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

Financial Stability Report

Number 16

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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	Common Wealth of Independent States
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
EJL	Southeastern Europe
FDI	Foreign Direct Investments
GDP	Gross Domestic Product
HHI	Herfindahl-Hirschman Index
IMF	International Monetary Fund
KAS	Kosovo Agency of Statistics
KCC	Kosovo Chamber of Commerce
KPST	Kosovo Pension 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
POS	*Point of Sales*
NPL	Non-Performing Loans
ODC	Other Depository Corporations
pp	Percentage points
PPT	Third Party Liability
PTK	Post and Telecommunications of Kosovo
RAA	Return on Average Assets
RAE	Return on Average Equity
RLI	*Rule of Law Index*
ROE	Return on Equity
RWA	Risk Weighted Assets
SDR	Special Drawing Rights
VAT	Value Added Tax

Note: Users of the data are required to cite the source.
Suggested citation: Central Bank of the Republic of Kosovo (2020), Financial Stability Report No. 16, Prishtina.
Any needed correction will be made in the electronic version.

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1. Governor's Foreword

The Central Bank of the Republic of Kosovo (CBK) presents to the public the 16th issue of the Financial Stability Report (FSR). Through a risk-based analysis perspective, FSR aims to inform the public about the state of the financial system and 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 2019 translated into increasing risks for the economy and foreign financial markets, mainly due to the increase of protectionism, geopolitical uncertainties, and Brexit-related uncertainties. These dynamics further deteriorated with the announcement of the pandemic situation and the ensuing global economic recession, signalling an increase in external risks with potential negative impact on the economy and financial stability in the country.

Kosovo's economy marked stable economic growth in 2019, despite the unfavourable dynamics in the economies of the main trading partners. However, the announcement of the pandemic in early 2020 has completely changed the dynamics in the domestic economy, where the unprecedented health, economic and social crisis has translated into growing uncertainties and risks to financial stability. Although the effects of increased risks to the financial sector and its stability in the short term may have been mitigated by measures taken by relevant institutions, in the medium term, the risks to the financial system are expected to increase.

Macroeconomic stability and an environment with favourable financing conditions have continued to support the growth of lending to the private sector during 2019. Financial system has operated generally in a favourable environment, with low and medium risks from the macroeconomic environment and the private sector respectively. The banking sector increased its activity, mainly supported by the increase in lending and investments in the securities market, while the performance and health indicators of the banking sector remained high.

The pension sector was also characterized by accelerated growth in 2019, attributed to high return on investment and stable income from contributors. 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 led the sector to operate at a loss. In 2019, the microfinance sector also marked an acceleration of activity and high performance.

CBK has continued to work in the field of macro-prudence based on the Macro-prudential Legal Framework. During 2019, the general 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, CBK has continued to work on completing and advancing the legal and regulatory framework of the financial system in general and the banking sector in particular, contributing to the approximation of the regulatory framework to 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, influencing the expansion and greater use of financial services through digitized electronic services.

Fehmi MEHMETI

Governor

2. Summary of main risks and developments of financial stability

Kosovo banking sector was characterized with positive dynamics during 2019, where the high positive performance and high indicators of capitalization and liquidity of the sector prove the high stability of the sector. Increase of lending from banks continued to support the economic growth of the country. However, the announcement of COVID-19 pandemic is expected to increase the risks towards sector functioning and to represent a challenge for the financial sector in the country. In short-term period, risks are expected to be managed due to the high level of health indicators of the sector, supported, inter alia, by ongoing regulatory reforms.

Developments related to the pandemic resulted in the increase of uncertainties and risks to the financial sector and financial stability. All dimensions of risks to which the financial sector is exposed have been increased. While the effects of increased risks to the financial sector and its stability in the short-term may have been mitigated from government subsidiary measures, savings, family aids, institutional reserves, in the medium-term, the risk for the sector will increase. Termination of the economic activity for a period and challenges in the normal functioning of the enterprises have significantly impacted and will continue to impact their ability to generate revenues, which unavoidably will create difficulties in fulfilling the financial obligations and absorption capacity for lending. This situation will impact the employees and revenues of households, as the decrease in the activity of enterprises may reduce incomes or discontinue the salary payment. Having a chain effect, this situation will further impact the weakening of consumption, difficulties in fulfilling the financial obligations, as well as the capacity to obtain loan, thus impacting the lending attractiveness. Pressure on financial incomes of almost all stakeholders will increase – return on investments from pension funds will decline as a result of the decrease of asset price and interest rates; discontinuation of insurance activity will increase the pressure on the sector incomes; decrease of lending, increase of credit risk and increase of funding cost will increase the pressure on banking sector incomes.

Before the announcement of COVID-19 pandemic, the sector was generally operating in a favourable environment, with minor and moderate risks from the macro-economic environment and private sector. Credit developments showed positive dynamics, with deceleration tendencies of double-digit trend of lending increase over the years, as well as sector sensitivity indicators from potential shocks were at high levels, considered with moderate risk compared to their historic trend (table 1).

Developments in the macro-economic environment were favourable in 2019, supporting the Kosovo financial sector stability. However, this period was characterized with increase of uncertainties at the global level. Increase risks in the foreign economy and financial markets, mainly as a result of protectionism, geo-political uncertainties, as well as uncertainties related to the Brexit have resulted in slowing the economic growth of euro area and most of the Balkans.

Table 1. Banking sector risks*

Risks	I-st half 2018	II-nd half 2018	I-st half 2019	II-nd half 2019	Risk trend
Macroeconomic risk					↓
Financial position of nonfinancial sector					↓
Credit developments					↓
Robustness of the Banking Sector					↓
	Negligible risk	Low risk	Average risk	Above average risk	High risk

Source: CBK (2020)

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 to 1.3 percent from 1.9 percent of annual increase. The Western Balkans is also estimated to have slowed down the economic activity growth to 3.5 percent from 4 percent in the previous year, as a result of reflection of global uncertainties and political uncertainties in many of these countries. Unlike the euro area and the Western Balkans, the economy of Kosovo has been characterized with the acceleration of economic activity growth in 2019 as result of the net export increase.

Risks to financial sector continued to significantly increase as a consequence of the outbreak of COVID-19 pandemic. The economic crisis driven by the COVID-19 pandemic and measures undertaken to prevent the pandemic are expected to be reflected in significant economic decline at the global level and increase of uncertainty for the financial system. Euro area economy is expected to experience higher economic activity shrinkage than the last global financial crisis. Crisis caused by COVID-19, but also the increase of political uncertainties in the Balkans, will significantly impact the economies of these countries. Kosovo economy is expected to experience more significant economic decrease as a result of its dependence on external funding sources, namely tourism and service export, as well as limited fiscal space for supporting the internal demand as a result of euroization (lack of monetary policy function).

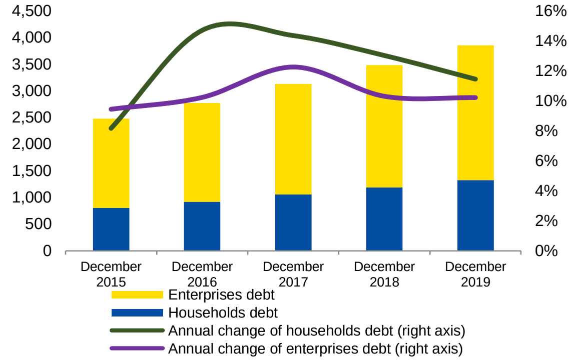
Private sector debt continued to increase in 2019, supported by the double digit increase of internal lending, as well as increase of external debt. Macroeconomic stability, as well as ongoing improvement of credit portfolio, in an environment of credit portfolio, in an environment of favourable funding conditions, has supported the increase of lending for the private sector. Increase of competition, strategic focus in certain market segments from banks, as well as longer experience in building relations with customers were other factors that continued to support the double digit lending of the sector. Stock of loans to enterprises from banking sector increased for 9.8 percent, as well as trend of increase of new loans accelerated to 9.7 percent from 4.9 percent in December 2018.

Loans to enterprises from financial intermediaries marked an increase of 14.5 percent, but are at lower share to total debt of enterprises of around 2.8 percent. External debt of enterprises continued to increase and reached 21.2 percent of total debt. Loans to enterprises from banks to GDP ratio[2] amounted to 28.1 percent in December 2019, which represents an increase of 1.2 percentage points.

* The generation methodology of the risk is based on the methodology of the Kosovo Financial Stability Map. This table includes sub-indicators such as: Lendingto-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.

[2] Based on the CBK projections for annual GDP.

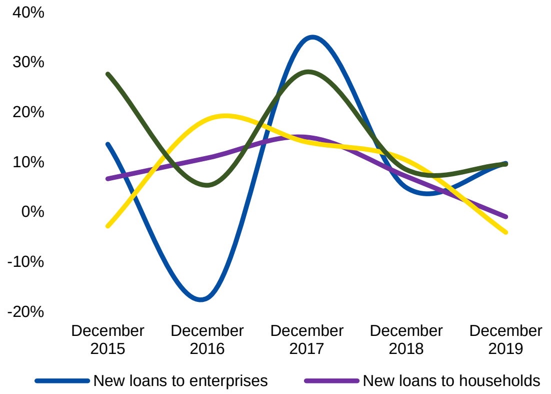
Chart 1. Debt of enterprises and households, EUR million



Source: CBK (2020)

Loans of banking sector to households marked an increase of 10.3 percent, but the trend of double digit increase of new loans, in particular consumption loans, changed the direction this year. New loans were characterized with annual decrease of 1.0 percent, impacted from the annual decrease of 4.1 percent of consumption loans. Stock of loans from micro-finance institutions increased for 23.3 percent (amounting to 13.5 percent of the loan value from banks).

Chart 2. Annual change of new loans



Source: CBK (2020)

External household debt increased by 6.9 percent and reached 5.5 percent of total debt. In December 2019, total household debt increased by 11.5 percent and as a percentage of GDP reached 17.7 percent. Despite the increase, private sector debt levels relative to GDP remained the lowest in the region.

The ratio of the credit value of the banking sector to the value of collateral, as well as debt to revenues, continued to remain relatively low at 29.2 and 42.5 percent, respectively. Other private sector performance indicators have been characterized by positive developments. The enterprise sector has been characterized by an increase in the volume of industrial production and an increase in the turnover in the retail trade. The climate indicator as well as the credibility of the business have changed the downward trend that has characterized them during 2018 and have marked an increase in 2019, which suggests more optimistic expectations of enterprises for economic activity before the outbreak of the Covid-19 pandemic. The entrepreneurial initiative has also increased, estimated by the increase in the number of open businesses, but that the net balance of open and closed businesses was lower as a result of the closure of more businesses. The decision to impose a 100% tax on products from Serbia as well as Bosnia and Herzegovina have increased uncertainty for companies that are sensitive to imports from these countries. Whereas, the outbreak of the Covid-19 pandemic and the unprecedented crisis caused as a result, will significantly increase the risk for the sector as a whole, which will materialize with financial losses and declining solvency (increased credit risk).

Labour market conditions have improved relatively where the unemployment rate has declined, although a worrying dynamic in the labour market in the country remains the gradual reduction of the labour force due to emigration and employment of Kosovars in EU countries through work visas. Household income sources showed an upward trend, remittances increased by 6.4 percent and workers' compensation marked[3] an annual increase of 6.8 percent

However, the slow dynamics of improvement of the labour market conditions and the high

[3] Income from compensation of employees- income of seasonal workers abroad as well as Kosovar workers abroad for a period of less than one year.

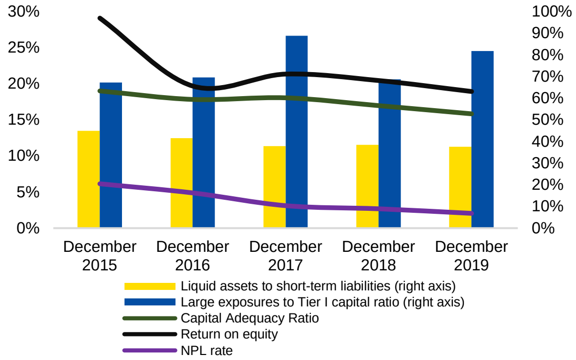
dependence on external sources of financing, which are characterized by higher sensitivity, pose a risk of increasing the debt burden of households in such circumstances of continuity of high credit growth for this sector. In particular, the most sensitive segment in the event of a materialization of any shock, such as the Covid-19 pandemic, may be the non-collateral consumer loans with longer maturities.

The performance and health indicators of the banking sector during 2019 remained at levels close to the previous year, without any significant development. The profit of the banking sector marked an annual decline of 2.0 percent, mainly influenced by the increase in interest expenses on deposits. The profit of the banking sector is expected to face the pressure caused by the Covid-19 pandemic crisis. The decline in lending and the increase in the need to allocate expenses for provisions to cover potential losses will affect both the decline in the sector's revenues and the increase in expenditures. Despite the increase in credit risk, competitive pressures and the possible decline in credit demand will limit the opportunities for banks to increase interest rate on loans. Whereas, the already low interest rate on deposits, as well as the high share of transferable deposits which do not bear interest expenses, makes the opportunities for positive effects on the realization of profit from the management of interest expenses, to be limited. Therefore, given this and the statements of banks in the bank lending survey that signal the decline in lending and increased credit risk, the current position of profitability will face downward pressures.

The quality of the loan portfolio has continued to improve, especially in the enterprise sector, influenced by the process of repayment of non-performing loans from banks' balance sheets, as well as other economic and structural factors that have improved the solvency and debt collection. The ratio of non-performing loans to total loans of the banking sector decreased to 2.0 percent from 2.7 percent a year earlier. The increase of the credit stock by 10.1 percent as well as the decrease of the stock of non-performing loans by 16.0 percent affected the decrease of the NPL ratio. The enterprise sector was characterized by improved loan portfolio quality in almost all economic activities. Whereas, households were characterized by an increase in the stock of non-performing loans, but which was not reflected in the NPL rate due to the higher growth rate of lending to this sector. The outbreak of the Covid-19 pandemic, as well as the effect of preventive measures on its spread on the performance of enterprises and household incomes, will increase credit risk in the coming period, with medium-term effects on the credit structure of the sector.

The position of capital of the sector in December 2019 continued to reflect high stability. The capital adequacy ratio decreased to 15.8 percent from 17.0 percent.

Chart 3. Selected indicators of financial soundness



Source: CBK (2020)

This decrease reflects the increase in risk-weighted assets as a result of the increase in lending activity, in addition to the relatively slower growth of regulatory capital, which was also affected by the distribution of dividends by some banks. The banking sector has a strong regulatory capital base, 89.4 percent of which is tier 1 capital, which mainly results from the high realized and retained profit. The generation of capital from internal sources, i.e. through the generation of profit, is an important element that continuously ensures the maintenance of a high level of capitalization. The crisis caused by the Covid-19 pandemic will increase the pressure on the level of banks' capital, affecting the increase in demand for provisions as well as the level of profit.

The main liquidity indicators give positive signals for banking liquidity stability. Private sector deposits marked an accelerated growth of 16.2 percent, mainly as a result of the increase in household deposits. At the sector level, deposits exceeded loans by 129.6 percent. Liquid assets increased, but the higher growth of short-term liabilities led to a slight decline in their ratio to 37.6 percent from 38.5 a year earlier. However, the ratio of liquid assets to short-term liabilities is considered high above the regulatory minimum of 25 percent. The balance of liquidity reserves of commercial banks in the CBK continues to exceed the required reserve by 57.0 percent, despite the negative interest rate on excess reserves. The environment of low interest rates has continued to encourage households to shift their deposits in favour of short-term maturity, which in addition to the accelerating trend of long-term lending resulted in highlighting mismatches in maturity between assets and liabilities. The continuous increase in the share of transferable deposits and the widening of the gap for the short-term period increase the sector's exposure to financing risk in the event of a sudden withdrawal of deposits, or their movement between banks. Such a situation can pose a challenge for banks' liquidity management, despite the current high level of liquid assets. All this, taking into account the underdeveloped financial market in Kosovo that may delay the conversion of these assets, such as, securities, cash and cash equivalents, as well as the lack of monetary policy instruments as a result of euroization. In the following period, the crisis triggered by the Covid-19 pandemic may increase the pressure on the liquidity situation of the sector through the effect of the slowdown in deposit growth as a result of the decline in economic activity and external sources of financing. At a time when demand for financing and liquidity from the private sector will increase, the pressure to manage liquidity from banks may increase. In the absence of mechanisms for direct liquidity injection into the market by the CBK, the need for liquidity and financing can be managed through reserve management, inter-bank liquidity agreements and external financing through parent banks.

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, remaining in positive quotas despite a strong shock recorded in May this year. New collections from contributors have continued to show solid growth. While the funds investment strategy of, which in the past was more focused on the foreign market, in this period there is an increase in investment in the domestic market, i.e. securities of the Government of Kosovo and time deposits in the banking sector.

