



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

Financial Stability Report

Number 15



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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 Investment |
| 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 Savings 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 | Non-performing loans |
| ODC | Other Depository Corporations |
| POS | Point of Sales |
| pp | Percentage points |
| 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 |
| TPL | Third Party Liability |
| 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 15th 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.

The dynamics that characterized the global economy during the first half of 2019 were translated into increased risks to the economy and external financial markets, largely due to increased protectionism, geopolitical uncertainties, and Brexit-related uncertainties. These dynamics are expected to continue, thus signalling a risk to the economic activity and financial sector of Kosovo's main trading partners, with a potential negative impact on the country's economy and financial stability. Euro area economy, as Kosovo's main trading partner, and the region where the highest level of remittances are generated, suffered a setback in economic growth. Due to increased uncertainties reflected in the decreased credibility of businesses and individuals, expectations for the second half of the year suggest a slowdown of the economic activity. The Western Balkans are also estimated to have marked a slowdown in the growth of economic activity compared to the previous year, as a result of the reflection of global uncertainties and political uncertainties in many of these countries.

Kosovo's economy marked sustainable economic increase, despite the unfavourable dynamics in the economies of its major trading partners. However, the prospects for economic growth in the second half of 2019 but also in 2020 may be adversely affected by increased external risks, which may affect the reduction of external funding sources and consequently the decrease in domestic demand and export of goods. Even the internal risks, which are mainly related to the potential delays in the

consolidation of institutions, can lead to a lower level of realization of capital expenditures and consequently result in a decrease in the domestic demand.

The macroeconomic stability and a favourable financing environment have given rise to the growth of lending to the private sector during the first half of 2019. Continuous improvement of loan portfolio quality, increased competition, strategic focus on certain market segments by banks, and the longer experience in building customer relations were among other factors that continued to sustain fostering financial intermediation in the economy. In the reporting period, 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.

During the first half of 2019, the pension sector was characterized by accelerated growth, as a result of the high return on investment and sustainable income from contributors. While in the past the fund investment strategy was more focused on the foreign market, this year we have seen an increase in domestic market investment, mainly in Kosovo Government securities and time deposits in the banking sector.

The insurance sector was characterized by an increase in activity and a higher level of premiums collected, although the increase in the level of claims paid and operating expenses affected the sector to operate at a loss. In the first half of the year, the microfinance sector also marked an accelerated activity and high performance.

The Central Bank of the Republic of Kosovo continued its work on the operationalization of the Macroprudential Policy, which was adopted in 2016 with the aim of identifying, monitoring and evaluating systemic risk in order to maintain financial stability. In the first half of 2019, the overall developments of

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

In order to promote financial stability, the CBK has continued to work on supplementing and advancing the legal and regulatory framework of the financial system in general and the banking sector in particular, contributing to the alignment of the regulatory framework with international standards with the added function of maintaining financial stability.

Also, the financial industry has continued the trend of expansion and advancement of digital services, affecting the extension and use of financial services through digitalized electronic services.

Fehmi MEHMETI

Governor

2. Summary of main risks and developments of financial stability

Indicators of main risks to the banking sector have been characterized by different trends during the reporting period (table 1). Risk from the macroeconomic environment was characterized by a decrease and was assessed as a low-level risk, mainly as a result of positive developments in the domestic economic environment such as higher GDP growth, lower trade deficit and the decrease of the public debt stock. Also, the sector's sustainability risk has shown a decrease trend compared to the previous year, although it is estimated to be at a moderate level. With the exception of profitability (as a result of lower profit than in the previous year), almost all other sustainability sub-indicators such as banking sector structure, exposures to government debt and external sector (loans to non-residents), liquidity and financing have mitigated the risk that may threaten the

stability of the banking sector. Whereas, the private sector risk was assessed with a slightly higher grade, along with the risk from credit developments, which was assessed as slightly higher, due to the positive gap of the lending ratio of the banking sector to the gross domestic product.

Developments in the macroeconomic environment continued to be favourable in the first half of 2019, supporting the sustainability of Kosovo's financial sector.

However, this period has been characterized by an increase of uncertainties at a global level. The increased risks to the economy and external financial markets, mainly as a result of increased protectionism, geopolitical uncertainties and Brexit-related uncertainties, are expected to continue, thus increasing the risk to the economic activity and financial sector of Kosovo's main trading partners, with a potential negative impact also in the economy and financial stability in the country.

Table 1. Banking sector risks¹

| Risks | First half 2017 | Second half 2017 | First half 2018 | Second Half 2018 | First half 2019 | Risk trend |
|--|-----------------|------------------|-----------------|-----------------------|-----------------|------------|
| Macroeconomic risk | | | | | | |
| Financial position of the non-financial sector | | | | | | |
| Credit developments | | | | | | |
| Sustainability of the banking sector | | | | | | |
| | Negligible risk | Low risk | Medium risk | Over the average risk | High risk | |

Source: CBK (2019)

The euro area economy, as the main trading partner of Kosovo, and the region where are generated the highest level of remittances, slowed down the economic growth. Amid the growing 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. The Western Balkans are also estimated to

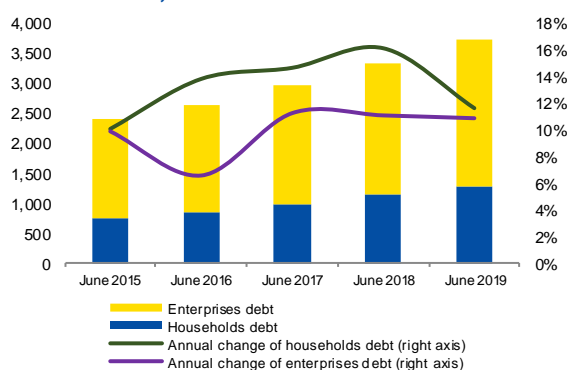
have slowed down the economic activity growth compared to the previous year, as a result of the reflection of global uncertainties and political uncertainties in many of these countries. Kosovo's economy marked sustained economic growth. However, growth prospects can be adversely affected by increased external as well as internal risks such as lower levels of

¹ The risk table generation methodology is based on the methodology of the Kosovo Financial Stability Map. This table includes sub-indicators such as: Lending-to-GDP gap, Increase of private-sector lending, Private sector lending to GDP ratio, as well as growth in specific sectors such as enterprises and households. In calculating the sustainability of the banking sector, in addition to the Financial Stability mapping indicators, 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 in foreign currency.

budget spending, especially capital investment.

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 an environment of favourable 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 sector's double-digit lending. Loans granted by the banking sector to enterprises grew by 10.7 per cent, but the growth trend of new loans slowed down to 2.4 per cent, compared to 8.4 per cent in June 2018.

Chart 1. Debt of enterprises and households, EUR million



Source: CBK (2019)

Loans granted to enterprises by other financial intermediaries increased by 15.8 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 20.6 per cent of total debt. Loans to enterprises granted by banks to GDP² ratio reached 26.2 per cent in June 2019 (compared to 25.2 per cent marked in the previous year).

Banking sector loans to households increased by 10.4 per cent, while loans granted by microfinance institutions increased by 27.9 per cent (reaching 13.1 per cent of the value of loans granted by banks). External debt of households increased by 7.1 per cent and reached 7.1 per cent of total debt. In June 2019,

total household debt increased by 11.7 per cent and as a percentage of GDP, it reached 18.0 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 42.1 and 44.8 per cent, respectively. However, the banking sector's risk from private sector, albeit low, has shown a growing trend compared to the same period of the previous year. The enterprise sector has been characterized by a slight decline in trade activity, while industrial production has increased. Business climate and business confidence indicators have increased in June 2019, suggesting more optimistic expectations about enterprises' economic activity. On the other hand, business performance, namely net number of active enterprises, in June 2019, has decreased. During the first half of the year, the decision to impose a 100% fee on products of Serbia as well as of Bosnia and Herzegovina has led to increased uncertainties for enterprises that are sensitive to imports from these countries, which may affect the increase of prices.

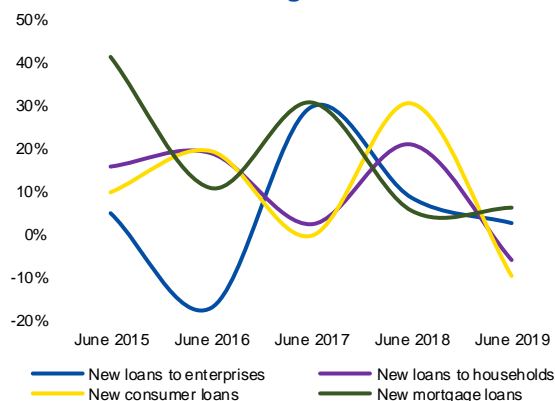
The risk to banks from the household sector has also shown a growing trend. Labour market conditions have improved, where, relatively, the unemployment rate has declined, although a concern in the dynamics of the country's labour market is also the gradual reduction of the workforce as a result of emigration and employment of Kosovars in EU countries through work permit visas.

Also, remittances slowed down the growing trend and may slow down further as a result of the lower prospects for economic growth 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 increase of indebtedness. In particular, the most vulnerable segment may be noncollateralised consumer loans and the consumer loans with longer maturity, which may present an eventual risk, especially in the event of materialization of increased political

² Based on the CBK estimates for the annual GDP 2019.

uncertainties or unfavourable macroeconomic conditions.

Chart 2. Annual change of new loans



Source: CBK (2019)

Banking sector performance and health indicators, even during the first half of 2019, remain at similar levels to the previous year, without any significant development.

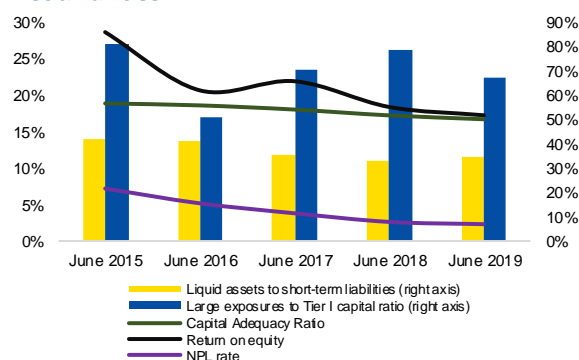
The banking sector's profit marked a marginal annual decline of 0.5 per cent, mainly driven by the increase in non-interest expenses. Sector profitability pressures are expected to increase, taking into account developments in interest rates that are expected to increase pressure on narrowing the interest 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 banks with lower deposit base 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 credit conditions through the extension of maturity, reduction of the average interest rate, increase of the amount approved and reduction of collateral requirements, so the potential continuation of this trend may pose a challenge to profitability level stability. This is because the increase in the cost of financing, influenced by competition pressures on withdrawal of deposits or the possible increase in the 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 foster the need for 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 writing off non-performing loans from banks' balances, as well as other economic and structural factors that have improved the repayment ability and debt collection capability. The ratio of non-performing loans to total banking sector loans dropped to 2.5 per cent from 2.8 per cent in June 2018. Growth in lending stock by 10.5 per cent yielded higher impact on the decline of the NPL ratio than the decline in the stock of non-performing loans by 1.6 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 a growth of non-performing loans stock, but which was not reflected in the NPL rate due to the higher growth rate of credit for this sector.

The sector's capital position continues to reflect high sustainability. The capital adequacy ratio was reduced to 16.8 per cent from 17.4 per cent.

Chart 3. Selected indicators of financial soundness



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, 88.4 per cent of which

is Tier 1 capital, which mainly results from high generated and retained profits. Generation of the capital from domestic sources, i.e. through generating a 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 10.0 per cent, mainly as a result of increased household deposits. At sector level, deposits surpass loans by 116.5 per cent. The faster annual growth of deposits against credit growth until June 2019, led to a decrease in deposits to loans ratio by 0.4 percentage points. Liquid assets marked an increase, which was also reflected in the increase of their ratio to short-term liabilities at 35.1 per cent, which is considered to be well above the regulatory minimum of 25 per cent. The liquidity reserve balance of commercial banks with the CBK continues to exceed the required reserve by 49.8 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 mismatches between assets and liabilities. The steady increase in the share of transferable deposits and the expansion of gap for the short term increases the sector's exposure to financing risk in case of sudden withdrawal of deposits or their movement among the banks. Such a situation could also pose a challenge to managing bank's liquidity, despite the current high level of liquid assets. This is due to the nondeveloped 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 advancements in the field of finances, among others, have made the sector more sensitive to possible cyber attacks and errors in systems, thus increasing the exposure to operational risk. Requirements for allocating capital for operational risk have increased, and thus 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 exposure to operational risk, the management of this risk as of June 2019 was adequate by isolating its consequences.

The pension sector was characterized by accelerated growth, as a result of high return on investment and stable income from contributors. The positive financial performance of assets invested abroad came as a result of the positive performance in the international financial markets, marking positive quotas despite a strong shock in May this year. New collections from contributors have continued to mark solid growth. While as regards the funds investment strategy, which in the past was more focused on the foreign market, in this period there is an increase of investments in the domestic market, namely in Government securities and time deposits in the banking sector.

The insurance sector, during the first half of 2019, was characterized by increased activity and a higher level of premiums collected. Nevertheless, the increase in the level of paid claims and operating expenses affected the sector to operate at a loss. Insurance sector assets have a low share of 2.8 percent in total financial system assets. The sector continues to be concentrated mainly on non-life insurance, i.e. compulsory third party liability. The penetration rate of 0.7 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 to mark high growth, mainly driven by the increase in lending and leasing activity, which is mainly financed by external sector borrowings. Despite its rapid growth, its weight at the level of financial intermediation remains low, at 4.3 per cent of total assets of financial system. Lending marked an annual growth of 23.7 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 (MFIs and NBFIs) and the products they provide. This sector continues to have good financial performance, which has been expressed in the last five years. Although compared to the previous period, the profit level was lower as a result of the higher increase of expenses (expenses for provisions for possible loan losses and personnel expenses) compared to the increase of revenues. ***The legal and regulatory framework and the financial infrastructure continued with a progress in view of developing the financial sector and maintaining financial stability.*** During 2018 and the first half of this year, 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. During this year, the Regulation on the Repurchase of Government Securities with the Central Bank of the Republic of Kosovo was approved, authorizing the CBK to conduct credit operations with commercial banks operating in Kosovo through lending backed by government securities as collateral.

The financial infrastructure has continued its technological enhancement and advancement, increasing its reach and use, with a particular emphasis on electronic and automated services.

Box 1. Financial Stability Map

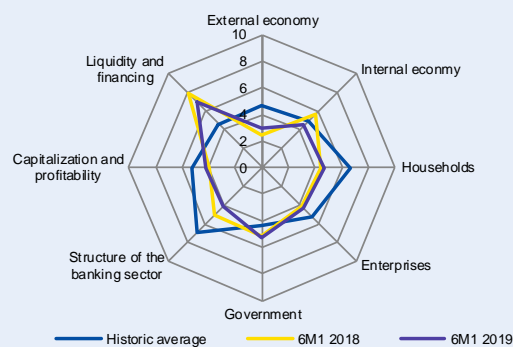
Financial Stability Map³ presents the developments in main indicators of risks to the stability of the banking sector (chart 4). The first half of 2019, on average, was characterized by a decrease of risk to the financial stability from the macroeconomic environment, but with a trend of a risk increase from the external economy. The risk from the activity of economic agents such as enterprises, households, and governmental sector has increased slightly, but with a decrease tendency in the second quarter of this year, excluding the sector of household that marked an increase of risk in Q2. Internal sustainability indicators of the sector reflected changing developments. Capitalization and profitability of the sector has been characterized by a slight increase of the risk scale, but with an increase trend in Q2 2019. Whereas the risk from banking sector structure has marked a decrease in the first two quarters, showing a more significant decrease tendency in the second quarter. The liquidity and financing position has moderated the risk, but this tendency came to an end in the second quarter compared to the same period of the previous year. Finally, most of the indicators stand below or near the historic average risk level, excluding the government and liquidity and financing indicators.⁴

The decrease in unemployment in countries with the highest concentration from where remittances are received, along with the decrease in oil prices, have contributed positively to the risk scale decline in the external macroeconomic environment. Whereas, developments in all other external economic indicators such as the slower economic growth of Kosovo's trading partners for the period until June 2019, prospects for economic activity in Europe according to the Organization for Economic Cooperation and Development in Europe, as well as key interest rates were unfavourable and contributed to the increase in risk for the first half of the year, thus neutralizing the positive effect of decrease in unemployment and oil prices. However, the second quarter has been characterized by a decrease trend of risk to financial stability from the external economy, driven by the decrease in unemployment, decrease in oil prices and reduction of key interest rates.

Domestic economy indicators, excluding the inflation indicator, were characterized by positive developments in the context of financial stability

that neutralized the effect of the increase of risk by inflation pressures, positively affecting the overall domestic economy risk scale. Kosovo's economy marked a growth acceleration and positive production gap in June 2019, positively affecting the risk grade.

Chart 4. Financial stability map



Source: CBK (2019)

Also, the trade deficit was narrowed, reflecting in a lower negative ratio of the current account balance to GDP, which together with the increase of the average of the real effective rate of euro exchange in the first two quarters of the year and the decrease in the external debt to GDP ratio (as a result of lower debt stock and higher GDP growth) contributed to the decline in the risk scale. On the other hand, inflationary pressures contributed to the increased risk, which was on average higher in June 2019 than in the previous year, and with an increase tendency influenced by the imposition of fee on goods imported from Serbia and Bosnia and Herzegovina.

Household and enterprise sectors were characterized by increased risk. Lending to 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.

The household loan portfolio quality indicator, which was marginally lower in the first two quarters of this year compared to the previous year, together with the remittance trend indicator, contributed to the increase of risk to the household sector, which represent an important source of the sector's revenues, which was also characterized by a decline as a result of the lower annual growth rate of remittances.

³ 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 grade 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.

⁴ Progress of risk from indicators of Financial Stability Map and contribution of integral components at the relevant risk level is presented in Annex 1.

On the other hand, lending to households continued its increasing trend, but as GDP growth was higher than lending, the lending gap to GDP for this sector expanded at a negative level, which was also reflected with a slight decrease in risk scale. Another positive development for the household sector was the lower average unemployment rate during the first half of 2019, with a decrease trend in the second quarter of this year. Within the enterprise sector, the components that marked improvement were the credit portfolio quality, the index of industrial turnover and the confidence of businesses. However, the positive effects of these components were defeated by the added value indicator of the trade sector in GDP and the net balance of businesses registered and closed during this period, which showed a decline reflecting slowed-down activity compared to the previous year and consequently, in addition to the enterprise borrowing trend, led to a slight increase of risk to the financial stability coming from the enterprise sector.

Risk from government sector also 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 and debt cost, as well as the ratio of tax income to GDP, which marked a marginal increase of risk, reflected by the slower increase of tax income in the second quarter of this year, as compared to the same period of the previous year. On the other hand, the only component with a positive impact was the increase in the ratio of negative budget balance to GDP during the first half of this year. However, this indicator had an increase tendency of risk in the second quarter of this year. The banking structure indicator has been characterised by a decrease in the risk scale as a result of positive developments in all constituent components, excluding the diversification of the overall portfolio of bank financing sources which resulted in narrowing compared to the previous year. The most significant improvement is recorded in the component of negative deviation to 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, decrease of concentration of enterprise credit portfolio, higher diversification of overall credit portfolio.

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, thus narrowing the gap to the minimum regulatory rate. The report of net interest income to sector's 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. Similarly, sector profit before tax has increased during this period at a slower rate than the assets, as well as slower increase of share capital resulted in the decrease of the ratio to sector's assets, which consequently contributed negatively to the risk scale. Components with a positive effect on the capitalization indicator were the decline in large exposures to Tier 1 capital, along with the continuous improvement of the credit portfolio. All components of the sector liquidity and financing indicator, except for the loan to deposit ratio, had a mitigating effect on the financial stability risk.

Accelerated lending increase in relation to deposit increase has contributed to the increase of the loan to deposit ratio, which is reflected with 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 3 to 6 months liquidity gap between assets and liabilities. However, the gap deepening was slower than in the previous year, and as a result of more rapid asset growth, the gap to asset ratio was lower, thus giving a lower risk scale. The liquidity ratio was also higher, contributing to the decrease of the risk. Another component with a mitigating effect on the risk indicator was the higher annual deposit growth compared to the previous year, which is a positive development in the context of the sustainability of funding sources, along with the decline in liabilities to the external sector.

It should be noted that the level of liquidity and financing risk was higher than the historical average, but this largely reflects the nature of the components included in the indicator such as the growth rate of household deposits which has been fluctuating over the years, being higher at the beginning of the sector's operation and naturally beginning to decline as a result of the sector's development and then in recent periods again increasing, as well as the loans to deposits ratio which also followed a naturally increasing trend since the beginning of operation of the sector and which have contributed to expansion of the liquidity gap over the years.

3. The external environment and developments in the domestic economy

The external economic environment has been characterized by an increase of uncertainties in the first half of 2019. Increased protectionism, increased geopolitical uncertainties, and uncertainty over Brexit have led to slower economic activity in the euro area. These

unfavourable developments have also been transmitted to the economies of the Western Balkan countries, which have been characterized with slower growth, with the exception of Kosovo and North Macedonia which have marked an accelerated economic growth.

Table 2. Selected macroeconomic indicators of Kosovo's main trading partners

| Description | Real GDP | | | Unemployment rate | | | Inflation | | |
|-----------------|----------|----------|----------|-------------------|----------|----------|-----------|----------|----------|
| | 6M1-2017 | 6M1-2018 | 6M1-2019 | 6M1-2017 | 6M1-2018 | 6M1-2019 | 6M1-2017 | 6M1-2018 | 6M1-2019 |
| Euro area | 2.4 | 2.4 | 1.3 | 9.5 | 8.6 | 7.8 | 1.6 | 1.5 | 1.4 |
| Germany | 2.3 | 2.2 | 0.7 | 4.0 | 3.6 | 3.3 | 1.7 | 1.7 | 1.6 |
| France | 1.9 | 2.2 | 1.4 | 9.6 | 9.2 | 8.6 | 1.3 | 1.8 | 1.4 |
| Italy | 1.8 | 1.2 | 0.1 | 11.5 | 11.2 | 10.5 | 1.5 | 0.9 | 1.0 |
| Kosovo | 3.6 | 3.6 | 4.2 | 30.6 | 28.0 | 26.1 | 1.7 | 0.3 | 3.2 |
| Montenegro | 4.4 | 4.7 | 3.1 | 16.3 | 15.3 | 14.7 | 2.5 | 3.7 | 0.5 |
| North Macedonia | -0.6 | 2.0 | 3.6 | 22.8 | 21.4 | 17.7 | 0.9 | 1.2 | 1.2 |
| Serbia | 1.8 | 4.9 | 2.8 | 13.2 | 13.4 | 11.2 | 3.4 | 1.7 | 2.4 |
| Albania | 4.1 | 4.3 | 2.4 | 14.4 | 12.9 | 12.3 | 3.7 | 1.7 | 1.7 |

Source: Eurostat for Euro area countries and Statistical Agencies for countries in the region, 2019.

Closure of quantitative easing program⁵ within the framework of the monetary expansionary policy pursued by the ECB, as well as the escalation of trade tensions have had negative effects on the confidence of businesses and individuals in the Euro area, affecting an economic activity growth of only 1.3 per cent (2.4 per cent in the same period in 2018) (table 2). **Weaker dynamics of economic activity in the Euro area are also reflected in the Western Balkan countries.** Economic activity in these countries was characterized by an average growth of 3.2 per cent, which is a slowdown compared to the rate of 3.9 per cent recorded in the first half of 2018. The weakening of external demand has negatively affected the region's exports and external sources of financing. Also, the increased political uncertainties in the Western Balkan countries could be reflected in a further decline in

investor and consumer confidence, thus directly affecting real growth and economic development.

Unlike the euro area and the Western Balkans, **Kosovo's economy is characterized by accelerating economic activity growth in the first half of 2019.** In the second half of 2019, estimates for the increase of external risks could be reflected in the slowdown of economic activity, mainly through increased trade deficit and reduced external sources of financing.

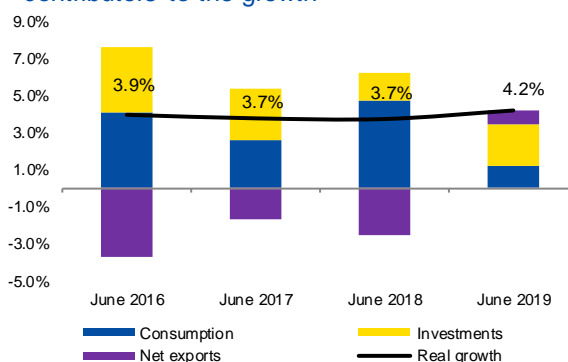
⁵ The quantitative easing program is an unconventional (non-standard) instrument of expansionary monetary policy measures. The European Central Bank has launched a quantitative easing program in March 2015 through the acquisition of assets (debt instruments and other financial

instruments) in the market with the primary aim of stimulating economic growth through enhancing the monetary base in the market (to be realized), by increasing lending by lowering interest rates) and thereby reaching an inflation rate close to the ECB target of 2%.

3.1. Domestic economy

The increased uncertainties in the external environment during the first half of 2019 did not affect the dynamics of the domestic economy, as real GDP growth is estimated to have marked an accelerated growth compared to the previous year. The acceleration of economic growth came as a result of the positive contribution of net exports and investments, which affected the annual growth of 4.2 per cent in the first half of 2019 (chart 5).

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



Source: KAS and CBK calculations (2019)

Quarterly official data released by KAS suggested accelerated growth in investment value by 7.5 per cent, driven mainly by increased financial intermediation in the country as well as foreign direct investment. Consumption was characterized by a slowdown of 1.1 per cent, as in the first half of 2019 consumer finance sources such as remittances, employees compensation and public sector wage spending were characterized by slower growth. On the other hand, despite weakening external demand and lower metal prices in international markets, exports of Kosovo goods have marked an accelerated growth, while imports of goods have been characterized by slower growth. This has led to net exports marking a lower trade deficit of about 3.9 per cent compared to the same period in 2018.

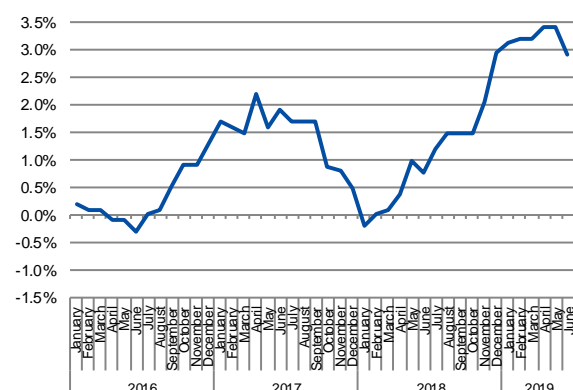
For 2019, the CBK estimates suggest real GDP growth of 3.9 per cent, while in 2020 economic growth is expected to be around 4.1 per cent. This increase is expected to be generated by investments and consumption by 2.7 percentage points, while net exports are

expected to contribute negatively by 1.3 percentage points (0.2 percentage points negative contribution in 2019).

This level of economic growth could be adversely affected by external risks, such as the slowdown in growth in the euro area and the not-so-optimistic prospects for the Western Balkans as well as the decline in metal prices, which may affect the reduction of external funding sources and consequently in the decline of domestic demand and export of goods. In addition to external risks, internal risks are on the rise, especially fiscal risks. The low level of realization of budget expenditures, especially of capital expenditures, pose a risk of reducing aggregate demand in the country.

Despite the decline in prices of main goods in international markets, prices in Kosovo have increased. This price increase has begun since the last quarter of 2018 and has continued throughout the first half of 2019. The rise in prices in the country has been attributed to some extent to the 100 per cent fee on goods imported from Serbia and Bosnia and Herzegovina, especially the price increase in food prices. By June 2019, the average annual inflation rate expressed through the consumer price index (CPI) reached 3.2 per cent (0.3 per cent in the same period in 2018) (chart 6).

Chart 6. Inflation rate, annual change



Source: KAS (2019)

For 2019, CBK estimates suggest that the average inflation rate is expected to be around 2.3 per cent. In line with the CBK forecasts are the expectations of commercial banks in the

country⁶, which suggest that the inflation rate in 2019 will be 2.6 per cent.

In the first half of 2019, the dynamics that characterized the fiscal sector resulted in higher growth of budget revenues (7.7 per cent) versus budget expenditures (2.9 per cent). The high increase in budget revenues compared to expenditures has resulted in the budget being almost balanced, with only EUR 0.3 million of surplus (EUR 37.1 million was the deficit in the same period of 2018). Public debt, which amounted to EUR 1.13 billion, was also characterized by an increase of 9.3 per cent. **As a percentage of GDP, public debt, in June 2019, reached 16.5 per cent from 16.3 per cent, as it was in June 2018.** The increase of public debt is attributed to the increase of domestic debt of 17.1 per cent (reaching EUR 722.0 million), while external public debt decreased by 2.1 per cent to EUR 409.4 million.

The country's economy continues to face imbalances in the external sector. However, in the first half of 2019 this imbalance has improved as the current account deficit reached euro 288.1 million, which is 17.1 per cent lower compared to the same period in 2018. **In relation to GDP, the current account deficit dropped to 8.9 per cent from 11.3 per cent in the first half of 2018.** This reduction in the current account deficit is attributed to the increase in positive balances of services, secondary income and primary income, while the deficit in goods has marked a slower increase.

The increase in export of goods and the slower growth of imports has caused the deficit in the trade of goods to increase by only 3.9 per cent (12.9 per cent growth in the same period of 2018) and reach EUR 1.4 billion. In relation to GDP, the trade deficit of goods has dropped to 44.0 per cent from 44.8 per cent in June 2018.

The export value of goods was EUR 178.1 million, coinciding with a 5.5 per cent annual increase (5.8 per cent decline in the same period of 2018)⁷. On the other hand, the import of goods was characterized by a slowdown, which reached EUR 1.6 billion or 4.0 per cent more compared to the previous year (10.5 per cent increase in the same period of 2018).

The balance in the trade of services amounted to EUR 293.8 million, an increase of 17.1 per cent compared to the same period in 2018. This higher level of the services balance is attributed to an increase in services export of 12.2 per cent, while services imports recorded a slow growth of 7.6 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 employees⁸, being the main category of primary income, marked an increase of 10.4 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 405.6 million in the first half of 2019 and marked an annual increase of 5.5 per cent.

In the first half of 2019, FDI received in Kosovo marked an annual growth of 19.3 per cent and amounted to euro 110.8 million. FDI's growth was mainly recorded in the construction sector, while real estate investment, renting and business activities, which account for about 92 per cent of total FDI, reached a level of EUR 102.0 million which is almost similar to the same period of 2018.

⁶ Banks' expectations on price dynamics in Kosovo are received on a quarterly basis, in the framework of a survey conducted by the Central Bank of the Republic of Kosovo with 9 commercial banks operating in Kosovo (Bank Lending Dynamics and Inflation Expectations). Banks report their expectations on inflation dynamics on a quarterly basis and for the whole year.

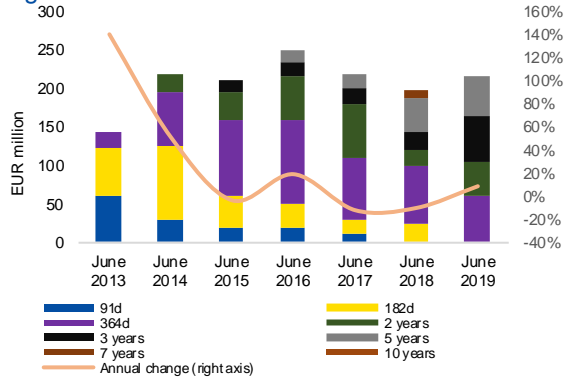
⁷ The source of data on export and import of goods in Kosovo is the Kosovo Agency of Statistics.

⁸ Employees 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.

3.1.1 Securities market

The internal securities market continues to be the main source for public debt financing. By June 2019, domestic debt stock amounted to EUR 722 million, accounting for about 63.8 per cent of total public debt.

