK (2019)

Calculation of required capital buffer is made according to the relevant instructions of the Basel Committee, whereby the requirement for capital buffer (as a percentage of risk-weighted assets) is zero when the gap is less than 2 percentage points and with the increase the gap of 2 to 10 percentage points is required to hold the capital buffer up to the maximum level of 2.5 per cent. According to the above outcomes, which suggests that Kosovo has just obtained a positive lending to GDP gap, and continues to be in a gradual phase of deepening financial intermediation to reach at least the level of the countries in the region, the needs for potential countercyclical requirements were so far never present (figure 104).

Figure 104. Countercyclical capital buffer



Source: CBK (2019)

It shall be noted that, in the final assessment of countercyclical capital buffer, in order to use the instrument as a tool of Macro-prudential Policy in the future, the strength of the lending gap indicator shall be considered in to a limited

extent due to the short history of the banking sector (short time series and uniformity of developments without any period of financial stress).

Therefore, in this context, additional indicators shall be analysed and the qualitative data and judgment of field professionals shall be largely used for decision-making on the possible use of this instrument.

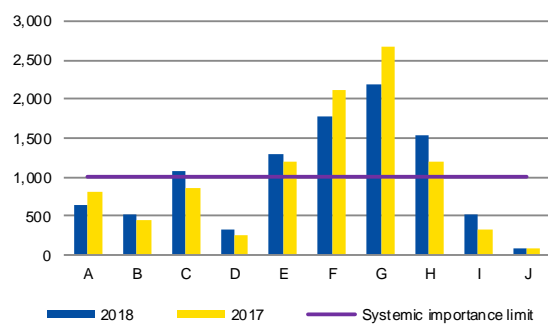
In this context, other relevant indicators are monitored on a regular basis along with the lending gap, which together with qualitative information and relevant expert judgment is allocated a special weight to the formation of a final judgment on developments in the area of systemic risk and the report of credit to GDP. These indicators include, inter alia, the dynamics of general credit growth and growth in specific sectors, credit exposures in particular sectors, collateral to loan ratio, debt-to-income ratio, etc.

### 8.3. Systemically important banks

The model for identifying systemically important banks is an important tool for continuous assessment of the structural and cross-sectorial dimension of systemic risk associated with systemically important banks.

General results of the model, based on the data of December 2018, suggest that five banks are of overall systemic importance (figure 105).

Figure 105. Overall rate of systemic importance



Source: CBK (2019)

**Table 15. Indicators used to assess the systemic importance of banks in Kosovo<sup>49</sup>**

Criterion	Indicators
Size (Weight 25%)	Assets without provisions
Substitutability (Weight 25%)	Value of transactions to total transactions value ratio of the sector through payment system The share to total loans to households The share to total loans to nonfinancial corporations The share to total household deposits
Interconnectedness (Weight 25%)	The share to total loans to other financial corporations and placements in other banks (excluding parent banks) The share to total financial corporation deposits and other borrowings (including parent bank) The share in securities
Interstate activity and complexity (Weight 25%)	Claims on external sector Liabilities to external sector The share of off-balance items

Source: CBK (2019)

Three of these banks resulted to have systemic importance in all criteria. Results also show that one bank which has no general systemic importance has shown a systemic importance in interconnectedness criteria. The general scale of systemic importance ranged between 1,072 base points to 2,198 base points, which represents an increase compared to 2017. One of the banks which has consistently remained at the systemic significance limit has increased systemic points this year by exceeding the systemic limit as a result of the increase of general assets as well as exposures and liabilities with other financial institutions.

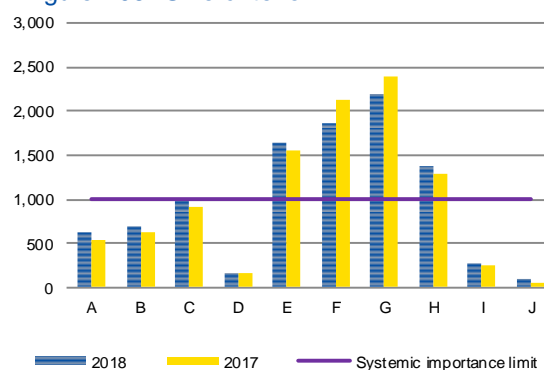
Meanwhile, the upper limit of systemic points has decreased as a result of increased competition from smaller banks which increased their share in total assets and sector loans, which has affected the drop in systemic points for larger banks.