The insurance sector during 2019 was characterized by increased activity and higher level of premiums collected. Despite this, the increase in the level of damages paid and operating expenses affected the sector to operate at a loss. Insurance sector assets have a low share of 2.7 percent in total financial system assets. The sector continues to be mainly focused on non-life insurance, i.e. compulsory third-party insurance. The level of penetration remains the same, at 1.4 percent (gross written premiums in relation to GDP), which 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 record high growth, mainly influenced by the growth of lending and leasing activity, which are financed mainly by borrowing in the external sector. However, the growth trend slowed down for the first time in the last 5 years.Despite rapid growth, its share in the level of financial intermediation remains low, at 4.2 percent of the total financial system assets. Lending marked an annual growth of 20.5 percent (slowdown in annual growth of 7.2 percentage points) more oriented towards the household sector. The high interest rates that characterize this sector, on average marked a slight decline, although there were large differences in interest rates between institutions (MFIs and NBFIs) and the products offered. The sector continued with high financial performance, recording a record level of profit. The sector continues to be characterized by low levels of non-performing loans, which increased to 2.6 percent from 2.2 percent a year earlier. Coverage of non-performing loans with provisions also decreased, but remains at a satisfactory level.

The legal and regulatory framework and financial infrastructure have continued the progress in the function of developing the financial sector and maintaining financial stability. During 2019, the CBK has continued to work on completing and advancing the legal and regulatory framework of the financial system in general and the banking sector in particular, contributing to the approximation of the regulatory framework with international standards with the added function of maintaining financial stability. Work has also continued on reviewing the regulatory framework for real estate appraisal to improve information in this area with a strong emphasis on financial sector stability, as well as reviewing the regulatory framework in the payment system to reflect the systemic importance of the payment system.

During this year, the regulation for repurchase of securities of the Government of Kosovo with the Central Bank of the Republic of Kosovo was approved, which authorizes 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 to expand and advance technologically, increasing its reach and use, with a particular emphasis on electronic and automated services. The outbreak of the Covid-19 pandemic is expected to accelerate this trend. At the same time, the increase in the use of digitalized services is expected to increase the degree of risk of errors in information technology systems or potential cyber-attacks, thus increasing the exposure to operational risk and the need for proactive surveillance for protection against this risk and minimizing potential losses.

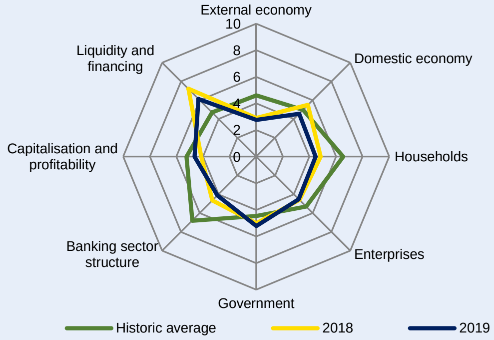
Box 1. Financial Stability Map

Financial Stability Map[4] presents the developments in main indicators of risks to the Kosovo financial stability (chart 4).The year 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 in the last quarter. The risk from the activity of economic agents such as enterprises, households, marked a decrease, but with a slight increase in the government sector. 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 Q4 2019. Whereas the risk from banking sector structure has marked a steady decrease. Whereas, the most significant decrease of risk in this period was marked in the liquidity and financing indicator, which however continues to have the highest risk scale. Finally, most of the indicators stand below or near the historic average risk level, excluding the government and liquidity of financing indicators.[5]

The decrease in unemployment in countries with the highest concentration from where remittances are received, along with the decrease in oil prices, has contributed positively to the fall of the risk grade by the external macroeconomic environment. Whereas, developments in all other external economic indicators such as the slower economic growth of Kosovo's trading partners, prospects for economic activity in Europe according to the Organization for Economic Cooperation and Development in Europe, as well as increase of basic interest rates have had positive increase contribution to the increase in risk scale, by decreasing this way positive effect of decrease in unemployment and oil prices. In the last quarter of the year, almost all indicators contributed in the risk increase from external economy.

Domestic economy indicators were characterized by positive developments in the context of financial stability that neutralized the negative effect derived by the single component of this indicator- increase of risk by inflationary pressures. However, the last quarter of the year marked a trend of risk increase, influenced by the expansion of the production gap, as a result of the slowdown in economic growth in Q4, as well as the expansion of the negative balance of current account to GDP.

Chart 4. Financial stability map



Source: CBK (2020)

The household and enterprise sectors were characterized by decrease in risk. Lending to enterprises continued with the highest increase in relation to GDP, affecting the lending gap to GDP for this sector to move from a negative to a positive level, which was reflected with an increasing contribution to the risk scale. The slowdown in the growth of the trade sector and the lowest positive net balance of enterprise registration also contributed to the increase in the risk scale. However, these developments were completely neutralized by the positive contribution made by other indicators such as the improvement of the quality of the enterprise loan portfolio, the industrial turnover index and the significant increase of the sector realiability index in the second half of the year.

All component indicators contributed in decreasing risk to the household sector, with the exception of the loan gap indicator, which remained at a similar level. Lending to households slowed down the increase trend, therefore, the slowdown in GDP growth did not change the gap likewise the case of enterprises. The quality of the household loan portfolio continued the upward trend, bringing a lower loan risk. Unemployment rate marked a decrease while the receipt of remittances increased, reflecting higher income to the households.

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. On the other hand, components with a positive impact were the

[4] The Financial Stability Map (FSM) graphically presents the movement of the level of risk in the main risk categories to financial stability in the banking sector of Kosovo, and enables comparison with the historical average risk scale for the respective categories. The increase in the distance from the centre of the map to the indicators reflects an increase in risk and a decrease in the ability to withstand shocks to financial stability, and vice versa. The full methodology of the FSM model for Kosovo, which has undergone continuous revisions in indicators and their method of calculation, is presented in the CBK Study Material no. 6

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

increase of budgetary revenues to GDP, as well as narrowing, on average, of the negative budget balance to GDP, which however in Q4 showed an increase trend.

The risk stemming from the structure of the banking sector has been characterized by a decrease, as a result of positive developments in almost all components. The exception was the diversification of the overall portfolio of banks' financing sources, which was lower compared to the previous year. The most significant improvement was noted in the component of negative deviation to the average capitalization rate of the sector, which means that banks have converged towards the average capitalization rate of the sector, as a result of the increase in the capitalization rate of smaller banks along with the decrease of the average capitalization rate of the sector. Other positive developments include the decrease in the asset concentration of the three largest banks, the decrease in the enterprise loan portfolio concentration, and the higher diversification of the overall loan portfolio.

The position of sector capitalization and profitability, although favourable throughout the year, was characterized with an increase in risk. The sector capitalization rate marked a decrease, by decreasing the difference versus the minimum regulatory rate.

The ratio of net interest income to sector assets, on average, decreased, as a result of the higher growth of sector assets in relation to the increase in net interest income. Similarly, the slowdown in profit growth and the lower growth of share capital in relation to assets, affected the decline in the ratio of profit to assets, respectively share capital to assets. The components with a positive effect on the capitalization indicator were the improvement of the quality of the loan portfolio as well as the decrease of large exposures in relation to tier 1 capital, but the latter showed an upward trend in the last quarter of the year.

All components of the liquidity and financing risk indicator of the sector had a positive contribution to the most significant risk reduction with which this indicator was characterized. The higher annual growths of household deposits, as well as the decrease of the share of liabilities to the external sector in the sources of financing/liabilities of the sector, were the most important factors in reducing the risk. Despite the sharp decrease in the risk scale on this indicator, its deviation above the historical average level continues, as a reflection largely of the nature of components included in the indicator.[6]

[6] The loan/deposit rate indicator has followed a naturally increasing trend since the beginning of the operation of the sector, and in recent periods we reflect a higher ratio (higher risk scale). Similarly, the growth rate trend of household deposits has been characterized by significant fluctuations over the years, being higher at the beginning of the operation of the sector and naturally began to decrease as a result of the development of the sector, but which has increased again in the recent periods.

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, slowdown in China's economic growth, increased geopolitical uncertainties, and uncertainties 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 seen slower growth, with the exception of Kosovo and Northern Macedonia which have marked an accelerated economic growth compared to previous year.

Table 2. Selected macroeconomic indicators

Description	Real GDP				Unemployment rate				Inflation			
	2017	2018	2019	2020	2017	2018	2019	2020	2017	2018	2019	2020
Euro area	2.5	1.9	1.3	-10.2	9.1	8.2	7.6	10.4	1.5	1.8	1.2	0.3
Germany	2.5	1.5	0.6	-7.8	3.8	3.4	3.2	3.9	1.7	2.0	1.3	0.3
France	2.3	1.8	1.5	-12.5	9.4	9.0	8.5	10.4	1.2	2.1	1.3	0.3
Italy	1.7	0.8	0.3	-12.8	11.3	10.6	10.0	12.7	1.3	1.2	0.6	0.2
Kosovo	4.2	3.8	4.2	-12.3	30.5	29.6	25.7	n/a	1.5	1.1	2.7	0.8
Montenegro	4.8	5.1	3.5	-9.0	16.1	15.2	15.1	n/a	2.8	2.9	0.5	0.7
North Macedonia	1.2	2.7	3.6	-4.0	22.4	20.7	17.3	20.4	2.1	2.3	0.7	-0.9
Serbia	2.1	4.4	4.1	-3.0	13.2	12.7	10.4	13.4	3.2	2.0	1.9	1.4
Albania	3.8	4.1	2.2	-5.0	13.7	12.3	11.5	11.8	3.2	1.8	1.7	2.4

Source: ECB, WEO, Eurostat, CBK and Agencies of Statistics in the countries of region

Explanation: the GDP projection for Kosovo was realized in July 2020 by the CBK, while for other countries in the region forecasts are of IMF which were realized in April 2020

Closure of quantitative easing program[7] as part 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 increase in economic activity of only 1.3 percent (1.9 percent in 2018) (table 2). As a result of measures taken to combat the COVID-19 pandemic, the Eurozone economy is expected to record a 10.2 percent decline in economic activity.

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 3.5 percent, which is a slower rate compared to the rate of 4.0 percent recorded in 2018. The weakening of external demand has negatively affected the region's exports and external sources of financing. Also, the problems caused by COVID-19 but also the increased political uncertainties in the Western Balkan countries are expected to reflect further decline in the credibility of investors and consumers, thus directly affecting economic activity.

Unlike the Euro area and the Western Balkans, **in 2019, Kosovo's economy was characterized with accelerating growth in economic activity**. **However,** the increase in external and internal risks during 2020, caused by COVID-19, is expected to be reflected in decline in economic activity through the decline in domestic demand and the increase in the trade deficit.

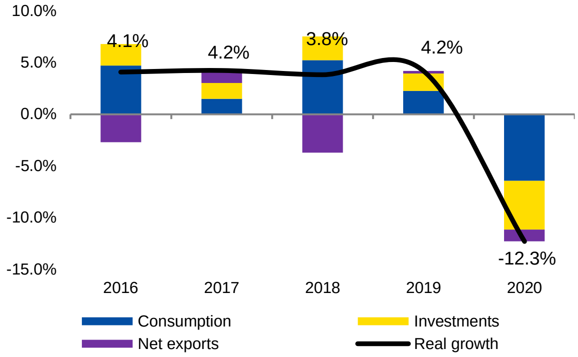
3.1. Domestic economy

The increased uncertainties in the external environment during the year 2019 did not affect the dynamics of the domestic economy,

[7] 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%.

as real GDP growth is estimated to have marked an accelerated growth (4.2 per cent) compared to the previous year (3.8 percent). The acceleration of economic growth came as a result of the positive contribution of net exports and investments, while the domestic demand marked a lower positive contribution compared to the year 2018. (chart 5).

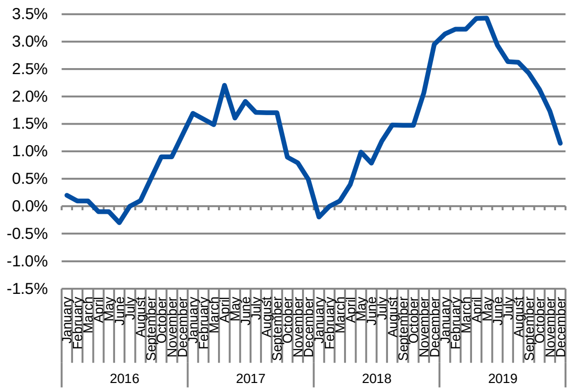
Chart 5. Real GDP growth rate and contributors to the growth



Source: KAS and CBK forecast (2020)

Despite the weakening of external demand and lower metal prices in international markets, exports of goods have marked an accelerated growth in 2019 while imports of goods have been characterized by a slowdown in growth.

Chart 6. Inflation rate, annual change



Source: KAS (2020)

This caused net exports in real terms to reduce in trade deficit by about 0.8 percent (14.4 percent increase in 2018). Official quarterly data published by KAS suggested an increase in the value of investments by 5.7 percent and an increase in consumption by 2.3 percent, an activity mainly supported by increased financial intermediation in the country, increased remittances, employee compensation and a positive fiscal impulse.

The dynamics in 2020 changed completely, after the rapid spread of the COVID-19 virus and the declaration of a pandemic by the WHO. To manage the pandemic and the health crisis, similar to governments around the globe, the Government of Kosovo undertook restrictive measures in March 2020 when it comes to movement, travel, public and non-public activities, activities in some of the business services, etc. Prioritization of public health and restrictive measures were translated into declining economic activity in the country. Domestic demand is expected to shrink, while net exports are expected to deepen the trade deficit and consequently increase the negative contribution to GDP.

Despite the decline in prices of main goods in international markets, prices in Kosovo have increased.

This price increase started since the last quarter of 2018 and has continued in the first half of 2019, slowing down in the second half of the year. The increase 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, in particular the increase in food prices. By December 2019, the average annual inflation rate expressed through the Consumer Price Index (CPI) was 2.7 percent (1.1 percent in 2018) (chart 6).

For 2020, CBK estimates suggest that the average inflation rate is expected to be around 0.8 percent. In line with the CBK forecasts are the expectations of commercial banks in the country[8], which suggest that the inflation rate in 2020 will be lower compared to that in 2019.

In 2019, the dynamics that characterized the fiscal sector resulted in higher growth of budget revenues (7.5 percent) versus budget expenditures (7.2 percent). Despite the higher increase in budget revenues, the

[8] 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.

higher level of expenditures has affected the budget deficit to increase by 3.5 percent and reach 168.4 million euros (162.7 million euros in 2018). As a percentage of GDP, the primary budget deficit was 2.3 percent (2.4 percent in 2018). The public debt was also characterized by an increase of 9.9 percent, reaching the value of 1.2 billion euros. **As a percentage of GDP, public debt reached 17.5 percent from 16.9 percent in 2018.** The increase in public debt is attributed to the increase in domestic debt of 17.0 percent (which reached 791.9 million euros), while external public debt decreased by 1.8 percent, reaching 408.9 million euros.

The country's economy continues to face imbalances in the external sector. However, the dynamics that have characterized the external sector during the year 2019 have resulted with improvement in net exports, where the current account deficit reached the amount of 410.2 million euros (19.4 percent lower compared to 2018). **In relation to GDP, the current account deficit has decreased to 5.8 percent, from 7.6 percent in 2018.** This reduction in the current account deficit is attributed to the increase in positive balances of services and primary and secondary income, while the goods deficit also marked a slowdown.

The increase in exports of goods and the slowdown in increase of imports have affected the **deficit in trade of goods to increase by 4.5 percent**[9] **(11.6 percent increase in 2018) and reach about 3.1 billion euros**. In relation to GDP, the trade deficit of goods has decreased to 44.0 percent, from 44.3 percent that was in 2018. The value of exports of goods was 383.5 million euros, which corresponds to an annual increase of 4.4 percent (2.8 percent decrease in year 2018).

The balance in trade of services marked the value of 926.9 million euros, an increase of 8.3 percent compared to that in 2018. The improvement of the balance in the trade of services is attributed to the increase of exports of services by 7.3 percent, while the import of services marked an increase of 6.2 percent. The structure of imported and exported services remained almost unchanged from the previous year, dominated by travel and transport services, computer services and other business services. Travel restrictions and undertaken measures by EU governments for their citizens visiting Kosovo are estimated to discourage the diaspora from visiting Kosovo during the third quarter of the year and, consequently, will result in exports of services and general economic activity decreasing (over 50 percent of total exports of services are realized during the third quarter of each year - of which about 78 percent are travel services).

Within the balance of payments of Kosovo, the net income from employee remuneration[10] which is the main category of primary income, increased by 8.5 percent. Also, the balance of secondary income was characterized by an increase, mainly as a result of the higher level of remittances, which constitutes the largest category within thesecondary income account. **Remittance inflows marked the value of euro 851.7 million euros in 2019 and marked an annual increase of 6.4 percent.**

In 2019, FDI collected in Kosovo was almost the same as the previous year (271.8 million euros). Increase in FDI was recorded mainly in the real estate sector, rent and business activities as well as in the industry sector, while in the construction and commercial services sector there was a decrease in FDI.