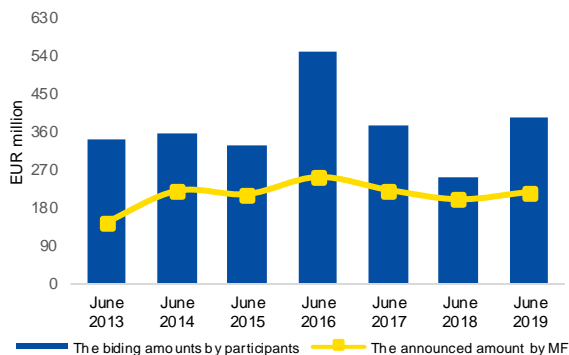
Chart 7. Value of issued debt, annual growth



Source: CBK and Ministry of Finance (2019)

During the first half of 2019, the Government of Kosovo issued debt of EUR 215.0 million, which is 8.7 per cent higher than in the same period of the last year, thus putting an end to the downward trend of the past two years. (chart 7). Historically, the demand to invest in securities has exceeded the amount offered by the Government of Kosovo. Similarly, it continued even during the first half of 2019, where the demand to invest in these instruments was 1.83 times higher than the primary market offer of securities (1.17 as of June 2018) (chart 8).

Chart 8. Amount demanded and average rate of Kosovo's Government Securities



Source: CBK and Ministry of Finance (2019)

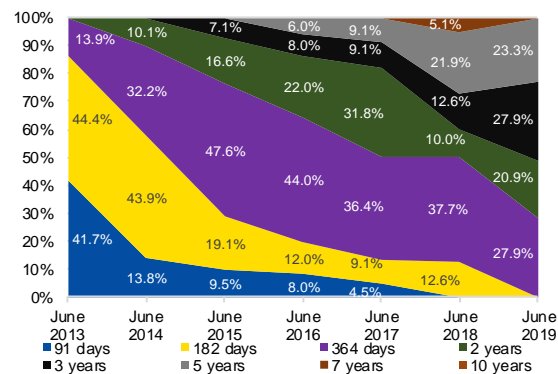
The average maturity of the securities continued to expand, reflecting the increased interest for long-term debt. The

securities structure in the first half of 2019 has been dominated by government bonds.

Treasury bills (with a maximum maturity of up to 1 year), which in the past dominated the securities structure, reduced their share in the first half of 2019 to 27.9 percent (50.3 percent as of June 2018) of total securities, the rest comprising of government bonds.

Government bonds with a maturity term of '3 years' marked the highest annual growth (by EUR 35 million), and dominated the structure of total securities (chart 9).

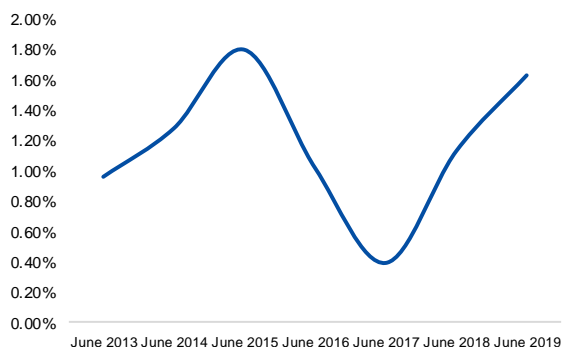
Chart 9. Share in securities, by maturity



Source: CBK and Ministry of Finance (2019)

The average interest rate on securities of the Government of Kosovo marked an increase (chart 10). This increase was also reflected in specific categories of securities. Within bonds, the highest interest rate increase (of 96 basis points) to 2.76 percent was recorded for 5-year bonds. Whereas, treasury bills with a maturity of '364 days' recorded the lowest increase of 17 basis points to 0.54 percent. The overall increase in interest rates may also be a result of the encouragement to invest in Kosovo Government securities by financial institutions in the country, which continue to have satisfactory financial performance in their primary areas of activity (especially banks and pension funds).

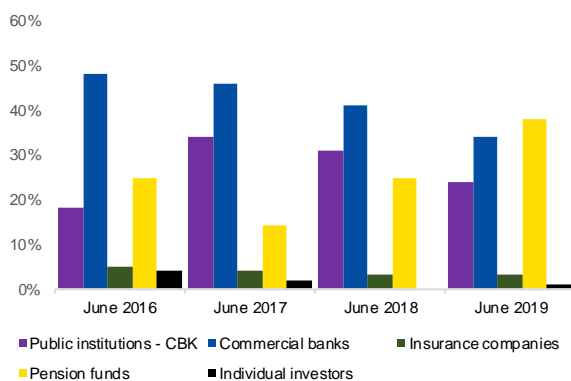
Chart 10. Average interest rate on Kosovo's Government securities, by maturity



Source: CBK and Ministry of Finance (2019)

For the first time, the primary holders in securities auctions are pension funds, while in the past it was dominated by commercial banks. (chart 11).

Chart 11. Holders of securities



Source: CBK and Ministry of Finance (2019)

Commercial banks have reduced their exposure to Kosovo Government securities (from 6.5 percent of total banking sector assets in June 2018, exposure decreased to 5.7 percent in June 2019). While pension funds have significantly increased investments in Kosovo Government securities, increasing the level of exposure (from 9.0 per cent share in total pension fund assets in June 2018 to 14.2 percent in June 2019).

Increased share in securities investments of pension funds may be the result of their strategy to diversify investments. On the other hand, the decrease of commercial banks share in securities investments may be a result of banks' orientation towards lending activity, given the high profitability in the presence of high quality credit portfolio.

Activity of trading with securities in the secondary market has increased during this period.

The number of transactions executed from January to June 2019 has increased to 49, from 23 as of June last year. Whereas, the volume of trading in the secondary market was 78.1 percent higher compared to the previous period, reaching EUR 66.5 million by June 2019. Developments in the primary securities market were also reflected in the secondary market. About 87.8 per cent (60.9 per cent January-June 2018) of the number of transactions and 97.2 percent (69.3 percent January- June 2018) of the volume of transactions in the secondary market were government bonds, the remainder being treasury bills. The Central Bank of the Republic of Kosovo has started investing in government securities through the secondary market since the end of 2015, and is now one of the key actors in the secondary securities market. As of June, the CBK accounted for 23.7 per cent of total government debt in the form of securities. The secondary market has continued to advance in terms of how transactions are executed. One of the instruments applied for short-term interbank lending in the secondary market is repurchase agreement (REPO). In December 2018, the first transactions for short-term liquidity needs between commercial banks were realized through government securities repurchase agreements. While this year, the Regulation on the Repurchase of Securities with the Central Bank of the Republic of Kosovo was approved, authorizing the CBK to conduct short-term credit operations with commercial banks operating in Kosovo (box 2).

Box 2. Regulation on the Repurchase of Securities with the Central Bank of the Republic of Kosovo

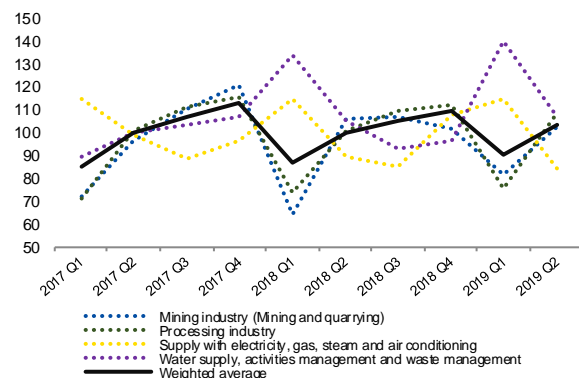
In the framework of trading in the secondary market of securities, in December 2018, for the first time, interbank transactions called repurchase agreements were executed where the collateral is based on the Securities of the Government of Kosovo. The Board of the Central Bank of the Republic of Kosovo on April 25, 2019 approved the Regulation on the Repurchase of Securities with the Central Bank of the Republic of Kosovo, which authorizes the CBK to conduct credit operations with commercial banks in the country performing the role of lender based on securities as collateral. This regulation will provide banks with an alternative for managing short-term liquidity and financing. In addition to the conditions set out in the regulation, which must be met for the submission of a borrowing request from banks, the CBK is authorized to determine the repo rate which will be calculated based on the base rate, which is the refinancing rate of the European Central Bank, plus the difference adjustment rate set by the CBK. Repurchase agreements market (REPO) plays a very important role in facilitating the liquidity circulation in the financial system. At the same time for many central banks the repurchase agreement is an instrument for monetary policy implementation through which banks are provided with safer financing. Regular operation of this instrument supports liquidity in the market, providing efficient capital allocation to the economy and reducing financing costs. However, over-use of this instrument may have consequences for financial stability given the effects that its use may cause, such as excessive debt growth and the creation of actors' dependence on short-term financing.

3.2. Financial position of enterprises

Developments in economic and financial indicators of enterprises suggest an increase 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 an increase of 4.0 per cent compared to the

first half of 2018. The growth in this index was higher in the extractive industry (8.3 per cent), which is also noted by the increase of 3.1 per cent of value added in this sector. In the processing industry and water supply, the increase in the index was lower (5.3 respectively 3.3 per cent) while a 2.4 per cent decrease was marked in electricity and gas supply (chart 12).

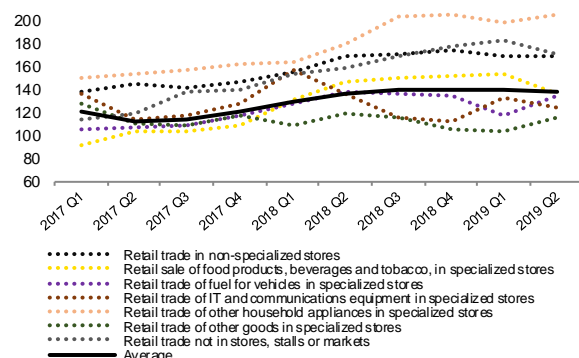
Chart 12. Industrial turnover index (2017=100)



Source: ASK (2019)

Average turnover index in retail trade recorded an average increase of 4.4 per cent by June 2019 (chart 13), which was also noted by the 6.1 per cent increase in value added in the sector. **Business climate and confidence indicators have changed the downward trend that characterized them in 2018 and marked an increase in the first half of 2019.**⁹

Chart 13. Retail trade turnover index (2013=100)



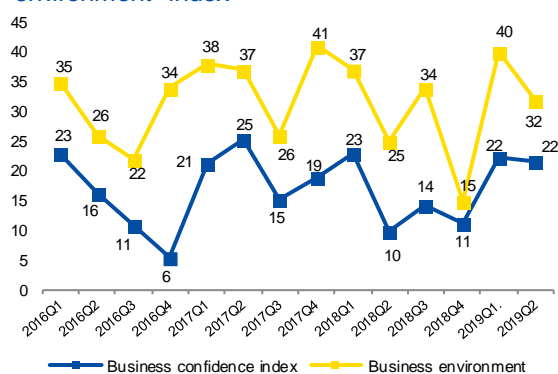
Source: KAS (2019)

businesses in four sectors of the economy: manufacturing, construction, services and trade.

⁹ 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

The business climate indicator, which assesses the current economic situation (profitability) of business and expectations for the next six-month period, was higher by an average of 5.0 percentage points, while the business confidence indicator, which has a more general assessment character unlike the previous indicator, which focuses only on the financial performance of the business, was higher by 5.4 percentage points on average (chart 14).

Chart 14. Business confidence and environment index



Source: KEC (2019)

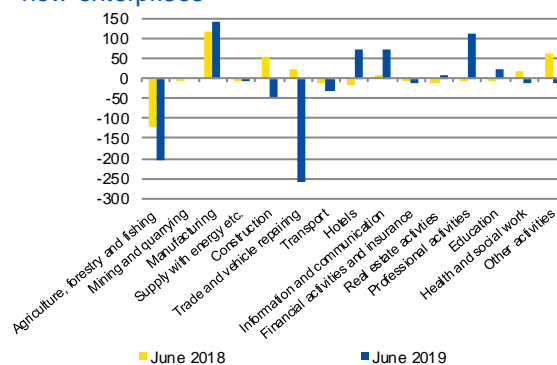
Despite the increase in business climate and business confidence indicators, the entrepreneurial initiative has decreased. As of June 2019, 5,059 new enterprises were registered, which represents an annual decrease of 2.6 per cent. The sectors that recorded the highest annual decrease in the number of registered businesses were trade, agriculture, construction, etc., while in the sector of production and professional activities the number of newly registered enterprises was significantly higher (chart 15).

On the other hand, 888 enterprises were closed during this period, which is almost the same level as in the same period of 2018.

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 dealing with bank account sequestration and the accelerated procedure of selling collateral have

had a positive impact on the credit offer and have caused the easing of collateral requirements and reduction of interest rates.

Chart 15. Annual change in the number of new enterprises

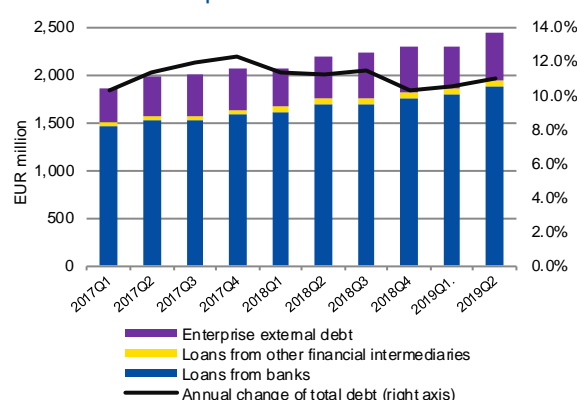


Source: KAS (2019)

However, numerous obstacles remain, that hinder business performance and access to finance. High level of informality, poor implementation of contracts, lack of cadastral data, along with the lack of financial transparency and weak financial quality reporting continue to be an obstacle for enterprises to access financing. **The debt of enterprises to domestic and foreign financial institutions has continued to increase.**

Domestic debt, namely debt to the banking sector in the country, increased by 10.8 per cent in June 2019.

Chart 16. Enterprises debt



Source: CBK (2019)

Enterprise loans issued by other financial intermediaries marked an increase of 15.7 per cent, albeit still remaining at low weight in total corporate debt with around 2.7 per cent. External debt of enterprises continued to grow

and reached 20.6 per cent of total debt. In June 2019, total corporate debt marked an annual growth of 11.0 per cent and reached 34.1 per cent of the GDP (figure 16).

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. Loans from banks issued to enterprise to GDP ratio reached 26.2 per cent in June 2019 (compared to 25.2 per cent in the previous year). This implies that lending has grown at a faster rate than GDP affecting the credit gap to GDP to be positive.¹⁰

As a result of the higher credit growth, even the net debt position of enterprises towards the banking sector marked a decrease. Enterprise deposits marked an accelerated annual growth of (16.8 per cent) while the growth rate of lending to the enterprise sector was slower (10.6 per cent) and this led enterprises to reduce their debt position to the banking sector by 2.1 per cent. In terms of currency, 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 2.4 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 2.4 per cent (8.4 per cent in the same period of the year 2018). According to the purpose, new investment loans marked a decrease of 2.3 per cent and reduced their share in the structure from 63.0 per cent to 60.0 per cent of total new enterprise loans, by June 2019. New noninvestment loans marked a lower increase rate of 11.6 per cent and increased their share in the structure from 35.2 per cent to 38.3 per cent of total new loans to enterprises by June

2019. In terms of maturity, the first half of 2019 was characterized by the growth trend of loans with longer maturity, where 32.9 per cent of new loans issued had a maturity of 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 36.8 per cent to total new loans to enterprises.

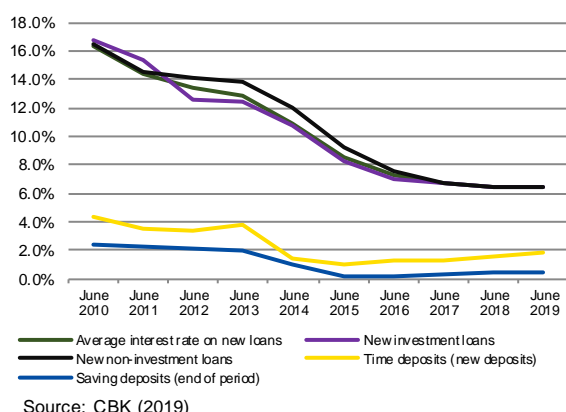
The borrowing of small and medium enterprises in the first half of 2019 was also supported by the Kosovo Credit Guarantee Fund (KCGF), whose use has marked a continuous growth trend. KCGF, which aims at increasing the access to finance for SMEs by guaranteeing the credit portfolio of financial institutions, began to guarantee the first loans for SMEs in September 2016. In June 2019, the number of bank loans guaranteed by KCGF was 3,004 while the approved amount of guarantees amounted to EUR 54.6 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 8 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 remained almost the same compared to the previous year. As of June 2019, banking sector average interest rate for new loans to enterprises was 6.5 per cent, the same level as in the first half of 2018 and at a half level lower than in 2013 (chart17). This decline of interest rates resulted from the continuous competitive pressures, the improvement of the loan portfolio quality, the progress in structural

¹⁰ Lending gap calculated by Hodrick-Prescott filter.

reforms for reducing risks in collateral implementation and good access to financing.

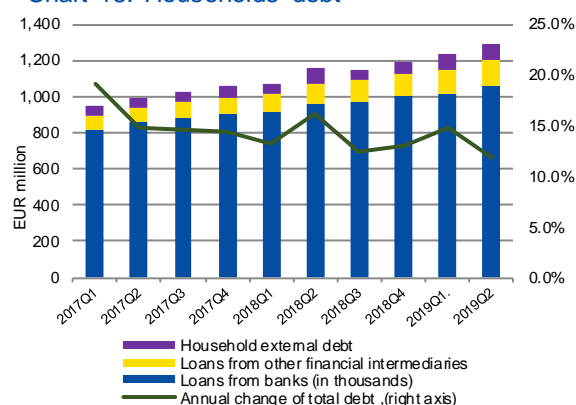
Chart 17. Interest rates for enterprises



3.3. Financial position of households

Households' debt, like the debt of enterprises, continued to grow in the first half of 2019. Domestic debt to the banking sector has increased by 10.3 per cent, while the debt to microfinance institutions, which has reached 13.1 per cent of the debt to the banking sector, has increased by 27.9 per cent. The external debt of households marked an increase of 7.1 per cent and reached 7.1 per cent of the total debt. In June 2019, total household debt increased by 11.7 per cent and as a percentage of GDP reached 18.0 per cent (chart 18).

Chart 18. Households debt



New loans issued by the banking sector for households marked a decline. Overall growth of new debt to banks was lower by 6.0

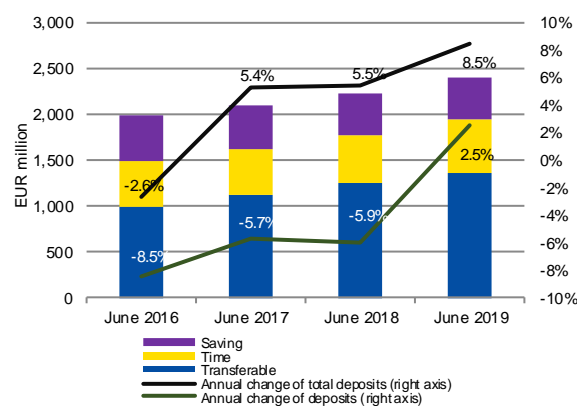
per cent while in the first half of 2018 it increased by 20.7 per cent. By purpose, new consumer loans declined by 9.8 per cent compared to the same period in 2018, while investment and mortgage loans increased by 15.1 and 6.0 per cent, respectively.

The decline of consumer loans had an impact the share of total new loans households to mark a decline to 73.6 per cent from 76.7 per cent as it was in the same period of 2018.

The net credit position of households to the banking sector increased as a result of higher volume of deposits compared to loans and the higher growth rate of household deposits compared with the previous year.

Household deposits amounted to EUR 2.4 billion¹¹, representing an annual growth of 8.5 per cent (chart 19). Loans, on the other hand, continued their double digit growth and amounted to EUR 1.1 billion, affecting an increase of 7.0 per cent of the traditional credit position of households towards the banking sector.

Chart 19. Household deposits

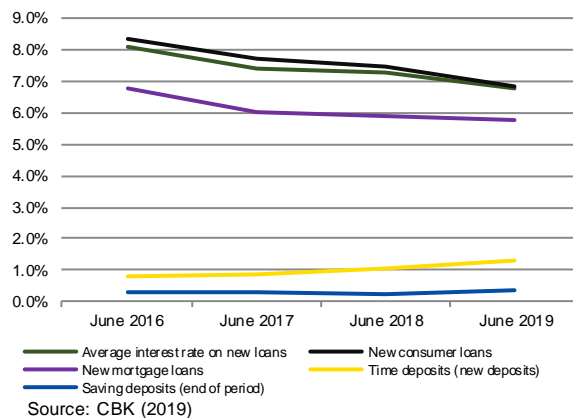


Regarding the net foreign currency position, the household sector has increased its foreign currency credit position by 3.3 per cent, as a result of foreign currency deposits growth, which reached 5.8 per cent of total household deposits, while foreign currency lending remains at a similar level of 0.2 per cent of total household loans.

¹¹ Including foreign currency deposits, converted to euro equivalent.

Household savings, in the form of time and transferable deposits, marked an increase during first half of 2019. 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 (chart 20).

Chart 20. Interest rates for households



Households total deposits increased by 8.5 per cent (5.5 per cent increase in the same period of 2018). Time deposits increased by 12.3 percent, while the average interest rate on time deposits was 1.28 percent in the first half of 2019 or 0.2 percentage points higher than in the same period of 2018.

Also saving deposits marked an increase of 2.5 percent while the interest rate on saving deposits reached 0.34 percent (0.26 percent in the first half of 2018).

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 6.9 per cent or 0.6 percentage points lower compared with the first half of 2018, while interest rates on mortgage loans of 5.8 per cent remained almost unchanged. 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. Household income sources indicated an increasing trend, where remittances increased by 5.5 per cent while compensation of employees¹² marked an annual increase of 7.7 per cent.

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

| Description | June 2016 | June 2017 | June 2018 | June 2019 |
|---|-----------|-----------|-----------|-----------|
| Household debt to banks (in millions) | 764.3 | 858.4 | 961.1 | 1,060.5 |
| of which in foreign currency | 3.3 | 2.9 | 2.7 | 2.5 |
| Household deposits at banks (in millions) | 2,003.1 | 2,110.5 | 2,227.4 | 2,416.0 |
| of which in foreign currency | 110.8 | 113.1 | 135.2 | 139.3 |
| Net position to banks (credit position) in millions | 1,238.8 | 1,252.0 | 1,266.3 | 1,355.5 |
| Debt-to-income ratio | | | 100.6% | 44.8% |
| Average loans value per number of employees | 2,325.2 | 2,400.6 | 2,813.6 | 2,968.0 |
| Economic dependance rate | | 247% | 374% | 259% |

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.

¹² 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.

The level of salaries for the period of 2012-2018, according to KAS, marked an increase in both the public and private sectors, where on average the net wage has increased by 29.7 per cent reaching EUR 498 in 2018. In the first half of 2019, the monthly net salary of employees, according to the Labour Force Survey¹³, on average, continued to be in the range from EUR 400 to EUR 500. In terms of the labor market, the labor force participation rate in the second quarter of 2019 was 39.9 percent or 0.5 percentage points lower compared to the same period of the previous year, i.e. the inactivity rate increased by 0.5 percentage points and has reached 60.1 percent. The employment rate in the second quarter of 2019 reached 29.8 percent, which is 1.3 percentage points higher compared to the same period of 2018. On the other hand, the unemployment rate was 25.3 percent or 4.1 percentage points lower compared to the second quarter of 2018.

The households indebtedness, measured through the net debt-to-income ratio, in June 2019 decreased to 44.8 percent (100.6 percent in June 2018). This indicator does not present the full indebtedness as it only considers debt to a single 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 as of June 2019, it has improved to 259 percent from 374 percent as it was in the same period of 2018.¹⁴

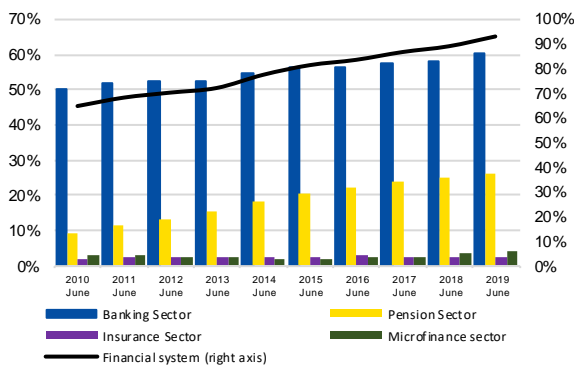
¹³ Kosovo Agency of Statistics, <http://ask.rks-gov.net/en/agency-e-statistics-te-kosoves/add-news/anketa-e-power-personal-afp-tm2-2019>

¹⁴ According to KAS, the projected rate of economic dependence on the EU will increase to 122.2 percent in 2023.

4. Developments in the financial system

The financial system continued its growth trend during the first half of 2019, with positive contribution from all constituent sectors. The value of financial system assets amounted to EUR 6.67 billion, corresponding to an annual growth of 11.2 percent. The positive developments of the financial system suggest greater public access to financial services. The increase in the financial intermediation rate (ratio of assets to GDP) by 4.0 percentage points to 93.1 percent, especially the increase in the financial intermediation rate of the banking and microfinance sector, shows increased competition pressures in the market for financing and provision of financial services (chart 21).

Chart 21. The weight of financial system sectors to GDP



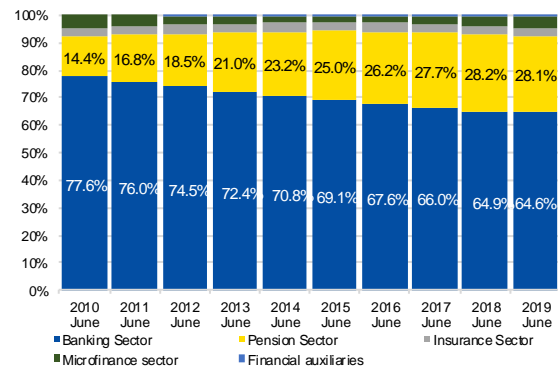
Source: CBK (2019)

The growth of banking and microfinance sector assets is mainly attributed to the willingness of these two sectors to expand their lending activity, supported by the continuous improvement of credit quality, increased competition and improved access to finance. The growth of the pension sector assets was made possible by the positive return on

investment and the increase in contributions received during this period. The insurance sector also marked an increase in assets, mainly driven by increased investment in securities and receivables from policyholders.

The structure of the financial system remains almost the same, with minor changes in some sectors. While the number of banks and pension funds is the same, two new institutions have been added to microfinance institutions. While the number of insurers has been reduced to 13 companies from 15 as it was in June 2018. This is due to the voluntary liquidation of one insurer by the sale of the portfolio to another insurer, while the other insurer has begun the process of forced liquidation due to the revocation of license from the CBK because of inability of this company to meet the legal requirements due to its financial difficulties (table 3). The financial auxiliaries sector has the largest number of institutions, but with very low activity (their share in total financial system assets is represented by 0.3 percent) (chart 22).

Chart 22. Share to total financial system assets



Source: CBK (2019)

Foreign capital dominates most of the financial system sectors, particularly in the banking and microfinance sectors.

Table 4. Number of financial institutions

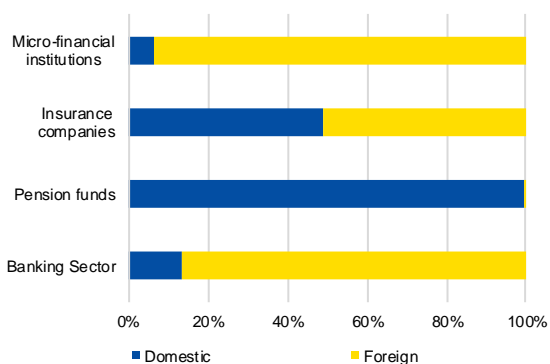
| Description | June 2010 | June 2011 | June 2012 | June 2013 | June 2014 | June 2015 | June 2016 | June 2017 | June 2018 | June 2019 |
|--------------------------------------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|
| Commercial banks | 8 | 8 | 8 | 9 | 10 | 10 | 10 | 10 | 10 | 10 |
| Insurance companies | 11 | 11 | 13 | 13 | 13 | 15 | 15 | 15 | 15 | 13 |
| Pension funds | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 |
| Microfinance institutions and- Banks | 17 | 17 | 19 | 18 | 18 | 18 | 18 | 17 | 21 | 23 |
| Financial auxiliaries | 29 | 32 | 39 | 40 | 41 | 43 | 46 | 49 | 53 | 53 |

Source: CBK (2019)

The banking sector is dominated by EU origin capital accounting for 57.5 percent of total banking sector assets. However, banks from other countries, mainly from Turkey, with a more proactive approach with the aim of market penetration have gradually increased their presence to 16.9 percent of the sector's assets.

Such developments have contributed to increased competitiveness of services and to lower banking concentration. The bank concentration rate¹⁵ dropped to 57.5 percent compared to June 2012 when the bank concentration rate was 72.1 percent. The insurance sector has undergone significant changes in ownership over the years and is now dominated by local companies, followed by companies originating from Albania.

Chart 23. Assets of financial system constituent sectors, June 2019



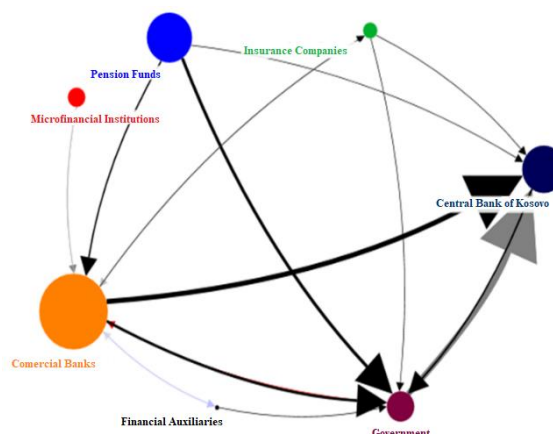
Source: CBK (2019)

Domestic insurance companies account for 48.9 percent from 47.1 percent in the previous year and compared to June 2015 when the share was 27.4 percent. Whereas, companies with Albanian capital represent 23.3 percent of insurance sector assets (figure 23).

¹⁵ Expressed as the ratio of the assets of the three largest banks to the total assets of the sector.

The financial system in Kosovo has a simple structure, regarding the traditional model of activities, with minimal linkage of activities between system sectors. Major links are in the form of deposits with the CBK and commercial banks (figure 1). However, the level of these interconnections is low, thus minimizing the possibilities of transferring problems and risks from one institution to another.

Figure 1. Institutional interconnections of the Kosovo Financial System

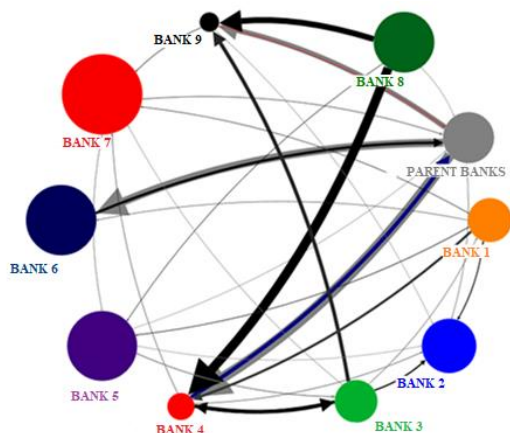


Source: CBK (2019)

Note: the size of each node (circle) reflects the total assets of each banking institution, excluding the Central Government where the total liabilities in the form of securities to these institutions are taken into account. Direction of arrows means the claims on the institution to which the arrow is directed while the thickness of the connection line and the arrow reflects the level or size of the interconnection. The situation is as of June 2019.

The most pronounced interconnection is between commercial banks and the CBK, which is represented in the form of deposits for the mandatory reserve that banks must maintain at the CBK.