*Criteria of size* – Five banks with general systemic importance, resulted to be with systemic importance in terms of the criterion of size (figure 106).

The scale of systemic importance in this criterion ranged from 1,016 base points to 2,190 base points. Two of the largest banks were characterized by a decline in systemic importance in this criterion compared to the previous year. While smaller banks have accelerated the growth of their activity, namely lending activity, by increasing share of

assets compared to the previous year, and thus have marked an increase in systemic points in this criterion.

**Figure 106. Size criterion**



Source: CBK (2019)

*Criterion of substitutability* – four banks with general systemic importance resulted to be with systemic importance in the criterion of substitutability.

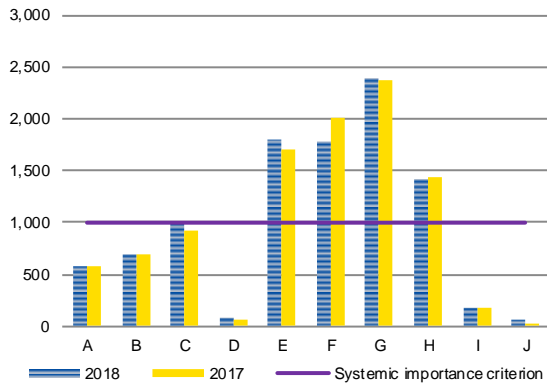
The scale of systemic importance in this criterion ranged from 1,420 base points to 2,398 base points (figure 107).

The majority of banks have seen an increase in systemic rates on this criterion. While two of the systemic banks have seen a decrease in points, one mainly driven by the fall in credit stock and household deposits, while the other bank due to the decline in the share as a result

<sup>49</sup> For the theoretic base and the complete methodology of assessing Banks with Systemic Importance, please refer to the CBK working paper no. 7 "Identification of Banks with Systemic Importance and Additional Capital in Kosovo".

of the slower increase in relation to smaller banks.

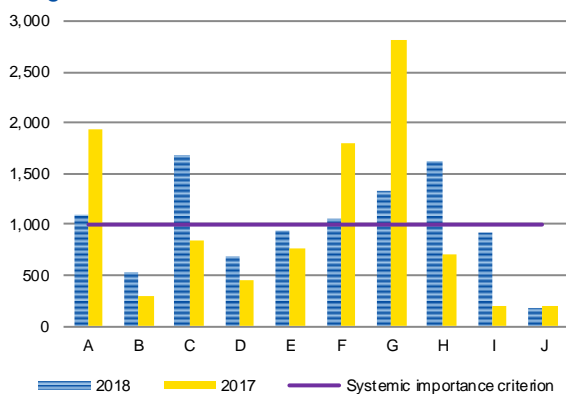
Figure 107. Substitutability criterion



Source: CBK (2019)

*Criterion of interconnectedness* – This criterion is characterized by the largest variations because banks can easily shift their balance to financial institutions as well as investment in securities. In December 2018, five banks resulted to be with systemic importance in the criterion of interconnectedness, compared to three in December 2017. The scale of systemic importance in this criterion ranged from 1,047 base points to 1,680 base points (figure 108). A bank which is not of general systemic importance continues to have systemic importance in the criterion of interconnectedness due to the higher share of liabilities to other financial institutions.

Figure 108. Interconnectedness criterion



Source: CBK (2019)

However, the scale of systemic significance has seen a decline in this criterion, implying that the balance of assets and liabilities with other

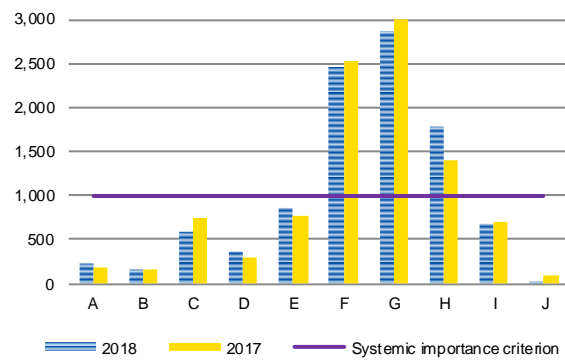
financial institutions, as well as investment in securities, have decreased in concentration by spreading more equitably among banks compared to the previous year.

*Criterion of inter-state activity and complexity* – Three out of five banks with overall systemic importance have resulted to be with systemic importance in the criterion of inter-state activity. The scale of systemic importance in this criterion ranged from 1,776 base points to 2,868 base point (figure 109).