3.2. Financial position of enterprises

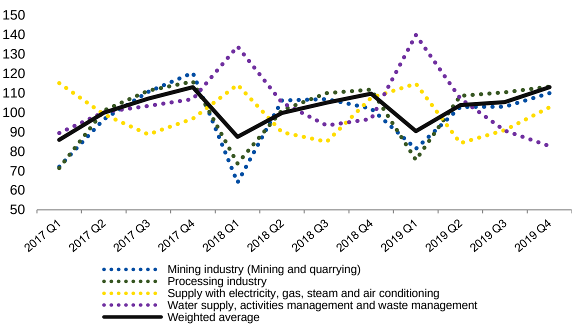
Developments in economic and financial indicators of enterprises suggest an increase in the volume of industrial production and an increase of turnover in

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

[10] Compensation od employee includes salaries, wages and other benefits received by resident workers abroad. This includes seasonal or other short-term workers (less than one year) and border workers who have the centre of economic interest in their economy.

retail trade during 2019. 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 2.6 per cent. The increase of this index was higher in the extractive industry (4.8 percent), which is justifiable also by the growth of 5.9 percent of value added in this sector. In the processing industry the growth of the index was lower (2.8 percent) while in the water supply and electricity supply sector it decreased by 2.0 percent and 1.0 percent respectively (chart 7).

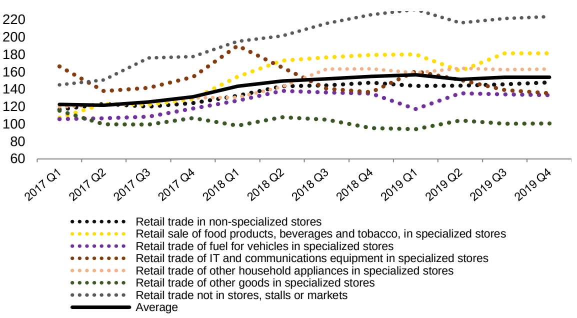
Chart 7. Industrial turnover index (2017=100)



Source: ASK (2020)

The average turnover index in the retail trade sector was increased by 2.7 percent, which is an almost similar with the rate in the industry sector (chart 8). An increase of 5.7 percent was also marked in the value added of this sector.

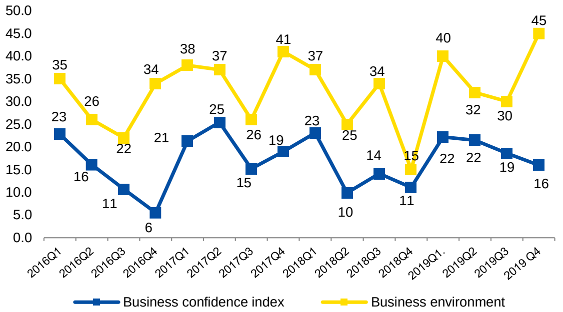
Chart 8. Retail turnover index (2013=100)



Source: KAS (2020)

The business climate indicator and the confidence indicator have changed the declining trend that has characterized them during the year 2018 and increased in the year 2019.[11] The business climate indicator, which estimates the current economic situation (profitability) of the business and expectations for the next six-month period, was higher by an average of 9.0 percentage points, while the business confidence indicator, which has a more general assessment character for the business situation, unlike the previous indicator that focuses only on the financial performance of the business, was higher by an average of 5.0 percentage points (chart 9).

Chart 9. Business confidence and environment index



Source: KEC (2020)

As a result of the increase of business climate indicators and business confidence, the entrepreneurial initiative was also increased. In 2019, 10.004 new enterprises were registered, which represents an annual increase of 2.0 percent. The sectors that marked the highest annual increase in the number of registered businesses were manufacturing, hotels, professional activities, etc.; while in the agricultural and trade sectors the number of newly registered enterprises was significantly lower (chart 10).

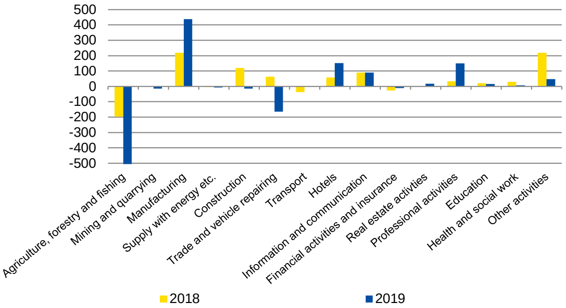
In addition to the increase in the number of new businesses registered, an increase was also marked in the number of closed businesses. During 2019, 1.769 enterprises were closed, or 24.1 percent more compared to that in 2018.

Continued progress in the effective implementation of legislative and regulatory requirements reforms has contributed in reducing barriers to loan access, but many challenges remain still.

[11] The business climate indicator and the business confidence indicator are compiled by the Kosovo Chamber of Commerce, as part of the regular quarterly study 'Business Climate in Kosovo' which surveys businesses in four sectors of the economy: manufacturing, construction, services and trade.

Progress in the scope of private enforcement agents as well as amendments to the Law on Enforcement Procedure relating to the seizure of a bank account and the accelerated procedure for selling collateral have had a positive impact on loan offer and have eased collateral requirements and reduced interest rates. However, numerous barriers remain, which hinder business performance and access to finance. High level of informality, poor implementation of contracts, lack of cadastral data, together with lack of financial transparency and low quality of financial reporting, continue to be obstacles to access to finance for enterprises.

Chart 10. Annual change in the number of new enterprises



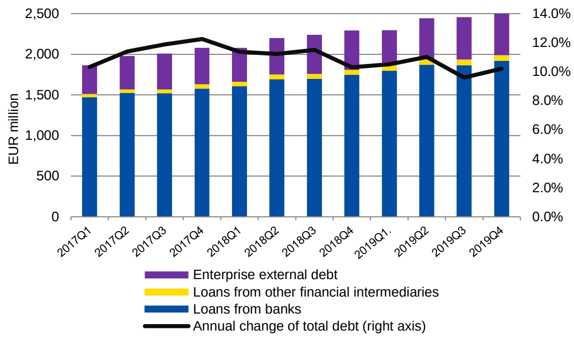
Source: KAS (2020)

The enterprise debt to domestic and foreign financial institutions has continued to increase. Domestic debt, that is, the debt to the banking sector in the country has increased by 10.0 percent in 2019. Enterprise loans issued by other financial intermediaries increased by 14.5 percent, but remain with small weight in total enterprise debt at about 2.8 percent.

The external debt of enterprises continued to grow, reaching 21.2 percent of total debt. Total enterprise debt marked an annual increase of 10.2 percent and reached 35.7 percent of GDP (chart 11).

The increase in lending to enterprises by the banking sector has contributed to the process of approximating the degree of financial intermediation to the countries of the region. The ratio of enterprise loans from banks to GDP reached 28.1 percent in December 2019 (26.9 percent in 2018). This means that lending was increased faster than GDP, affecting the loan gap to GDP ratio to be positive.[12]

Chart 11. Enterprises debt



Source: CBK (2020)

As a result of the higher growth of deposits, the net debt position of enterprises to the banking sector marked a slower growth. The deposits of enterprises marked the most accelerated annual growth rate (25.0 percent) while the growth rate of lending to the enterprise sector was slower (10.0 percent) and this affected enterprises to increase their debt position to the banking sector for 2.6 percent (10.3 percent increase in 2018). In terms of foreign currency, the enterprise sector has a net loan position to the banking sector, as a result of the higher level of foreign currency deposits compared to loans. However, foreign currency position remains low as a result of the low share of loans and deposits in foreign currency, at 0.1 percent for foreign currency loans to total loans, and 2.0 percent for foreign currency deposits to total enterprise deposits.

The readiness of the banking sector in lending for enterprises has increased higher compared to the previous year. New loans increased by 9.7 percent (4.9 percent in 2018). By the objective, new non-investment loans increased by 28.1 percent and increased their share in the structure from 34.0 percent to 39.7 percent of total new loans to enterprises. New investment loans increased by only 1.0 percent and reduced the share in the structure from 63.6 percent to 58.5 percent of total new loans to enterprises. In terms of maturity, the year 2019 was characterized by an increase in loans with a

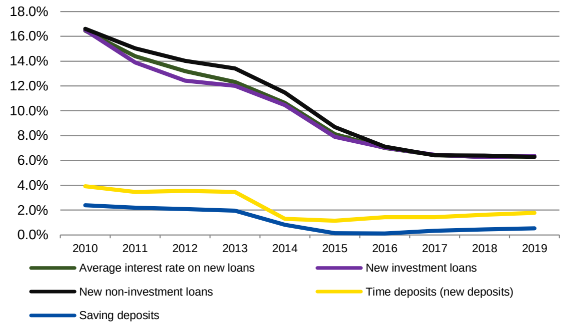
[12] Credit gap calculated with the Hodrick-Prescott filter.

maturity of 2 to 5 years, where 52.0 percent of new loans belonged to this category (46.4 percent in 2018). Short-term loans also increased in structure, while loans with a term of 5 to 10 years decreased from 27.1 percent to 15.9 percent in the general structure of new loans to enterprises.

Borrowing of small and medium enterprises in 2019 is also supported by the Kosovo Credit Guarantee Fund (KCGF), the use of which has marked a continuous growth trend. The KCGF, aiming to enhance the access to finance for SMEs through guaranteeing the loan portfolio of financial institutions, has started by guaranteeing the first loan to SMEs in September 2016. In December 2019, the number of bank loans guaranteed by KCGF was 4,052 while the approved amount of guarantees reached 75.2 million euros. The structure of guaranteed loans is a representation of the general structure of loans in the banking sector, dominated by loans to the wholesale and retail trade sector, followed by the services sector and manufacturing sector. The agriculture, forestry and fisheries sector was representing 10 percent of the total guaranteed loan portfolio. The positive development prospects of the KCGF, both in terms of capital growth and the guaranteed value of loans, and with focus on supporting specific sectors with more difficult access to finance such as the agricultural sector, are expected to be reflected in facilitating lending conditions and further increase of lending to SMEs in general, and certain sectors in particular. The altered dynamics during 2020 and the confrontation with the unprecedented economic and social crisis as a result of the measures taken to manage the health crisis have further strengthened the role of KCGF in supporting economic recovery by facilitating access to finance. In this regard, the Government of Kosovo in cooperation with the World Bank have foreseen the increase of the fund's capital and the creation of new guarantee windows for certain sectors that resulted to be more affected by the pandemic such as the manufacturing sector, young entrepreneurs, women in business, etc.

The cost of borrowing for the enterprise sector marked a slight increase compared to the previous year.

Chart 12. Interest rates for enterprises



Source: CBK (2020)

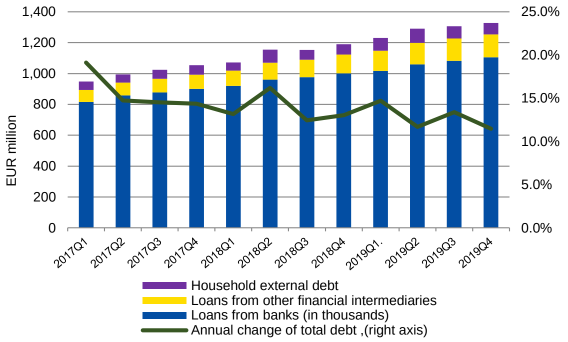
The average interest rate on new loans of the banking sector to enterprises was 6.32 percent, a slightly higher level compared to 2018 (6.28 percent). This level of interest rates has come as a result of constant competitive pressures, improving the quality of the loan portfolio, progress in structural reforms to reduce collateral risks and good access to finance.

3.3. Financial position of households

The debt of households, such as enterprises, was increased in 2019. Domestic debt to the banking sector has increased by 10.3 percent, while debt to microfinance institutions, which has reached 13.5 percent of the value of debt to the banking sector, is increased by 23.3 percent. External household debt increased by 6.9 percent and constitutes 5.5 percent of total debt. Total household debt increased by 11.5 percent and as a percentage of GDP was 17.7 percent (chart 13).

New loans issued by the banking sector for households marked a decrease. Overall growth of new debt to banks was lower by 1.0 per cent while in the first half of 2018 it increased by 7.1 per cent. By purpose, new consumer loans decreased by 4.1 per cent compared to the same period in 2018, while investment and mortgage loans were lowest by 1.9 percent. On the other hand, mortgage loans increased by 9.5 percent.

Chart 13. Households debt

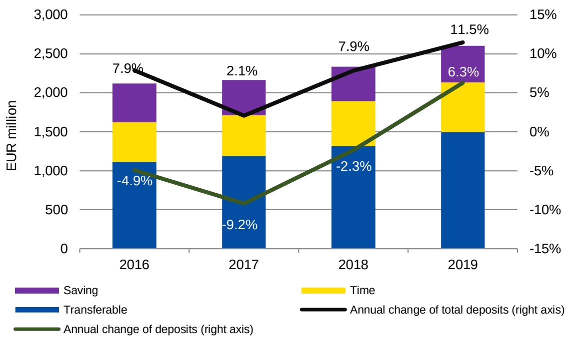


Source: CBK (2020)

The decrease in consumer loans affected that high share of these loans in total new loans to households to decrease to 71.7 percent from 74.0 percent in 2018.

The net loan position of households versus the banking sector increased as a result of the larger volume of deposits compared to loans but also the higher growth rate of household deposits compared to the previous year.

Chart 14. Household deposits

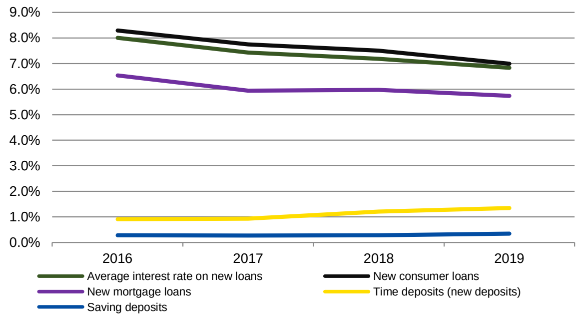


Source: CBK (2020)

Household deposits amounted to 2.6 billion euros[13], which represents an annual increase of 11.5 percent (chart 14). Also, loans continued to double-digit growth of 10.3 percent and reached the value of 1.1 billion euros. As a result, the loan position that households traditionally have had versus banking sector increased by 12.3 percent in 2019.

When it comes net foreign currency position, the household sector decreased its foreign currency lending position by 1.4 percent, as a result of the decrease of deposits in foreign currency, which decreased to 5.8 percent of total household deposits (6.0 percent in 2018), while foreign currency lending remains at about 0.2 percent of total household lending.

Chart 15. Interest rates for households



Source: CBK (2020)

Household savings, in the form of savings deposits, time deposits and transferable deposits, increased in 2019. This increase in deposits has come as a result of the gradual increase of interest rates on deposits which have affected the reduction of opportunity cost of maintaining savings and time deposit assets, respectively increasing household savings (chart 15). Total household deposits increased by 11.5 percent (7.9 percent increase in 2018). The time deposits marked an increase of 10.3 percent, while the average interest rate on time deposits was 1.35 percent in 2019 or 0.13 percentage points higher compared to that in 2018. The savings deposits have also increased by 6.3 percent while the interest rate in savings deposit reached 0.35 percent (0.28 percent in 2018). **The cost of new household debt continued to decrease, affected by competitive pressures and favourable financing conditions.** The consumer loans marked an average interest rate of 7.0 percent (7.5 percent in 2018), while interest rates on mortgage loans fell to 5.7 percent (6.0 percent in 2018). The household interest rates expected to decline further, under negative economic growth prospects. Household income sources showed an upward trend, remittances increased by 6.4 percent while employees' remuneration[14] marked an annual increase of 6.8 percent.

[13] Including foreign currency deposits, converted to euro equivalent.

[14] 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.

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

Description	2016	2017	2018	2019
Household debt to banks (EUR million)	799.5	900.6	1,001.1	1,104.7
Of which in foreign currency	2.9	3.0	2.6	2.6
Household deposits at banks (EUR million)	2,120.5	2,164.2	2,334.2	2,601.9
Of which in foreign currency	100.8	122.6	140.4	138.5
Net position to banks (credit position) in EUR million	1,321.0	1,263.5	1,333.1	1,497.3
Debt to income ratio		26.3% *	38.3%	42.5%
Average valoe of loans per employees	2,409.5	2,522.1	2,901.0	3,041.4
Economic dependence rate	274.0%	250.0%	268.0%	253.0%

Source: CBK (2020)
* The household debt-to-income indicator began to be reported on a regular basis and with consistent methodology from banks as of 2018.