Figure 2. Banking interconnections of the Kosovo banking sector



Source: CBK (2019)

Note: the size of each node (circle) reflects the total assets of each banking institution, excluding the parent banks where the total claims of the parent banks in the form of credit lines or subordinated debt to the respective banks in the country are taken into account. Direction of arrows means the claims on the banking institution to which the arrow is directed while the thickness of the connection line and the arrow reflects the level or size of the interconnection. The situation is as of June 2019.

Insurance companies and pension funds also hold claims in the form of transferable deposits (current accounts) to the CBK, which together with commercial banks comprise 29.9 percent of the CBK total deposits. Deposits that non-bank financial institutions hold in commercial banks represent significant inter-institutional exposure (excluding exposure to government) or some of these institutions. Insurance companies hold about 46.7 percent of their assets as deposits in commercial banks, financial auxiliaries with 26.2 percent, while pension funds and microfinance have 8.3 percent and 6.1 percent, respectively, of their assets as deposits in commercial banks. Thus, deposits of these institutions comprise 7.8 percent of total banking sector deposits. Consequently, the importance of the banking sector in maintaining the stability of the financial system is undisputed and the liquidity of the banking sector is an important factor in the stable functioning of these institutions, since in the context of interconnections, deposits are the main channel for possible transfer of inter-institutional problems. Whereas, the commercial banks claims to other non-bank financial institutions that are represented in the form of loans constitute a minor role in

financial interconnections due to the fact that these loans represent only 0.3 percent of total loans in the banking sector. The interconnection figure also includes the exposure of the financial system to the Central Government, expressed in the form of securities, as it is considered that the importance of such exposures is increasing in conditions when investment opportunities by institutions are limited particularly in government securities and deposits-loans. While other institutions have claims on the Government from investments made in government securities, the Government has claims (exposure) only on the CBK and commercial banks through deposits held in these institutions.

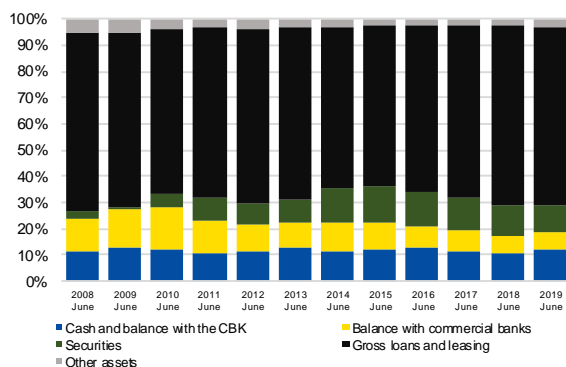
Interbank links are even more concentrated than inter-institutional ones, with some banks being relatively smaller having significant exposures to each other within the financial system in the country (figure 2). Large banks have their main exposures in foreign markets, to parent banks or other banks and financial institutions. The links highlighted between the 4 banks in the country shown in the figure above are mainly represented in the form of financing sources such as deposits. The most pronounced relationship is between bank 8 with two banks 4 and 9, where bank 8 has financial claims on bank 4 and 9, expressed as time deposits (which are at the same time financing sources for banks 4 and 9). Bank 3 has claims on bank 9, while bank 4 has more liabilities than claims. Whereas, the interconnections with the respective parent banks are more pronounced with banks 4, 9 and 6, mainly in the form of liabilities. Bank 4 has the highest level of liabilities to its parent bank, in the form of credit lines borrowed in the interbank money market. Also, bank 9 represents liabilities to the parent bank through credit lines, while bank 6 has liabilities to the parent bank for borrowings in the form of subordinated debt.

4.1. Banking activity

Banking sector activity has further expanded during the first half of 2019 that

was mainly driven by lending activity. Banking sector assets increased by 10.6 per cent from a year earlier, reaching EUR 4.30 billion. The growth of the sector's assets is mainly attributed to the positive dynamics that characterized the lending activity (chart 24) driven by the increase in credit demand, which was supported to some extent by the improvement of bank financing conditions.¹⁶

Chart 24. Share to assets structure



Source: CBK (2019)

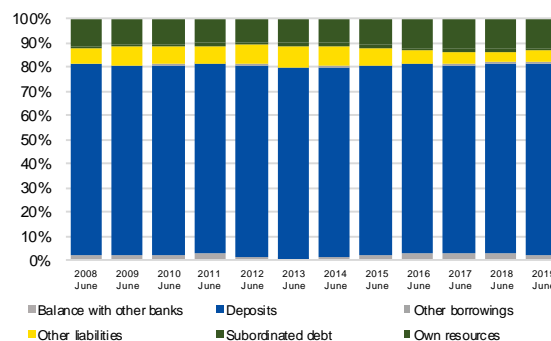
Within assets, annual growth of 24.2 per cent was recorded by cash and bank reserves held at the CBK. Despite the continued negative interest rate applied by the CBK on the surplus of obligatory reserve that commercial banks hold at the CBK, this sub-category marked an annual growth of 31.4 per cent.

Assets have not undergone major structural changes over the years, except for the subcategory 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 weight that these instruments bear, and new investment opportunities at a time when lending should have a cautious approach to the risk it bears. However, for the second consecutive year the stock of securities was characterized by annual decline of 6.9 per cent, mostly affected by the decline in foreign government securities investments. Also, the banking sector exposure to the Government of Kosovo decreased to 5.9

percent of total sector assets from 6.7 percent in the previous year.

The banks' strategy to focus on lending rather than in investment in securities in the last two years is mainly attributed to factors such as the decline of credit risk, support to the Credit Guarantee Fund, better knowledge of clients and confidence in them, focus on more strategic sectors for the economy, which have consequently also facilitated bank lending conditions (according to the bank lending survey).

Chart 25. Share to the structure of liabilities and own resources



Source: CBK (2019)

The banking sector activity continues to be mainly financed by household and enterprise deposits, which this year marked a higher growth than in the previous year.

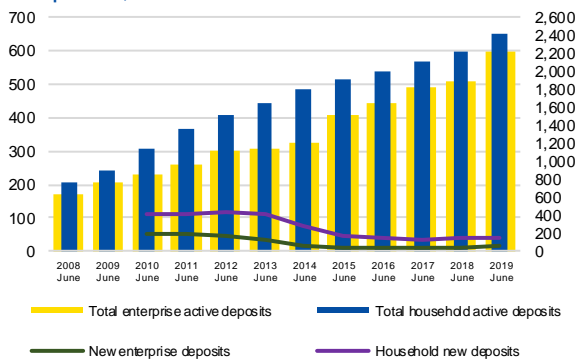
The banking sector activity is supported by deposits at the level of 79.6 per cent (chart 25). Total deposits increased by 11.0 per cent to EUR 3.43 billion, driven mainly by households transferable deposits. Household deposits, which make up 70.5 per cent of total deposit stock, increased by 8.3 per cent (chart 26). As households are more susceptible to changes in the economic environment, the risk borne by this segment is relatively higher in terms of the immediate withdrawal of deposits from banks or their transfer from one bank to another.

Unlike last year, the growth of deposits from the financial sector was marked by growth. This was affected by the Kosovo Pension Fund deposits, driven, of course, by the better

¹⁶ Box 2: Bank Lending Survey

conditions for investing funds in Kosovo in the situation when the ECB decided since September 2018 the base interest rate on deposits in monetary union countries banks to be further reduced. Corporate deposits were up 16.8 percent from a year earlier. The most significant increase was marked by transferable deposits, followed by time deposits and savings.

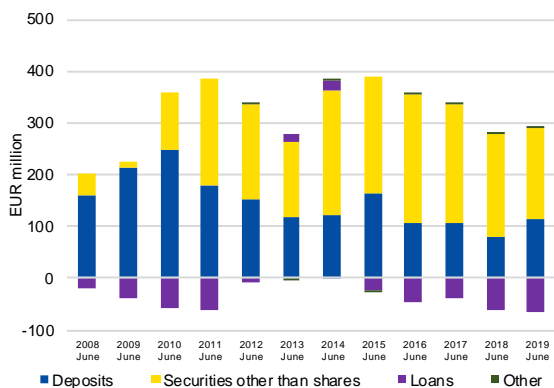
Chart 26. Stock of total deposits and new deposits, EUR million



Source: CBK (2019)

Exposure of the banking sector to the external sector is relatively low, but it increased in June 2019, driven mainly by increased demand for deposits in the form of deposits. The net lending position to the external sector increased by 4.5 per cent, reaching EUR 229.2 million (charts 27 and 31).

Chart 27. Net position to nonresidents

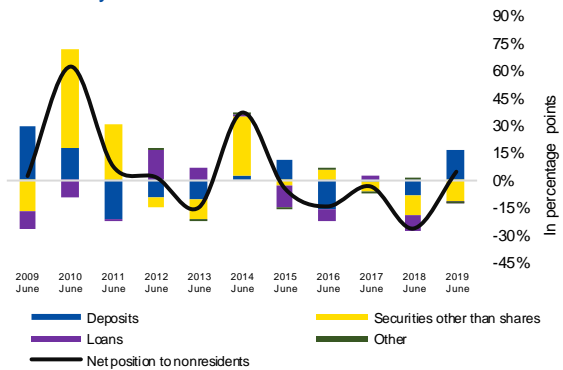


Source: CBK (2019)

Claims on non-residents account for about 10.3 per cent of total banking sector assets, where 88.5 per cent of them are deposits and investments in securities. Of the deposits held

in the external sector, about 90 per cent are with foreign banks.

Chart 28. Contribution of items to annual change of activity with nonresidents



Source: CBK (2019)

On the other hand, banking sector liabilities to non-residents account for 5.0 percent of total banking sector liabilities mainly in the form of credit lines. Loans from external sector and external sector deposits held in the country, together account for 99.2 percent of total liabilities to non-residents. About 50 percent of these liabilities are towards parent banks.

Thus, in general, the banking sector has a low exposure to the external sector and a low level of foreign currency assets, which reduces the effects of transfer of problems from external sector and avoids possible losses from changes in the exchange rate to the Euro currency.

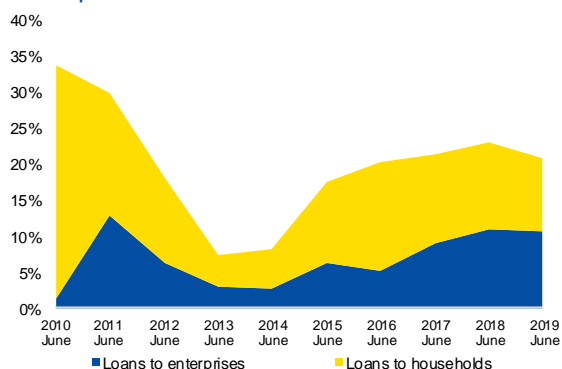
4.1.1 Credit developments

The banking sector’s lending activity continued its double digit growth trend even during the first half of 2019, driven more strongly by credit demand relative to credit supply. Positive impact on lending requirements was the improved quality of applications by both enterprises and households¹⁷. On the other hand, excluding the tightening of lending standards for enterprises, banks applied an easing approach to enterprises and households regarding lending conditions, mainly through lowering the average interest rate, increasing the approved amount, reducing collateral requirements and reducing the charges with

¹⁷ Box 2: Bank Lending Survey.

other rates. Such easing was mainly made possible by the support of the Credit Guarantee Fund, further improvement of credit portfolio, increase of banking and non-banking competition and favorable position of bank liquidity. The stock of active loans with domestic banks amounted to euro 2.94 billion, representing an increase of 10.5 percent, mainly due to the increase in lending to enterprises (chart 29).

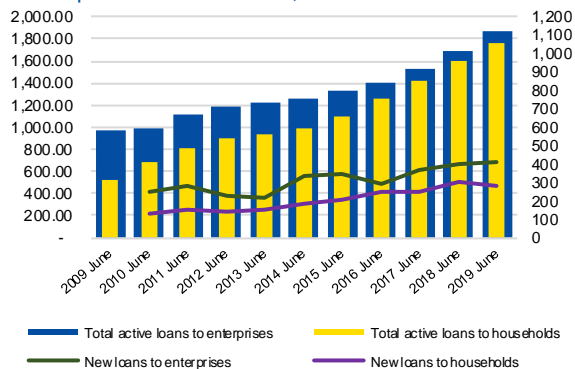
Chart 29. Annual growth of loans to enterprises and households



Source: CBK (2019)

Loans to enterprises increased by 10.7 per cent reaching EUR 1.87 billion. Whereas, during the first half of 2019, new loans to enterprises increased by EUR 413.5 million (chart 30), of which EUR 248.3 million for investment purposes, which is 6.0 million less than the increase in the previous year, and EUR 158.5 million for non-investment purposes, which is 16.4 million more compared to the same period of the previous year.

Chart 30. Stock of total loans and new loans to enterprises and households, EUR million



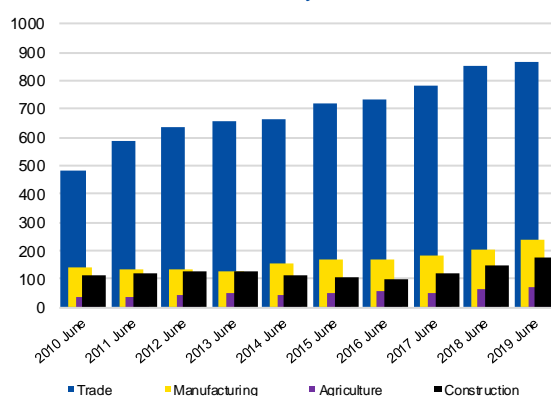
Source: CBK (2019)

Bank lending has increased to almost all economic sectors, and particularly the

credit stock base has grown more for the construction and manufacturing sectors.

Loans to manufacturing and construction sectors increased by 20.0 percent and 21.4 percent, respectively. However, the share of these sectors in the total loan portfolio is relatively low.

Chart 31. Stock of loans by economic sectors



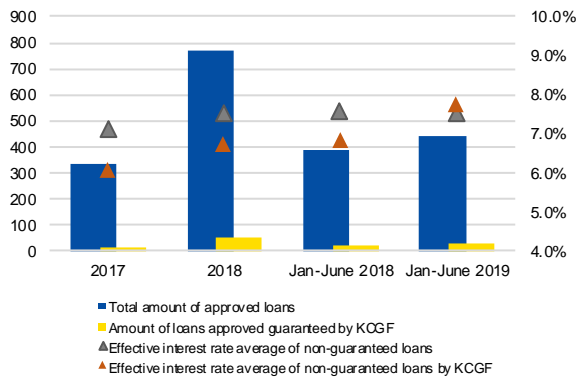
Source: CBK (2019)

The trade sector, which dominates the structure of total loans, marked an increase in lending of 1.7 percent. Whereas, only the mining sector was characterized by a decline of 13.1 percent, but the share to total credit stock is very low, at only 1.3 per cent (chart 31).

Significant lending support to small and medium-sized enterprises was provided by the Kosovo Credit Guarantee Fund as of September 2016, whose use has marked a continuous growth trend. The cumulative number of bank loans to SMEs guaranteed by KCGF amounted to 3,004 by the end of June 2019 (1,386 at the end of June 2018). While the value of guaranteed loans amounted to EUR 114.1 million, a double increase from the guaranteed value of EUR 51.9 million as of June of the previous year. Loans guaranteed by economic sectors are represented similar to the overall structure of the banking sector loans, with loans to the wholesale and retail trade sectors dominating, followed by the services and manufacturing sectors. The agriculture, forestry and fisheries sector had a share of 8.4 percent in the total guaranteed loans portfolio. The positive outlook for the increase in the KCGF value and focus on supporting specific sectors with more difficult

access to finance such as the agricultural sector are expected to be reflected in the further growth of lending to SMEs in general, and specific sectors in particular.

Chart 32. Loans approved and guaranteed by KCGF

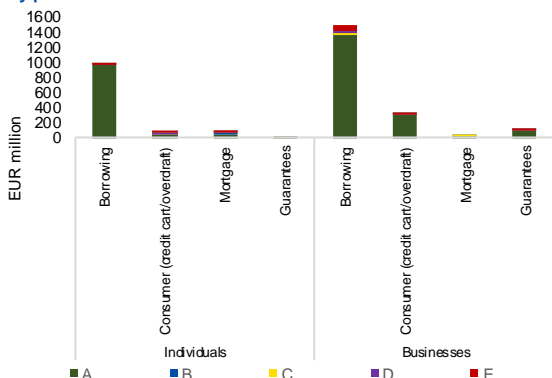


Source: CBK, Credit Registry (2019)

Loans guaranteed by KCGF only for the period January-June 2019 were EUR 4.5 million higher than in the same period of the previous year. The effective interest rates on loans guaranteed in smaller amounts had double digit value, unlike loans guaranteed at higher values that are similar to the sector average. The average effective interest rate on all guaranteed loans reached 7.7 per cent (chart 32).

The banking sector's exposure to households is growing at an accelerated pace, where lending to this segment has marked a double digit increase in the past five years.

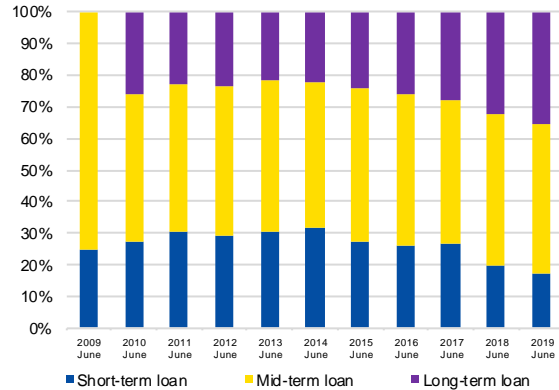
Chart 33. Natural and legal borrowers by type and credit classification



Source: CBK, Credit Registry (2019)

Forecasts for good economic growth and low level of customer debt load (based on the debt to income ratio indicator), despite increased lending by banks, lead to the expectations for the risk of a decline in the quality of household loan portfolios being low. As of June 2019, the value of loans to households amounted to EUR 1.1 billion, or 10.4 percent higher than in the previous year.

Chart 34. Share to total loans: enterprises



Source: CBK (2019)

However, this growth was slower than the growth in the previous year, which can be attributed to the decline in new consumer loans by 9.8, a category that comprises the largest share (of 73.6 percent) of new loans to households (chart 34). Chart 33 depicts the stock of loans issued by the banking sector until June 2019, broken down into natural and legal persons. These data are not published in time series, but are sourced from the credit registry. They refer to the recent period and here provide the static state, without presenting the progress of development¹⁸.

Largest portion of credit (about 79.0 percent) is characterized as loans, while consumer and mortgage loans have a share of about 12.0 and 2.2 percent, respectively. However, with regard to the categorization of credit, it should be taken into account that the category of loans may also include loans issued for mortgage purposes, especially with lending to natural persons. Depending on the credit policies of banks or promotional offers, these loans may be issued without collateral and guarantor, and due to regulatory restrictions¹⁹, they cannot be

¹⁸ Consumer loans to legal entities may include lines of credit that are categorized as overdrafts and fall under consumer loans.

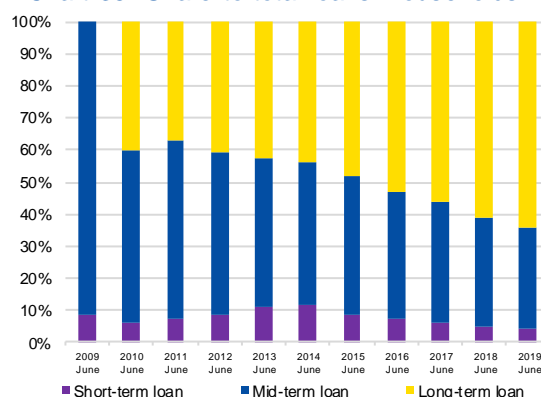
¹⁹ Article 6 of the Regulation on Residential Mortgage Loans sets out the purposes on the basis of which the loan is issued and categorized as residential mortgage loan.

categorized into residential mortgage loans. In terms of weight, about 30 percent of the loan stock turns out to be loans intended for natural persons, while about 50 percent are loans to legal entities. Mortgage loans to natural persons comprise about 1.9 percent of total loans, while those to legal entities comprise 0.3 percent. On the other hand, consumer loans to natural persons account for about 1.9 percent of the share compared with those to legal entities that have a share of 10.0 percent. However, consumer loans (including credit cards and overdrafts) to legal entities should be carefully analyzed as unlike natural persons who use this type of loan mainly for consumer purposes, legal persons may use these loans for commercial purposes.

Almost all types of loans have over 90.0 percent credit rating A (or standard). For legal entities, about 90 percent of credit categorized as loans have credit rating A, while for legal entities, 97.7 percent of 'loan' credits appear to be with credit rating A.

Long-term loans since 2018 managed to dominate the structure of total loans, representing 45.8 percent.²⁰ Long-term loans increased by 18.5 percent to EUR 1.34 billion, followed by medium-term loans, which increased by 7.3 percent to EUR 1.22 billion. Medium-term loans dominate the structure of total loans to enterprises, whereas for households, this category has reduced at an accelerated pace its share in recent years, replaced by the growth of long-term lending, which is also the category with the highest share in loans to households (chart 35).

Chart 35. Share to total loans: households



Source: CBK (2019)

According to the Bank Lending Survey (Box 3), households' orientation towards long-term loans was mainly driven by banks' credit policies, through easing of lending standards and conditions, especially through facilitations applied to loans for house purchase by reducing the collateral requirements, increasing the approved amount and lowering the interest rates.

Such a structure of lending in the economy coincides on the one hand with the business needs for mid-term financing, and on the other hand with the needs of households for long-term real estate investments financing.

²⁰ The short-term period covers a maturity of up to 1 year, the medium-term period covers a maturity of 1 to 5 years, and the long-term period covers a maturity of over 5 years.

Box 3. Bank Lending Survey²¹

The latest results of the Bank Lending Survey ²² reflect the developments in bank lending activity during the period of April - June 2019 (referred to as Q2 2019)²³, and expectations for lending activity for the period of July-September 2019 (referred to as Q3 2019).

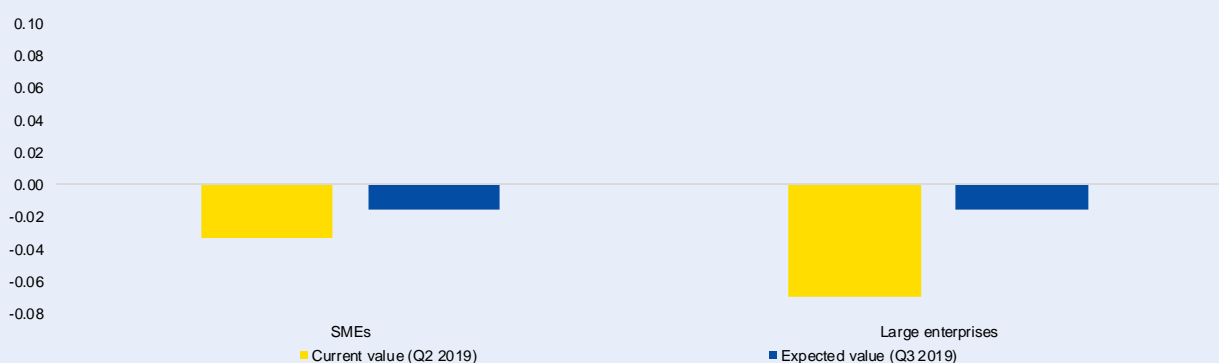
The dynamics of lending to **enterprises** during this period, based on the bank lending survey, results to be positively affected by credit demand side.

Within the credit supply, banks have reported to have slightly tightened standards applied during the process of assessing the enterprises' applications for loans.

Within loans to enterprises, credit standards for large enterprises tightened while credit standards for loans to SMEs remained almost unchanged, with the exception of one of the banks which declared a tightening up of standards to a certain extent.

For the next quarter, Q3 2019, banks stated that they expect similar developments as regards standards of lending to enterprises in general. Banks are expected to prioritize short-term lending to enterprises in general (chart 36).

Chart 36. Bank's credit standards applied when assessing credit applications of enterprises



Source: CBK (2019)

The main factors stated by banks, which have impacted the tightening of credit standards were the unsatisfactory prospects of the parent bank, the low tolerance of banks to risk, the unfavorable prospect for banks in the domestic market. The tightening of lending standards was also impacted by the reduction of lending by parent banks, but only to a certain extent, as this applies only to one of the banks but with a relatively high share in the banking sector lending. Whereas, a factor that contributed to the easing of credit standards was the support

of lending to enterprises by the Credit Guarantee Fund.

Within the credit offer, banks also reported to have eased the terms and conditions for lending to enterprises. Both for SMEs and for large enterprise loans, banks eased lending conditions, mainly through lowering the average interest rate, increasing the approved amount and reducing the charging of rates other than interest rates. Whereas, banks declared tightening of conditions for SMEs through reducing the loan maturity (chart 37).

²¹ The Bank Lending Survey is conducted by the Central Bank of the Republic of Kosovo with nine (9) banks operating in Kosovo and representing 99.9 percent of total sector lending. The survey is conducted on a quarterly basis. This survey covers the period April-June 2019 and the period of July-September.

²² Responses 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 Credit Standards Index show ease of lending whereas negative values are characterized by a tightening of lending. Also, positive values of the Credit Demand Index show an increase of demand and the negative values show a decline.

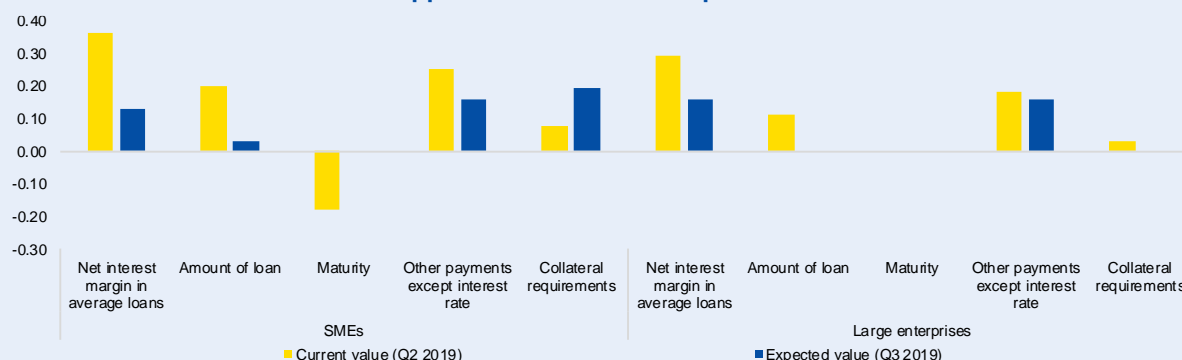
²³ The period April - June is referred to as 'Quarter 2' - Q2, while the period July - September is referred to as 'Quarter 3' - Q3.

The easing of terms and conditions for loan approval was impacted by support from the Credit Guarantee Fund, increased competition pressure from other banks, and the favourable liquidity position of banks.

For Q3 2019, banks expect an overall easing of conditions, albeit at a lower rate than in the previous quarter. More specifically, the

average interest rate on loans for both categories is expected to continue the downward trend, and it is also expected to continue the reducing of charges other than that of interest. Whereas, the reduction of requirements for collateral is expected only for SMEs.

Chart 37. Terms and conditions applied for loans to enterprises



Source: CBK (2019)

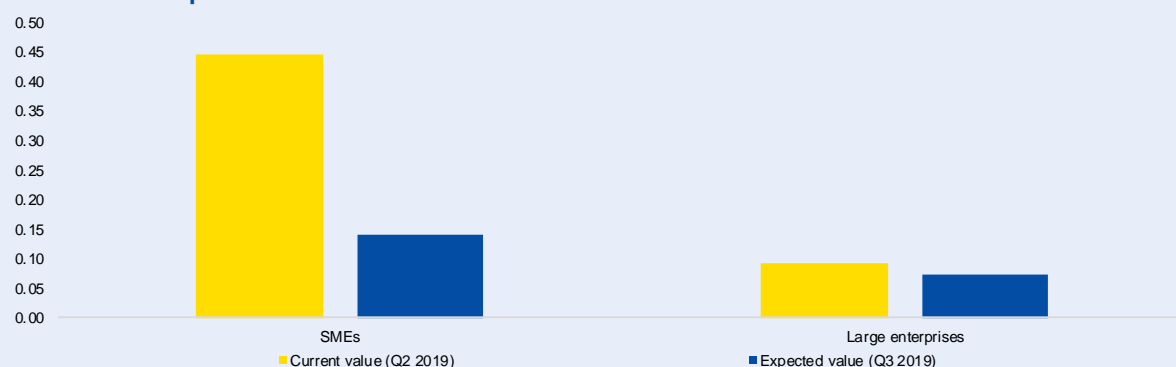
During the reporting period, banks reported increased demand for loans by enterprises. However, the index showing credit demand was significantly higher for SMEs than for large enterprises, which indicated a marginal increase (chart 38). Moreover, the quality of applications received from both SMEs and large enterprises improved during this period.

Within the demand for loans by enterprises, there was an increase in demand for inventory

and working capital financing, as well as for fixed investments financing, while banks stated a decline in the demand for debt refinancing, which provides positive signals in terms of the financial health of enterprises.

For Q3 2019, banks expect further growth in credit demand, but at a much lower level than during Q2 2019. Similarly, credit demand will be higher for SMEs.

Chart 38. Enterprise demand for loans



Source: CBK (2019)

Regarding the timeline, the survey results show that there was greater demand for long-term loans during this period, also the demand for short-term loans increased but to a lower degree. Whereas, the credit offer broken down

by loan maturity results with no significant movements. In the next quarter, banks expect easing of lending standards to a certain extent for short-term loans and almost unchanged demand for the same. Similar changes are

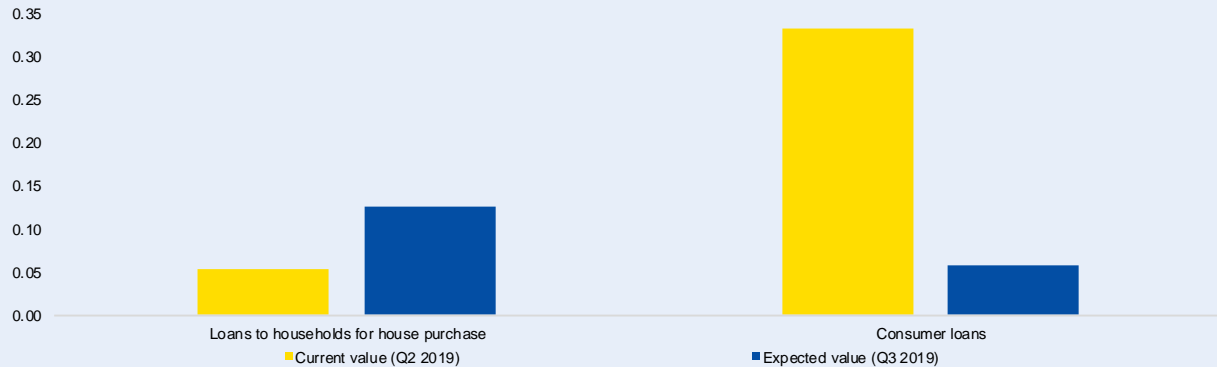
expected for the category of long-term loans (chart 39).

The dynamics of lending to **households** during the reporting period, according to the survey, were positively affected both by the favorable credit supply and household loans demand. The credit standards applied when examining household loan applications were

eased in particular for short-term consumer loans (chart 42).

Unlike Q2 2019, in the next quarter, banks expect a higher degree of easing for home purchase loans to some extent, while easing of lending standards for consumer loans is expected to be lower.