Compared to the previous year, the rate of systematic importance has seen a decrease as a result of the fall in external sector demand from banks with the highest share in this category.

It shall be noted that the sector has proven over the years that it is well capitalized and the application of capital buffers for systemic importance to Tier 1 capital recommended by Basel and EBA would not exceed the current level of capital for the banking sector in Kosovo.

Figure 109. Interstate activity and complexity criterion



Source: CBK (2019)

Therefore, currently, the model serves only to monitor the dynamics of systemic importance and more informed and adequate supervision of institutions according to their systemic importance, and does not present a recommendation for the application of capital buffer to institutions of systemic local importance.



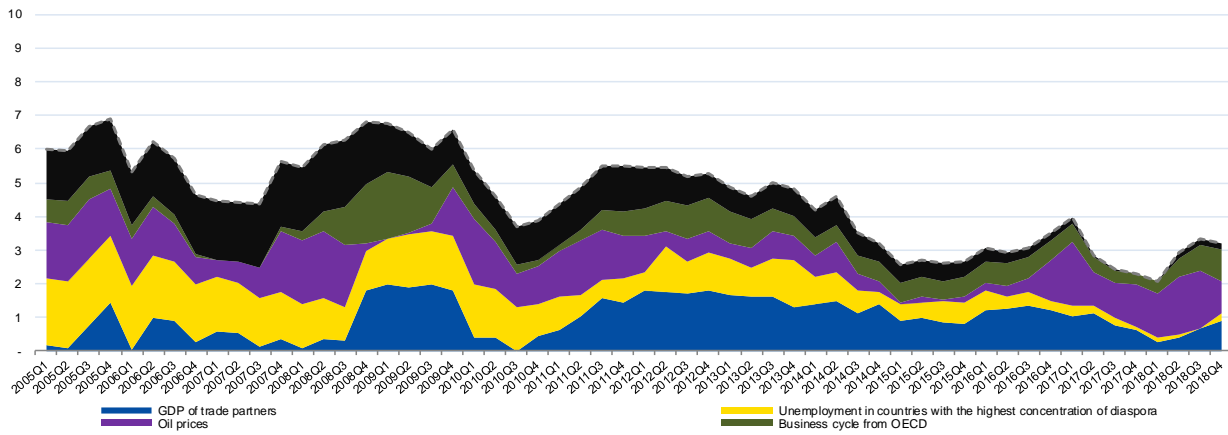


9. Statistical Appendix



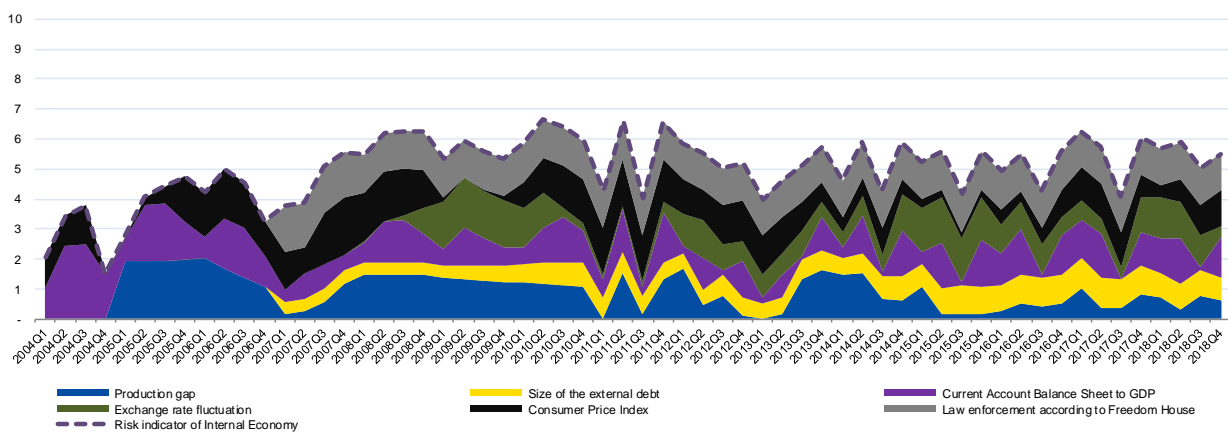
Appendix 1. Financial Stability Map - The dynamics of changing the risk of indicators and the contribution to risk from the relevant components