The level of salaries for the period 2012-2018, according to KAS, marked an increase in both the public and private sectors, where on average the net wage has increased by 29.8 per cent to 498 euros in 2018. In 2019, the monthly net salary of employees, according to the Labour Force Survey[15], was in the range of EUR 400 to EUR 500. In terms of the labour market, the labour force participation rate in the second quarter of 2019 was 40.5 percent or 0.4 percentage points lower compared to the same period of the previous year, i.e. the inactivity rate increased by 0.4 percentage points and has reached 59.5 percent. The employment rate reached 30.1 percent, which is 1.3 percentage points higher compared to 2018. On the other hand, the unemployment rate was 25.7 percent or 3.9 percentage points lower compared to 2018. **The burden of households with debt, measured through the debt-to-income ratio has increased to 42.5 percent (38.3 percent in 2018).** This indicator does not present the full debt burden as it considers debt only by a banking institution, not considering multiple borrowing in banks and other financial institutions as well as external debt. On the other hand, the economic dependence indicator, which represents the ratio of total inactive population (over 15 years old) and employment, in 2019 has improved to 253 percent, from 268 percent in 2018.[16]

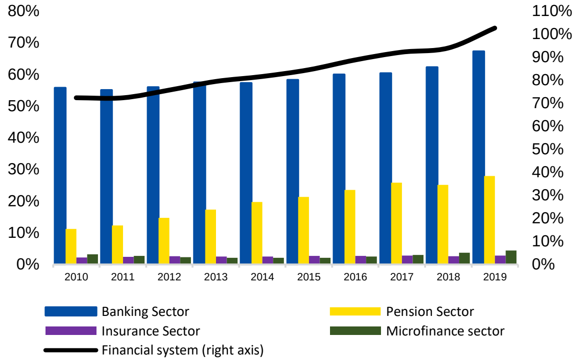
[15] Kosovo Agency of Statistics, https://ask.rks-gov.net/media/5369/anketa-e-fuqisë-punëtore-afp-2019.pdf

[16] 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 in 2019, marking a significant increase of its activity, with positive contribution from all constituent sectors. The value of financial system assets amounted to EUR 7.26 billion, corresponding to an annual growth of 14.9 percent (an increase of 6.9 percent in 2018). The positive developments of the financial system suggest greater public access to financial services, especially banking services. The financial intermediation rate (assets to GDP ratio) increased by 8.6 percentage points to 102.5 percent, being impacted by the expansion level of the banking sector, but also including the impact of the pension and microfinance sectors (chart 16).

Chart 16. The weight of financial system sectors to GDP



Source: CBK (2020)

The growth of the banking and microfinance sector assets is mainly attributed to the increase of their lending activity, the continuous improvement of credit quality, increased competition and improved access to finance.

Table 4. Number of financial institutions

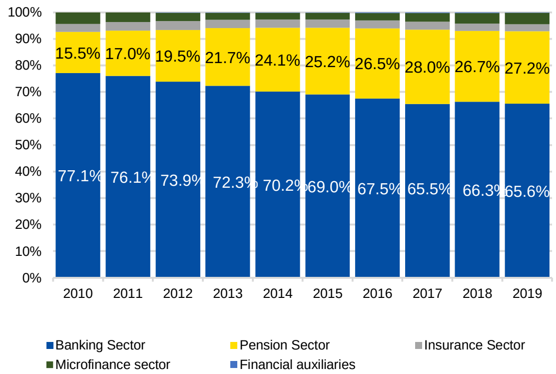
Description	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Commercial banks	8	8	9	9	10	10	10	10	10	10
Insurance companies	12	13	13	13	14	15	15	15	14	13
Pension funds	2	2	2	2	2	2	2	2	2	2
Microfinance institutions and- Banks	17	20	17	17	18	18	16	18	22	20
Financial auxiliaries	28	34	38	39	42	44	48	52	51	51

Source: CBK (2019)

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 driven mainly by the increase of the level of deposits held at the CBK, investments in securities and the categories of borrowing and payable.Regarding the structure of the financial system the number of commercial banks and the number of pension funds remained the same as in the previous year.

While the number of microfinance institutions in 2019 declined at 20 microfinance institutions and non-bank financial institutions due to the licence revoking of two microfinance institutions. Also the number of insurance companies declined at 13, as a consequence of the licence revoking of one insurer (table 4). While, financial auxiliaries sector has the highest number of financial institutions, albeit their share to total financial system assets is represented by 0.2 percent (chart 17).

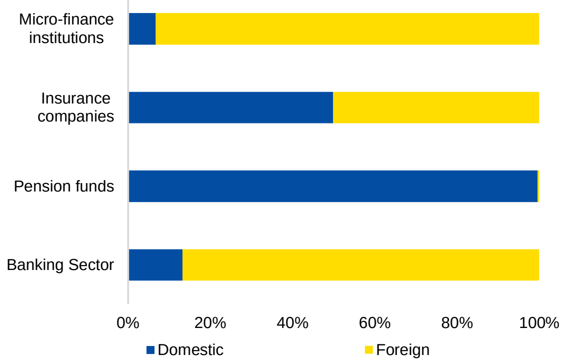
Chart 17. The share to total financial system assets



Source: CBK (2020)

Foreign capital dominates most of the financial system sectors, particularly in the sectors whose activity is lending (chart 18).

Chart 18. Ownership of financial system constituent sectors, December 2019



Source: CBK (2020)

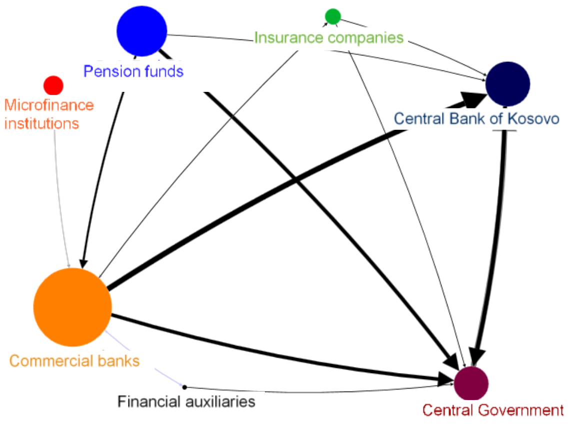
The banking sector is dominated by EU-origin capital accounting for 6.9 percent of total banking sector assets. Domestic banks were characterized with the same presence as in the previous year marked in the banking market (with 13.3 percent). Banks with the origin from Turkey marked a slight decline of their share in the market, with a share of 16.5 percent in 2019 (17.5 percent in 2018).

Such developments have contributed to increased competitiveness of services and to lower banking concentration. The bank concentration rate[17]dropped to 56.9 percent from 57.3 percent as it was in the previous year. The insurance sector continued to have a lower concentration as a consequence of more balanced spread of assets in the market. However, compared to the previous year, the data show that there is a slight increase of concentration as a consequence of a licence revoking of one of the insurance companies, during 2019.

Insurance companies with domestic capital comprise 49.9 percent of total assets from 47.7 percent in the previous year. Whereas, companies with foreign capital come from Austria, Slovenia and Albania (chart 18).

The financial system in Kosovo has a simple structure, with respect to the traditional model of activities, with minimal linkage of activities between system sectors.

Figure 1. Institutional interconnections of the Kosovo Financial System



Source: CBK (2020)

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 December 2019.

Interconnections between sector actors have not changed significantly in 2019. 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.

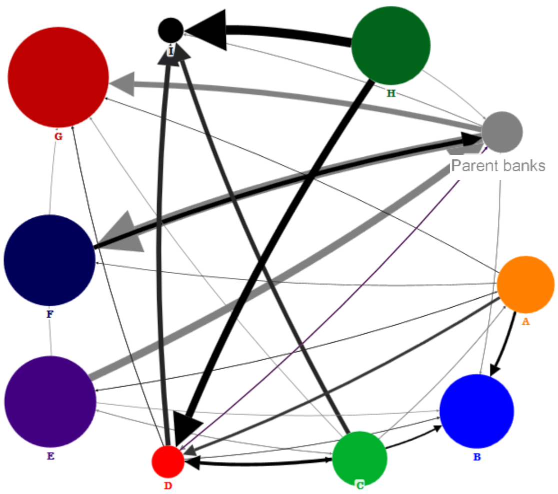
The most pronounced interconnection is between commercial banks and the CBK, which is represented in the form of deposits for the mandatory reserve that banks must maintain at the CBK.

Insurance companies and pension funds also hold claims in the form of transferable deposits (current accounts) to the CBK, which together with commercial banks in December 2019 accounted for 35.0 percent of total CBK 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 46.8 percent of their assets as deposits in commercial banks. Financial auxiliaries, in December 2019, increased the balance sheet share with commercial banks in their total assets to 45.3 percent from 29.3 percent the previous year.

[17] Expressed as the ratio of the assets of the three largest banks to the total assets of the sector

While pension funds and microfinance had 9.4 percent and 4.7 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 0.2 percent of total loans in the banking sector.

Figure 2. Banking interconnections of the Kosovo banking sector



Source: CBK (2020)

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.

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 deposit-loans. The CBK is the main investor in government securities, followed by pension funds and commercial banks. 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.

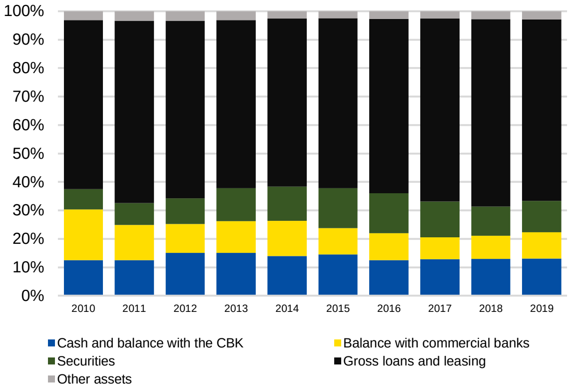
Interbank links are even more concentrated than inter-institutional ones, with some banks being relatively smaller having significant exposures to each other within the financial system in the country (figure 2). Large banks have their main exposures in foreign markets, to parent banks or other banks 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 link is between bank H with two banks I and D, due to the financial claims expressed as time deposits that bank H has to these two banks (which are also sources of financing for the latter, banks I and D). Bank C also has more pronounced interconnection with banks I and D, in the form of claims against them. Bank C has liabilities to bank D as well, but which are almost half lower than the claims to it. The interconnections with the respective parent banks are more pronounced with banks F, G and D, mainly in the form of liabilities as credit lines borrowed in the interbank money market, as well as interdependent debt. Bank E also has a strong relationship with the parent bank, but in the form of claims on it, respectively deposits in the parent bank and other branches of the group.

4.1. Banking activity

Banking sector activity during 2019 was characterized by an increase mainly driven by the increase of lending and investments in the securities market. Banking sector assets increased by 13.7 percent from a year earlier, reaching EUR 4.76 billion. The growth is mainly attributed to the positive dynamics that characterized the lending activity, which continues to be supported mainly by deposits.

Within assets, the category of balance sheet with commercial banks (annual increase of 29.3 percent) and the category of cash and reserves held in the CBK (annual increase of 14.9 percent) were characterized by high annual growth. The increase within the balance sheet category with commercial banks came as a result of the placement of assets in the external sector in the form of time deposits and transferable deposits. On the other hand, despite the continuation of the negative interest rate applied by the CBK on the excess reserve requirement that commercial banks hold in the CBK, this subcategory marked an annual increase of 20.8 percent. This increase reflects the high level of deposits collected during 2019, but also the low possibilities for investments/placements of assets.

Chart 19. Share to assets structure

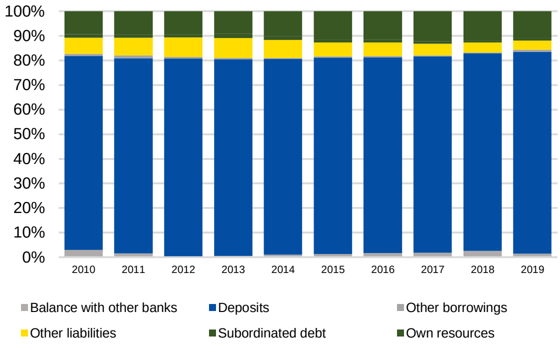


Source: CBK (2020)

The sector has not suffered structural changes in the assets side over the years, with the exception of the securities subcategory which increased from 2012 as a result of the start of the domestic securities market and the active participation of banks in this market (chart 19). The stock of securities marked an annual increase of 22.4 percent, influenced to some extent by the increase in investments in securities of foreign governments. However, investments in Kosovo government securities for the second year in a row had the highest share in this instrument (54.6 percent, respectively 59.8 percent in the previous year).

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.

Chart 20. Share to the structure of liabilities and own resources

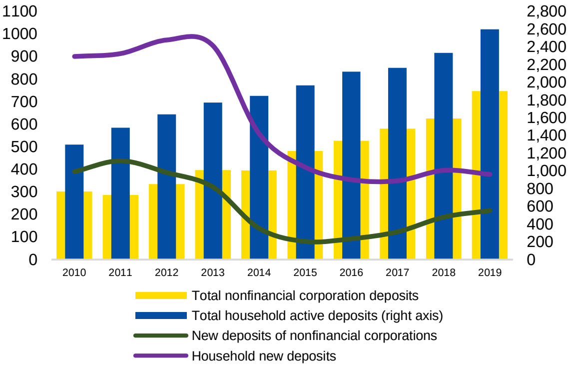


Source: CBK (2020)

The banking sector activity is supported by deposits at the level of 82.1 percent (chart 20). Total deposits increased by 16.2 percent to EUR and reached the level of EUR 3.91 billion, driven mainly by households' transferable deposits.

Household deposits, which comprise 66.6 percent of total deposits stock, marked an increase of 11.5 percent (chart 21). Remittances have an important role in increasing household deposits, the level of which continued to increase during 2019. Their impact on the banking sector is highest in the last two quarters of the year as a result of the summer season and the year's end feasts when the number of emigrants who visit the country increases. This effect of remittances on the level of household deposits is expected to be observed also in the coming year, as the outbreak of Covid-19 with have a negative impact on the visit of the diaspora in the country during the summer season and in the year's end feasts.

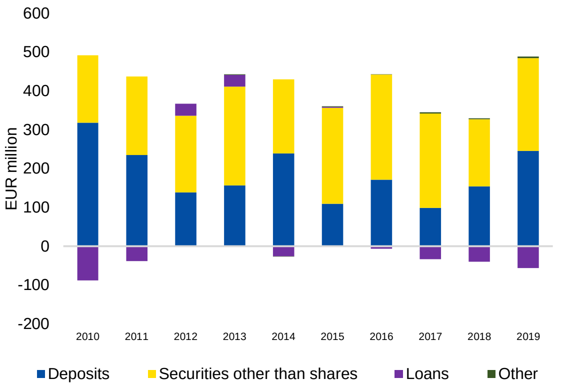
Chart 21. Stock of total deposits and new deposits, EUR million



Source: CBK (2020)

This year was characterized with a more significant increase of deposits from the financial and nonfinancial sector. Within the financial sector, insurance companies increased the level of (time) deposits held in local banks, in order to improve the liquidity level of the sector (cash and cash equivalents to technical reserves or liabilities). Also, Pension Funds increased the level of (term) deposits in the banking sector, but at a lower value compared to the previous period. Deposits collected from non-financial corporations marked a significant increase compared to last year. This increase in deposits may have come as a result of the transfer of funds or donations received from foreign and domestic investors to the bank accounts of businesses and their suppliers, to invest in projects intended to develop a certain sector of the economy. **Exposure of the banking sector to the external sector continues to be low, but marked a significant increase compared to 2018.** The net lending position to the external sector marked a significant increase, by 49.1 percent, reaching the value of EUR 431.6 million (charts 22 and 28). This significant increase in the net lending position was mainly due to investments in the external sector, in the form of deposits and securities.

Chart 22. Net position to nonresidents



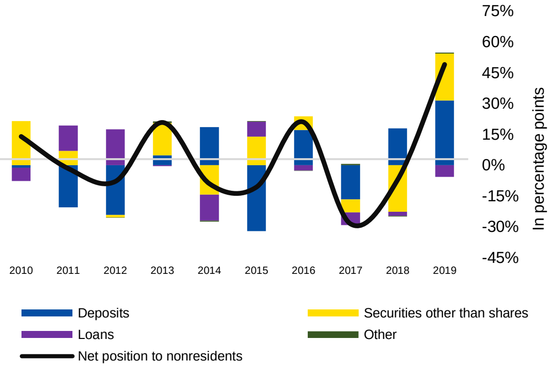
Source: CBK (2020)

Claims on non-residents account for about 13.8 percent of total banking sector assets, where 91.7 percent of them are deposits and investments in securities.

Banking sector liabilities to non-residents account for 4.8 percent of total banking sector liabilities mainly in the form of credit lines and external sector deposits held in the country. Loans from external sector and external sector deposits held in the country, together account for 99.2 percent of total liabilities to non-residents.

Despite the increase in the recent period, in general, the banking sector has low exposure to the external sector. The low level of foreign currency assets further reduces the effects of external transfer problems and avoids possible losses from unfavourable exchange rate fluctuations against the euro currency.

Chart 23. Contribution of items in annual change activity with nonresidents



Source: CBK (2020)

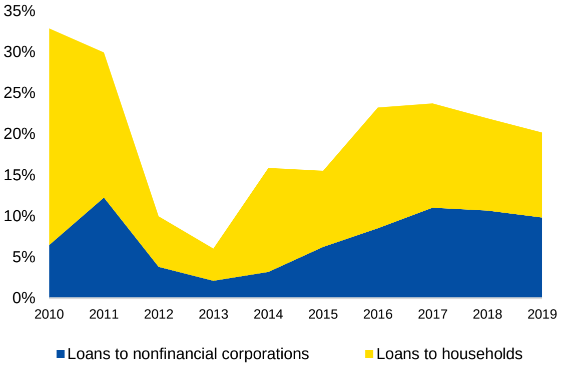
4.1.1 Credit developments

The banking sector's lending activity continued its double-digit growth trend for the fourth year in a row. However, for 2020 the expectations are that this trend of credit growth will stop, as a result of the changing dynamics of the domestic and foreign economy, in facing the spread of the COVID-19 pandemic.