Chart 39. Bank's credit standards applied when assessing household credit applications

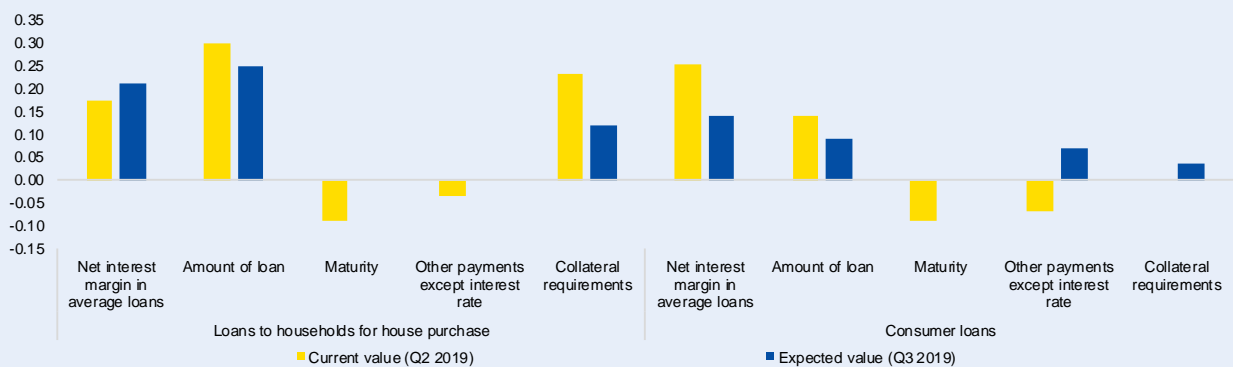


Source: CBK (2019)

Improvement of conditions for lending to households during the reporting period for home purchases was achieved through increasing the size of loans, lowering of collateral requirements and lowering of interest rates (chart 40). Conditions for consumer loans were mainly improved by

lowering the interest rate and increasing the amount approved. The easing of terms and conditions was driven by increased competition pressures from other banks and other non-bank financial institutions, favorable domestic market prospects, low risk on collateral required, and favorable banking sector liquidity position.

Chart 40. Terms and conditions applied for loans to households

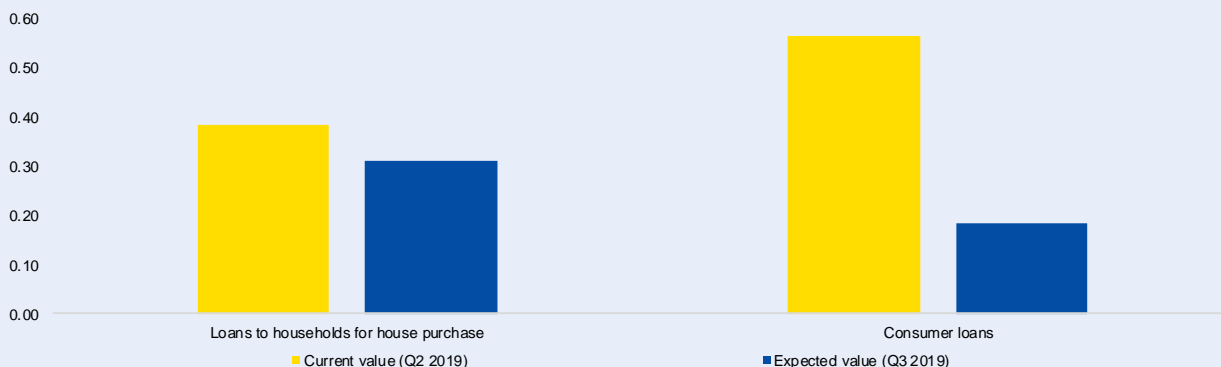


Source: CBK (2019)

In the next quarter, banks have stated that they expect lending conditions to generally ease for households for both categories. Conditions for home purchase loans are expected to be eased by lowering interest rates and increasing the size of approved loans, and

lower collateral requirements to some extent. While, the conditions for consumer loans are expected to be positively affected mainly through lowering the interest rate and increasing the amount of approved loans.

Chart 41. Household demand for loans



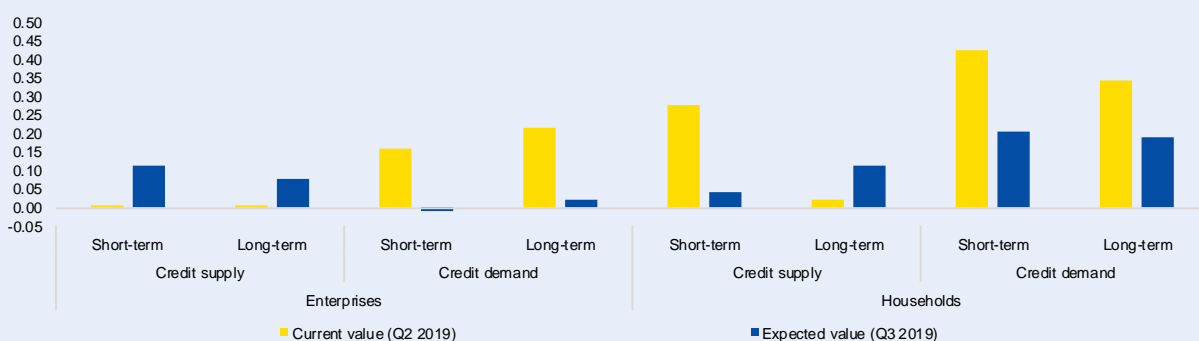
Source: CBK (2019)

Banks reported increased demand for household loans. Both categories of household loans had higher demand, but the demand for consumer loans was higher than the demand for home purchase loans (chart 41). The increase in household demand for consumer loans is mainly attributed to the increased consumer confidence in their credit repayment ability and the increased demand for financing expenditures other than home purchase. Whereas, banks stated that positive developments in the real estate market contributed positively to the demand for home

purchase loans. Also, the quality of applications received, both for home purchase and consumer loans, has improved.

Banks expect further increase in the demand for loans over the next quarter, but unlike Q2 2019, demand for home loans is expected to grow higher than demand for consumer loans. In this forecast, banks take into account the impact of their campaigns to provide affordable housing loan terms, as well as the impact of developing or launching some major residential complex projects.

Chart 42. Change of credit standards and demand for loans by maturity



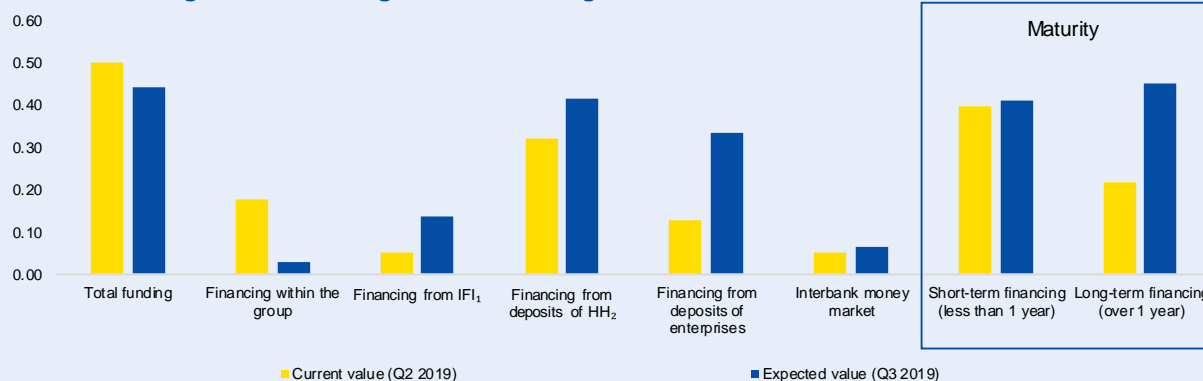
Source: CBK (2019)

Regarding the timeline, the survey results show that households during this period had higher demand to some extent for short-term loans versus those with longer maturity.

The credit offer broken down by loan maturity results to be concentrated on facilitations applied for short-term loans and almost unchanged for long-term loans.

Unlike Q2 2019, banks expect that in the next quarter, the credit supply easing will be oriented towards long-term loans, while for the short-term loans marginal easing is expected. Demand for loans is expected to increase similarly for both maturities (chart 42).

Chart 43. Change of the banking sector financing



Source: CBK (2019)

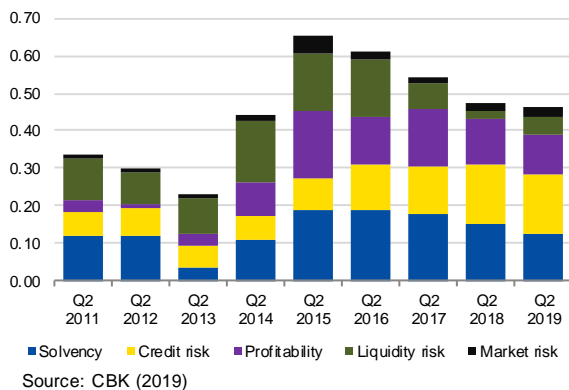
Banks reported satisfactory growth of total **financing** in the reporting period, more precisely they reported deposits to be the main source of financing, especially short-term deposits from households. Also, the increase in lending activity results to have been positively influenced by the increase in financing from parent banks. Although bank financing through long-term funds marked an increase during the reporting period, the short-term financing continued to dominate.

Similarly, banks expect increased access to financing through household deposits, but unlike the previous quarter, banks expect, in terms of maturity of funds, long-term financing to dominate the fund structure. Also, compared to Q2 2019 financing from parent banks is expected to be significantly lower, while funds from international financial institutions are expected to increase the support of financing bank activities (chart 43).

5. Risks of the banking sector

During the first half of 2019, the banking sector operated in an environment with low risks and satisfactory capacity to cope with potential 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 indicate a declining risk and vice versa.²⁴ According to the aggregate risk index, the banking sector on average has marked a slight increase in the risk exposure compared to the previous period (June 2018), and more pronounced increase compared to the end of last year (December 2018) (chart 44). Liquidity indicator, followed by profitability and solvency indicator, and to a limited extent market risk indicator, affected the increase of risk (index decrease) compared to December 2018. Whereas, compared to the same period of the previous year, the index decrease (risk increase) was influenced by solvency and profitability indicators.

Chart 44. Stability index of the banking sector, by risk criteria



On the other hand, there was an improvement marked in the credit risk indicator (compared to December 2018 respectively June 2018), liquidity and market indicators (compared to June 2018).

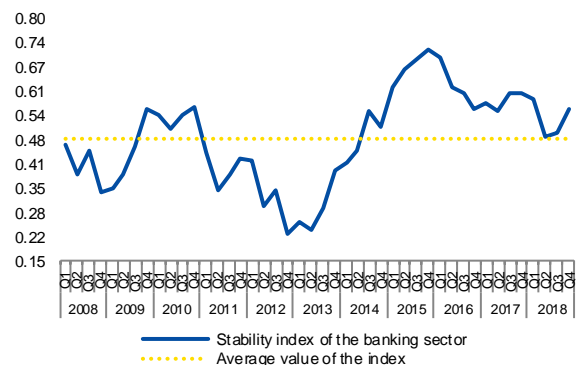
The decline in credit risk is mainly

²⁴For further information on the methodology of building the banking sector stability index, refer to the Financial Stability Report no.9.

attributed to the low level of non-performing loans and the downward trend in the value of these loans (since the fourth quarter of 2014) (chart 45). The decrease in **liquidity risk** compared to the same period of the previous year was due to the increase in liquid assets, in the form of deposits and assets held with the CBK. **The increase in solvency risk** is attributed to a decrease in the level of capitalization, but is nevertheless significantly higher than the minimum required by the CBK regulation. The faster growth of risk-weighted assets driven by the sharp increase in lending in recent years, in addition to the slower growth of regulatory capital, has led to a decline in the capital rate.

The increase in profitability risk is mainly attributed to the lower profit realised by banks, which is a result of the higher increase in expenses versus revenues.

Chart 45. Aggregated index of the banking sector stability



Although the aggregate stability index is slightly below average, the banking sector is stable and can handle the risks it is exposed to.

Table 5. Risks of the banking sector

| Risks | Indicators | June 2016 | June 2017 | June 2018 | June 2019 | Risk direction | Interpretation |
|--------------------|--|-----------|--------------|----------------|----------------|----------------|---|
| Credit risk | Nonperforming loans (NPL) ratio to total loans (%) | 5.3% | 3.9% | 2.8% | 2.5% | ↓ | Credit risk declined further, as a result of higher increase of lending against the decline of NPL. Improvement of credit portfolio quality also from the write-off process of lost loans from the balances of banks. Also, the decline of the NPL stock and the increase of provisions has had an impact on the increase of the coverage ratio of provisions. |
| | NPL coverage with provisions (%) | 119.9% | 136.6% | 155.6% | 161.2% | | |
| | Large credit exposure/First Tier Capital (%) | 61.9% | 66.7% | 79.1% | 67.2% | | Concentration of large credit exposures declined further, despite its low level (below the maximal level of 300%). The decline of the ratio came as a result of exposures primarily from the banks with the higher weight in the banking sector. |
| Profitability risk | Net income from the interest (EUR million) | 163.3 | 160.3 | 159.7 | 171.0 | ↑ | Positive impact on the increase of the profit in this year was yielded by net interest income as a result of increased loan volume. While the increase of provision expenses during the first half increased its pressure in the sector profitability declining non-interest interest net income, resulting in a decline of profit margin. Risk direction is considered to be increasing in a continuous pressure of cost increase of financing. |
| | Net income from non-interest (EUR million) | 47.5 | 17.7 | 41.7 | 32.6 | | |
| | Expenses/Income | 60.3% | 67.3% | 64.6% | 65.1% | | |
| | Return on Average Equity (ROE) | 29.1% | 19.7% | 21.3% | 20.4% | | |
| Market risk | Assets and liabilities gap sensitive to interest rates (EUR million) | 1,396 | 1,526 | 1,700 | 1,803 | ↑ | The gap between assets and liabilities sensitive to interest rates has expanded. Shifting to some extent towards long-term financing, compared to the previous years as a result of the increase of deposit interest rates, was not sufficient to have an impact on improvement of this indicator against the continuous increase of long-term lending with a fixed rate. Consequently, had an impact on the increase of the interest rate risk in the future. |
| | Opened positions in foreign currency to Tier 1 capital (%) | 1.8% | 2.3% | 1.7% | 1.5% | | Net aggregated opened position in foreign currency declined during the first half, declining to some extent the exposure, which already stands far from the regulatory minimum. |
| Solvency risk | Regulatory capital/Assets with risk weight (%) | 18.6% | 18.1% | 17.4% | 16.8% | → | Regulatory capital ratio marked a decline as a result of the higher increase of the risk weighted-assets driven by credit growth. The continuous credit growth, and as a result of the increase of the capital demand, increased pressure on profitability due to the decrease of interest rates on loans and the increase of deposits interest rates, as well as the spread of the dividend, capital adequacy ratio is expected to under pressure in the future. |
| | Tier 1 capital/risk weighted assets (%) | 16.3% | 16.2% | 15.7% | 14.9% | | |
| | Equity/Assets | 12.3% | 13.0% | 13.0% | 12.2% | | |
| Liquidity risk | Loans-to-deposits ratio (%) | 80.7% | 82.8% | 86.2% | 85.8% | ↓ | Liquidity indicators show a good financial position of the banking sector and for the potential of the credit activity expansion. Liquid assets to total short-term liabilities ratio increased as a result of the liquid assets growth (being impacted by the increase of the reserve balances with the CBK, investments in foreign government bonds and in Kosovo's Government). |
| | Liquid assets to total short-term liabilities ratio (%) | 41.5% | 35.9% | 33.2% | 35.1% | | |
| | Liquidity gap (EUR million) | 380.0 | 414.5 | 463.5 | 503.1 | | Liquidity gap expanded as a result of the time mismatch expansion between assets and liabilities, which was emphasised in the category of the term maturity "6 months up to 1 year". This situation reflects the increase of short-term lending during this period, primarily for households based on the results of the bank lending survey. |
| | | | Growing risk | Declining risk | Unchanged risk | | |

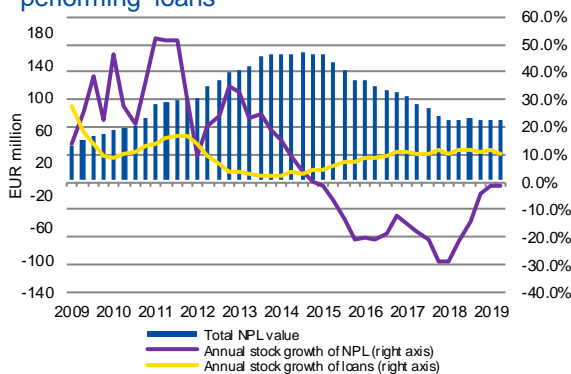
Source: CBK (2019)

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 mainly of the enterprise segment. Regulatory changes for the write offs of loans categorized as 'loss' from banks' balances within defined deadlines²⁵, was among the factors influencing the reduction of nonperforming 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 lending can increase the risk of the banking sector facing with the repayment ability of this segment, which may weaken in the future 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 to be eased in the following period and that consequently affect the level of indebtedness of households.

Chart 46. Annual growth of loans and non-performing loans



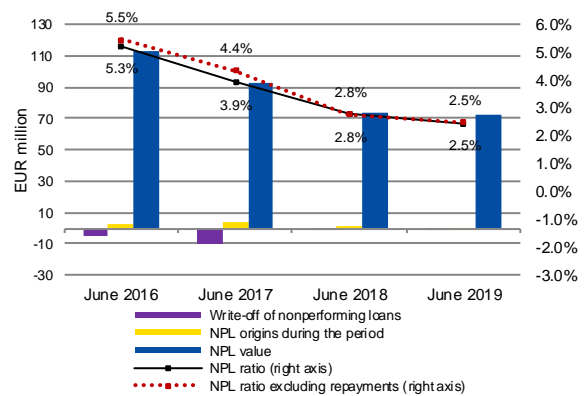
Source: CBK (2019)

The ratio of nonperforming loans to total banking sector loans decreased to 2.5 percent from 2.8 percent as it was in June 2018. Loans stock growth of 10.5 percent had higher impact on the decline of NPLs ratio than the decline of

non-performing loans stock by 1.6 per cent (chart 46).

In June 2019 the written-off loans amounted to EUR 1.1 million, which in absolute terms has affected the reduction of total non-performing loans by 1.4 percent. Likewise, the repayment of loans classified as non-performing provided a reduction contribution of 1.1 percent. Moreover, unlike the previous year, the nonperforming loans originations during this period had a reduction effect of 0.8 percent on the total nonperforming loans stock (chart 47).

Chart 47. The effect of write-offs process



Source: CBK (2019)

Other factors such as the growth of economic activity and the improvement of structural factors have also contributed to the improvement of the credit portfolio quality. Part of the effect of the NPL decline can be attributed to other factors such as the good financial performance of the enterprise sector this year, based on the business climate indicator²⁶, which may have contributed to the repayment ability of these borrowers. In addition, the activity of Private Enforcement Agents has facilitated and accelerated the process of loan repayment, while the advancement in structural reforms to facilitate collateral realization has increased the confidence of banks and consequently increased the volume of loans issued by banks. These factors were reflected in the recovery of nonperforming loans during the period.

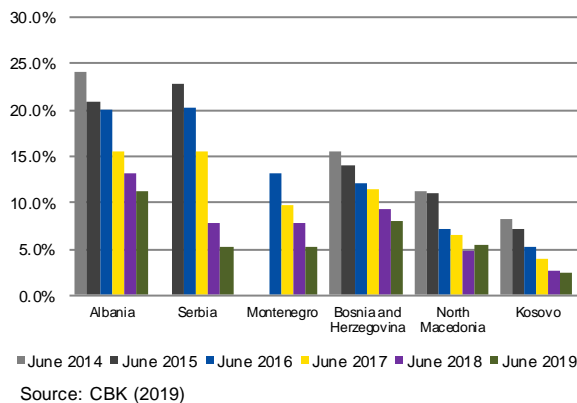
The quality of Kosovo's credit portfolio remains at the best level in the region. Over the years,

²⁵ CBK 2017, Regulation on Credit Risk Management, Article 18.

²⁶ For more information see Section 3.3 Financial position of enterprises.

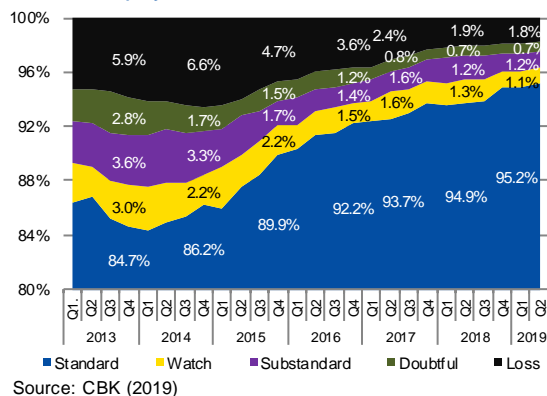
Kosovo has had the lowest ratio of non-performing loans compared to the countries of the region (chart 48). Improved quality of the loan portfolio in the first half of 2019 has contributed to further improvement of the position, where the NPL ratio was half that of Montenegro, the second highest ranked country in the region regarding credit portfolio quality.

Chart 48. NPL to total loans ratio in the region countries



Credit exposures with higher credit ratings, namely standard loans, continued the trend of increased share in the loan portfolio, and in June 2019 represented 95.2 percent of total loans.

Chart 49. Structure of loans classified by overdue payments

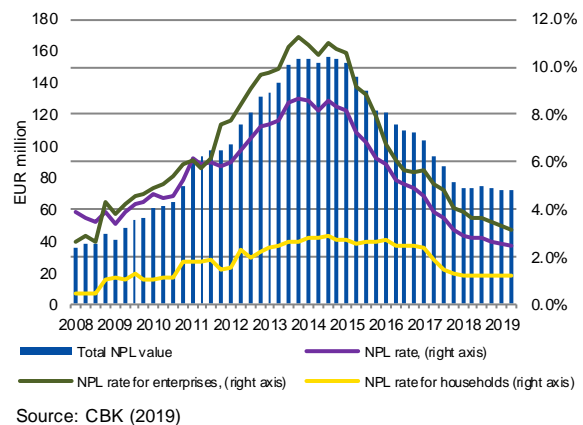


Standard loans, which include credit exposures with no difficulties, with delays of less than 30 days, or fully covered by collateral, have consistently increased their share, where in June 2019 they increased their weight by 1.4 percentage points in favor of lowering the weight of low-rated loans classified as “watch”, “substandard” and “loss” by 0.6, 0.5 and 0.3 percentage points, respectively (chart 49).

The most credited segment and, at the same time, the most burdened by nonperforming loans is the enterprises segment, although their credit quality has improved during the first half of 2019.

This segment represents about 65.2 percent of total credit portfolio. The ratio of non-performing loans to enterprises decreased to 3.1 percent from 3.6 percent in the previous year, as a result of the decline in the stock of non-performing loans of 3.5 percent (chart 50).

Chart 50. Nonperforming loans

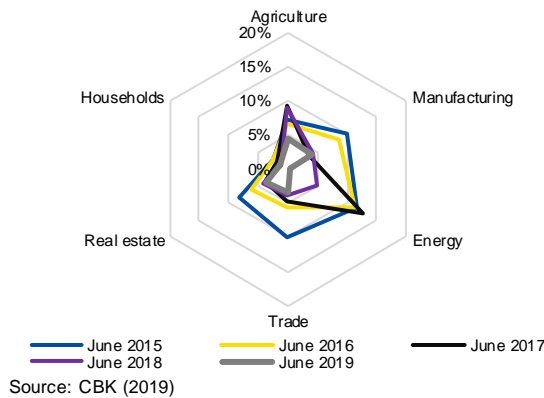


By economic activity, almost all sectors were characterized by improved loan portfolio. **The agricultural sector continues to have the highest rate of non-performing loans.** The NPL ratio for the trade sector, which represents the most credited sector, in June 2019, dropped to 3.3 percent from 3.8 percent in the previous year. While the agricultural sector, although it continues to have the highest NPL rate, this was 4.4 percentage points lower than in the previous year, down to 4.5 percent. This sector, which represents the most strategic sector of the economy, is one of the least credited sectors by banks, where only 2.9 percent of total credit stock is intended for agriculture. The following sector is represented by manufacturing sector with an NPL rate of 3.9 percent and the real estate sector with 3.8 percent (chart 51).

Credit portfolio quality for enterprises has improved, suggesting recovery of nonperforming loans during the period as a result of better economic performance of

enterprises.²⁷ The increase in KCGF utilization, which guarantees up to 50% of SME loan principal, covering part of their credit risk, is expected to be reflected in the increase in lending to sectors that have historically been less credited because of the higher credit risk carried by these sectors.

Chart 51. NPL ratio to loans stock, by sectors

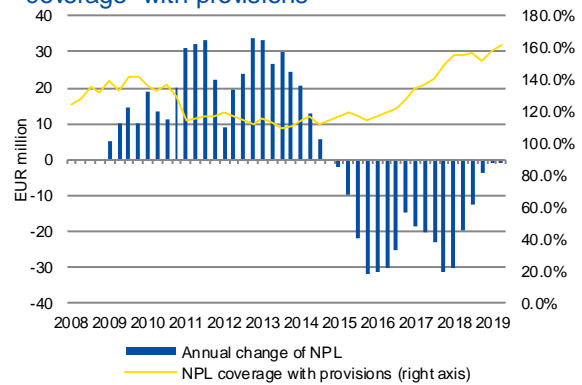


Although lending to households, especially consumer ones, has an upward trend, the credit quality of this segment remains low. Households recorded an increase in the non-performing stock of 7.9 per cent, however, the growth of the lending base affected the NPL ratio to remain unchanged at 1.2 per cent. In improving the quality of the loan portfolio contributed the regulatory factors such as the process of write-off of loss loans from bank balances according to established terms. The financial position of households is considered to be 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 conditions deteriorate, remittances mark a reduced growth rate and economic activity declines, factors that would be reflected in increased households indebtedness and weakening of their repayment ability.

²⁷ The decline in NPL can partly be attributed to the methodological changes in calculations, where from 2017 off-balance-sheet assets are not included in the calculation.

Chart 52. Annual change of NPL stock and coverage with provisions



The sector provisioning ratio has further increased as a result of the improvement of the loan portfolio quality and the increase of the provisioning stock value during this six-month-period. The accelerated pace of growth of loans to households increased the need for higher provisioning to cover potential credit losses. In June 2019, the stock of nonperforming loans decreased by 1.6 per cent, while the value of provisions for possible credit losses increased by 1.9 per cent. Consequently, the provisioning ratio increased to 161.2 per cent from 155.6 per cent as it was in June 2018 (chart 52).

The banking sector maintains a high level of provisions, which exceed the regulatory requirements, where the surplus provisions account for 40.6 per cent of the total provisioning stock held. Whereas, as a result of the increase in the provisions value, the ratio of 1.4 per cent of the net non-performing loans coverage by the loan loss provisions²⁸ to regulatory capital this year was higher than in the previous year by 1.3 per cent.

Exposure to credit risk declined during this period, driven by improved quality across all sectors and increased provisioning. The favourable macroeconomic conditions reflected in the better performance of the enterprise and household sector, as well as the regulatory measures taken for write-off of lost loans, have strengthened the credit

²⁸ Net non-performing loans represent the value of non-performing loans remaining after deducting provisions for these loans.

standing of the sector and impacted on the reduction of credit risk exposure.

The decline in credit risk exposure is expected to have a positive effect on lending dynamics in the coming period, in addition to the positive prospects for economic growth in the country. Maintaining a low level of credit risk would be further enabled by individual banks' initiatives to change credit standards in line with the dynamics and economic situation in the country, and by closely following developments in the financial performance of enterprises and mainly of households.

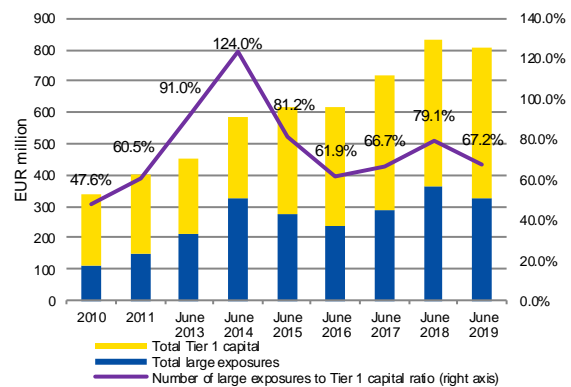
5.1.1 Large credit exposures

The credit exposure rate has dropped to 70.0 per cent from 81.2 per cent in the previous year, and is significantly below the maximum regulatory level.²⁹ The annual decline in the value of large exposures by 10.1 per cent and the increase of the Tier 1 capital by 4.2 per cent influenced the decrease of the exposure rate (chart 53).

The concentration of credit risk, expressed as a ratio between the large exposures value to the number of these exposures, has increased. The average value of large exposures³⁰ reached EUR 6.5 million from EUR 5.8 million as a result of the effect of the decline in the number of large exposures. The ratio of the three largest exposures to total exposures increased to 54.4 per cent from 53.2 per cent. The level of large credit exposures of the total banking sector is largely raised by banks operating as bank branches in Kosovo. 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

above the cap of the regulatory capital requirement.

Chart 53. Concentration of credit risk



Source: CBK (2019)

Whereas one branch of a foreign bank and two other banks where one of them is with systemic importance would result to be undercapitalized in case of default of the three and five largest borrowers. This proves that the sector, despite being below the maximum regulatory level of credit exposures, is vulnerable to potential shocks to these positions. This situation is especially emphasized with the branches of foreign banks³¹

5.2. Sustainability of profit and interest rate risk

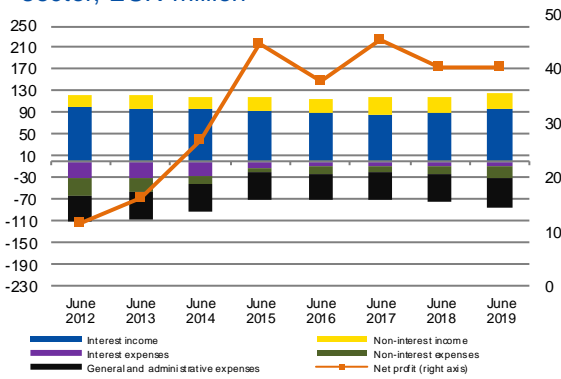
Kosovo's banking sector profit remained close to the level of the same period of the previous year, with a marginal annual decline of 0.5 percent, driven by the increase of non-interest expenses (mainly in the form of loan loss provisions). The net profit amounted to EUR 40.3 million (EUR 40.5 million in June 2018) (chart 54).

²⁹ 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.

³⁰ Ratio of total exposure to the number of exposures.

³¹ 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.

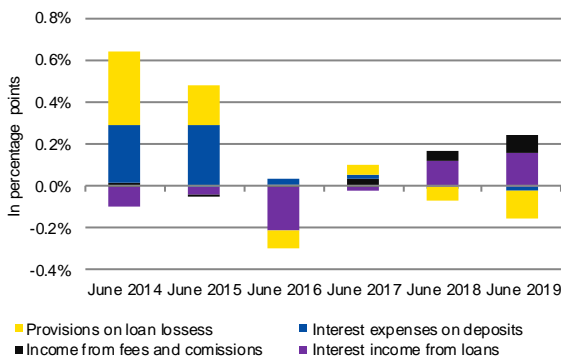
Chart 54. Profit structure of the banking sector, EUR million



Source: CBK (2019)

Although the cost of financing through deposits has increased, the level of profit was offset by lending activity revenues which marked a higher increase than interest expenses, causing net interest income this year to increase by EUR 6.0 million or 7.4 percent (4.8 percent in the previous year) (chart 56).

Chart 55. Main contributors to the growth/decline of the profit



Source: CBK (2019)

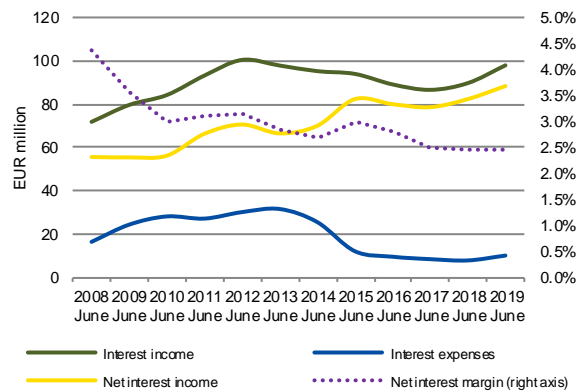
Despite the competitive pressures reflected in the reduction of interest rates on loans (to 6.3 percent or a decrease of 0.2 percentage points³²), the expansion of lending activity during the first half of 2019 resulted in total interest income increase of EUR 8.3 million (or 9.3 percent). Whereas only interest income on loans recorded an annual increase of 7.2 percent or euro 6.4 million, and were among the main contributors to the realization of profit.