Figure 1. External economy



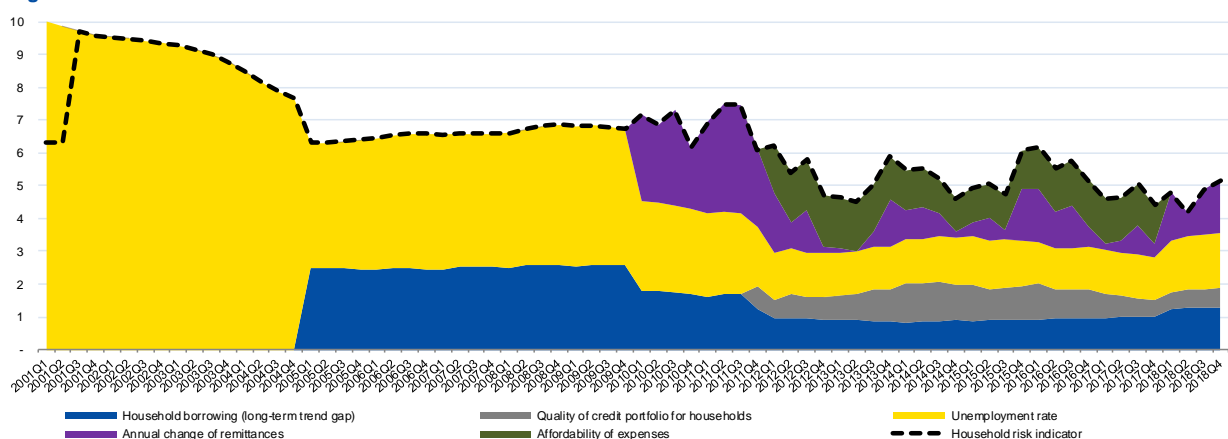
Source: CBK (2019)

Figure 2. Internal Economy



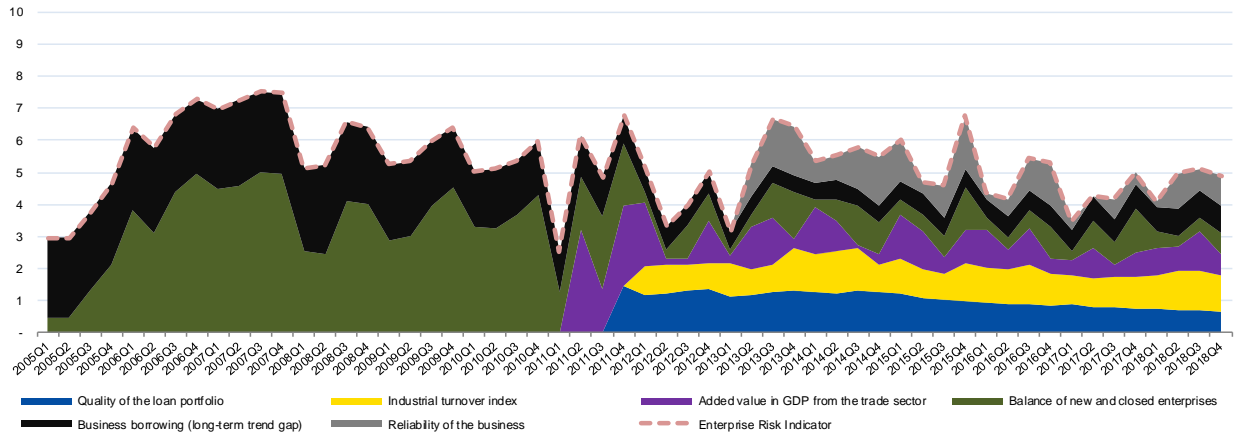
Source: CBK (2019)

Figure 3. Households



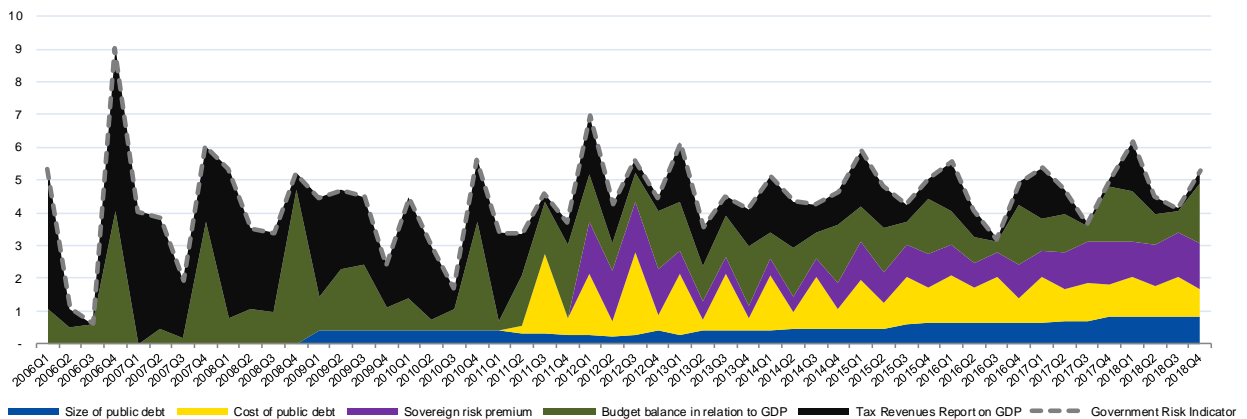
Source: CBK (2019)