The dynamics of lending activity for non-financial corporations and households, according to the bank lending survey, turns out to have had a positive impact during 2019 both on the credit supply side and on the credit demand side. Improving the credit supply by banks, mainly through lowering the average interest rate on loans and extending the maturity of loans contributed to the growth of lending.

Other factors affecting lending dynamics were the continuous improvement of the loan portfolio quality, sufficient liquidity and banking competition, which played a key role in the expansion of banks' lending activity in the last four years.The stock of active loans in domestic banks reached 3.03 billion euros, which represents an increase of 10.0 percent, supported mainly by loans to non-financial corporations (chart 24).

Chart 24. Annual growth of loans to nonfinancial and households

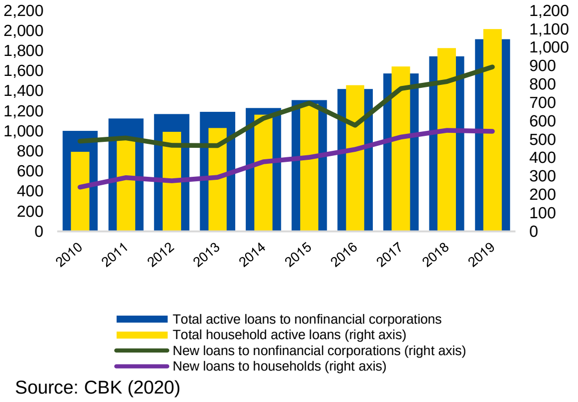


Source: CBK (2020)

Loans to non-financial corporations increased by 9.8 percent and reached the value of 1.92 billion euros. Whereas, new loans to non-financial corporations increased by EUR 895.8 million (chart 25), of which for investment purposes by EUR 524.2 million and non-investment loans by EUR 355.6 million.

Bank lending has increased to almost all economic sectors, with the exception of the trade sector, which recorded a marginal decline. The sectors that were credited the most in 2019 were manufacturing, mining, construction and financial services.

Chart 25. Stock of total loans and new loans to nonfinancial corporations and households, EUR million

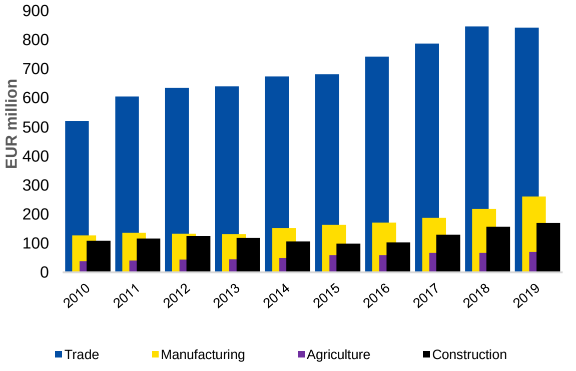


Source: CBK (2020)

Loans to manufacturing and construction sectors increased by 19.9 percent and 8.7 percent, respectively, reaching the value of EUR 261.5 million and EUR 170.3 million, respectively. However, the share of these sectors in the total loan portfolio remains relatively low.

The trade sector, which dominates the structure of total loans, marked an annual decline of 0.5 percent (chart 26). Whereas, the energy sector was characterized by a decrease of 30.6 percent, although the share in the total loan stock consists of 2.3 percent.

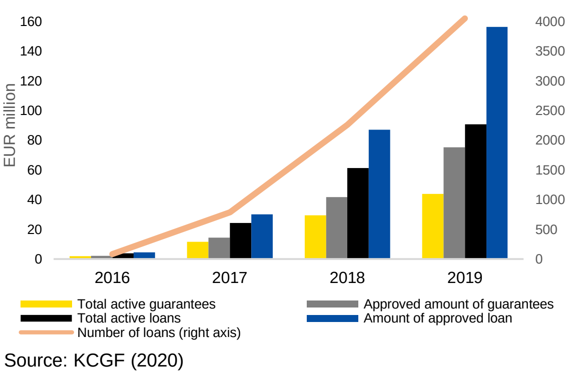
Chart 26. Stock of loans by economic sectors



Source: CBK (2020)

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 4,052 by the end of June 2019 (2,262 at the end of 2018). The total amount of guaranteed loans in 2019 amounted to EUR 156.3 million, an almost double increase from the guaranteed value of EUR 87.2 million in the previous year (chart 27).

Chart 27. Loans approved and guaranteed by KCGF



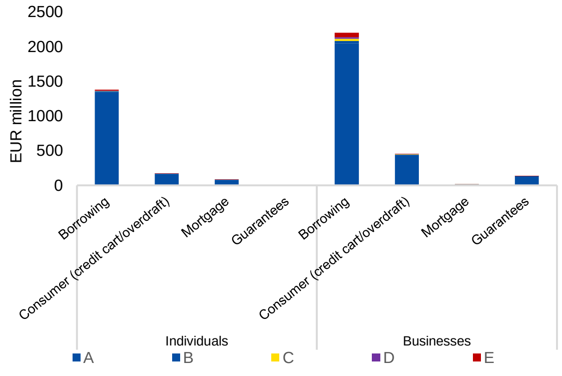
Source: KCGF (2020)

The structure of guaranteed loans is a representation of the general credit structure of the banking sector, in which case loans dominate the wholesale and retail trade sector, followed by the services and manufacturing sectors.

The agriculture, forestry and fisheries sector had a representation of 10.0 percent in the total guaranteed loan portfolio, which represents an increase in weight along with the representation of 7.0 percent in the previous year. The positive prospects of increasing the value of KCGF and focusing 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 certain sectors in particular. Also, during the first half of 2020, after the emergence of the economic and health crisis produced as a result of the spread of the COVID-19 pandemic, KCGF continued to support SMEs through credit guarantees. Moreover, during this period, the guarantee capital of KCGF has increased by EUR 6.5 million for agribusinesses, as a result of the financial agreement between the Government of Kosovo and Germany. This will increase the access to finance by businesses (increased liquidity to operate), which is much needed in this period of crisis caused by COVID-19.

The banking sector's exposure to households has increased continuously, albeit the increasing double digit trend of new, especially consumer loans, changed direction this year.

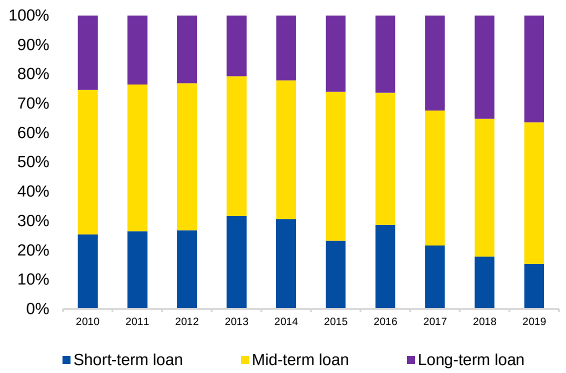
Chart 28. Individual and corporate borrowers by type and credit classification, December



Source: CBK, Credit Registry (2020)

Low level of debt burden of customers (based on the debt-to-income ratio indicator), the high quality of household credit rating, and the best banking offer are among the factors that have influenced the accelerated growth of lending to this segment in recent years. By December 2019, the value of loans to households reached EUR 1.10 billion, or 10.4 percent higher compared to the previous year. However, the growth rate of lending to this segment turns out to have slowed down, a dynamic that is attributed to the decline of new consumer loans by 4.1 percent, a category that has a high share of 71.7 percent of new loans to households (chart 28). Chart 29 informs about the stock of loans issued by the banking sector until December 2019, divided to natural and legal persons. These data are not published in time series, but are based on the credit register. They refer to the last period and here they offer the static state, not presenting the development progress.[18]

Chart 29. Share to total loans: nonfinancial corporations



Source: CBK (2020)

Largest portion of credit (about 80.6 percent) is characterized as loans, while consumer and mortgage loans have a share of about 14.1 and 2.2 percent, respectively. However, with regard to the categorization of loans, it should be borne in mind that the category of borrowings may also include other categories of loans.[19] Depending on the credit policies of banks or promotional offers, these loans may be issued without collateral and guarantor, and due to regulatory restrictions[20]. In terms of weight, 31.1 percent of the loan stock turns out to be loans intended for natural persons, while 49.5 percent are loans to legal entities.

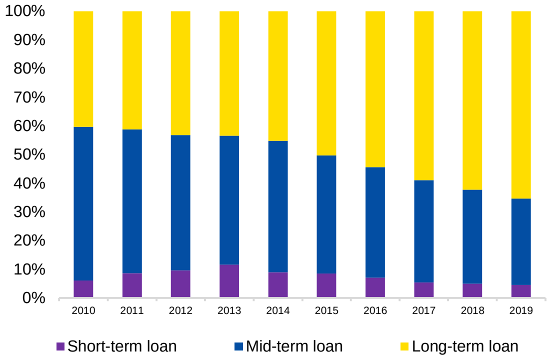
[18] Consumer loans to legal entities may include lines of credit that are categorized as overdrafts and fall under consumer loans.

[19] Borrowing loans for natural persons may include credit lines which are granted for mortgage purposes, construction and reconstruction, if they do not fulfil terms and conditions to be classified in the category "mortgage loans".

[20] 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.

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 3.9 percent of the share compared with those to legal entities that have a share of 10.2 percent.

Chart 30. Share to total loans: households



Source: CBK (2020)

However, consumer loans (including credit cards and overdrafts) to legal entities should be carefully analysed 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, 93.1 percent of credit categorized as loans have credit rating A, while for legal entities, 97.4 percent of 'loan' credits appear to be with credit rating A.

Long-term loans dominate, which dominate the structure of total loans, representing 47.0 percent, marked the highest annual increase of 14.9 percent.[21] Their value reached the amount of EUR 1.42 billion. Loans with medium-term loans, increased by 9.5 percent to EUR 1.25 billion. Medium- term loans are mainly dominated by loans to non-financial corporations, while long-term lending is mainly a feature of the household loan portfolio (chart 30). 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 housing loans by reducing the collateral requirements, increasing the approved amount and lowering the interest rates.

[21] 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.

Bank Lending Survey[22]

The latest results of the Bank Lending Survey[23] reflect the developments in bank lending activity during the period of October - December 2019 (referred to as Q4 2019)[24], and expectations for lending activity for the period of January - March (referred to as Q1 2020).

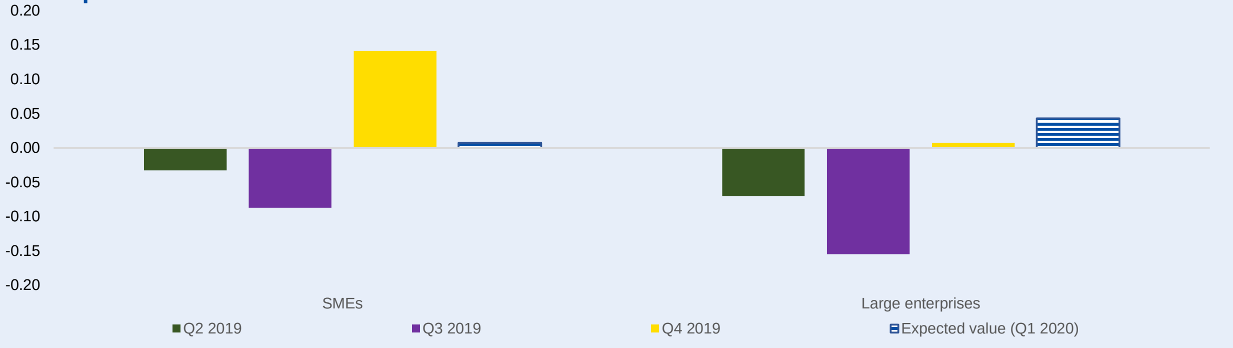
Note: *This survey was conducted during January 2020, when the COVID-19 virus had not yet reached global proportions and turned into a pandemic. Consequently, the effects of this virus, already declared a pandemic by the World Health Organization, were not reflected in banks' expectations for lending dynamics during the first quarter of 2020. Uncertainties created in the realization of income by both households and enterprises, as a result of measures taken to prevent the spread of the virus, will potentially be reflected in the credit supply from the banking sector and the demand for loans from economic entities. However, the materialization and the degree of difficulties of banks as a result of potential risks depend on the duration of the crisis, the situation in the internal and external sectors and the measures that the relevant institutions will take to support the financial system and the country's economy in general.*

The dynamics of lending to **enterprises** during Q4 2019, based on the bank lending survey, results to be positively affected by credit demand side.

Within the credit supply, banks have reported to have eased to some extent the standards applied during the process of assessing the enterprises' applications for loans. Within enterprise loans, credit standards for large enterprises remained largely unchanged, while credit standards for loans to SMEs were eased to a certain extent.

For the first quarter of 2020, banks are expected to keep credit standards almost unchanged for SMEs and marginal relief for large enterprises (chart 31).

Chart 31. Bank's credit standards applied when assessing credit applications of enterprises



Source: CBK (2020)

The main factors that influenced the easing of credit standards, according to the banks, were the support of enterprises from the Kosovo Credit Guarantee Fund (KCGF) and the increased competitive pressures between banks in the country. In the same period, one of the major banks in the banking sector stated that financing from the parent bank had a positive impact on easing credit standards.

[22] Bank Lending Survey is conducted by the Central Bank of the Republic of Kosovo with 9 banks operating in Kosovo and represent 99.9 percent of total sector lending. The survey is conducted on a quarterly basis. This survey covers the period October - December 2019 and expectations for the period January - March 2020.

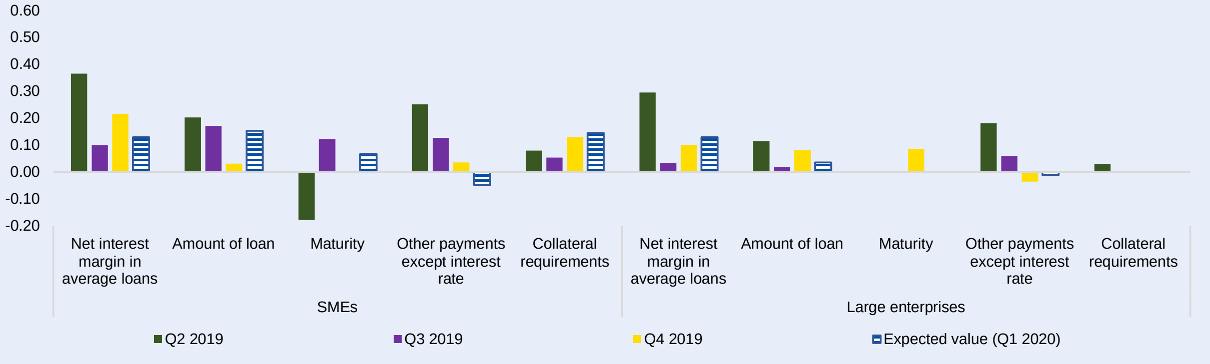
[23] Responses of individual banks were aggregated by using the appropriate weight of each single bank to total credit portfolio of the banking sector. Positive values of the Credit Standards Index show ease of lending whereas negative values are characterized by a tightening of lending. Also, positive values of the Credit Demand Index show an increase of demand and the negative values show a decline. The most widely used methodology can be found in the Bank Lending Survey Report on the CBK website.

[24] The period October - December is referred to as the 'Quarter 4' - Q4, while the period January - March is referred to as the 'Quarter 1' - Q1.

Within the credit offer, banks reported that the terms and conditions applied by banks when granting loans to enterprises were eased to a degree similar to the previous quarter. Competitive pressure from other banks as well as support from the KCGF eased lending conditions to some extent. Specifically, there was a greater easing in interest rates and collateral requirements, where the same in the previous quarter were almost unchanged. These changes are largely attributed to the terms and conditions for SMEs. While to a smaller extent, banks also increased the maturity of approved loans to large enterprises (chart 32).

Banks expect that during the next quarter, the terms and conditions for new loans will be eased to a lower extent compared to this quarter. In this context, banks stated that they will offer lower interest rates although at a lower level compared to Q4 2019, eases on the size of approved loans and more favourable collateral requirements. The above easing will support SMEs to a higher level.

Chart 32. Terms and conditions applied for loans to enterprises



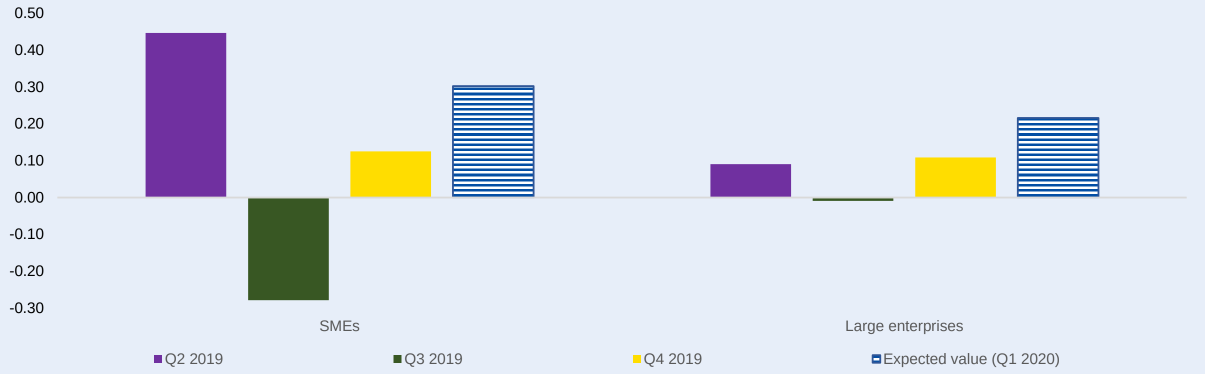
Source: CBK (2020)

During the reporting period, the demand of enterprises for bank loans turned out to have increased, although in the previous survey, banks had reported expectations for higher demand growth from the enterprise segment. The increase in demand for enterprises was similar for both SMEs and large enterprises (chart 33). Moreover, there was a marginal improvement in the quality of applications received from SMEs, while the quality of loan applications from large enterprises remained almost unchanged. Banks also stated the continuation of the downward trend of the ratio of non-performing loans to total loans to enterprises.