Non-interest income also increased, mainly consisting of fees and commissions, which

³² As about 90 per cent of interest income and expense is realized by intermediary activity, net interest revenue is directly affected by changes in interest rates on loans and deposits (Chart 55 and 56).

increased by EUR 3.4 million, reaching a value of EUR 29.6 million (chart 55).

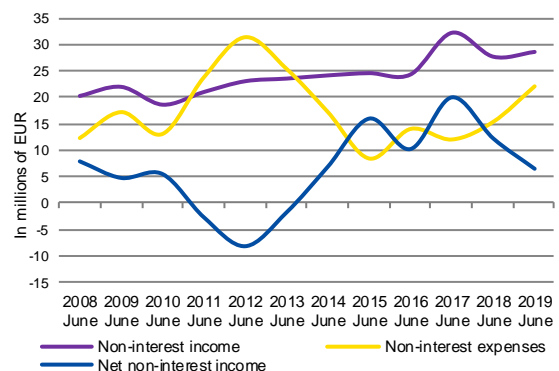
Chart 56. Interest income and expenses



Source: CBK (2019)

On the other hand, expenses increased as a result of provisions expenses which consequently contributed to the marginal decrease in profit. The increase in provision expenses is in line with the process of write-off of nonperforming loans from the balance sheets within the set deadlines.

Chart 57. Non-interest income and expenses



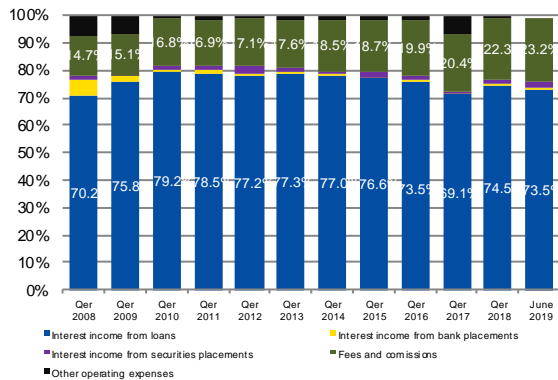
Source: CBK (2019)

Influenced by the increasing pressures of banks to expand their deposit base, interest expense, unlike previous years, changed direction and increased by EUR 2.3 million (or 29.4 percent). This is due to the increase in the average interest rate on deposits (at 1.3 percent or an increase of 0.1 percentage points³³) and a significant annual increase in deposits. However, most of the deposit expansion consists of the category of

³³ As about 90 per cent of interest income and expense is realized by intermediary activity, net interest revenue is directly affected by changes in interest rates on loans and deposits (Chart 55 and 56).

transferable deposits, which do not represent expenses for the banks.

Chart 58. Structure of banking sector income



Source: CBK (2019)

These developments led to an increase in net interest income, but due to the similar growth of both the interest bearing asset stock and the interest bearing liabilities stock, the net interest margin remained unchanged from the same period of the previous year, at 2.5 percent.

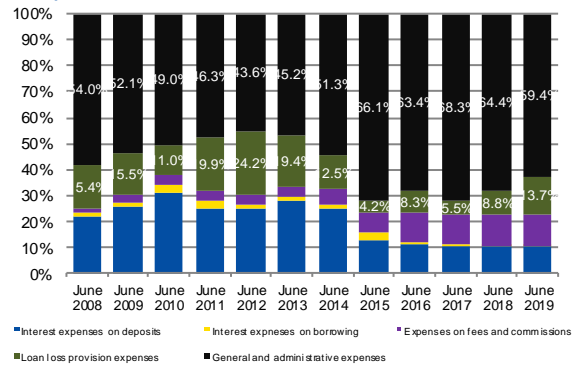
The sector's profit is expected to face the pressure of reduced opportunities for lowering financing costs through deposits against the pressure to expand their base. On the other hand, constant competition pressures to reduce the cost of mediation are also expected. The already low interest rate on deposits with a tendency for further growth, as well as the high share of transferable deposits (about 60 percent of total deposits) that do not carry interest expenses causes that possibilities for positive effects on profit realization through interest expense management be limited.

Therefore, given this and the banks' statements in the bank lending survey signalling the possibility of further decline in the interest rates on loans, the current profitability position will face downward pressures which may encourage banks to explore new ways for profit generation.

Banks' efforts to increase efficiency in managing general and administrative expenses, as well as in adapting the business

model to market needs are expected to intensify as a result of competition pressures.

Chart 59. Structure of banking sector expenditures



Source: CBK (2019)

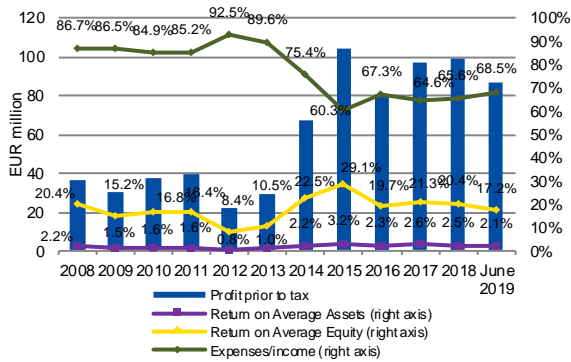
Narrowing of interest margins and the technological advances in the finance sector will drive banks in Kosovo to advance their business processes and models in order to increase efficiency in cost management and securing new sources of income generation. Banks have already increased the efforts to reduce operating costs by rationalizing activities and reducing branches, along with undertaking strategic actions to encourage increased use of automated and electronic services (chart 59). 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 slightly as a result of the marginal decline in profits, however, they still remain at the highest level in the region. Kosovo's banking sector average return on assets and return on equity dropped to 2.1 percent, respectively 17.2 percent from 2.5 percent and 20.4 percent a year earlier (chart 60).

These levels are well above the region's average, which marked a return on assets of 1.6 percent and a rate of return on equity of 12.1 percent.³⁴

³⁴ Countries in the region include Albania, Serbia, Bosnia and Herzegovina, Northern Macedonia and Montenegro.

Chart 60. Profitability indicators of the banking sector

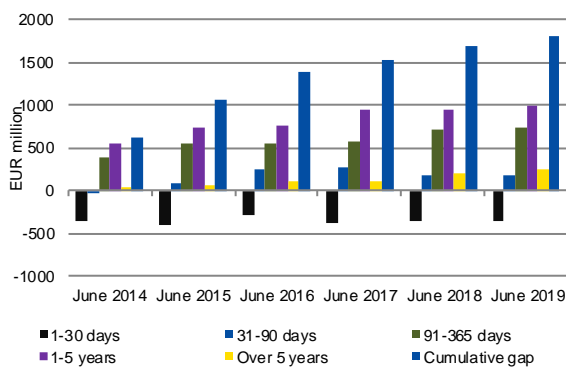


Source: CBK (2019)

5.2.1 Risk from interest rate fluctuations

The continued growth of bank lending on the one hand and the high share of transferable and shorter-term deposits increase the banking sector's exposure to risk from interest rate fluctuations.

Chart 61. Cumulative gap between assets and liabilities sensitive to interest rates



Source: CBK (2019)

The risk is manifested in the sense of generating income from reinvestment of assets and creation of expenses for refinancing activities when the maturity mismatches between assets and liabilities are significant (chart 61).

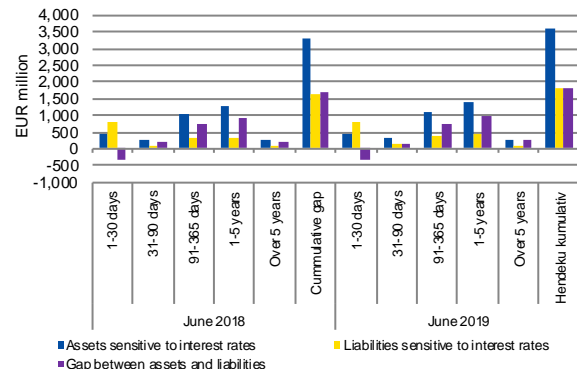
Kosovo banking sector's balance is mainly characterized by fixed interest rates, thus, the sector is affected by interest rate movements mainly at maturity of these positions.

Increase in the cost of financing, driven by the increase in the interest rates in the domestic market with a view to promoting deposits, especially from banks with lower deposit base or the potential rise in interest rates at a global

level in the medium term, may affect the increase of sector expenses pressure, as the main asset category, loans, are contracted at a fixed interest rate and have longer maturity.

This situation will promote the need for possible changes in the structure of assets and liabilities of the sector for effective risk management.

Chart 62. Assets and liabilities sensitive to interest rates



Source: CBK (2019)

Compared to the previous year, the gap widened with all maturities, except for the '31-90 days' maturity which narrowed. The positive gap for maturities over 1 year was further widened and deepened to a negative value for the maturity of '1-30 days', as a result of the increase in short-term liabilities along with the increase in longer maturity assets (chart 62). This means that the sector in the short-term maturity would face the risk of possible interest rate increases that would affect the cost of refinancing. The widening of the positive cumulative gap implies that a signal for lower interest rates in the market would increase the risk of refinancing, but at the same time would be conducive to generating income from re-investment of maturing assets.

It should be noted that the possible decline of interest rates can have a direct negative effect on interest income from investments in securities and other instruments, but the effect from the decline in the rate of financial intermediation can also be assessed as a positive signal as it affects the demand for loans and can also be understood as a reduction of burden on the borrowers.

The analysis of sector's sensitivity to potential interest rate increase 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 rate sensitive assets are higher than the liabilities for the one year period and, under the assumption that the same maturing instruments could be reinvested at a higher rate, the sector would result with positive effects on income.

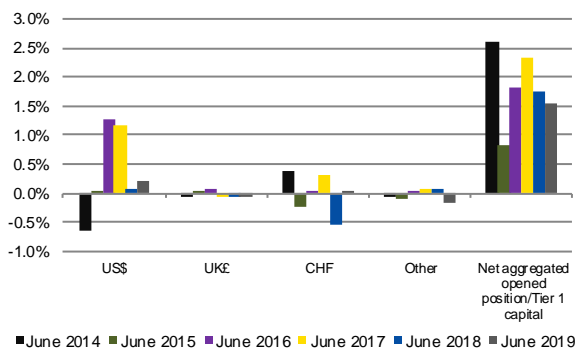
5.3. Risk from the position in foreign currency

The aggregate net open position in foreign currency decreased during the first half of the year, reducing the exposure to the risk of currency change.

The aggregate net open position for all foreign currencies declined to euro 7.4 million equivalent from euro 8.1 million, consisting of 1.5 percent of Tier 1 capital (1.7 percent in June 2018) (chart 63).

Banking sector exposure has decreased in terms of currency mismatches, where the growth of assets in foreign currency equivalent to euro dominated the increase in liabilities in foreign currency equivalent to euro. These movements caused the gap between assets and liabilities in foreign currency to shift from the negative level of the previous year to a positive level.

Chart 63. Opened positions in foreign currency to Tier 1 capital



Source: CBK (2019)

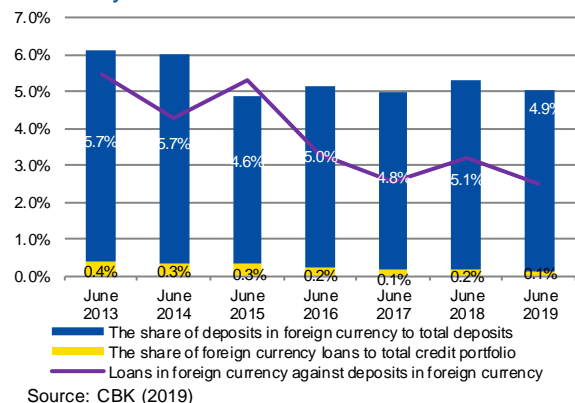
By specific currencies, the net disaggregated position to Tier 1 capital declined marginally for the British pound, while it increased for the US dollar and the Swiss franc. Liabilities in other aggregate currencies and the British pound increased, thus exceeding assets in these currencies. This means that the banking sector is more exposed to the risk of a possible depreciation of euro against these currencies at the time of maturity as the value of equivalent liabilities in euro would result to be higher and would consequently increase the cost of currency financing. While asset positions in the US dollar and the Swiss franc this year exceeded liabilities in this currency.

The ratio of net open positions for each currency to Tier 1 capital remains well below the maximum level of 15 per cent allowed under the relevant regulation.

Therefore, currency fluctuations have a marginal impact on the financial position of the sector, given the rather low level of foreign currency positions. This is also evidenced by the 'stress test' analysis which suggests a low level of sensitivity of the sector's capital position to exchange rate fluctuations.

The indirect credit risk from foreign currency exposure remains low as foreign currency loans remain negligible. Loans in foreign currency account for only 0.1 per cent of total loans, a decrease of euro 0.9 million of the foreign currency credit portfolio compared to the same period of the previous year.

Chart 64. Loans and deposits in foreign currency



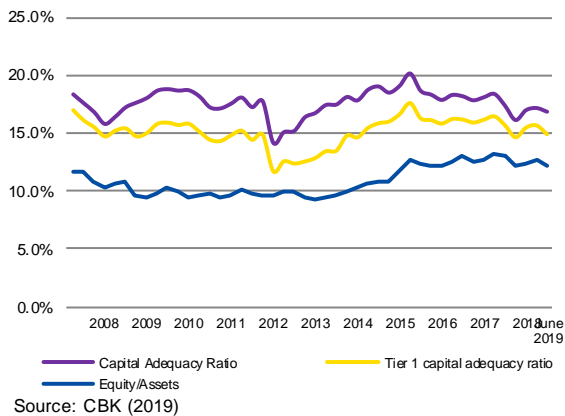
Source: CBK (2019)

Foreign currency deposits also have a low share, at 4.9 percent, despite the increase of EUR 10.3 million recorded in this six-month period (chart 64).

5.4. Capital

The sector's capital position continues to reflect high sustainability. The capital adequacy ratio decreased to 16.8 percent from 17.4 percent (chart 65).

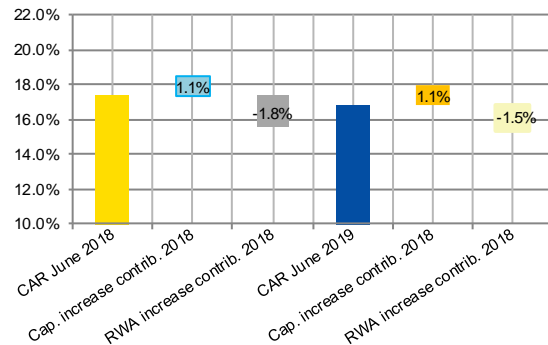
Chart 65. Banking sector capitalization



This decline reflects the increase in risk-weighted assets as a result of the increase in lending activity, along with the increase in regulatory capital. Despite the decline, the banking sector has a strong regulatory capital base, 88.4 percent of which is Tier 1 capital, largely resulting from high profits realized and retained, which at the same time indicates that banks are oriented towards the creation of capital mainly within their activity (retaining profit as equity).

Regulatory capital marked an increase of 6.5 per cent, contributing to the increase of capital adequacy ratio by 1.1 percentage points (chart 66). Within regulatory capital growth was recorded by 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.

Chart 66. Regulatory capital contribution and RWA to the capitalization ratio



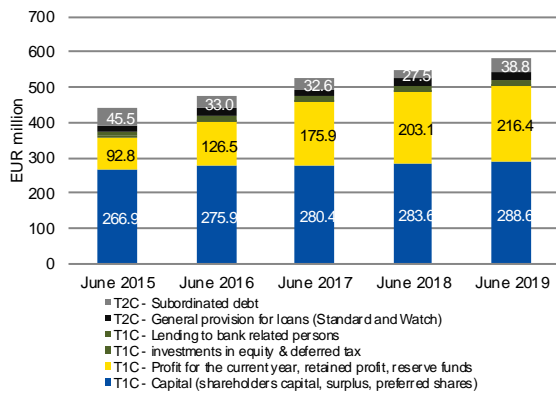
Source: CBK (2019)

The credit growth this year has led to increased sector exposure to risk-weighted assets. The increase of 9.8 per cent in risk-weighted assets contributed to the decline of the capital adequacy ratio by 1.5 percentage points. Consequently, the higher effect of the increase in risk-weighted assets than that of the increase in the regulatory capital decreased the capital adequacy ratio by 0.5 percentage points (chart 66).

According to individual banks, some of the banks that have expanded their lending activity have faced a decline in the capital adequacy ratio as a result of higher increase in risk-weighted assets. However, only one of these banks faced an increase in the risk profile, expressed through the ratio of risk-weighted assets to total assets, while the other banks had higher increase of total assets versus risk-weighted assets.

Financial leverage also declined as a result of higher growth of assets against equity. The financial leverage ratio (equity to asset ratio) dropped to 12.2 percent from 13.0 percent in the same period of the previous year, suggesting a reduction of activity financing through share capital in relation to financing through debt (chart 67).

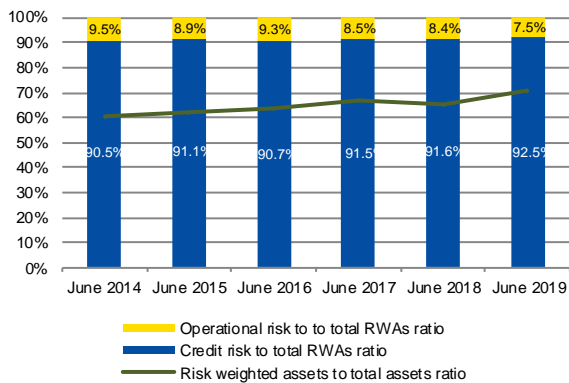
Chart 67. Regulatory capital structure



Source: CBK (2019)

Within the risk-weighted assets, both the credit risk-weighted assets and the ones intended for operational risk marked an increase. Since the banking sector's business model is predominantly the lending activity, 92.5 percent of capital requirements for risks are intended for credit risk and 7.5 percent for operational risk (chart 68).

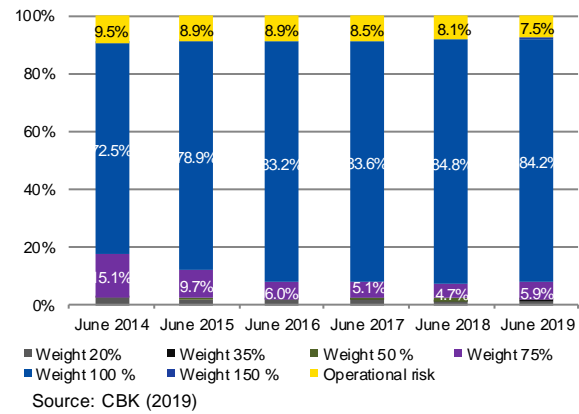
Chart 68. RWAs to total assets ratio



Source: CBK (2019)

In June 2019, credit risk weighted assets increased by EUR 286.7 million (or 10.5 percent annual growth), reaching EUR 3.0 billion. All categories marked an increase, but the largest contribution to the increase of risk-weighted assets was provided by 100% risk-weighted assets which marked an annual growth of 8.9 percent, and which dominate the total RWAs (chart 69). These movements are in line with the developments in the balance sheet of the growth of long-term lending (loans with maturity of 'over 5 to 10 years' expanded the share in total loans by 2.2 percentage points).

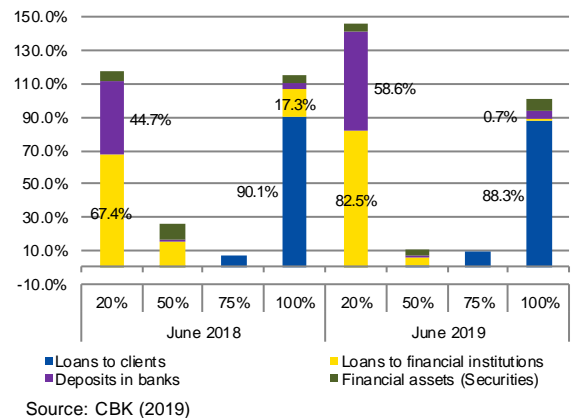
Chart 69. RWA structure by risk weight



Source: CBK (2019)

About 88.3 percent of total loans to the private and public sector in June 2019 are 100% risk-weighted, while 82.5 percent of loans to other financial institutions are 20% risk-weighted (chart 70).

Chart 70. Assets classification by risk weight



Source: CBK (2019)

The level of capital holding for operational risk has increased steadily over the years despite the continued increase in exposure to this risk. The digital revolution has affected every aspect, including the impact on the financial system, by fostering the ever-increasing adoption of advanced technology systems and the creation of infrastructure for the provision of digitalized services.

Banks in Kosovo have also been exposed to these developments, which in recent years have invested heavily in providing electronic banking services. Increasing reliance on digital services is increasing the risk of errors in information technology systems and/or potential cyber attacks. Therefore monitoring and evaluating the operational risk is a very

important issue in terms of financial stability as operational risk can simultaneously present systemic risk due to losses and the panic that may spread.

In the first half of 2019, capital allocation requirements to cover potential operating losses stood at EUR 242.8 million, marking a growth of 1.1 per cent compared to the previous year. However, operational risk management is assessed as adequate, with no cases of its materialization, and with allocation of capital to cover this risk in accordance with regulatory requirements.

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

5.5. Financing and Liquidity Risk

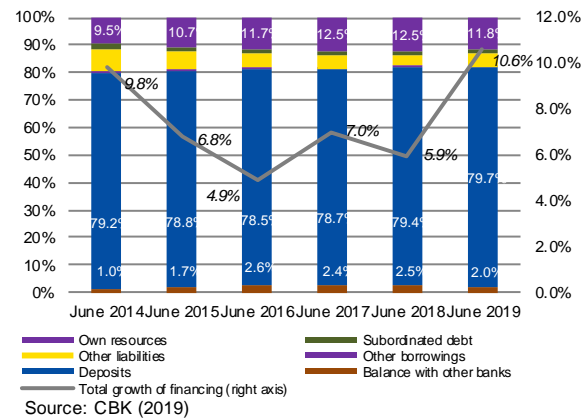
The main source of bank activities financing continues to be represented by deposits which marked an increase, mainly from households deposits. Under the influence of low interest rates, the share of transferable deposits has increased, which in combination with the increase in long-term lending, contributed to emphasising the maturity mismatches between these items. This may create uncertainties to the stability of sector financing in the sense that immediate withdrawal of transferable deposits is less predictable and the likelihood of converting other liquid assets into cash is limited and uncertain in non-favourable economic situations. However, the main liquidity indicators give positive signs for the current situation of the 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 maturity mismatches between investments and financing.

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

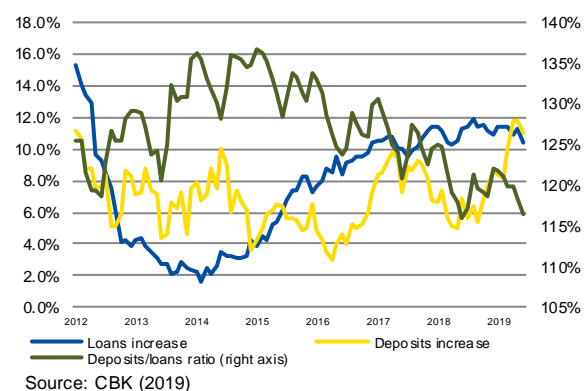
June 2019, deposits accounted for 79.7 per cent of the financing, while non-bank sector (enterprises and households) deposits alone accounted for 88 per cent of total deposits, indicating that inter-bank financing is at a very low level and that banks are very little exposed to external sector financing (chart 71).

Chart 71. Financing structure



Deposits recorded an annual increase of 11.0 per cent, reaching the amount of EUR 3.4 billion. While, non-bank sector deposits alone amounted to EUR 3.0 billion, and increased at an annual rate of 10.0 per cent. Banks continue to finance increased lending activity, mainly from deposits. This year, the deposits surpassed loans by 116.5 per cent, an indicator that marked an increase of 0.6 percentage points from the previous year, driven by the larger expansion of deposits (chart 72).

Chart 72. Increase of loans and deposits of the banking sector

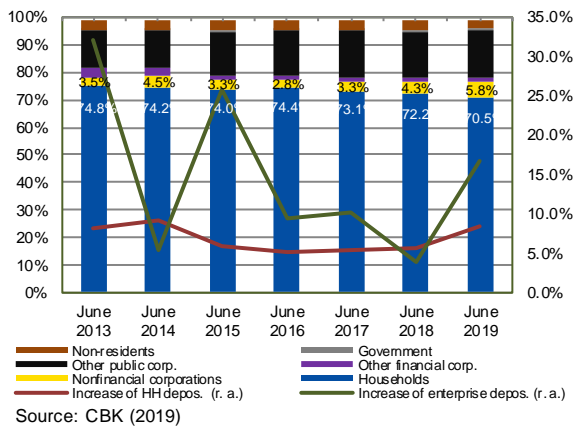


Household deposits, which represent the main source of financing, continued to increase despite the prevailing low interest rates in the market.

The growth trend continued even this year, at an accelerated pace of 8.5 per cent from 5.5 per cent as it was in June 2018. The household deposit stock amounted to EUR 2.4 billion.

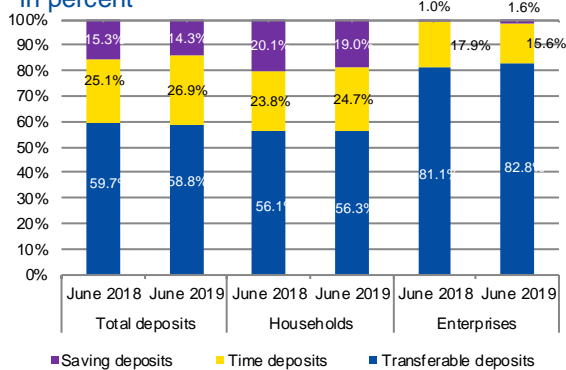
Most of them were transferable deposits which, with their annual increase of 9.0 per cent, contributed to the increase of total household deposits (chart 73).

Figure 73. Deposits structure



Enterprise deposits continued with the growth trend, with a 16.8 per cent annual increase, a considerable increase compared to the previous year. Enterprise deposits were supported by positive financial performance of enterprises, as well as by the increase of average interest rate in these deposits during these six months.

Chart 74. Structure of deposits by maturity, in percent



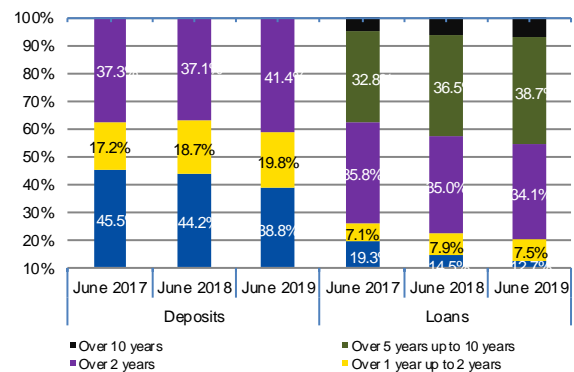
Source: CBK (2019)

The enterprise deposit stock amounted to EUR 596.8 million, with a share of 17.4 per cent in total deposits. The increase of enterprise deposits was mainly driven by the increase of transferable deposits by 19.2 per cent, due to the base effect. Time deposits were characterized by an increase of 2.0 per cent,

which could have been influenced by the slight increase of 0.29 percentage points of the average interest rate on these deposits during first half of 2019, which reached 1.87 per cent.

The structure of total deposits by maturity is dominated by transferable deposits, which marked an increase also this year, at an annual rate of 9.4 per cent. Transferable deposits reached 58.8 per cent of total deposits in June 2019 (chart 74). Whereas, 39.7 per cent of total deposits is composed of household transferable deposits. Time deposits recorded a significant annual increase of 19.0 per cent, while saving deposits recorded an annual increase of 4.0 per cent, thus putting an end to the downward trend of the last three years. 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 at a still low level.

Chart 75. Maturity structure of deposits and loans



Source: CBK (2019)

Deposits and loans maturity emphasize structural mismatches between them, which are more pronounced with 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 44.2 per cent to 38.8 per cent, dominated the structure of time deposits. Whereas loans with maturity period of ‘over 5 to 10 years’ are the ones with the highest share (38.7 per cent) in total loans and which expanded their share as of June 2019 (figure 75).

The high share of transferable deposits and domination of deposits with short term maturity, on the one hand, and the increase of long-term lending, on the other hand, have increased the needs for a stable bank financing, which may be manifested in increase of competition in the banking system in terms of movements of interest rates.

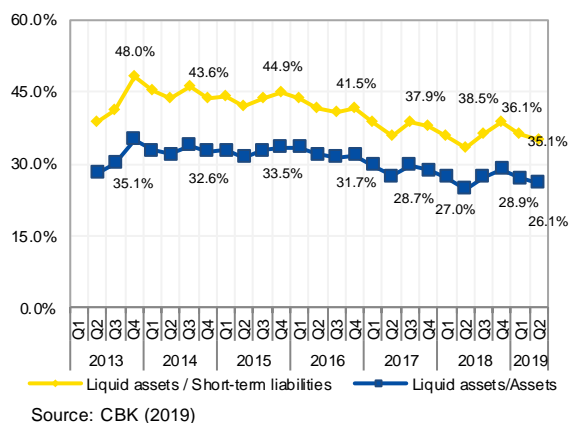
Competition pressures to reduce interest rates on loans to stimulate credit activity may at the same time create conditions for increase of interest rates on deposits by some banks in order to stimulate savings to ensure more stable financing.

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 also reflected through the increase of their ratio to short-term liabilities during the year. The higher ratio than the regulatory minimum³⁵ points to a potential for expansion of lending activity. In June 2019 the ratio of liquid assets to short-term liabilities increased to 35.1 per cent from 33.2 per cent in June 2018.

This result was driven by the higher increase of liquid assets versus the increase of short-term liabilities of 16.4 per cent and 10.1 per cent, respectively.

Chart 76. Liquidity indicators



³⁵ The ratio of liquid assets to short-term liabilities is defined in the Regulation on Liquidity Risk Management at 25% (Article 17. Liquidity rate)

³⁶ Liquidity surplus is characterized by seasonality effects. The tendency to increase the level of excess liquidity reserves is observed during the third

Likewise, the ratio of liquid assets to total assets increased to 26.1 per cent (24.8 per cent in June 2018), as a result of higher increase of liquid assets versus total assets (chart 76).

Liquid assets growth during the period resulted from the increase of EUR 92.8 million in the balance of reserves with the CBK, or an annual growth of 32.6 per cent, as well as increase in foreign governments and Republic of Kosovo Government bonds of 34.1 percent and 16.7 percent, respectively. On the other hand, the treasury bills of the Republic of Kosovo marked a decrease of 36.0 percent, which did not significantly affect the liquid assets stock given that they do not have a large share in total liquid assets. The share of liquidity reserves with the CBK increased to 34.8 per cent of liquid assets, becoming the main category as opposed to the same period of the previous year when they were the second main category after the financial instruments.

Liquidity reserves of commercial banks continue to be at high levels, exceeding the required reserve held with the CBK by 49.8 per cent. As of August 2016, CBK applied a negative interest rate on the surplus of required reserve that commercial banks in the country hold with the central bank, in line with the ECB's decision to apply negative rates on deposits.

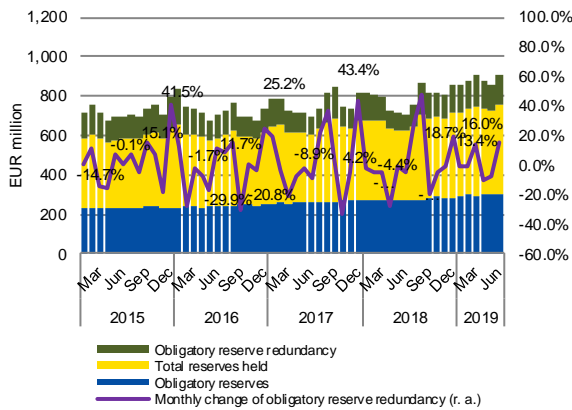
The application of the negative rate affected the reserve surplus immediately in the following month, where in September 2016 the surplus was reduced by 29.9 per cent (chart 77).³⁶ However, no long-term effects of negative rates measures at the level of the reserve surplus have been observed, potentially due to the limited scope for saving or even investing assets.