Figure 4. Enterprise sector



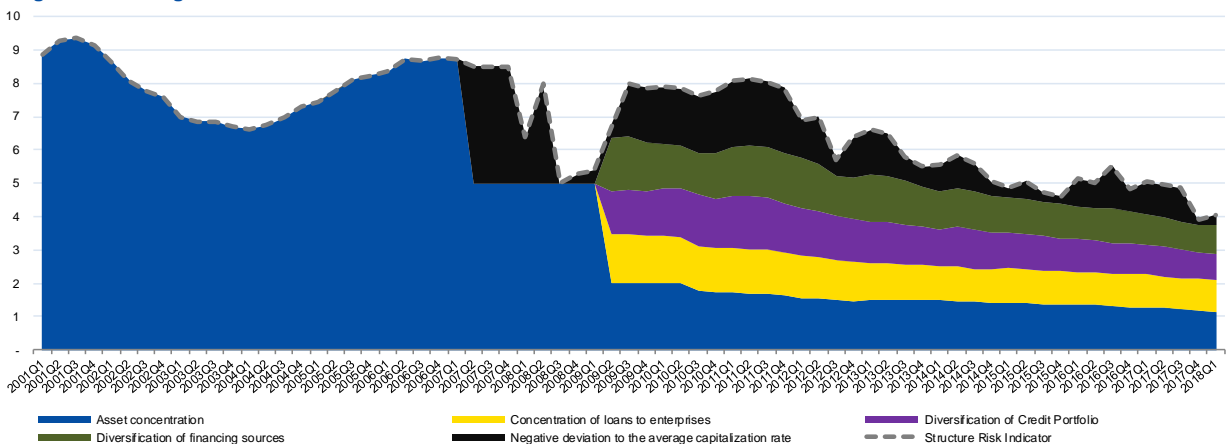
Source: CBK (2019)

Figure 5. Government sector



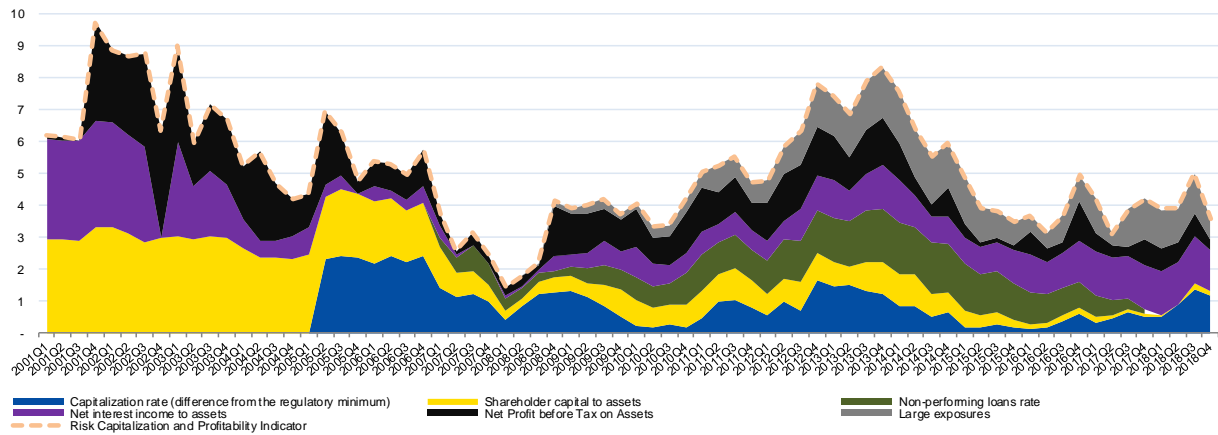
Source: BQK (2019)