According to the survey, the increase in demand for loans from enterprises was largely influenced by the demand for debt restructuring, expressed by only two banks but with a large share in the sector. At the same time, enterprises increased demand to some extent for financing inventories and working capital. The demand for acquisition, merger or restructuring of enterprises was characterized by a low positive index, presenting the situation in two banks.

In the following quarter, banks expect greater activity of enterprises, reflecting this in their forecasts for changes in credit demand during Q1 2020. Significantly increased demand is expected from both SMEs and large enterprises. Increased demand for credit is expected to be affected by the need for enterprises to finance fixed investments as well as inventories and working capital.

Chart 33. Household demand for loans



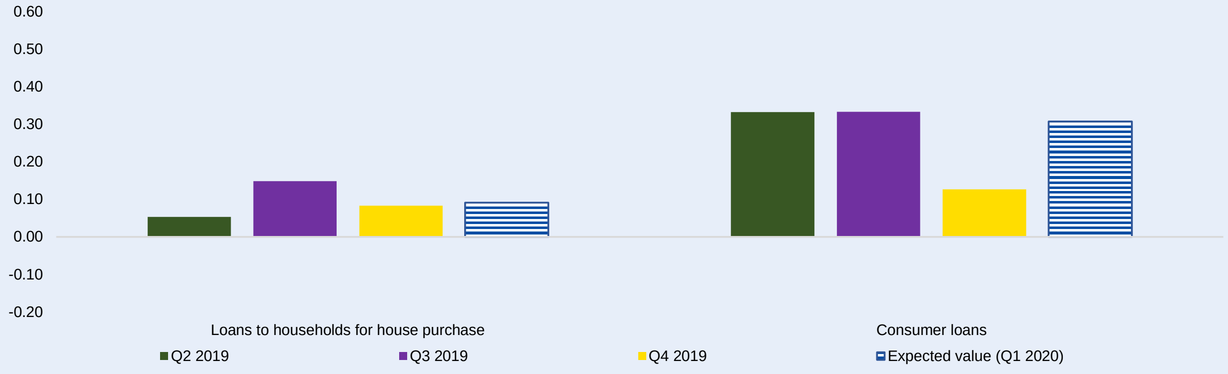
Source: CBK (2020)

Regarding the timeline, the survey results show that the greatest demand during this period was for short-term loans, also the demand for long-term loans increased but to a lesser extent. Whereas, the credit offer divided according to the maturity of the loans also favours short-term loans. In the next quarter, banks do not expect significant movements in credit standards in both timelines. Meanwhile, banks expect a significant increase in demand for long-term loans. At the same time, the demand for short-term loans is expected to increase but at a lower level (chart 34).

The dynamics of lending activity to **households** during the reporting period, according to the survey, were positively affected by both favourable credit supply and household demand for credit. Credit standards applied during the review of loan applications by households were eased, in particular for consumer loans (chart 34).

Banks' expectations for Q1 2020 give indications for the continuation in the higher easing of credit standards for consumer loans, while for the segment of home loans they do not expect significant changes.

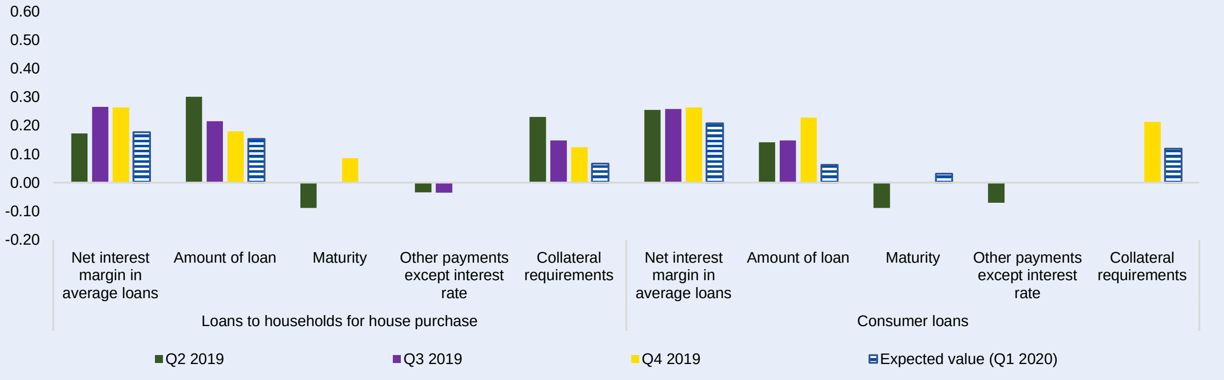
Chart 34. Bank's credit standards applied when assessing household credit applications



Source: CBK (2020)

Terms and conditions for new loans to households were generally eased in the fourth quarter of 2019. New consumer loans had a greater easing. Mainly, the terms and conditions for consumer loans were eased through lower interest rates, an increase in the approved amount and a reduction in collateral requirements. Similarly, the terms and conditions for home loans were supported by offering more favourable interest rates (positive index of 0.26), increasing the amount of approved loans (positive index of 0.18) and to a lesser extent, lower collateral requirements (positive index of 0.13) (chart 35).Increased competitive pressures from the banking sector, the high quality of the loan portfolio, as well as to a lesser extent, the increased tolerance for risk along with the favourable prospects of the banking market in the country, turn out to have been key factors in easing the terms and conditions of lending for households during the fourth quarter of 2019.

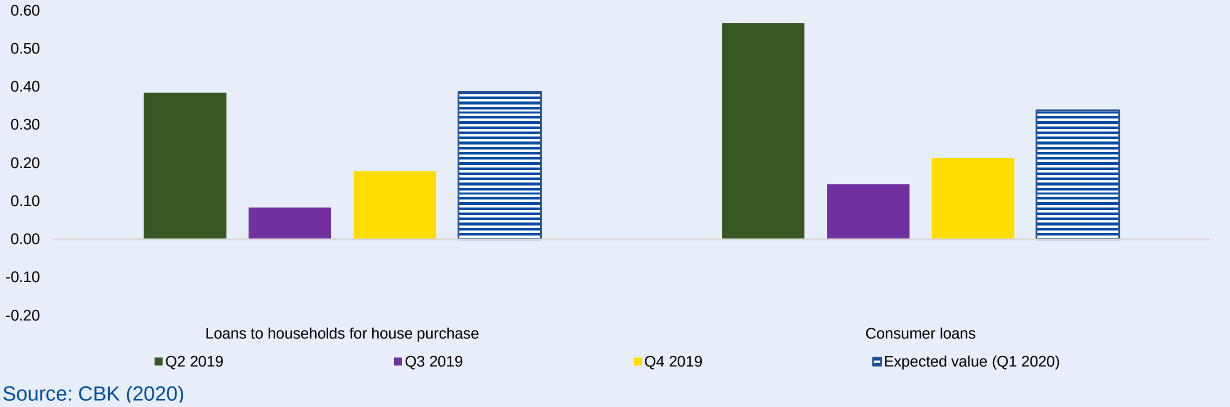
Chart 35. Terms and conditions applied for loans to households



Source: CBK (2020)

Further easing of terms and conditions is expected in the next quarter, positively affected by the lower risk perceived by banks, increasing competition between domestic banks and improving the quality of the loan portfolio. Banks are expected to offer similar terms and conditions for both consumer loans and home loans.

Chart 36. Household demand for loans

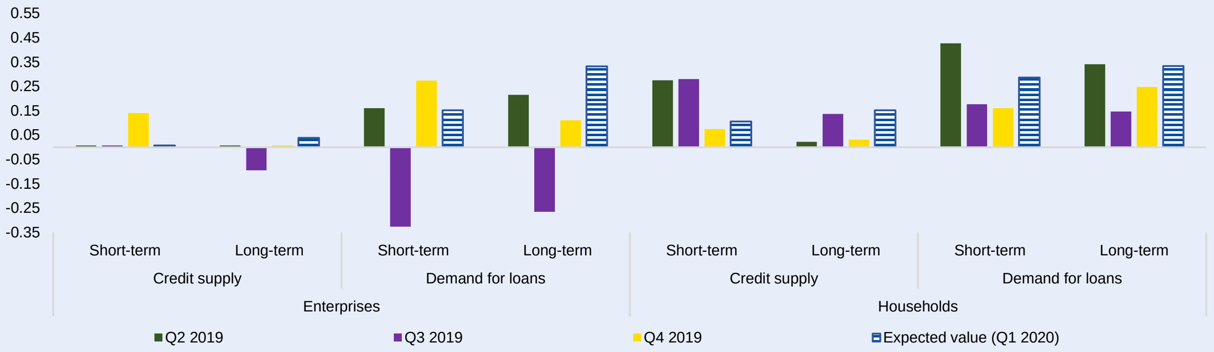


Source: CBK (2020)

Banks reported increased demand for household loans. Both categories of household loans had increased demand, but the demand for consumer loans was higher than the demand for home loans (chart 36). The increase in household demand for consumer loans is mainly attributed to the increase in consumer confidence in their loan repayment capabilities. Whereas, consumer financing and debt restructuring requirements during this quarter made a negative contribution to the growth of demand for loans from households.Also, the quality of applications received for home loans as well as consumer loans to some extent, turns out to have improved.

Banks expect further increase in demand for loans during the next quarter, but unlike Q4 2019, the demand for home loans is expected to increase higher than the demand for consumer loans.

Chart 37. Change of credit standards and demand for loans by maturity



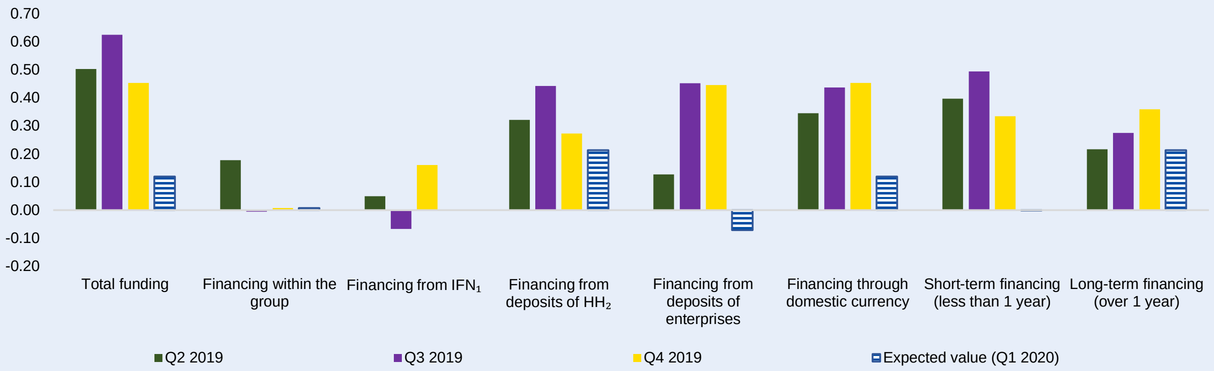
Source: CBK (2020)

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 Q4 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 37).

Chart 38. Change of the banking sector financing



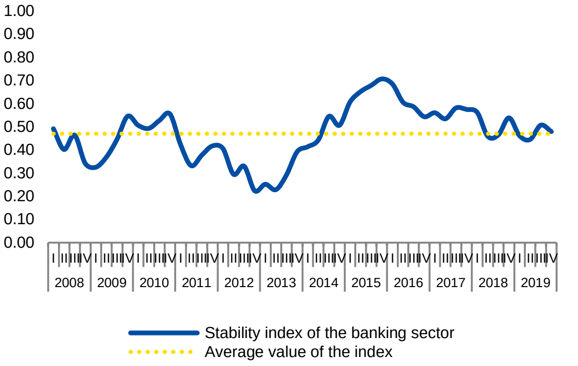
Source: CBK (2020)

Banks reported satisfactory growth of total **financing** in the reporting period. Given the traditional model of the banking sector in Kosovo, financing continued to be dominated by household and enterprise deposits. The results show that bank financing increased significantly from corporate deposits. Two of the banks also declared an increase in funding from international financial institutions. According to maturity, in this quarter the index was approximate for short-term and long-term deposits. For the next quarter, banks expect increased access to finance, albeit at a significantly lower intensity. Financing through household deposits is expected to increase, while financing from corporate deposits is expected to decrease to some extent compared to the previous quarter. Unlike the fourth quarter of 2019, in the next quarter, no support is expected in financing the activity of banks in the country by international financial institutions. Moreover, in the following quarter, surveys signal expectations for increased long-term financing, while short-term financing is expected to remain unchanged (chart 38).

5. Risks of the banking sector

During the whole year of 2019, the banking sector operated in an environment with low risks against which can successfully cope 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 Stability index of the banking sector was built in order to measure and assess internal conditions of the banking sector which reflect the stability of the sector. 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. The index was calculated on quarterly basis to evaluate if there is an increase or decrease of risk sensitivity through this index.[25]

Figure 39. Aggregated index of the banking sector stability



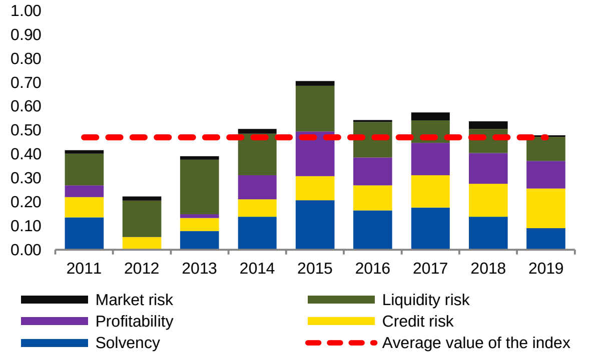
Burimi: BQK (2020)

Based on the aggregated overall index of the sector's stability, the banking sector has marked, on average, a year-on-year increase of the sensitivity to the risk (a decline of the index) (chart 39). Compared to the previous year, a decline of the index (read: increase of sensitivity to the risk), marked the indicator of the solvency, market risk and profitability. While, an increase of index (a decline of sensitivity to the risk) marked the indicator of credit risk. A neutral impact on the calculation of the overall index was marked by the indicator of the liquidity risk.

The decline of the sensitivity to credit risk is mainly 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 40)**. The increase of sensitivity to solvency risk** is attributed to a decrease in the level of capitalization, but is nevertheless significantly higher than the minimum required by CBK regulation. The decline of the capitalization level was driven by the faster increase of risk bearing assets compared to the slower increase of regulatory capital. The faster growth of risk-weighted assets was driven by the accelerated increase of lending in recent years. While, slowdown growth of the capital came as a result of the spread of the dividend during 2019.

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

Figure 40. Aggregated index of the banking sector stability



Burimi: BQK (2020)

The indicator that **measures the sensitivity to market risk has the lowest weight** in the overall index of financial stability due to the low level of assets and liabilities that are in foreign currency against total assets, respectively liabilities of the banking sector. Also, the level of loans and deposits in foreign currency is quite low. As a result, movements in this indicator have a very low impact on the aggregate financial stability index. In this

[25] For detailed information on the methodology of building the stability index of the banking sector, please refer to the Financial Stability Report no. 9.

indicator, measured through the open position in foreign currency against tier 1 capital at the end of December 2019, there was an increase (to 5.1 percent, from 1.3 percent marked in the previous year).

Neutral impact of risk sensitivity was the liquidity risk indicator compared to the same period of the previous year. This is because the level of liquid assets to short-term liabilities, respectively total assets were at levels close to the previous period.

Although the overall aggregate index has marked an increase in risk sensitivity, it easily stands above the historical average of the index (2008-2019). This is an additional indicator that implies that the banking sector is stable and can withstand the risks to which it is exposed.