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 accelerated long-term lending, resulted in highlighting the

quarter months and in December of the respective years. Reserve surplus 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.

maturity mismatches between assets and liabilities in June 2019.

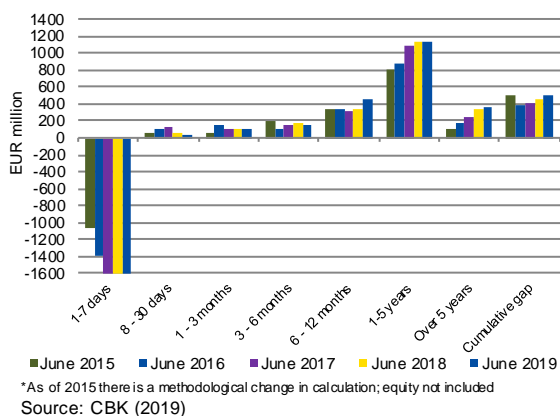
Chart 77. Liquidity reserves



Source: CBK (2019)

Deposits of enterprises and especially of households are the source of financing of the increased lending activity of banks. The maturity mismatches between investments and financing are increasing in the conditions where transferable deposits have increased and loan maturities have been extended, a development that increases exposure to liquidity risk.

Chart 78. Liquidity gap*



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

The cumulative liquidity gap expanded to EUR 503.1 million from EUR 463.5 million a year earlier. This result was mainly due to the more pronounced expansion of the positive gap between assets and liabilities of maturity periods over 6 months up to 1 year. Positive

gap expansion was also recorded in categories with a maturity period 'over 5 years' and '1-3 months'. About 37.8 per cent of total assets are categorized within the '1-5 years' maturity in relation to the liabilities of the same maturity, which account for only 11.9 per cent of total liabilities.

The negative gap results only in the maturity '1-7 days' maturity, amounting to EUR 1.8 billion. This category of maturity accounts for 69.9 percent of total liabilities, while assets comprise 18.9 percent. Consequently, maturity mismatches of the balance sheet items are most pronounced in the maturity categories '1-7 days' and '1-5 years' (chart 78). 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 analysis³⁷

According to credit portfolio shock test results, the banking sector's capital position appears to be generally stable, with very 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 sufficient provisions for covering the losses resulting from the growth of nonperforming loans under the assumed situations of shocks to 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 one bank would suffer losses, whereas 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 borrowers a higher interest increases, but this risk is not taken into account in stress test analysis.

³⁷ 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.

Table 6. Assumptions on credit risk

| Indicators | Base scenario | Adverse scenario | Severe scenario |
|--|--------------------|------------------|-----------------|
| | Assumptions | | |
| GDP (real growth rate, %) | 3.9 | 0.5 | -2.5 |
| Loan (credit growth rate, %) | 10.4 | 5.0 | 0.0 |
| Interest rate change on net positions of the balance sensitive to IR (pp.) | n/a | + 1 pp. | + 2 pp. |
| Depreciation of EUR 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 assumed situations of withdrawal of significant amounts of deposits. In all supposed scenarios, the liquidity position of most banks results as stable, except for the assumption of withdrawal of 38.3 per cent of deposits at the end of the fifth consecutive day, where eight banks will result with no liquid assets (table 10).

6.1 Assessment of resilience to macroeconomic and financial shocks to credit portfolio and capital position.

The stress test analysis on credit risk assessed the resilience of the banking sector, for the one-year period based on the situation in the first

half of this year, to potential shocks to the credit portfolio as well as to the capital position, that may arise from unfavourable macroeconomic developments occurring during the current year. 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 annual growth of 3.9 per cent. Economic growth is assumed to be accompanied by high double-digit growth in lending³⁸ and at the same time will affect the improvement of the credit portfolio³⁹ (table 7 and 8). 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 | Resilience | NPL rate reactions | | |
|---|------------|--------------------|------------------|-----------------|
| | | Base scenario | Adverse scenario | Severe scenario |
| GDP real growth (%) | -0.56 pp | -2.18 pp | | |
| Expansion of output gap | 0.80 pp | | 2.65 pp | 5.05 pp |
| Increase of interest rate on loans (pp) | 0.20 pp | | 0.20 pp | 0.40 pp |

Source: CBK (2019)

However, profit is assumed to remain almost the same as in the first half of this year, on the grounds that interest income on loans may be

increased by the effect of increases in the loan value, but this effect may be limited by the constant pressures for the decrease of interest

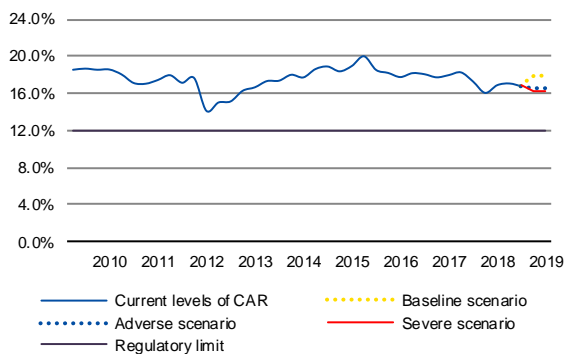
³⁸ Banks' forecasts for 2019 suggest that the annual growth of the banking sector lending will be 10.4 per cent.

³⁹ 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.

rates on loans, while non-interest income is not expected to continue to grow due to limited space for further increase of fees and commissions. 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 for increase in interest rates on deposits. Consequently, the effects of the growth and decline of profit components will exclude each other, thus allowing us to assume that profit will remain close to the current year level. This scenario does not take into account the risk coming from the market. This is based on bank statements that interest rates on loans are expected to decline slightly⁴⁰, while interest rates on other assets, which are mainly affected by ECB decisions, such as interest on deposits held with European banks, which until September this year remained unchanged. However, the ECB's decision in mid-September to reduce the interest rate on deposits by 10 percentage points will affect banks' decisions on investments on deposits in the last quarter of this year. Therefore, under these conditions, in this scenario it is assumed that interest rates on assets and liabilities will be kept the same as in the first half of the current year.

Chart 79. Capital Adequacy Ratio, by scenarios



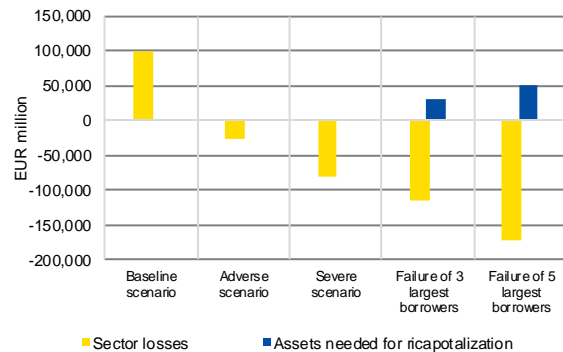
Source: CBK (2019)

Results based on these assumptions suggest a further improvement of the credit portfolio quality. Non-performing loans ratio would

drop to 0.3 per cent from the current level of 2.5 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 17.9 per cent from the current level of 16.8 per cent (chart 79 and table 8).

In the moderate scenario it is assumed that in 2019 there will be an economic growth of 0.5 per cent, a much slower growth compared to 2018 (table 6). The slowdown in economic growth is thought to have discouraging effects, causing underutilization of capacities, and consequently expansion of the output gap⁴¹. Slowdown of economic growth will be accompanied by narrowing of lending growth, depreciation of the Euro currency against other currencies applied to net foreign currency positions and increase of interest rate applied to the balance sheet gap of the interest rate sensitivity ($\Delta \text{Net interest income } i = \text{Gap } i \times \Delta \text{NI}i$). The profit is supposed to suffer a shock as a result of the slow growth of lending and the increase in the default rate of existing loans.

Chart 80. ST results for credit risk-losses and recapitalization



Source: CBK (2019)

These assumptions are reflected in the profit calculation for 2019, thus the net profit after tax, realized until June 2019, was taken as a basis, to which a 50 per cent shock (reduction margin) is then applied and the revenues are

⁴⁰ Bank Lending Survey.

⁴¹ 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.

deducted that would be realized had the NPLs not increased⁴².

These developments will deteriorate 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 of the sector will increase by 2,85 percentage points reaching 5.3 per cent from the current level of 2.5 per cent. Sector losses would amount to EUR 26.4 million (chart 80). These losses will be directly charged to the capital, which would result in bringing the capital adequacy ratio down to 16.5 per cent for 2019 (table 8).

At the level of individual banks, one bank would face capitalization problems, whose CAR would drop to 9.1 per cent, which is below the regulatory minimum. Additional funds needed to bring the capital up to the required minimum level will reach the value of EUR 2,9 million (table 8). This bank has no general systemic 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 results for this bank should be interpreted with caution.

In the severe scenario it is assessed the sensitivity of the 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 repayment ability 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 gap⁴³. As a result of shocks in the real sector, it is assumed that lending will not increase in the following period. The depreciation of the Euro currency

against other currencies is assumed to be higher than in the moderate scenario. This scenario also assumes higher interest rates increase on balance sheet positions compared to the moderate scenario (table 6). 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 investment uncertainty created, and which subsequently, at a later stage, would create pressures 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 on sources of financing, and based on the fact that the monetary authority of the European Union has decided, in September this year, on further reduction of deposit interest rate of 10 percentage points, and the bank investment strategies would be affected by this decision in the end of year period. The analysis is based on static balance sheet assumption, 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 default of existing loans. These assumptions are reflected in the calculation of profit for 2019, thus the net profit after tax realized up to June 2019, has served as a basis, on which a shock (reduction margin) of 60 per cent was applied and the income were deducted that would be realized, if there were no increase in the NPL⁴⁴.

⁴² The assessment of the 'lost' revenues as a result of the increase of the NPL's was initially conducted by calculating ex-post the general interest rate on loans for each bank, which was then multiplied by the added value of the NPL's

⁴³ Since the sensitivity of non-performing loans to GDP has been calculated based on data when the country has only had economic growth periods, this

does not imply that the NPL rate would have a same magnitude response in circumstances of economic decline. Therefore, in the severe scenario where economic decline is assumed, the NPL sensitivity is based on the coefficient of response to output gap and not to the GDP.

⁴⁴ The assessment of the 'lost' revenues as a result of the increase of the NPL's was initially conducted by calculating ex-post the general interest

In the severe scenario, the credit portfolio will deteriorate, and thus the share of nonperforming loans to total loans will increase by 5.45 percentage points, reaching 7.9 per cent. Sector losses would amount to EUR 79.4 million (chart 80). However, the high level of provisions held by individual banks makes the sector appear 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 16.3 per cent by the end of 2019, which is well above the regulatory requirements (table 8). Moreover, even the assumption of increased interest rates has given positive effects on net interest income, due to the fact that the sector has a positive gap of balance sensitive to interest rates and under the assumption 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 EUR depreciation on sector revenues turns out positive due to the positive

net open position of the sector during the current year, albeit at very low level. This means that the potential depreciation of the EUR against other currencies would bring higher income because the net equivalent value in EUR would be higher.

At the level of individual banks, as in the case of moderate scenario, the same bank would face capitalization problems, whose CAR would drop to 8.5 per cent. Additional funds needed to increase capital at the minimum required level would be a total of EUR 3.5 million (chart 80, table 8).

The risk scenario from the default of large credit exposures: in this scenario, it is estimated the banks' resilience to the potential default of three and five major borrowers. The assumption of the failure of three major borrowers would affect the capitalization at sector level dropping to 15.1 per cent and the loss would reach EUR 114.2 million (chart 80 and table 8).

Table 8. Results of stress test scenarios for credit risk

| Description | Number of banks with CAR<12% | Capitalization rate | | | NPL rate | | | Additional assets needed for recapitalization (EUR thousands) |
|--|------------------------------|---------------------|-------------|--------------|--------------|-------------|--------------|---|
| | | higher level | lower level | sector level | higher level | lower level | sector level | |
| Current levels (prior to shocks) | | 138.1 | 10.3 | 16.8 | 4.2 | 0.0 | 2.5 | |
| Scenarios results | | | | | | | | |
| Baseline scenario: NPL decline for 2.18pp, credit growth of 10.4% | | 131.9 | 10.6 | 17.9 | 2.0 | -2.1 | 0.3 | |
| Adverse scenario: NPL increase for 2.85pp, annual slow down increase in lending for 5.5pp, interest rate increase for 1pp applied in the balance gap sensitive to IR, adjustment of positions in foreign currency based on EUR depreciation for 10pp. | 1 | 135.1 | 9.1 | 16.5 | 7.0 | 2.9 | 5.3 | 2,956 |
| Severe scenario: NPL increase for 5.45pp, stagnation in lending, interest rate increase for 2pp applied in the balance gap sensitive to IR, adjustment of positions in foreign currency based on EUR depreciation for 20pp. | 1 | 139.0 | 8.5 | 16.3 | 9.6 | 5.5 | 7.9 | 3,521 |
| Failure of three largest borrowers | 3 | 134.6 | (8.1) | 15.1 | 48.0 | 0.0 | 8.5 | 30,513 |
| Failure of five largest borrowers | 3 | 134.6 | (13.9) | 14.2 | 62.7 | 0.0 | 10.7 | 49,448 |

Burimi: BQK (2019)

Three banks would face high losses, among which one bank of general systemic importance would appear as undercapitalised, and another bank which is a branch of a foreign bank⁴⁵, its CAR would drop to negative levels. These three

banks would need EUR 30.5 million to reach required level of capital.

The default of the five largest borrowers would further deteriorate the situation in these three banks. The losses would reach a total of EUR 172.8 million and the sector CAR would drop to

rate on loans for each bank, which was then multiplied by the added value of the NPL's.

⁴⁵ Operating in the capacity of a foreign bank branch, the bank is 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..

14.2 per cent. All three under-capitalized banks would need additional EUR 49.4 million to increase the capital (chart 80 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 sector total.

5.6.2 Assessing the resilience to liquidity position shocks

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

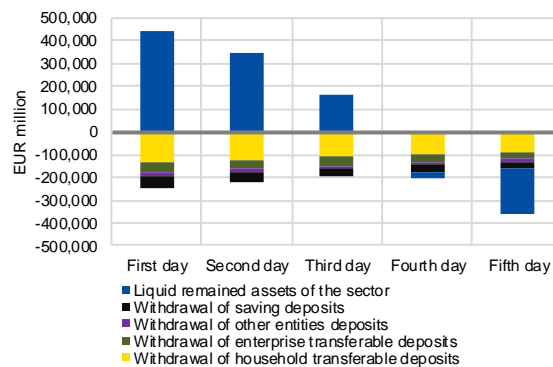
The test is based on two hypothetical scenarios that assess the adequacy of liquid assets of banks to withstand withdrawals of a certain amount of deposits within 5 days and to cope with the risk of the failure of concentrated deposits. The scenarios are quite conservative due to the fact that the possibility of banks meeting part of their liquidity needs through external financing sources has not been taken into account.

Scenario 1: Withdrawal of deposits on a daily basis

In this scenario, the withdrawal of deposits broken down by structure and entities is

considered, at different levels of withdrawals on a daily basis (table 9) for five consecutive days.

Chart 81. ST results for liquidity risk - scenario 1



Source: CBK (2019)

After each day, 5% of deposits are allocated from the remaining deposits for the purposes of bank operation in the following days. This implies that, under the assumed scenarios, the obligatory reserve of 10 per cent would be halved. 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 liquid assets, while the possibility of converting non-liquid assets to cash would be only 1 per cent of these assets within a day.

Table 9. Assumptions for liquidity risk scenarios

| Withdrawals of deposits | Assumptions for time withdrawals | Level of deposits withdrawal |
|--|-----------------------------------|------------------------------|
| 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% |
| Saving deposits | Every day, for 5 consecutive days | 10.0% |
| Time deposits | Every day, for 5 consecutive days | 8.0% |
| Five largest depositors | Intraday | 100.0% |
| Twenty largest depositors | Intraday | 100.0% |

Source: CBK (2019)

These assumed levels of daily withdrawals are based on the experiences of the banking sector of the countries of the region that 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

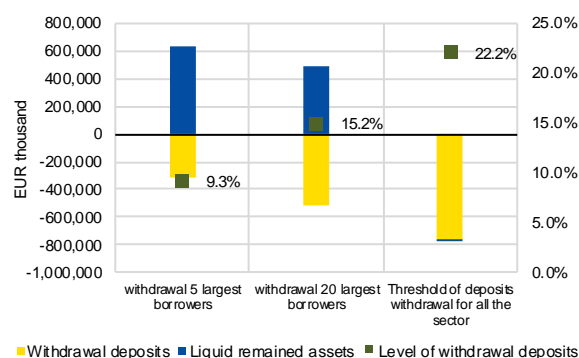
of such occurrences, based on the practices of the countries of the region it is assumed that in crises situations this level of withdrawals could materialize.

Scenario results suggest that banks could withstand withdrawal of deposits at defined levels on a daily basis until the third day. On the fifth day, liquidity problems would appear in eight banks, including here banks of general systemic importance. The value of deficient liquid assets of these banks would reach EUR 206.5 million (chart 81, table 10). The level of total deposit withdrawal in the banking sector on the fifth day would reach 38.3 per cent (chart 82, table 10).

Scenario 2: Withdrawal of deposits by the largest depositors

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

Chart 82. ST results for liquidity risk - scenario 2



Source: CBK (2019)

Table 10. Stress test scenario results for liquidity risk

| Results of credit risk scenarios | Number of banks which lack liquid assets | Level of withdrawal deposits (%) | Additional needed liquid assets (in thousands of EUR) | Loans to deposits ratio |
|--|--|----------------------------------|---|-------------------------|
| Scenario 1: Withdrawal of deposits on a daily basis at the end of the fifth day | 8 | -38.3% | (206,492.7) | 138.1% |
| Scenario 2.1: Withdrawal of deposits from 5 largest borrowers | 1 | -9.3% | (2,835.8) | 94.0% |
| Scenario 2.2: Withdrawal of deposits from 20 largest borrowers | 2 | -15.2% | (16,647.5) | 100.5% |
| Threshold - Withdrawal of deposits to the critical level of liquidity | | -22.2% | (47,556.7) | 109.5% |

Source: CBK (2019)

Whereas under the assumption that the twenty largest depositors of each bank will withdraw their deposits within the day, the liquidity situation would weaken in another

bank as well. The lack of funds for these two banks would amount to EUR 16.6 million (chart 76, table 9). The results of this scenario generally suggest that the Kosovo banking sector does not have a significant concentration of the source of financing, which are the deposits as the main component of liabilities.

5.6.2.1 The coping level of withdrawal of deposits before the liquidity position reaches critical levels

Liquidity problems for the entire banking sector would arise in case of withdrawal of 22.2 per cent of deposits within one day, which implies that the banking sector may be able to withstand the withdrawal of close to one quarter (1/4) of total deposits without needing extra liquid assets (chart 82 and table 10). Whereas at bank level, the bank with the lowest withdrawal threshold stands at 17.0 per cent, while the bank with the highest threshold stands at 37.0 per cent (as a result of the high level of liquid assets owned by this bank).

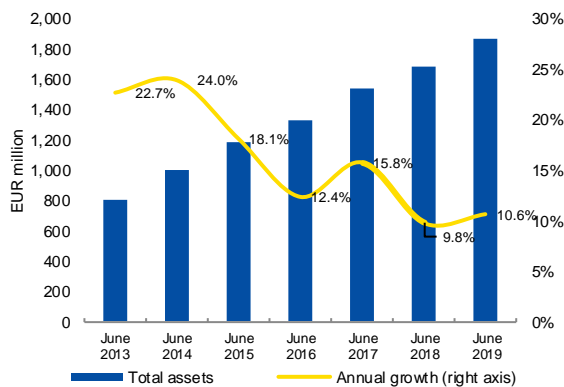
6. Non-bank financial institutions

6.1. Pension sector

Pension sector activity

Good financial performance during the first half of 2019 and stable income from the collected contributions impacted the further expansion of the pension sector.

Chart 83. Assets of the pension sector



Source: CBK (2019)

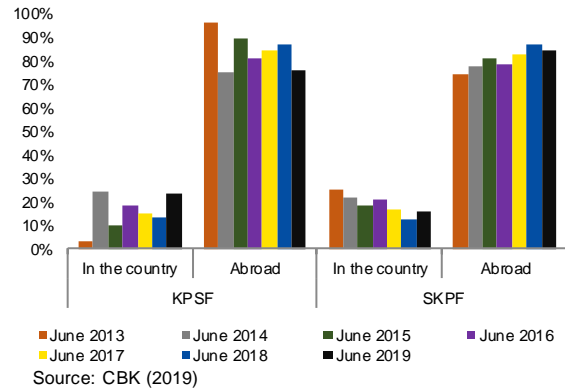
The value of assets of the pension sector was characterized by an annual growth of 10.6 per cent, amounting to EUR 1.87 billion (chart 80). The Kosovo Pension Savings Trust (KPST) represents the largest part of the sector's assets (99.6 per cent), while the remainder is managed by the Slovenian-Kosovo Pension Fund (SKPF). New collections marked an annual increase of 8.5 per cent, whose value reached EUR 90.8 million as of June 2019. Whereas, the return on investment during this period amounted to EUR 116.2 million (EUR - 13.1 million in the previous period).

Structure of KPST assets continued to be dominated by investments in external markets, however in the last year it was noticed a growth trend of investments in the domestic market, namely in government debt.

As of June 2019, the foreign markets investment portfolio decreased by 2.7 per cent, (an increase of 12.2 per cent as of June 2018) mainly as a result of investment orientation in the domestic market as well. The diversification of assets under management

can be attributed to the negative financial performance realized in 2018, despite the recovery recorded in the first quarter of 2019.

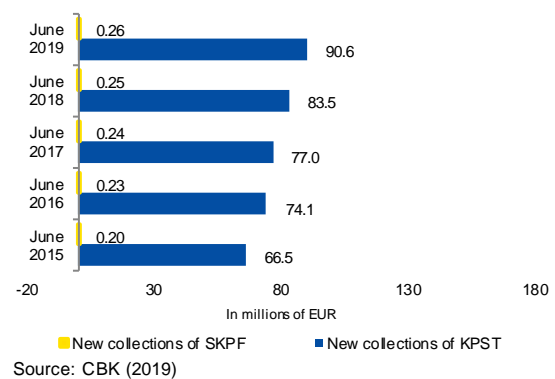
Chart 84. Structure of pension sector investments



Investments abroad decreased their share to 76.4 per cent (86.9 per cent in June 2018), while domestic investments increased their share to 23.6 per cent (13.1 per cent in June 2018) (chart 84).

Within domestic investments, the share of Kosovo's Government securities continues to be the category with the largest weight, followed by that of deposit certificates and cash held in the country. The weight of securities decreased to 60.4 per cent (68.9 per cent in June 2018), whereas the weight of certificate deposits increased to 33.1 per cent (23.1 per cent in June 2018). Dynamics of investments in Kosovo's Government securities depends on the demand but also on the amount offered by the Government as well as the competition at auctions.

Chart 85. Contributions collected by pension funds



Source: CBK (2019)

As of June 2019, the value of total assets of SKPF amounted to EUR 7.8 million, marking an annual decrease of 7.2 per cent (growth of 3.7 per cent in June 2018). The new collections amounted to EUR 259.3 thousand as of June 2019, corresponding to an annual growth of 3.3 per cent, which constitutes a higher growth than the growth marked in the previous year, which had reached 2.7 per cent (chart 85).

Largest part of SKPF assets continue to be invested abroad, with 81.3 per cent of total assets. The investment strategy abroad consists mainly of investments in the form of shares (81.4 per cent), securities (16.4 per cent), and cash (2.2 per cent). On the other hand, investment in Kosovo increased their share to 15.1 per cent of total SKPF assets, from 12.0 per cent in the same period of the previous year. Limited opportunities for investment in the domestic market lead to SKPF assets being allocated into Kosovo's Government securities (73.2 per cent), deposits in commercial banks (19.7 per cent) and the remainder as cash in SKPF's Treasury (7.1 per cent).

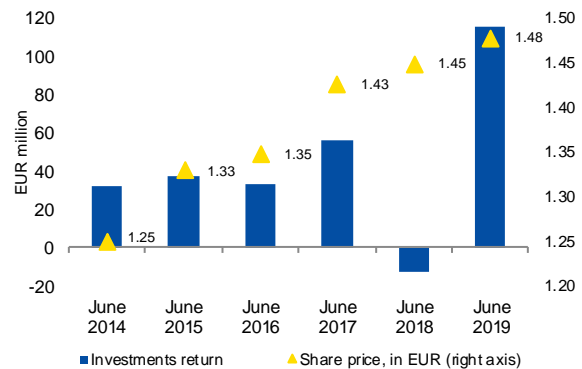
6.1.1 Pension sector financial performance

The pension sector marked a positive financial performance in the first half of 2019 as a result of the high return on investment in the foreign market. KPST had a return on investment of EUR 115.5 million compared to negative return on investment of EUR 13.2 million as of June last year (chart 86).

As a result of good financial performance, KPST closed the last day of June 2019 with a higher share price compared to the same period of the previous year. Specifically, the share price rose to EUR 1.48 compared to EUR 1.45 in June 2018. The high return on investment during this period came as a result of the positive performance in international financial markets, staying at positive quotas despite a strong shock which took place in May this year. Economic and corporate business indicators were encouraging for investors, although the potential risks of rising political

tensions and potentially the continued fluctuations in financial markets remain evident.

Chart 86. Financial performance of Kosovo Pension Saving Fund

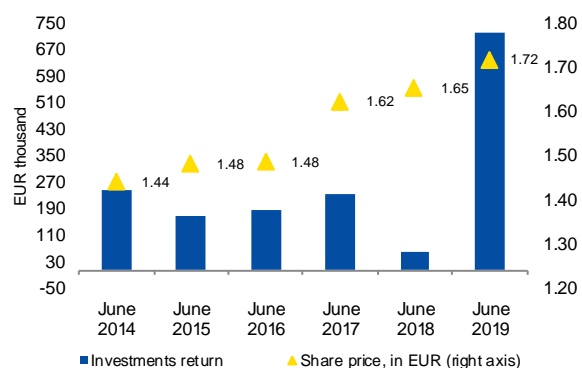


Source: CBK (2019)

SKPF marked positive return on investment during the first half of 2019.

As of June 2019, the gross return on investment amounted to EUR 716.2 thousand, compared to the return of EUR 54.1 thousand in June 2018 (chart 87). Whereas, the price of KPST shares on the last day of June 2019 increased to EUR 1.72 compared to EUR 1.65 in the previous period.

Chart 87. Financial performance of Slovenian-Kosovo Pension Fund



Source: CBK (2019)

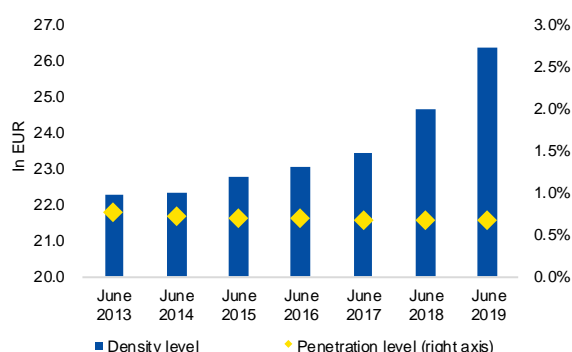
6.2 Insurance sector

6.2.1 Activity of the insurance sector

The insurance sector during the first half of 2019 was characterized by increased activity and higher level of premiums collected. However, they were insufficient for the sector to generate profits due to the increase in the level of

claims incurred and other operating expenses.

Chart 88. Development indicators of insurance sector



Source: CBK (2019)

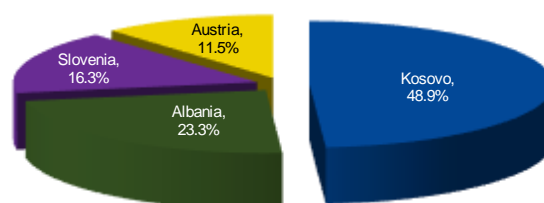
With a share of 2.8 per cent to total financial system assets, the insurance sector is the fourth largest sector by size. Sector intermediation level (gross written premiums in relation to GDP) results to have been at a level almost unchanged in the last five years, of 0.7 per cent, which is considered as relatively low, compared to the countries in the region. On the other hand, the density level, which represents written premiums per capita, has marked a gradual increase over the years, reaching at EUR 26.3 in June 2019 (chart 88).

The interconnection between the insurance sector and other segments of the financial system is still at a low level, which minimizes the possibilities of spread of risks to 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 has a significant weight in the operation and stability of the insurance sector and other sectors in the country's financial system.

The structure of the insurance sector continues to be dominated by 'non-life' insurer services, which represent 91.0 per cent of the insurance market assets, while the remainder consists of the assets of 'life' insurance companies. The number of insurance companies decreased in June 2019 as a result of withdrawal from the market of one 'life' insurer and liquidation of

one 'non-life' insurer. Consequently, the number of insurance companies decreased from 15 to 13 insurance companies, out of which 11 are 'non-life' insurance companies and 2 are 'life' insurance companies.

Chart 89. Structure of assets of insurance sector, by ownership (June 2019)



Source: CBK (2019)

The insurance market is slightly dominated by foreign origin insurers, however domestic insurers have the highest share to total sector assets. The voluntary withdrawal from the market of one of the 'life' insurers during 2018, and the liquidation of one of the 'non-life' insurers in the first half of 2019, resulted in a decline in the share of assets managed by foreign-owned companies to 51.1 percent (52.9 percent in June 2018). Thus, Albania had the highest share in total assets of the insurance sector in June 2019, followed by Slovenia and Austria (chart 89). It is worth mentioning that in the domestic market, two insurers originating from Albania have Austria as 'native' origin, and if this were taken into account, then insurers from Albania would have a share of 8.3 percent in total insurance market assets, while insurers originating in Austria would have 26.5 percent of the market.

The insurance market in Kosovo is characterized by a low concentration, which is a precondition for enabling of higher competition in the market, though with an increasing tendency during this period.

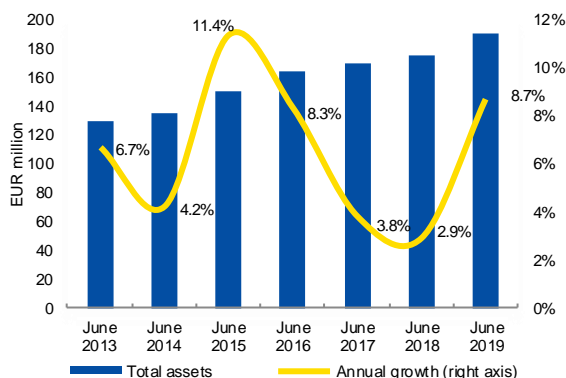
The Herfindahl⁴⁶ index calculated for gross written premiums for June 2019 shows 941 points (in June 2018 it was 877 points).

Whereas, the same index calculated based on insurance market assets shows lower values, i.e. 865 points in June 2019 from 807 in June 2018. Similarly, CR5⁴⁷ index for premiums in June 2019, calculated in relation to GWP (Gross Written Premiums) for the insurance sector is 55.4 percent (June 2018 - 53.6 percent) whereas calculated in relation to assets is 52.6 per cent (June 2018- 49.0 per cent). By sectors, the concentration is higher in the 'life' insurance sector, due to the smaller number of insurance companies in this sector. The increase of concentration in both assets and premiums is a result of the reduction in the number of insurance companies from 15 in June 2018 to 13, which is the current number.

Insurance sector assets amounted to EUR 190.0 million in June 2019, marking an annual growth of 8.7 per cent (chart 90). 'Non-life' insurer assets increased by 8.8 percent, whereas 'life' insurer assets marked an annual growth of 7.8 percent.