Figure 6. Banking sector structure



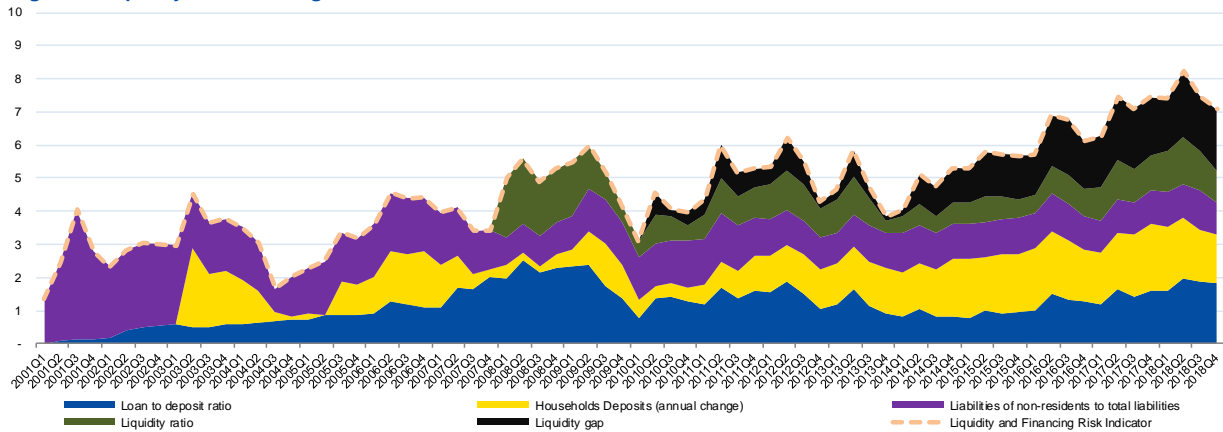
Source: CBK (2019)

Figure 7. Capitalization and profitability



Source: BQK (2019)

Figure 8. Liquidity and financing



Source: CBK (2019)

**Table 1. Financial soundness indicators, in percentage**

Banking sector	Core set	December 2015	December 2016	December 2017	December 2018
<b>Capital Adequacy</b>	Regulatory capital to risk-weighted assets	19.0	17.9	18.1	17.0
	Regulatory Tier I capital to risk-weighted assets	16.7	15.9	16.2	15.5
	Nonperforming loans net of provisions to capital	3.0	2.2	1.2	1.5
<b>Assets quality</b>	Nonperforming loans to total gross loans	6.2	4.9	3.1	2.7
Sectoral distribution of loans to total loans	<i>Other financial corporations</i>	0.4	0.4	0.2	0.2
	<i>Public nonfinancial corporations</i>	0.03	0.00	0.00	0.00
	<i>Other nonfinancial corporations</i>	65.6	63.9	63.6	63.4
	<i>Households</i>	33.9	35.7	36.2	36.3
	<i>NPISH</i>	0.01	0.02	0.01	0.01
	<i>Nonresidents</i>	0.02	0.02	0.02	0.01
	<i>Total</i>	100.0	100.0	100.0	100.0
	<b>Earnings and profitability</b>	Return on assets (ROA)*	2.5	2.4	2.8
Return on equity (ROE)*		21.6	19.9	22.1	18.3
Interest margin to gross income		75.8	68.1	65.1	78.4
Noninterest expenses to gross income		51.6	49.6	45.3	48.2
<b>Liquidity</b>	Liquid assets (core) to total assets	24.2	26.3	25.4	29.0
	Liquid assets (broad) to total assets	29.2	31.7	30.1	23.8
	Liquid assets (core) to short-term liabilities	30.9	34.5	32.2	32.2
	Liquid assets (broad) to short-term liabilities	37.3	41.5	38.2	40.0
<b>Sensitivity to market risk</b>	Net open position in foreign exchange to capital	1.8	4.4	1.2	3.8
<b>Encouraged set</b>					
	Capital to assets	12.2	12.1	12.6	12.2
	Large exposures to capital	63.5	66.9	81.7	65.9
	Personnel expenses to noninterest expenses	36.8	36.4	40.3	44.0
	Spread between reference lending and deposits rates	6.5	6.0	5.5	4.5
	Customer deposits to total (noninterbank) loans	130.3	125.8	119.5	122.8
	Foreign-currency-denominated liabilities to total liabilities	3.7	4.1	3.9	5.0

\*Net income before tax is considered.

Guide: Financial Soundness Indicators, Compilation Guide, IMF (2006)



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