Table 5. Risks of the banking sector

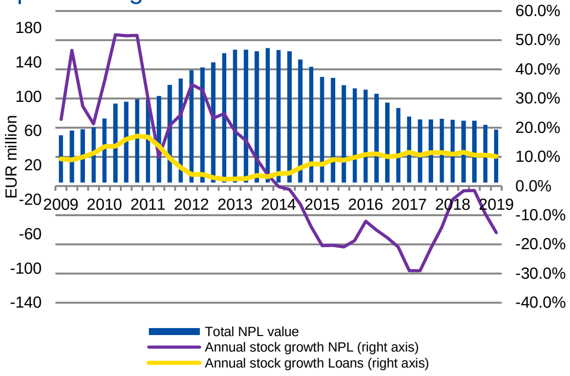
Risks	Indicators	2015	2016	2017	2018	2019	Risk direction	Interpretation
Credit risk	Nonperforming loans (NPL) ratio to total loans (%)	6.2%	4.9%	3.1%	2.7%	2.0%	↓	Credit risk declined further, as a result of higher increase of lending against the decline of NPL. Improvement of credit portfolio quality also from the written-off process of lost loans from the balances of banks. Also, the decline of the NPL stock has had an impact on the increase of the coverage ratio with provisions.
	NPL coverage with provisions (%)	115.1%	127.6%	149.7%	152.1%	163.5%		
	Large credit exposure/First Tier Capital (%)	67.3%	69.5%	88.9%	68.7%	81.8%		Concentration of large credit exposures has increased, albeit it stands below the maximum regulatory level of 300% The increase came as a result of the exposures increase mainly from large banks, with systemic importance.
Profitability risk	Net income from the interest (EUR million)	163.3	160.3	159.7	171.0	179.4	↑	Net income from interest increased, as a result of lending increase. But, the higher increase of expenses, mainly interest expenses on deposits, had an impact on the annual profit decline. All other expenditure categories marked an increase, increasing expenditures to income ratio.
	Net income from non-interest (EUR million)	47.5	17.7	41.7	32.6	23.3		
	Expenses/Income	60.3%	67.3%	64.6%	65.1%	67.2%		
	Return on Average Equity (ROE)	29.1%	19.7%	21.3%	20.4%	18.9%		
Market risk	Assets and liabilities gap sensitive to interest rates (EUR million)	1,740	1,538	1,735	1,684	1,871	→	Cumulative gap between assets and liabilities sensitive to interest rates has expanded, though mismatches narrowed in almost all maturities besides the one of "90-365" days. Narrowing of mismatches came as a result of the increase of time deposits with longer maturity and subordinated debt, and the increase of loans with shorter maturity.
	Opened positions in foreign currency to Tier 1 capital (%)	1.9%	4.6%	1.2%	1.3%	5.0%		Net aggregated opened position in foreign currency increased during the year, increasing to some extent the exposure, which albeit stands far from the regulatory minimum.
Solvency risk	Regulatory capital/Assets with risk weight (%)	19.0%	17.8%	18.1%	17.0%	15.8%	↑	Regulatory capital ratio marked a decline as a result of the higher increase of the risk weighted-assets driven by credit growth. The decline was impacted by the increase of risk weighted assets, but also due to the decline of the level of regulatory capital from three largest banks, with systemic importance.
	Regulatory capital/Risk weighted assets (%)	16.6%	15.8%	16.2%	15.5%	14.1%		
	Equity/Assets	11.7%	12.1%	12.6%	12.3%	11.2%		
Liquidity risk	Loans-to-deposits ratio (%)	74.7%	77.0%	80.3%	81.9%	77.6%	→	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 slightly decreased as a result of the higher increase of short-term liabilities compared to the increase of liquid assets.
	Liquid assets to total short-term liabilities ratio (%)	44.9%	41.5%	37.9%	38.5%	37.6%		
	Liquidity gap (EUR million)	398.1	405.1	463.8	494.4	513.6		Liquidity gap expanded as a result of the time mismatch expansion between assets and liabilities, which was emphasized in the category of the term maturity "6 months up to 1 year". This statement presents the increase of short-term lending during this period.
			Growing risk		Declining risk	Unchanged risk		

Source: CBK (2020)

5.1. Credit risk

The quality of credit portfolio at the banking sector level continued to improve in 2019, supported by the decline in non-performing loans mainly of the enterprise segment. The non-performing loan rate dropped at the lowest historical level to 2.0 per cent.

Chart 41. Annual growth of loans and non-performing loans



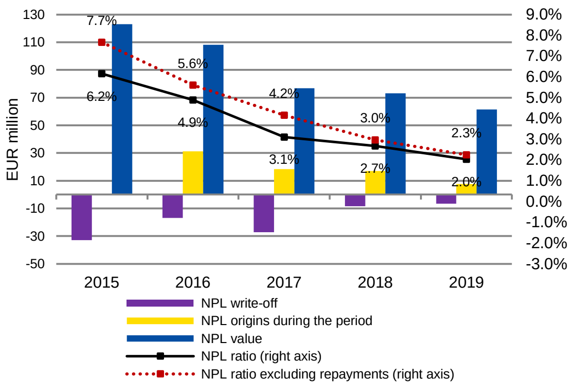
Source: CBK (2020)

The increase of the credit stock by 10.1 per cent as well as the decrease of the stock of non-performing loans by 16.0 per cent affected the decline of the NPL ratio (chart 41). However, the outbreak of the Covid-19 pandemic, and the effect of preventive measures of its spread on the performance of enterprises and household incomes, will affect the increase of credit risk in the following period.

The repayment of non-performing loans from the balance sheet of banks was a factor that contributed to the decline in the amount of non-performing loans. In December 2019, the written-off loans amountedEUR 6.6 million, which in absolute terms affected the reduction of total non-performing loans by 9.7 percent. The repayment of loans classified as non-performing provided a reduction contribution of 10.7 percent, but which was completely neutralized by the origination of non-performing loans during this period, which had an increasing effect of 11.3 per cent on the total nonperforming loans stock (chart 42).

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.

Chart 42. The effect of write-offs process



Source: CBK (2020)

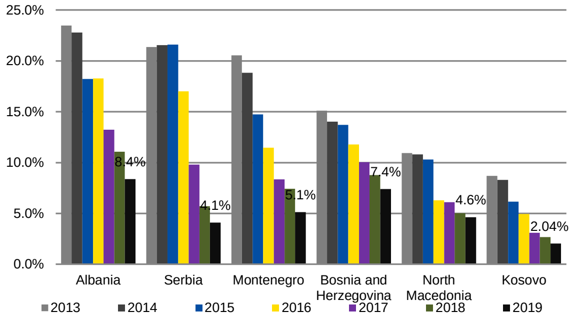
Part of the effect of the NPL decline can be attributed to other factors such as the good financial performance of the enterprise sector this year, based on the business climate indicator[26], which may have contributed to the repayment ability of these borrowers. In addition, the activity of Private 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.

Kosovo's banking sector continued to position itself at the best level in the region in terms of loan portfolio quality (chart 43). Over the years, Kosovo has the lowest ratio of non-performing loans compared to countries in the region, which have also continued the trend of improving the quality of the loan portfolio. However, it is expected that this trend will change direction for all countries, including Kosovo, as a result of the consequences of COVID-19 pandemic. The magnitude of the deterioration of credit quality will largely depend on how the pandemic is managed, the duration and extent of measures

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

to prevent it, the support measures of relevant governments and authorities, and specifics in the structure of countries' economies.

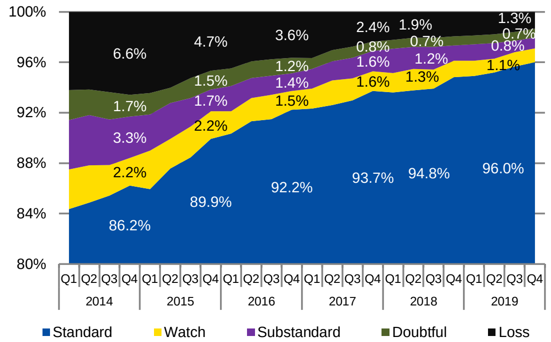
Chart 43. NPL to total loans ratio in the region countries



Source: IMF, respective Central Banks (2020)

Credit exposures with higher credit ratings, namely standard loans, continued the trend of increased share in the loan portfolio, and in December 2019 represented 96.0 per cent of total loans.

Chart 44. Structure of loans classified by overdue payments

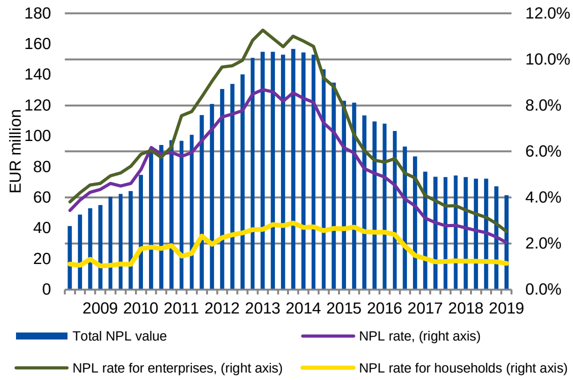


Source: CBK (2020)

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 December 2019 they increased their weight by 1.2 percentage points in favour of lowering the weight of low-rated loans classified as “watch”, “substandard” and “loss” by 0.2, 0.4 and 0.6 percentage points (chart 44).

The most credited segment and, at the same time, the most burdened by nonperforming loans is the enterprises segment. This segment represents about 65.2 per cent of total credit portfolio. The non-performing loans ratio for enterprises decreased to 2.5 per cent from 3.4 per cent in the previous year (chart 45).

Chart 45. Nonperforming loans



Source: CBK (2020)

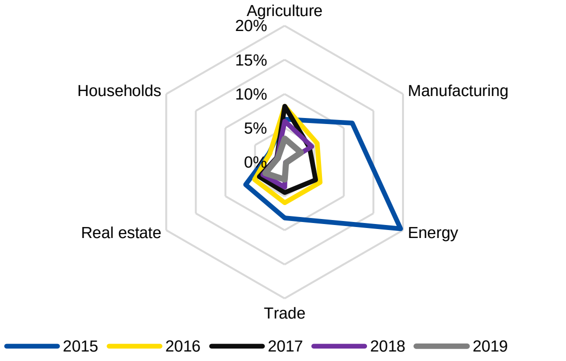
By economic activity, almost all sectors were characterized by improved loan portfolio.The NPL ratio for the trade sector, which represents the most credited sector, dropped to 2.6 per cent from 3.7 percent in the previous year. While the agricultural sector, although it continues to have the highest NPL rate, this was 2.5 percentage points lower than in the previous year, down to 3.5 percent. This sector, which represents the most strategic sector of the economy, is one of the least credited sectors by banks, where only 2.8 per cent of total credit stock is intended for agriculture. The manufacturing sector also marked a more pronounced improvement in the NPL rate from 4.6 per cent to 2.8 percent (chart 46). 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.

The quality of the credit portfolio will deteriorate as a result of the effects of the economic crisis caused by the COVID-19 pandemic. Temporary termination of economic activity and challenges to the normal operation of enterprises will significantly affect their ability to generate income, which will inevitably create difficulties in meeting financial obligations. This situation will be reflected in the declining quality of the credit portfolio in almost all economic sectors.

The quality of the household loan portfolio remained high, despite the

growing trend of loans, especially consumer loans.

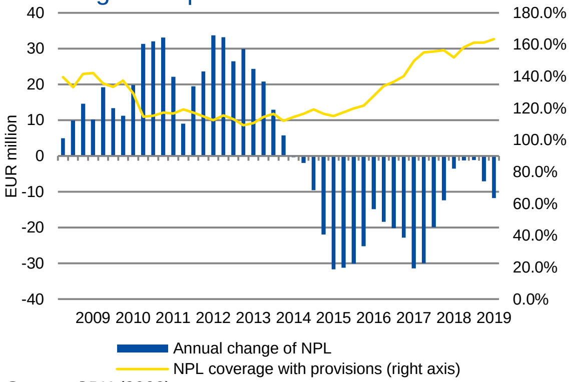
Chart 46. NPL ratio to loans stock, by sectors



Source: CBK (2020)

The stock of non-performing household loans increased by 2.4 percent, but the larger increase in the credit base caused the ratio of NPLs to decrease by 0.1 percentage points to 1.1 percent in December 2019.

Chart 47. Annual change of NPL stock and coverage with provisions



Source: CBK (2020)

However, the credit risk for households is expected to increase in the following period. The crisis caused by the COVID-19 pandemic will also affect the financial position of households, as the decline in the activity of enterprises will lead to income reductions, complete wage cuts and job losses.

Restrictions on movement will reduce remittances through informal channels, affecting the income level of many households. In a chain effect, this situation will affect further weakening of consumption and difficulty in meeting financial obligations.

The sector provisioning ratio has increased further in the second half of 2019, reaching 163.5 percent in December 2019. The increase in the provision rate is mainly attributed to the improvement of the loan portfolio quality, i.e. the annual decline of 16 percent in the amount of non-performing loans, as the amount of provisions for possible loan losses decreased by 9.7 per cent (chart 47).

In December 2019, the level of provisions of the banking sector was high, above regulatory requirements, where surplus provisions account for 44.4 percent of the total provisioning stock held. The coverage ratio of net non-performing loans to provisions[27] to regulatory capital remained at the same level as a year earlier, at 1.5 per cent. Demand for provisions is expected to increase in the following period, as a result of the expected deterioration in the credit portfolio of banks affected by the crisis caused by COVID-19 pandemic.

5.1.1 Large credit exposures

The credit exposure rate increased to 81.8 per cent from 68.7 per cent in the previous year, and is significantly below the maximum regulatory level.[28] The annual increase in the value of large exposures by 22.1 percent along with the slower increase of Tier 1 capital by 2.5 percent influenced the increase of the exposure rate (chart 48).

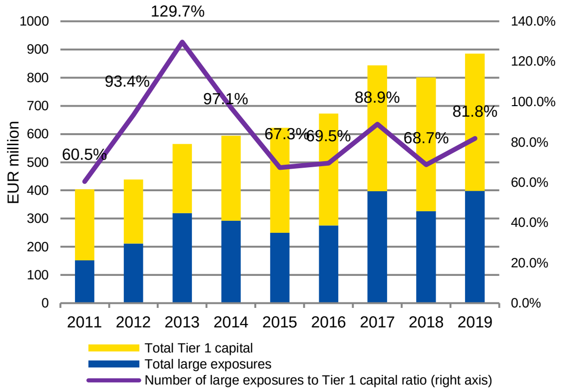
The concentration of credit risk, expressed as a ratio between the large exposures value to the number of these exposures, has increased.The average value of large exposures[29] reached EUR 5.9 million from EUR 5.3 million as a result of the effect of the highest increase in the value of exposures, as the number of exposures also increased.

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

[28] 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.

[29] Ratio of total exposure to the number of exposures.

Chart 48. Credit risk concentration



Source: CBK (2020)

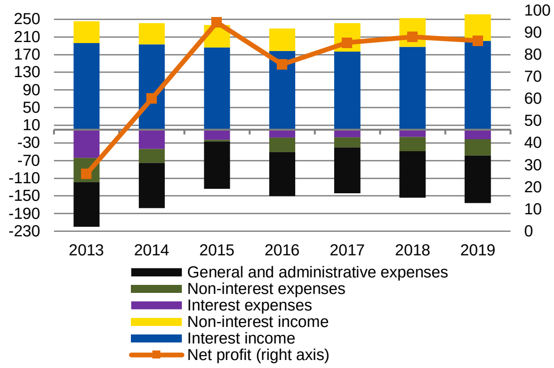
The ratio of the three largest exposures to total large credit exposures decreased to 51.1 per cent from 57.2 percent. The rate of large credit exposures in 2019 has increased as a result of increased exposures from the largest, systemically important banks. To a large extent, the rate of large credit exposures also differs from the actions of banks operating as foreign branches, which have the highest rate of first-Tier capital exposures, and which result in the highest sensitivity to analysis of the sustainability of potential shocks to credit exposures.[30]

Results of the sensitivity analysis of the sector toward shocks in the three and five largest exposures of banks, indicate in general the sensitivity of the sector toward shocks in these exposures. Therefore, although the sector is below the maximum regulatory level of credit exposures, it is sensitive to possible shocks in these positions. The crisis caused by COVID-19 may increase the risk in terms of performance of these exposures to and this situation increases the need for pro-active and dynamic approach in the management and treatment of large exposures.

5.2. Sustainability of profit and interest rate risk

Kosovo's banking sector profit marked an annual decline of 2.0 percent, driven by the increase of all categories of expenditures. The net profit decreased to EUR 86.2 million from 88.0 million in the previous year (chart 49).

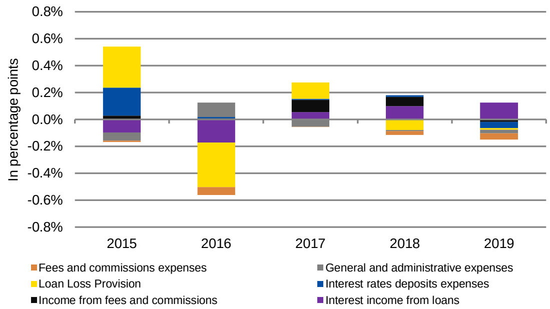
Chart 49. Profit structure of the banking sector, EUR million



Source: CBK (2020)

The main contributors to the increase in expenses, and at the same time the decrease in profit, were the interest expenses on deposits, which reflects the increase in the cost of financing for banks, followed by the expenses for fees and commissions (chart 50).

Chart 50. Main contributors to the growth/decline of the profit



Source: CBK (2020)

Despite the increase in interest expenses, net interest income for the banking sector increased by 4.9 per cent as a result of the higher growth of income from lending activity.