Within the assets, investments in securities of the Government of Kosovo and receivables from the insured were characterized by a significant increase, whereas the deposits held in commercial banks decreased.

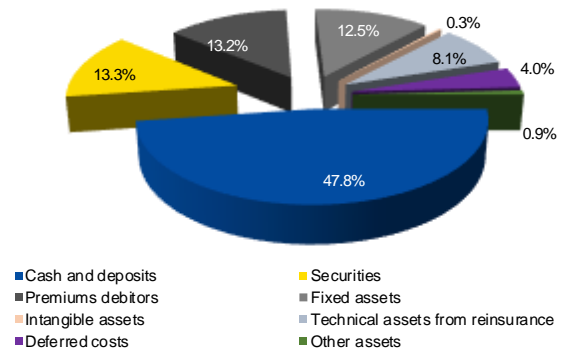
Chart 90. Assets of insurance sector



Source: CBK (2019)

Cash and deposits held with commercial banks and the CBK remain the dominant category in the balance sheet of the insurance sector with a share of 47.8 per cent. This asset structure suggests that the assets of the insurance companies contain a high percentage of high liquid assets.

Chart 91. Structure of assets of insurance sector (June 2019)



Source: CBK (2019)

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 13.3 per cent in June 2019, from 9.1 per cent in the same period of the previous year (chart 91). Within own liabilities and sources, technical reserves have the lead in the general structure.

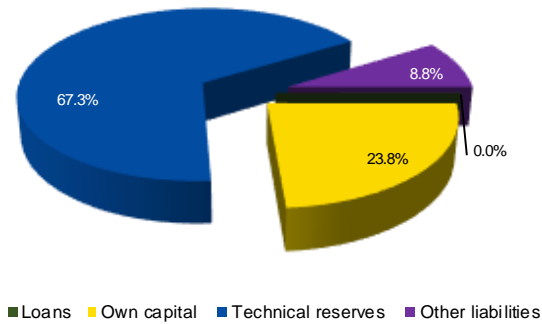
Technical provisions, which constitute the largest part of the liabilities of insurance companies in June 2019, recorded an annual growth of 10.6 per cent. Mainly, the increase in technical reserves was positively influenced by the annual growth of 12.6 per cent of gross claim provisions, followed by the gross premiums reserves, marking an increase of 5.7 per cent (chart 92).

⁴⁶ Herfindahl index is calculated by the following formula: $HI = \sum_{i=1}^n (s_i)^2$, where S 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.

⁴⁷ 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.

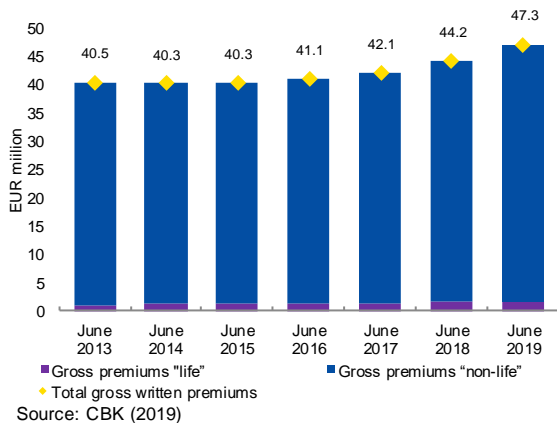
Chart 92. Liabilities and capital of insurance sector (June 2019)



Source: CBK (2019)

The value of the insurers’ total capital increased by 0.5 per cent reaching EUR 45.3 million. Further capital growth was offset by operation at a loss of insurers during this period.

Chart 93. Gross collected premiums



As of June 2019, the value of premiums written by insurance companies amounted to EUR 47.3 million, an annual increase of 6.9 percent (chart 93). The structure of written premiums is dominated by 'non-life' insurance premiums which represent 96.3 per cent of total written premiums.

By June 2019, these premiums amounted to EUR 45.5 million, an annual increase of 6.6 per

cent. The remainder of total written premiums consist of 'life' insurance premiums, which amounted to EUR 1.8 million, representing an increase of 18.0 percent.

The product that dominates the insurance market continues to be that of Third Party Liability. During the first half of 2019 compulsory insurance products are increased by 1.7 per cent, while their share in total gross written premiums decreased to 54.7 per cent, compared to 57.5 per cent in June 2018 (table 11). While voluntary insurance increased by 13.7 percent, their share in total gross written premiums increased to 41.6 per cent from 39.1 per cent in June 2018. Increased voluntary insurance share in total gross written premiums was influenced by the increase in premiums for products such as 'Accident and Health', Liability Insurance, Casco and other products which marked a slight increase (table 12).

Table 11 shows the statistics of the claims incurred during this period, which reached the value of EUR 23.7 million as of June 2019, from EUR 19.7 million in June last year. This increase in the value of damages incurred in the first half of 2019 is mainly attributed to compulsory insurance products, namely “MTPL”, which recorded an increase of EUR 4.3 million, while the category “Border Insurance” decreased by EUR 0.5 million. As of June 2019, the value of compulsory insurance claims incurred amounted to EUR 16.0 million. Whereas, as regards to the voluntary insurance, the value of the damages incurred amounted to EUR 6.9 million. Out of which, the categories "Casco" and "Insurance against financial losses" recorded the highest growth. Whereas, the category "Accidents and health" and "Loans and Guarantees" recorded a decrease.

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

| Activity | June 2018 | June 2019 | Change | Share: June 2018 | Share: June 2019 |
|-------------------------------|-------------|-------------|-------------|------------------|------------------|
| <i>Total non-life</i> | 42.7 | 45.5 | 6.6% | 96.6% | 96.3% |
| <i>Obligatory insurance</i> | | | | | |
| MTPL | 22.0 | 22.3 | 1.3% | 49.7% | 47.1% |
| TPL+ | 1.1 | 1.1 | 5.6% | 2.5% | 2.4% |
| Border insurance | 2.4 | 2.5 | 3.6% | 5.4% | 5.2% |
| <i>Voluntary insurances</i> | | | | | |
| Accident and health | 9.5 | 10.7 | 12.6% | 21.4% | 22.5% |
| Casco | 2.4 | 2.9 | 19.2% | 5.5% | 6.1% |
| Loans and guarantees | 1.8 | 1.7 | -5.5% | 4.0% | 3.5% |
| Property insurance | 2.7 | 2.7 | 0.1% | 6.1% | 5.7% |
| Insurance on financial losses | 0.4 | 0.6 | 80.9% | 0.8% | 1.4% |
| Liability insurance | 0.5 | 1.0 | 100.1% | 1.2% | 2.2% |
| Navy and transport | 0.1 | 0.1 | 2.4% | 0.2% | 0.2% |
| <i>Total life</i> | 1.5 | 1.8 | 18.0% | 3.4% | 3.7% |
| Total market | 44.2 | 47.3 | 6.9% | 100.0% | 100.0% |

Source: CBK (2019)

Table 12. Claims incurred, by business classes (EUR million)

| Activity | June 2018 | June 2019 | Change | Share: June 2018 | Share: June 2019 |
|-------------------------------|-------------|-------------|--------------|------------------|------------------|
| <i>Total non-life</i> | 18.9 | 22.9 | 20.8% | 96.2% | 96.4% |
| <i>Obligatory insurance</i> | | | | | |
| MTPL | 10.1 | 14.4 | 42.7% | 51.1% | 60.5% |
| TPL+ | 0.1 | 0.1 | -26.9% | 0.5% | 0.3% |
| Border insurance | 2.1 | 1.5 | -25.8% | 10.6% | 6.5% |
| <i>Voluntary insurances</i> | | | | | |
| Accident and health | 5.2 | 5.0 | -3.7% | 26.5% | 21.2% |
| Casco | 1.1 | 1.4 | 26.2% | 5.6% | 5.8% |
| Loans and guarantees | 0.1 | 0.1 | -28.5% | 0.4% | 0.3% |
| Property insurance | 0.2 | 0.2 | 6.6% | 1.1% | 0.9% |
| Insurance on financial losses | 0.1 | 0.2 | 193.0% | 0.4% | 1.0% |
| Liability insurance | 0.0 | 0.0 | -346.5% | 0.0% | -0.1% |
| Navy and transport | 0.0 | 0.0 | -259.6% | 0.0% | 0.0% |
| <i>Total life</i> | 0.8 | 0.9 | 13.3% | 3.8% | 3.6% |
| Total market | 19.7 | 23.7 | 20.5% | 100.0% | 100.0% |

Source: CBK (2019)

Claims paid by the insurance sector, which includes insurance companies and the Kosovo Insurance Bureau (KIB) claims, marked a slowdown of annual growth to 4.8 per cent (5.2 per cent in June 2018), reaching EUR 24.9 million at the end of June 2019 (chart 94). The higher increase in written premiums during this period along with the smaller increase in claims paid, resulted in a total decrease of claims paid to written premiums ratio to 52.7 per cent, from 58.8 percent in June of the previous year.

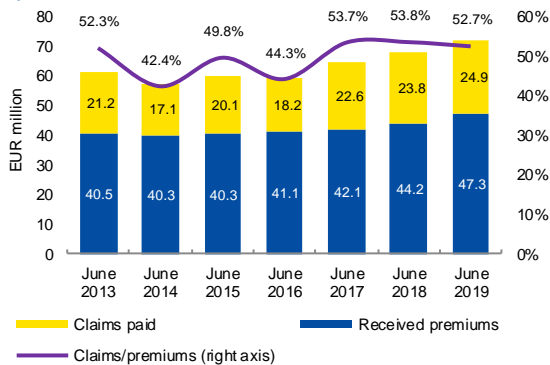
6.2.2 Financial performance of the insurance sector

The increase in damages incurred, along with the increase in operating expenses, despite the increase in premiums collected, was not sufficient for the sector to have positive financial results.

The insurance sector as of June 2019 recorded losses in the amount of EUR 2.7 million compared to the profit of EUR 0.8 million during the same period of the previous year. This financial result reflects the higher increase in claims incurred (20.4 per cent) compared to the increase in net income from premiums (3.9 per cent), and at the same time,

the annual growth of the sector's operating expenses of 10.1 per cent. It should be noted that 'life' insurers operated with a profit of EUR 214.4 thousands, whereas 'non-life' insurers operated with a loss of EUR 3.0 million.

Chart 94. Received premiums and claims paid



Source: CBK (2019)

Another indicator showing the negative financial performance during the first half of 2019 is the combined ratio at the level of 106.1 per cent compared to 95.4 per cent in June 2018, which implies that the insurance market for EUR 1 gained has spent EUR 1.06 compared to EUR 0.95 in the previous year. This ratio contains the ratio of claims to net income from premiums of 58.3 per cent and the ratio of operating expenditures to net income from premiums of 47.7 per cent, excluding income from investment interests.

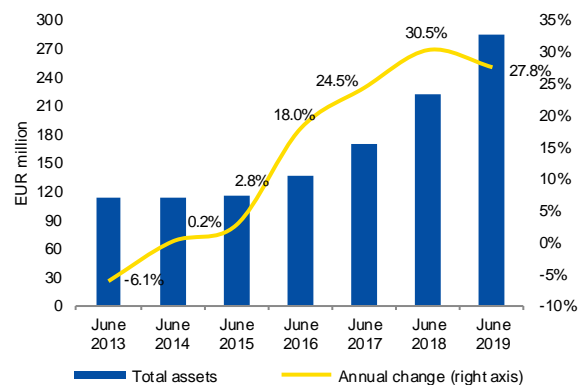
Insurance sector liquidity marked a decrease as of June 2019 compared to the same period of the previous year. The slower annual growth of cash and cash equivalents (3.4 percent) compared to the increase in technical reserves (10.6 percent) resulted in their ratio dropping to 90.6 percent from 97.0 percent in June 2018. The other liquidity indicator, cash equivalents to total liabilities ratio decreased to 80.1 percent, from 86.5 percent in June last year, due to the increase in liabilities of 11.6 percent.

6.3. Microfinance sector and financial auxiliaries

6.3.1 Activity of microfinance sector

The growth of microfinance sector assets is mainly attributed to the growth of lending and leasing activity. These activities are mainly financed by external sector borrowing, and to a lesser extent by own equity.

Chart 95. Assets of the microfinance sector



Source: CBK (2019)

Sector assets reached the value of EUR 285.1 million in June 2019, which corresponds to an annual growth of 27.8 per cent, representing a slowdown for the first time in the last six years in this reporting period (chart 95).

Twenty-three microfinance institutions⁴⁸ operate in the domestic market, of which 15 are foreign-owned and represent 93.8 per cent of total sector assets.

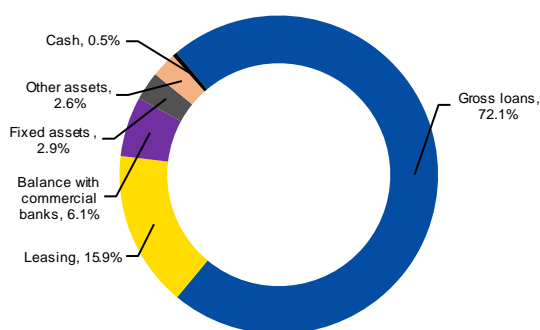
Herfindahl-Hirschman's index on assets resulted in 1,320 points in June 2019, reflecting a decline in concentration from the same period of the previous year (1,447 points). While the share of assets of the three largest institutions in total sector assets decreased to 51.3 per cent from 55.0 per cent in June 2018.

The structure of microfinance sector assets is dominated by loans comprising 72.1 per cent of total sector assets. The second most important category by weight is leasing with a share of 15.9 per cent (chart 96).

⁴⁸This includes five non-bank financial institutions that conduct lending, leasing and factoring activities.

Compared to the previous year, the weight of leasing in total sector assets has increased, compared to the slight decline in the loans category. Regarding liabilities, the activity of the microfinance sector is mainly financed by borrowings which account for 76.5 per cent of total liabilities and equity, whereas financing from the external sector alone accounts for 67.0 per cent of total liabilities and equity.

Chart 96. Structure of assets of microfinance sector (June 2019)



Source: CBK (2019)

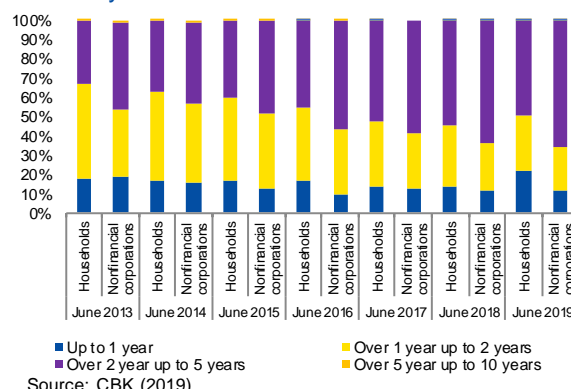
In the first six months of 2019, external sector borrowings continued with the same trend as in the previous year. The value of external sector borrowings amounted to EUR 191,1 million, indicating an annual increase of 25,3 per cent (32,9 per cent in June 2018).

The value of total microfinance sector loans, in June 2019, amounted to EUR 205.6 million, which represents an annual increase of 23.7 per cent comparing to increase of 29.1 per cent marked in the same period of the previous year. Moreover, this is the fourth consecutive year of double-digit increase in lending activity by microfinance institutions. This significant increase in lending was supported by the increase in the source of financing of microfinance institutions, mainly from the external sector and by the growth of own capital influenced by the profit realized in this period and retained profit from the past years.

During this period, microfinance institutions were more oriented towards lending to households, although lending to non-financial corporations increased as well. Specifically, loans to households, in June 2019, accounted for 67.4 per cent of total loans of the

microfinance sector and marked an annual increase of 27.9 per cent. According to maturity, household loans with maturity 'over 2 to 5 years' dominate the structure of these loans, with a share of 49.3 per cent in June 2019, however, in the last year it was noted a significant increase of loans with maturity 'up to 1 year' (chart 97). This may be as a result of granting of quick loans (maximum up to 1 year) by new microfinance institutions licenced in recent years.

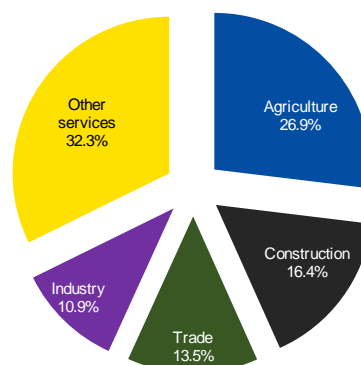
Chart 97. Loans to economic sectors, by maturity



Source: CBK (2019)

Loans to nonfinancial corporations represent 32.6 per cent of the total stock of active loans. In June 2019, these loans were characterized by an annual growth of 15.8 percent, although this increase is almost halved compared to the previous year (annual growth of 28.1 per cent in June 2018). Similar to household loans, loans granted to nonfinancial corporations continue to mainly have maturities 'over 2 to 5 years' (chart 97).

Chart 98. Structure of loans to nonfinancial corporations, by economic sectors (June 2019)

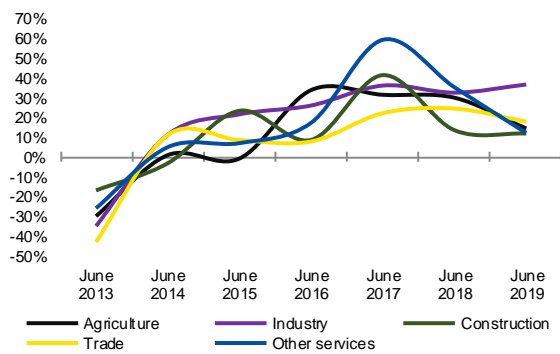


Source: CBK (2019)

The structure of lending to non-financial corporations by economic activity remains similar to previous periods. Unlike the banking sector, where loans to agriculture represent the category with the lowest share, with microfinance institutions the agriculture has the highest support, accounting for 26.9 per cent of total loans to non-financial corporations. Other categories with high access to microfinance financing are loans for other services and loans for the construction sector (chart 98).

In terms of performance, loans to the industry sector recorded the highest annual growth. Trade, agriculture and other services also had a significant increase in lending, but with weaker growth dynamics (chart 99).

Chart 99. Microfinance sector growth rate of loans to nonfinancial corporations, by economic sectors



Source: CBK (2019)

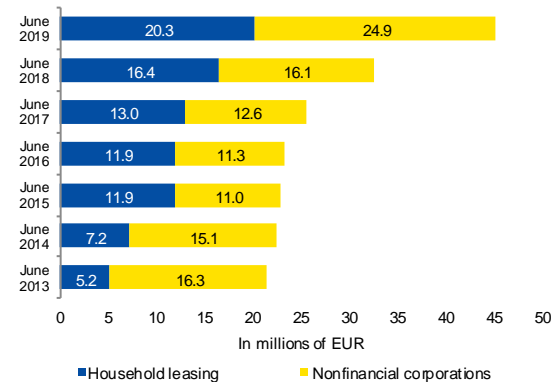
Leasing activity in microfinance institutions increased significantly. The value of the microfinance sector leasing increased to EUR 45.2 million, with an annual increase of 38.7 per cent (chart 100). The largest contribution to the increase to total leasing was made by leasing to nonfinancial corporations, which are the dominant category, whose value increased by 54.5 per cent compared to the value, in June 2018.

Leasing designated for households has a share of 44.8 per cent in the general structure of total leasing.

Within the leasing designated for households, mortgage leasing, which represents the dominant category, marked an increase of 16.3 per cent from 20.5 per cent increase in June

last year. Other leasing also recorded an annual growth of 31.5 per cent compared to an increase of 54.4 per cent in the same period of the previous year. Leasing designated for households continues to be dominated by long-term leasing with maturity 'over 10 years' with a share of 47.9 per cent, followed by leasing with maturity 'over 5 up to 10 years' with a share of 31.7 per cent.

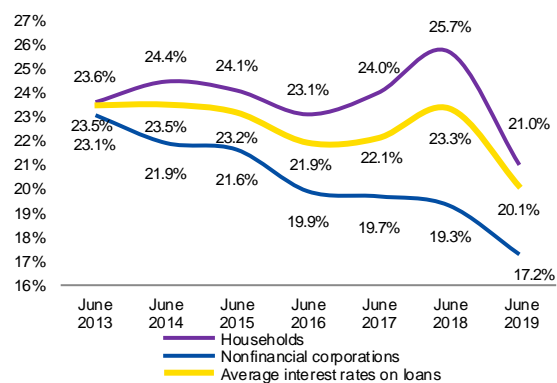
Chart 100. Microfinance sector leasing



Source: CBK (2019)

Within leasing designated for nonfinancial corporations, other leasing, which dominate leasing designated for nonfinancial corporations, were characterized by an increase of 42.5 per cent, and which contributed to the increase in total nonfinancial corporation leasing.

Chart 101. Average interest rate on microfinance sector loans



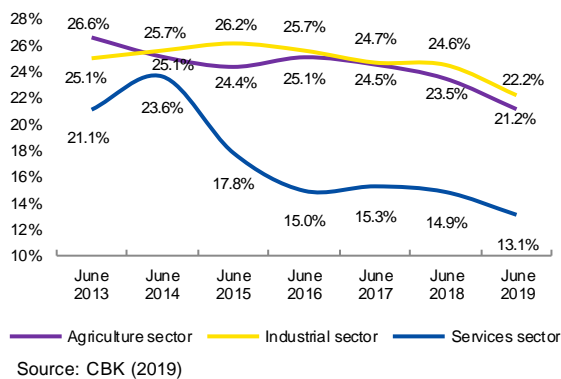
Source: CBK (2019)

Also leasing for equipment marked a significant increase from EUR 1.2 million, in June 2018, to EUR 3.6 million at the end of the first half of 2019. According to maturity of leasing for non-financial corporations, medium-term leasing 'over 2 to 5 years'

comprises the largest part, with a share of 90.3 per cent, followed by leasing with a maturity of '1 to 2 years' with a share of 3.9 per cent.

The average interest rate on microfinance sector loans marked a decrease in this period, down to 20.1 per cent in June 2019 (chart 101). The decline in the average interest rate on loans was recorded in the household sector and non-financial corporations sector.

Chart 102. Average interest rate on loans, by economic sectors



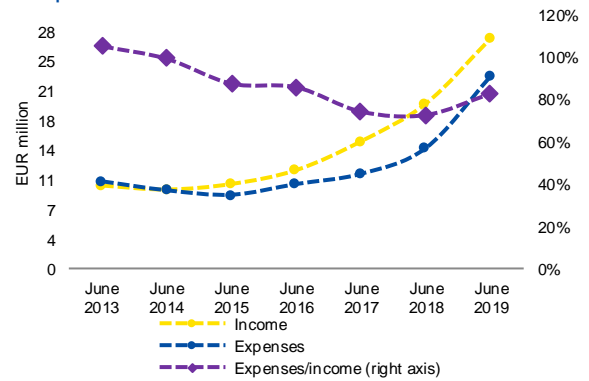
The average interest rate on loans to households decreased to 21.0 percent, in June 2019. While, the average interest rate on loans to nonfinancial corporations declined to 17.2 percent (chart 101). Within these loans, the services sector holds the lowest average interest rate with 13.1 percent, a decline of 1.7 percentage points compared to the same period of the previous year. The average interest rate on loans to the industrial sector dropped by 2.3 percentage points to 22.2 percent in June 2019. Also, the average interest rate on loans to the agricultural sector declined by 2.3 percentage points to 21.2 percent in June 2019 (chart 102).

6.3.2 Performance of the microfinance sector

The microfinance sector has been characterized by good financial performance in the last five years, gradually increasing income and net profits, excluding the recent period. By June 2019, the realized profit amounted to EUR 4.6 million, compared to the profit of EUR 5.3 million marked in the same period of the previous year. The profit decrease was a result

of the higher increase in expenditures compared to the increase in microfinance sector income.

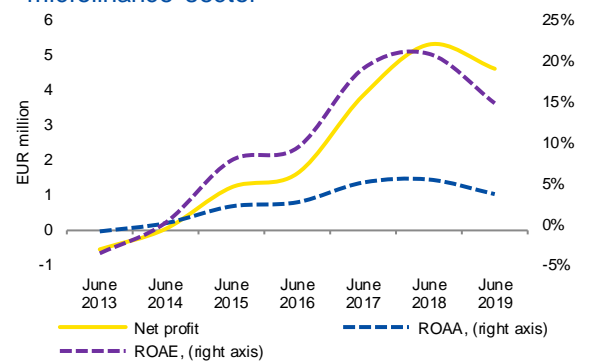
Chart 103. Microfinance sector income and expenditures



Microfinance sector income marked an increase of 39.8 per cent compared to the 29.9 per cent increase until June 2018, mainly affected by the increase in interest income. Expenditures marked a higher increase of 59.3 per cent, compared to the 27.1 per cent increase in June 2018 (chart 103). All expenditure categories were characterized by increase, but the largest contributor to the increase in total expenditures were the expenditures for provisioning for possible loan losses, which increased by EUR 3.1 million, to EUR 4.0 million marked in June 2019.

The ratio of expenditures to microfinance sector income marked a significant increase of 10.2 percentage points as a result of the higher increase in expenditures compared to the increase in income during this period.

Chart 104. Profitability indicators of microfinance sector



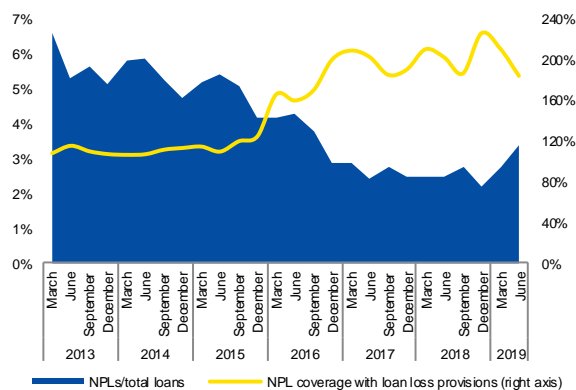
In June 2019, this indicator stood at 83.2 per cent, compared to 73.0 per cent in June of the previous year.

Profit realized by June 2019 led to a decline in profitability indicators. Return on Average Assets (ROAA) stood at 3.6 per cent in June 2019 (5.4 per cent in June 2018), while Return on Average Equity (ROAE) stood at 14.8 per cent (20.9 per cent in June 2018) (chart 104).

The microfinance sector continues to have a relatively low level of nonperforming loans. Non-performing loans increased, although their ratio to total loans remained low and was well covered by provisions (chart 105). The level of non-performing loans, in June 2019, was 3.4 per cent (2.5 per cent in June 2018). Whereas, their coverage by provisions, in June 2019, reached 184.0 per cent (202.2 per cent in June 2018).

The sector of financial auxiliaries comprises the largest number of financial institutions in the country but manages only 0.3 per cent of total assets. This sector consists of the exchange bureaus and money transfer agencies (MTAs). The value of financial auxiliaries' assets, in June 2019, amounted to EUR 16.9 million, representing an annual increase of 13.0 per cent.

Chart 105. Indicators of credit portfolio quality



Source: CBK (2019)

Financial auxiliaries' income marked an annual increase of 4.2 per cent, reaching EUR 4.2 million. The income structure of the financial auxiliaries is dominated by income from transfers (with a share of 68.5 per cent as of June 2019), which were characterized by an annual increase of 1.5 per cent. On the other hand, expenditures marked an annual decrease of 2.3 per cent, reaching EUR 2.4 million. Consequently, the net profit realized by these financial institutions by June 2019 amounted to EUR 1.8 million, representing an annual increase of 14.3 per cent.

7. Financial infrastructure in Kosovo

7.1. Payments system

The payment system plays an important role in the financial system and economy of a country, given that its efficient and safe operation represents a very important factor in maintaining and promoting the country's financial stability. There is only one system for interbank payments in Kosovo, the Interbank Payment System (IPS), operated and supervised by the Central Bank of the Republic of Kosovo.

The number of transactions processed by IPS during the first half of 2019 reached 5.9 million (5.4 million by June 2018), marking an annual increase of 8.7 per cent. In the same period, the value of total transactions reached EUR 6.58 billion (EUR 5.83 billion by June 2018),

representing an annual increase of 12.6 per cent. Priority massive payments and regular massive payments in the first half of 2019 represented about 80.1 per cent of the total interbank transactions executed (table 13). Priority massive payments represent about 2.4 million transactions executed (or 40.2 per cent of total transactions) and are mainly payments by governmental institutions (such as salaries and pensions). Similarly, regular massive payments represent about 2.3 million transactions executed (or 39.9 per cent of total transactions) and are mainly payments received by governmental institutions and include payment of taxes, fees, customs etc., while 0.3 million are Giro payments mainly dedicated to public utility payments (bills of public utility companies, governmental institutions such as the Customs Service and the Kosovo Property Agency) (table 13).

Table 13. Share of payment instruments in total IPS transactions, in percent

| Description | Number of total transactions | | Value of total transactions | |
|---------------------|------------------------------|-----------|-----------------------------|-----------|
| | June 2018 | June 2019 | June 2018 | June 2019 |
| Regular | 12.3% | 12.9% | 10.7% | 10.7% |
| Prioritized | 0.9% | 1.9% | 34.7% | 35.5% |
| Regular-massive | 39.8% | 39.9% | 6.1% | 5.9% |
| Prioritized-massive | 41.8% | 40.2% | 8.7% | 8.6% |
| Giro payments | 4.9% | 4.9% | 9.1% | 8.3% |
| Securities | 0.0% | 0.0% | 7.6% | 7.0% |
| Direct debiting | 0.0% | 0.0% | 0.0% | 0.0% |
| Bank-Bank | 0.1% | 0.0% | 23.1% | 23.9% |
| Returned | 0.1% | 0.1% | 0.0% | 0.1% |

Source: CBK (2019)

Regarding the value of transactions, priority payments are the category with the highest share in executed transactions, amounting to EUR 2.33 billion, followed by bank-to-bank category, amounting to EUR 1.57 billion in the first half of 2019. The number of total valid bank accounts⁴⁹ in June 2019 reached 2.14 million, representing an annual increase of 1.8 per cent. The virtual infrastructure is developing at a fast and safe pace. E-banking accounts, whereby online banking services are

provided, have continued to grow. In June 2019, the number of total E-banking accounts was 273.8 thousand⁵⁰ (table 14). The number of total transactions executed through E-banking accounts during the first half of 2019 reached 2.4 million, while the value of total transactions executed through E-banking accounts amounted to EUR 4.46 billion. The structure of E-banking accounts continues to be dominated by individual accounts with a share of 83.4 per cent to total E-banking

⁴⁹ The number of total bank accounts comprises: the number of current accounts, savings' accounts and other accounts at a bank.

⁵⁰ 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.

accounts, followed by business accounts with a share of 16.6 per cent.

Table 14. Banking sector network

| Description | June 2016 | June 2017 | June 2018 | June 2019 |
|------------------------------|-----------|-----------|-----------|-----------|
| Number of bank branches | 45 | 45 | 46 | 47 |
| Number of bank sub-branches | 207 | 194 | 178 | 160 |
| ATM number | 534 | 518 | 502 | 482 |
| POS number | 9,785 | 10,631 | 12,597 | 13,319 |
| Number of E-banking accounts | 215,233 | 288,016 | 230,707 | 273,752 |

Source: CBK (2019)

The number of total cards (debit and credit cards) that provide services of cash withdrawal and various payments increased by 9.1 per cent in June 2019 compared to the same period last year. As regards the cards, the number of debit cards reached 1,057,862 while credit cards reached 181,692. The number of debit cards was characterized by an annual increase of 8.9 per cent, while credit cards marked an annual increase of 10.3 per cent. According to the operators, Visa Cards (64.0 per cent) followed by Master Cards (34.0 per cent) had the highest share to the total cards, while the local cards had a share of 2.0 per cent. The banking infrastructure in the country has expanded in the context of Point-of-Sale (POS) network, whereas the number of Automated Teller Machines (ATMs) decreased compared to June 2018 (table 15).

Table 15. Share of transactions value processed with cards by terminals in total card transactions value, in percent

| Description | June 2016 | June 2017 | June 2018 | June 2019 |
|-------------------------------|-----------|-----------|-----------|-----------|
| ATM withdrawals in cash | 63.4% | 63.5% | 58.1% | 59.2% |
| ATM deposits | 25.4% | 27.7% | 31.5% | 30.1% |
| Credit transfers through ATMs | 0.0% | 0.0% | 0.1% | 0.1% |
| POS cash withdrawals | 0.5% | 0.1% | 0.2% | 0.2% |
| Card payments through POS | 10.7% | 8.6% | 10.1% | 10.4% |

Source: CBK (2019)

Despite the decline in the number of ATMs, the number of withdrawals through ATMs has increased to 8.2 million (7.0 million by June 2018), with a turnover of EUR 1.23 billion (1.02 billion by June 2018). The share of cash withdrawals through ATMs to total card transactions stood at 59.2 per cent in June 2019, indicating a high level of cash usage. Increasing the number of ATMs, which enable the deposit of money to customer accounts, has contributed to deposits increasing their share to 30.1 per cent of the total value of card transactions through terminals, compared to 25.4 per cent three years ago (table 15).

During the same period, the number of payments through cards at POS terminals reached 6.5 million, in the amount of EUR 217.2 million. Value of payments through POS to total card transactions in June 2019 reached 10.4 per cent.

8. Macro-prudential framework

In 2016, the Central Bank of the Republic of Kosovo, pursuant to the Law No. 03/L-209 on the Central Bank which empowers the CBK to draft and implement policies to maintain financial stability in the country, has adopted the Macro-prudential Policy, which is already published on the CBK official website.

In order to strengthen the CBK's legal basis in exercising its mandate for macro-prudence, the new draft law on banks expected to be approved in 2020 defines the CBK as the only authority responsible for macro-prudential oversight of banks. Also, the new law grants to the CBK the authority to issue relevant regulatory instruments.

8.1. Summary of developments in selected macro-prudential indicators

During the first half of 2019, overall dynamics in selected macro-prudential indicators in Kosovo were characterized by sustainability, resulting in parameters that were well above the regulatory requirements.

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

The banking sector as a whole and the systemic banks in particular remained well-capitalized and liquid during this period. Capital adequacy ratios for the banking sector and systemic banks stand well above the regulatory requirements. The good banking sector capitalization is also supported by the analysis of additional capital allocation in

relation to the degree of the systemic importance of banks.

Similar to the capital adequacy indicators, the leverage ratio of the whole banking sector and systemically important banks continued to remain 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, though widened in June 2019, 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 June 2019, the banking sector appears to have four systematically 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 to 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 at strengthening 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 framework 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 phase of growth beyond the fundamentals of the economy (growing faster than a country's 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.

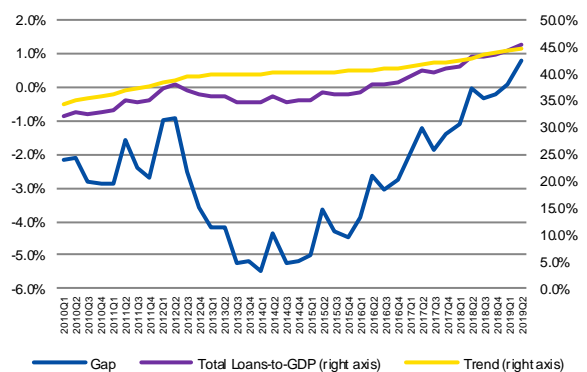
For calculation of Countercyclical Capital Buffer, the guidelines of the Basel Committee on Banking Supervision⁵¹ suggest monitoring of several assessing parameters if lending is growing beyond sustainable fundamentals and consequently is affecting the accumulation of systemic risk. In addition to assessing the parameters according to the relevant guidelines, relevant authorities shall assess the relevance of applying countercyclical capital requirements.

The CBK, in the Macro prudence Policy⁵², 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 the 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 counter-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 calculation practices from most countries in the world based on recommendations from empirical research, through one-sided Hodrick–Prescott filter (lambda 400,000).

In lending were included loans to the private sector⁵³ by banks as well as non-bank financial institutions. The latter, albeit with a low share to total lending, are growing at a higher growth rate and expanding their share to certain sectors. Therefore, the inclusion of non-banking sector loans, despite having a low share and currently without any significant effect due to the credit gap, provides consistency in calculation method with other countries, and ensures the inclusion of effects of the possible increase of the weight of lending to private sector by non-banking financial institutions. The ratio of private sector credit to GDP in Kosovo in June 2019 stood at 45.5 per cent. Whereas, the credit gap outcomes at the end of June 2019 suggest that the private sector in Kosovo has never gone through an 'over lending' period.

Chart 106. Lending gap



Source: CBK (2019)

⁵¹ Bank for International Settlements (2010). Guidance for national authorities operating the countercyclical capital buffer, the Basel Committee on Banking Supervision, December.

⁵² CBK (2018). *Macro prudence Policy*, Prishtina, June.

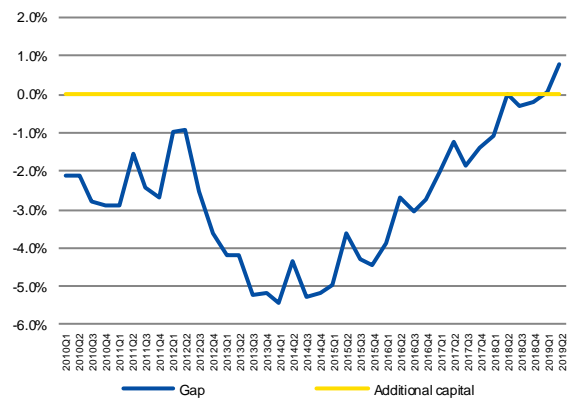
⁵³ Not including public sector loans and loans to financial enterprises in the calculation of the credit gap ensures that lending dynamics are not affected by possible changes in lending to the public sector or the financial sector.

However, the faster growth of credit-to-GDP ratio in recent years resulted in the credit-to-GDP gap reaching 0.808 per cent in June 2019, widened in a positive direction compared to previous periods (0.082 per cent in Q1 2019 and -0.200 per cent in Q4 2018) (chart 106). The positive widening of the credit-to-GDP gap implies that lending is growing at a faster rate than the gross domestic product, and the economic interpretation would be that the increase in lending to the private sector does not sufficiently justify the growth of the gross domestic product. However, it should be emphasized that the assessment of credit developments and whether credit growth is excessive, based on this indicator alone, should be considered in a limited way. This is due to the fact that the financial sector in Kosovo is still in the development phase and the economy of Kosovo is in the phase of increasing financial intermediation and convergence with other countries, as well as the short history of the banking sector with evenness of financial developments without any period of stress, makes it difficult to adequately assess the lending cycle in the country and to signal systemic risk accumulation. Consequently, other financial and economic indicators and much more expert judgment should also be considered when giving a judgmental assessment of the lending cycle. However, additional countercyclical capital is an adequate instrument to address the credit gap indicator in order to strengthen the banking sector's ability to cope with financial cycles.

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 of the gap of 2 to 10 percentage points, it is required the holding of the capital buffer up to the maximum level of 2.5 per cent. According to the above outcomes, which suggests that Kosovo has obtained a positive credit-to-GDP gap only in June last year and that 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 (chart 107).

Chart 107. Countercyclical capital buffer



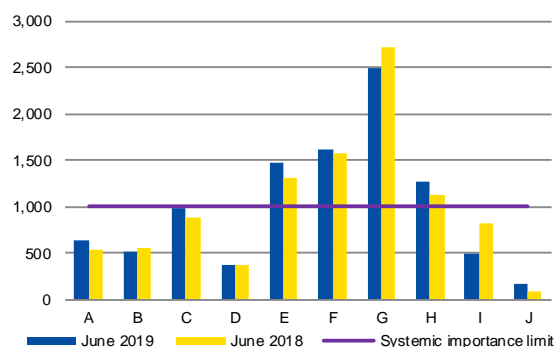
Source: CBK (2019)

In addition, other relevant indicators are monitored on a regular basis along with the lending gap, which together with qualitative information and relevant expert judgment are allocated a special weight in forming a final judgment on developments in the area of systemic risk and the credit-to-GDP ratio. 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 (table 16).

Chart 108. Overall rate of systemic importance



Source: CBK (2019)

General results of the model, with data as of June 2019, suggest that four banks are of general systemic importance (chart 108).

Table 16. Indicators used to assess systemic importance of banks in Kosovo⁵⁴

| Criterion | Indicators |
|--|--|
| Size (Weight 25%) | Assets without provisions |
| Substitutability (Weight 25%) | Value of transactions to total transactions value ratio i 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)

Two of these banks resulted to have systemic importance in all the criteria. The results also show that two banks that are not of general systemic importance have been systematically important in some criteria, one only in the interconnectedness criterion and the other bank in three criteria; size, interconnectedness and substitutability. The latter in the previous three years was very close to the threshold of systemic importance, and this year has further increased the systemic points as a result of the increase in total assets as well as exposures and liabilities with other financial institutions.

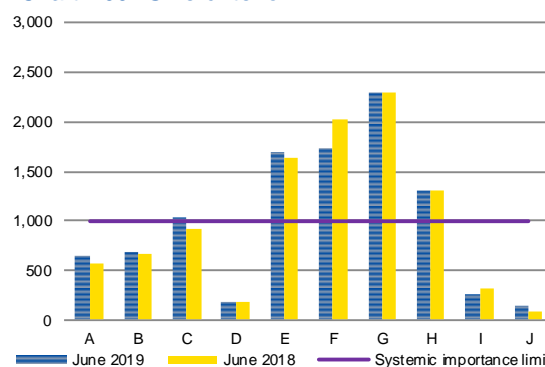
The overall scale of systemic importance ranges from 1,269 base points to 2,505 base points, which represents a decline of the upper limit compared to June 2018.

Although most banks have increased the systemic points, the upper limit of the bank's systemic points with the highest systemic importance declined as a result of increased competition from smaller banks which increased their share in total assets and loans of the sector, as well as increased banking

interconnectedness in the form of loans, placements and other deposits and liabilities.

Criterion of size – The four banks that are of general systemic importance and one bank that is not of general systemic importance were systematically important under the size criterion (chart 109).

Chart 109. Size criterion



Source: CBK (2019)

The scale of systemic importance in this criterion ranges from 1,038 base points to 2,293 base points. Two of the largest banks were characterized by a decline in systemic importance in this criterion compared to the previous year. Whereas, smaller banks have accelerated the growth of their activity, emphasizing lending activity, by increasing

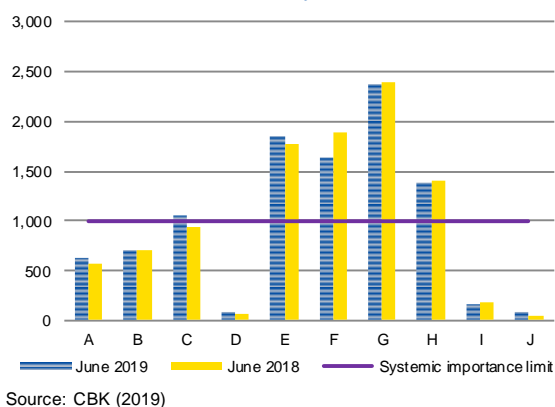
⁵⁴ For the theoretical base and the complete methodology of assessing Banks of Systemic Importance, please refer to the CBK working paper No.

7 "Identification of Banks with Systemic Importance and Additional Capital in Kosovo".

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

Criterion of substitutability – four banks of general systemic importance and one bank that is not of general systemic importance resulted as systematically important in the criterion of substitutability. The scale of systemic importance in this criterion ranges from 1,060 base points to 2,380 base points (chart 110).

Chart 110. Substitutability criterion

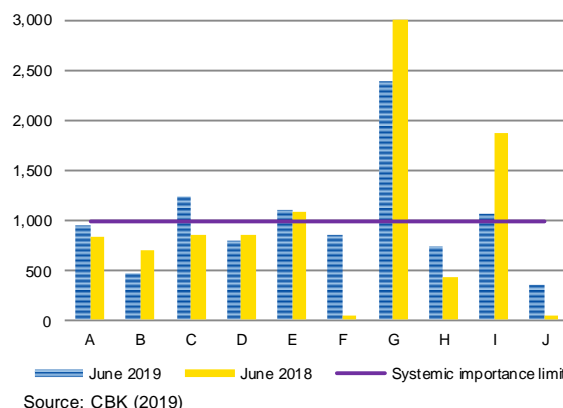


Most banks have marked an increase in systemic scale in this criterion. While the three systemic banks have marked a decline in points, one mainly driven by the decline in credit stocks and household deposits, while the other two banks due to the proportional decline in their share to the categories of this criterion such as; interbank transactions, loans and deposits of the private sector, in relation to the increase of share by smaller banks.

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 June 2019, four banks resulted to be of systemic importance in the criterion of interconnectedness, compared to three in June 2018 (five in December 2018).

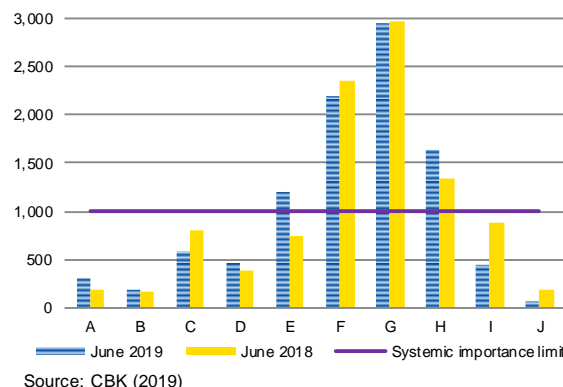
Criterion of inter-state activity and complexity – Four banks of general systemic importance have turned out to be systemically important in the criterion of inter-state activity. The sale of systemic importance in this criterion ranges

Chart 111. Interconnectedness criterion



The scale of systemic importance in this criterion ranges from 1,078 base points to 2,391 base points (chart 111). Two banks that are not of general systemic importance have been found to have systemic importance in the criterion of interconnectedness due to the higher share of liabilities to other financial institutions and investment in securities.

Grafik 112. Interstate activity and complexity criterion



In the first half of this year, systemic importance limits in this criterion have declined, although the scales of systemic importance of individual banks have increased, implying that the balance of assets and liabilities with other financial institutions as well as investments in securities decreased the concentration in the largest banks and increased the distribution among other banks compared to the previous year.

from 1,207 base points to 2,955 base points (chart 112).

Compared to the previous year, the scale of systemic importance has increased as a result of the higher external sector liabilities from the bank 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 systemically important banks above the Tier 1 capital recommended by Basel and EBA would not exceed the current level of regulatory capital for the banking sector in Kosovo.

Therefore, the model currently 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 local systemic importance.

9. Statistical Appendix

Appendix 1. Financial Stability Map – Dynamic of risk change of indicators and contribution to the risk of the appropriate components

Chart 1. External economy

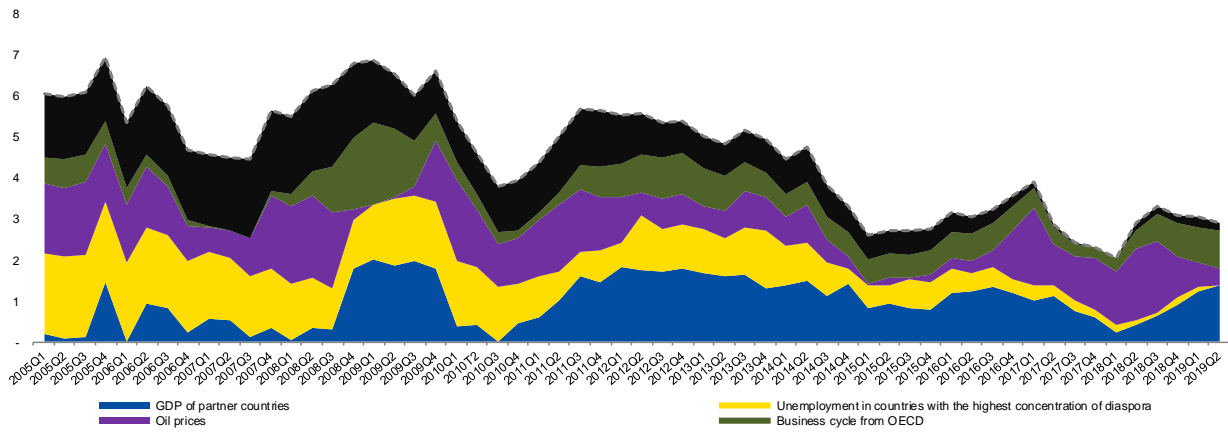


Chart 2. Domestic economy

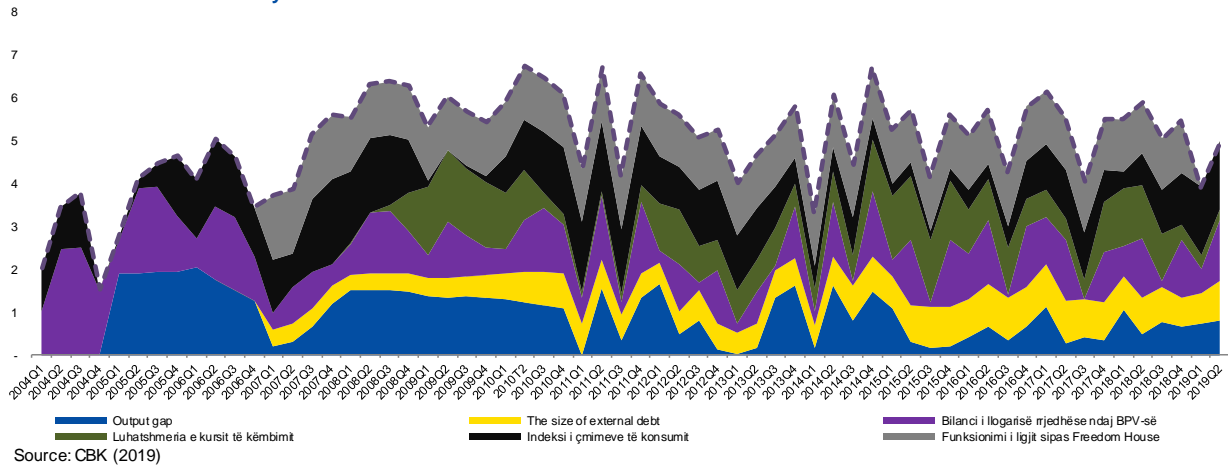


Chart 3. Households

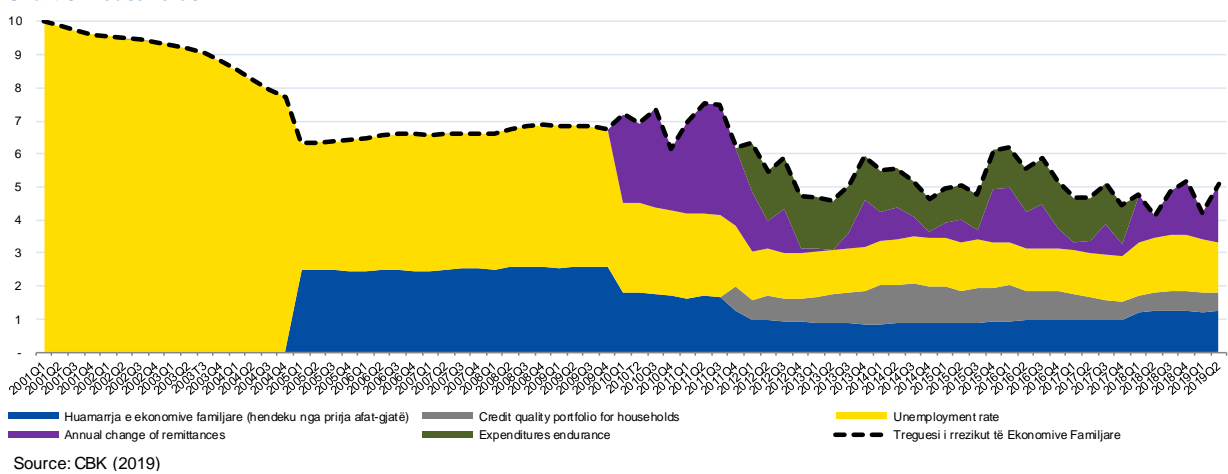


Chart 4. Enterprise Sector

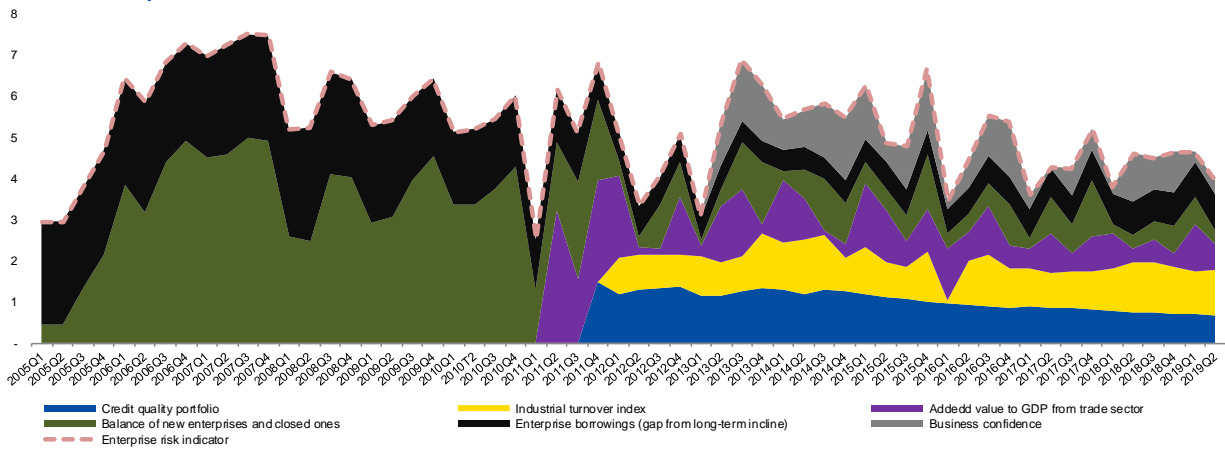


Chart 5. Government sector

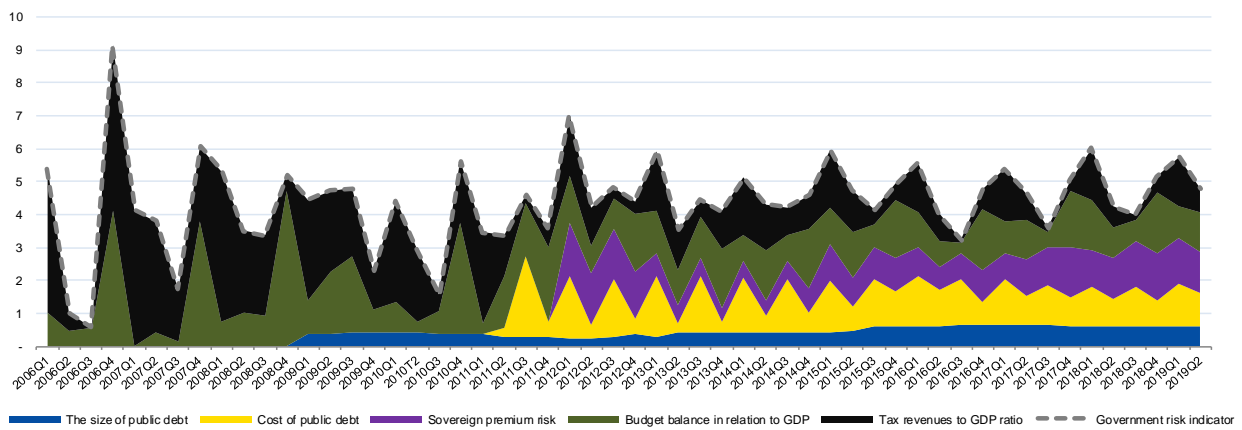


Chart 6. Banking Sector Structure

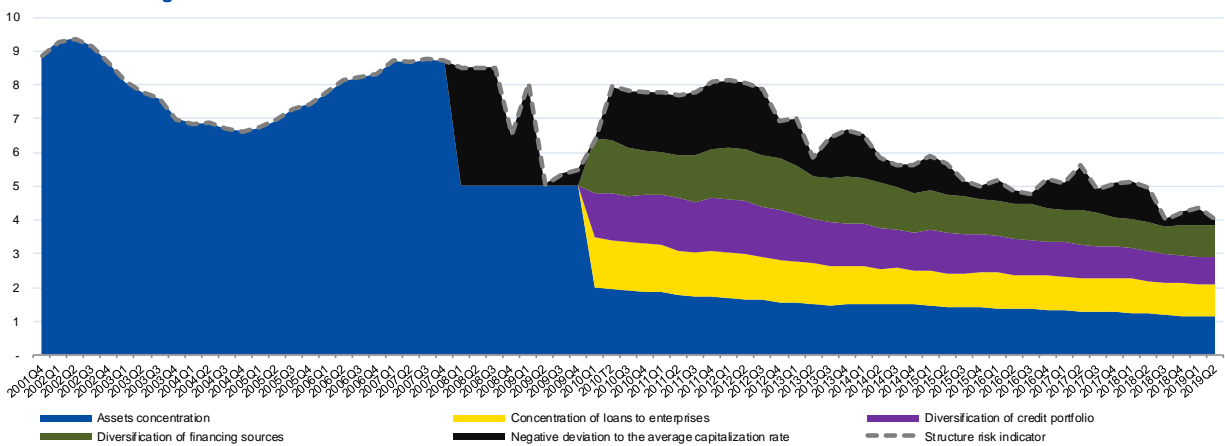
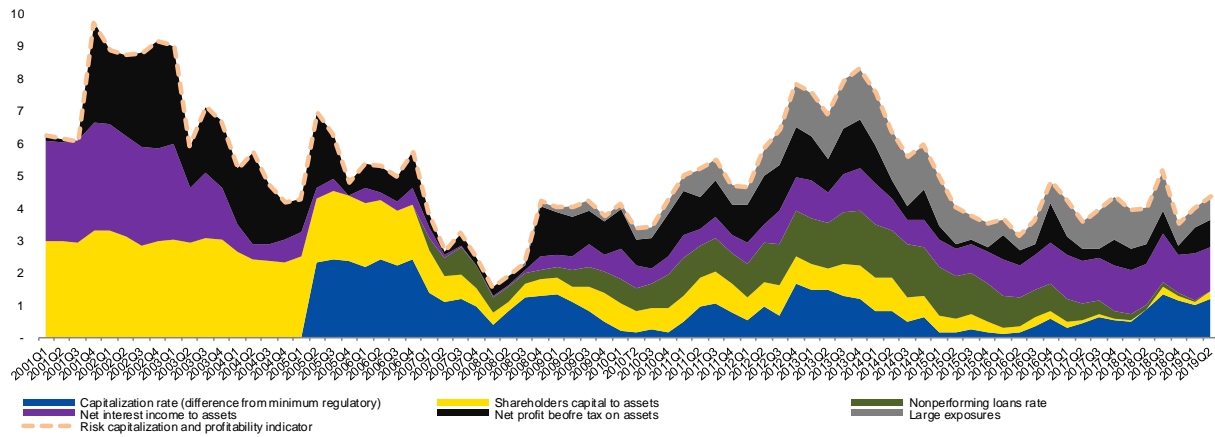
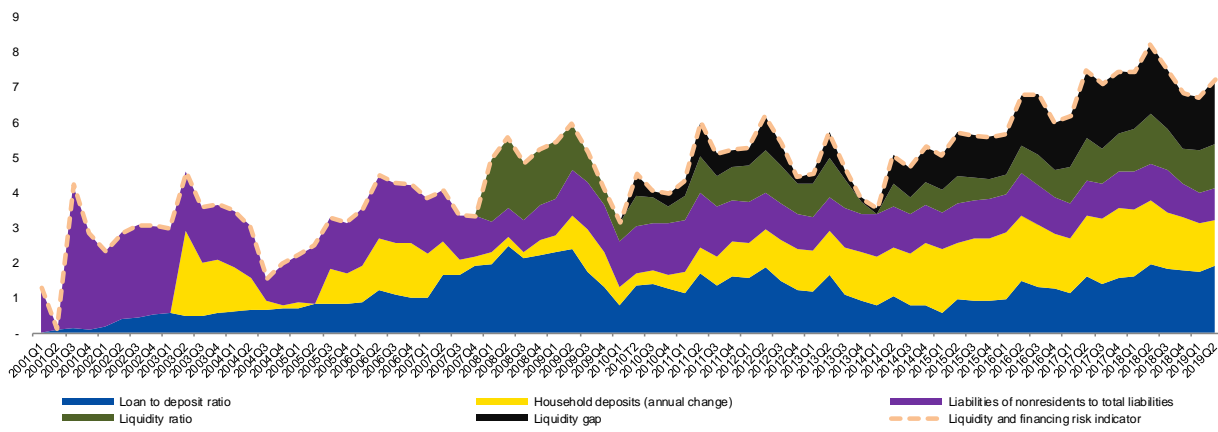


Chart 7. Capitalization and profitability



Source: CBK (2019)

Chart 8. Liquidity and financing



Source: CBK (2019)

Table 1. Financial soundness indicators, in percent

| Banking sector | Core set | June 2016 | June 2017 | June 2018 | June 2019 |
|---|---|-----------|-----------|-----------|-----------|
| Capital Adequacy | Regulatory capital to risk-weighted assets | 18.7 | 18.1 | 17.4 | 16.8 |
| | Regulatory Tier I capital to risk-weighted assets | 16.4 | 16.2 | 15.7 | 14.9 |
| | Nonperforming loans net of provisions to capital | 2.7 | 1.8 | 1.4 | 1.4 |
| Assets quality | Nonperforming loans to total gross loans | 5.3 | 3.9 | 2.8 | 2.4 |
| Sectoral distribution of loans to total loans | Other financial corporations | 0.5 | 0.3 | 0.3 | 0.2 |
| | Public nonfinancial corporations | 0.10 | 0.00 | 0.00 | 0.00 |
| | Other nonfinancial corporations | 64.4 | 63.8 | 63.6 | 63.7 |
| | Households | 35.0 | 35.8 | 36.1 | 36.0 |
| | NPISH | 0.02 | 0.01 | 0.01 | 0.01 |
| | Nonresidents | 0.0 | 0.0 | 0.0 | 0.0 |
| | Total | 100.0 | 100.0 | 100.0 | 100.0 |
| Earnings and profitability | Return on assets (ROA)* | 2.6 | 2.6 | 2.5 | 2.2 |
| | Return on equity (ROE)* | 20.8 | 21.9 | 19.0 | 17.7 |
| | Interest margin to gross income | 74.4 | 64.1 | 79.5 | 81.0 |
| | Noninterest expenses to gross income | 47.1 | 44.4 | 49.4 | 47.8 |
| Liquidity | Liquid assets (core) to total assets | 26.6 | 23.2 | 21.1 | 22.3 |
| | Liquid assets (broad) to total assets | 31.9 | 27.5 | 24.8 | 26.1 |
| | Liquid assets (core) to short-term liabilities | 34.4 | 30.3 | 28.2 | 30.0 |
| | Liquid assets (broad) to short-term liabilities | 41.3 | 35.9 | 33.2 | 35.1 |
| Sensitivity to market risk | Net open position in foreign exchange to capital | 1.7 | 2.2 | 1.7 | 1.5 |
| | Encouraged set | | | | |
| | Capital to assets | 12.3 | 13.0 | 13.0 | 12.2 |
| | Large exposures to capital | 48.1 | 64.8 | 77.3 | 70.0 |
| | Personnel expenses to noninterest expenses | 41.3 | 40.3 | 44.3 | 43.2 |
| | Spread between reference lending and deposits rates | 6.2 | 5.7 | 5.3 | 5.1 |
| | Customer deposits to total (noninterbank) loans | 120.4 | 116.8 | 113.8 | 117.1 |
| | Foreign-currency-denominated liabilities to total liabilities | 4.5 | 4.4 | 4.9 | 4.8 |

*Net income before tax is considered.

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



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