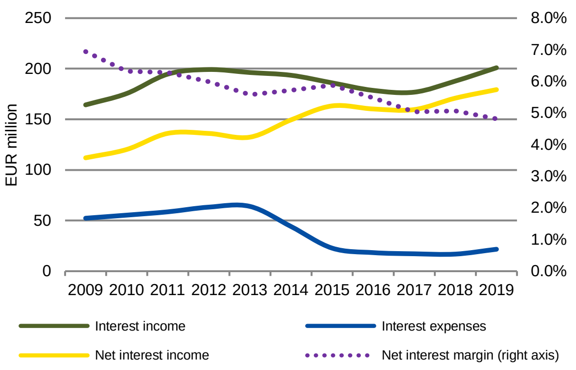
However, the net interest margin decreased to 4.8 percent from 5.1 percent in the previous year, as a result of the higher growth of the stock of interest-earning assets, an increase of 10.3 percent respectively (chart 51).

Total interest income increasedby EUR 13.2 million (or 7.0 per cent). Whereas only interest income on loans marked an annual increase of 7.2 percent or EUR 6.0 million, and were

[30] 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.

among the main contributors to the realization of profit.

Chart 51. Interest income and expenses

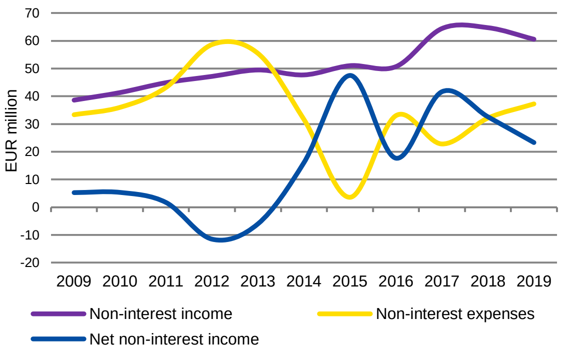


Source: CBK (2020)

The expansion of lending activity during 2019 contributed to the increase of interest income on loans, as the average interest rate on loans decreased slightly (the average annual interest rate on new loans in 2019 was 6.51 percent compared to 6.65 per cent in 2018). [31]

Non-interest income (fees and commissions as well as other operating income) decreased by 6.4 per cent, amounting to EUR 60.6 million. While, non-interest expenses increased, mainly as a result of higher expenses for fees and commissions, affecting the decline in net non-interest income (chart 52).

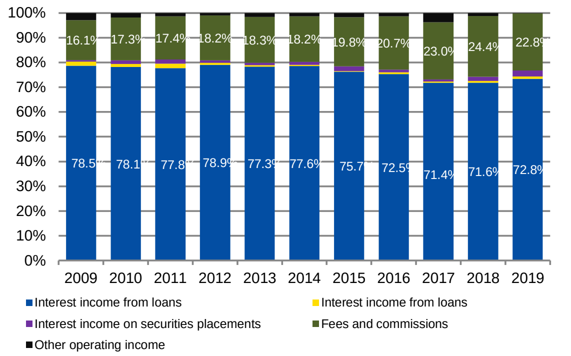
Figure 52. Non-interest income and expenses



Source: CBK (2020)

Influenced by the increasing pressures of banks to expand their deposit base, interest expense, unlike previous years, changed direction and increased by EUR 4 million (or 28.1 per cent). This is due to the increase in the average interest rate on deposits (at 1.46 per cent or an increase of 0.15 percentage point[32]) and a significant annual increase in deposits of 16 per cent. However, most of the deposit expansion consists of the category of transferable deposits, which do not represent an expense for banks.

Chart 53. Income structure of the banking sector



Source: CBK (2020)

Banking sector profit is expected to face the pressure caused by COVID-19 pandemic crisis.The decline in lending and the increase in the need to allocate expenses for provisions to cover potential losses will affect both the decline in the sector's revenues and the increase in expenditures. Despite the increase in credit risk, competitive pressures and the possible decline in credit demand will limit the possibilities for banks to increase lending. Whereas, the existing low interest rate on deposits, as well as the high share of transferable deposits (about 60 percent of total deposits) which do not bear interest expenses, makes the possibilities for positive effects on the realization of profit from the management of expenses for interests, be limited. Therefore, given this and the statements of banks in the bank lending survey that signal the decline in lending and increase in credit risk, the current position of profitability will face downward pressures.

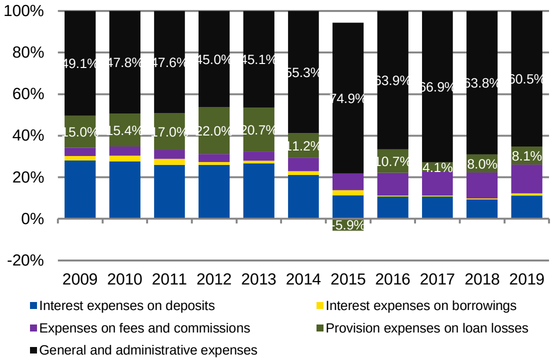
As a positive impact of the COVID-19 pandemic on the performance of banks may be

[31] 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).

[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).

the intensification of banks' efforts to digitalize services, as well as the increase in demand or useof these services by customers. As a result, the sector can benefit from increased cost management efficiency and reduced operating costs.

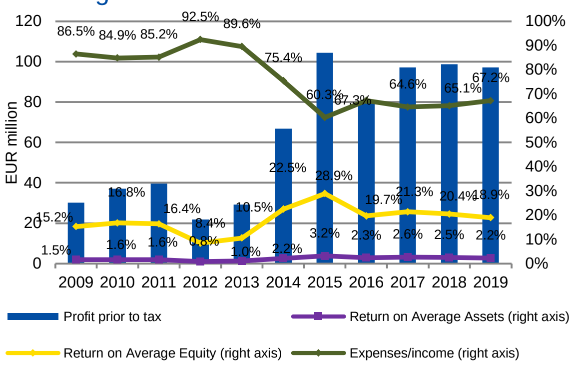
Chart 54. Structure of the banking sector expenditures



Source: CBK (2020)

Profitability indicators declined as a result of declining 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 2.2 percent, respectively 18.9 percent from 2.5 percent and 20.4 percent in the previous year (chart 55). These levels are well above the region's average, which marked a rate of return on assets of 1.4 percent and a rate of return on equity of 11.0 percent.[33]

Chart 55. Profitability indicators of the banking sector



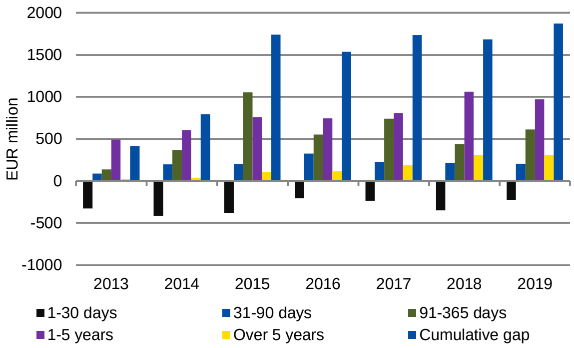
Source: CBK (2020)

[33] Countries in the region include Albania, Serbia, Bosnia and Herzegovina, North Macedonia and Montenegro.

5.2.1 Risk from interest rate fluctuations

The continued growth of long-term lending by banks on the one hand, and the high share of shorter-term deposits on the other hand, have generally increased the exposure of the Kosovo banking sector to the risk of interest rate changes, as they have increased maturity mismatches between assets and liabilities with interest.

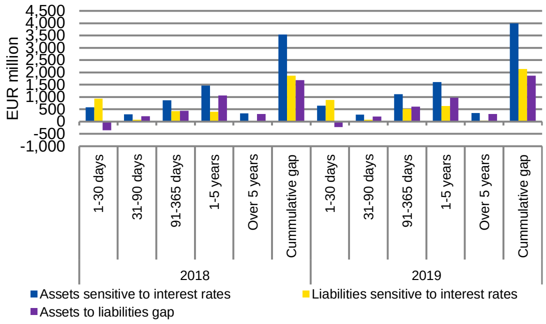
Chart 56. Assets and liabilities gap sensitive to interest rates



Source: CBK (2020)

In 2019, cumulative gap between assets and liabilities sensitive to interest rates has increased.

Chart 57. Assets and liabilities gap sensitive to interest rates



Source: CBK (2020)

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. In the short run, the possible increase in the cost of financing may increase the spending pressure of the sector, as the main category of assets, loans, are contracted at a fixed interest rate and have a longer maturity.

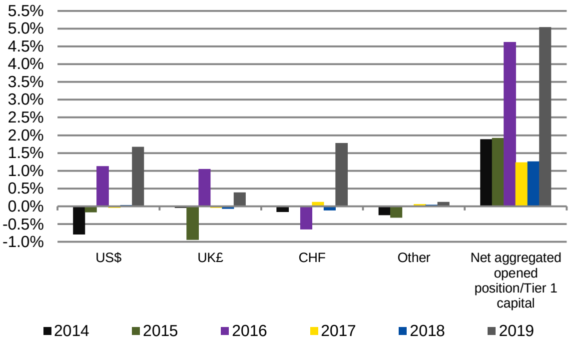
Compared to the previous year, the gap narrowed with all maturities, except for the '91-365 days' maturity which widened. The positive gap for maturities over 1 year narrowed as a result of the increase in deposits with longer maturity and the growth of interdependent debt, while the positive maturity gap of'91 -360' days widenedas a result of the increase in shorter-term loans to customers

This development of narrowing of maturities mismatches between assets and liabilities represents a positive development in reducing the risk exposure to interest rate fluctuations for the respective time periods, as it reduces the balance of expenses incurred for refinancing the balance sheet and revenues generated from reinvestment of funds.

5.3. Risk from the position in foreign currency

Banking sector exposure to the risk of changes in foreign exchange rates increased compared to the previous year, as a result of the increase in net open positions in foreign currency. The aggregate net open position for all foreign currencies increased to EUR 24.4 million equivalent from 5.9 million, consisting of 5.0 per cent of Tier 1 capital, 1.3 percent in December 2018 (chart 58).

Chart 58. Opened positions in foreign currency to tier 1 capital



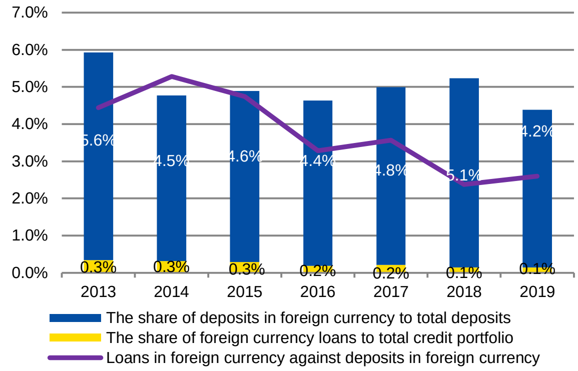
Source: CBK (2020)

By specific currencies, the net disaggregated position against tier 1 capital increased for all currencies, mainly as a result of the increase in foreign currency assets. For all currencies, the net open position is positive, which means that banks have more assets in foreign currency than liabilities. This means that the banking sector is more exposed to the risk of a possible depreciation of euro against these currencies.

The ratio of net open positions for each individual 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. Loansin foreign currency account for only 0.1 percent of total loans, an increase of EUR 0.3 million of the foreign currency credit portfolio compared to the same period of the previous year.

Chart 59. Loans and deposits in foreign currency



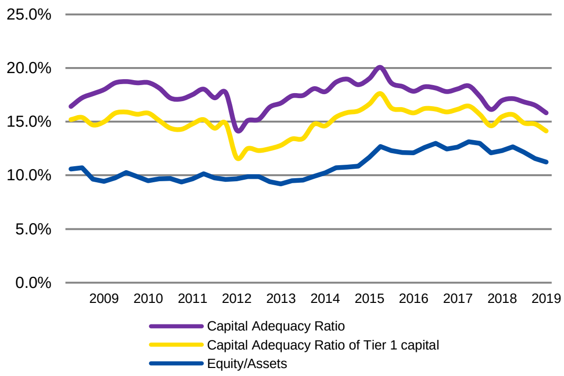
Source: CBK (2020)

Foreign currency deposits also have a low share, at 4.2 percent in December 2019, which represents an annual decline of EUR 4.9 million (chart 59).

5.4. Capital

The bank sector continues to be characterized by a high level of capital ratios, despite the slight decline over time. Capital adequacy ratio decreased to 15.8 per cent from 17.0 percent in December 2018 (chart 60).

Chart 60. Banking sector capitalization



Source: CBK (2020)

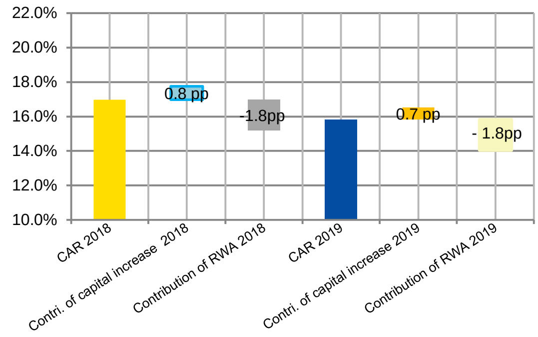
This decline reflects the increase in risk-weighted assets, 11.7 percent annual growth, as a result of increased lending activity. Regulatory capital marked also an increase of4.2 percent, but the higher effect of the increase in risk-weighted assets than the increase in regulatory capital reduced the capital adequacy ratio by 1.1 percentage points (chart 61).

Despite the decline in capital ratios, the bank sector has a robust regulatory capital base, 89.4 percent of which is Tier 1 capital. The high profits realized and retained have a high share in the Tier 1 capital, which at the same time is an indication that the banks are oriented in the creation of capital mainly within their activity (retaining the profit as equity).

Within regulatory capital, growthwas recorded by share capital and retained earnings from previous years, including the interdependent debt. While the distribution of dividends from banks that affect capital through reduction of undistributed profits, as well as loans from related parties, were the factors with a reducing effect on regulatory capital.

According to individual banks, three of the largest banks have faced a decline in the capital adequacy ratio, as a result of the increase in risk-weighted assets, but also the decrease in the level of regulatory capital. In addition to the decrease in the adequacy ratio, which howeverremains higher than the sector average, these banks have also reduced the risk profile, expressed through the risk asset ratio versus total assets. Almost allbankshad higher growth of total assets against risk-weighted assets, which is also reflected in the fact that the risk profile for the whole sector has declined.

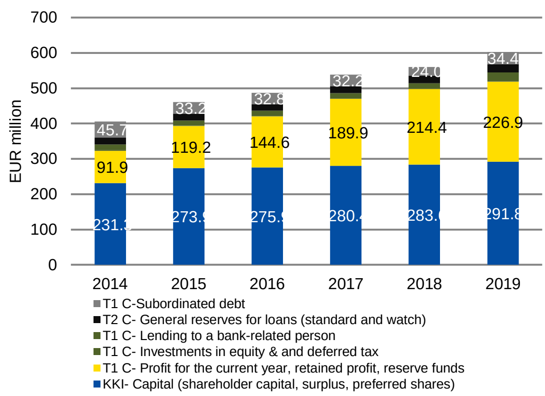
Chart 61. Contribution of Regulatory Capital and RWA to capitalization ratio



Source: CBK (2020)

The financial leverage also declined as a result of the higher growth of assets versus equity. The financial leverage ratio (equity to assets ratio) declined to 11.2 percent from 12.3 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 62).

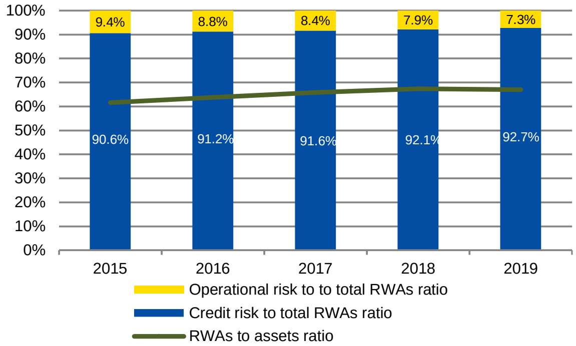
Chart 62. Structure of regulatory capital



Source: CBK (2020)

Within risk-weighted assets, the most significant increase was recorded in credit risk-weighted assets. Since the banking sector's business model is predominantly the lending activity, 92.7 percent of capital requirements for risks are intended for credit risk and 7.3 percent for operational risk (chart 63).

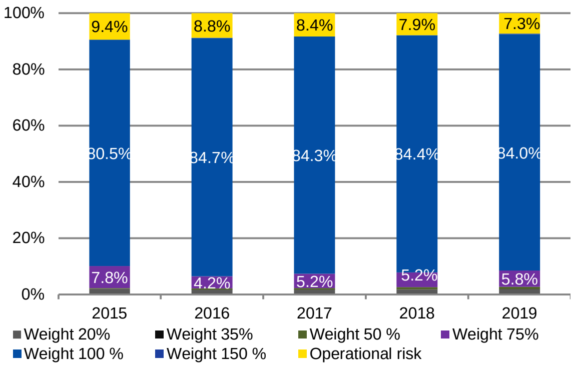
Chart 63. RWAs to total assets ratio



Source: CBK (2020)

In December 2019, credit risk-weighted assets increased by EUR 352.4 million (or 12.5 percent annual growth), reaching EUR 3.2 billion. All categories marked an increase, but the largest contribution to the growth of risk-weighted assets was provided by 100% risk-weighted assets, which marked an annual growth of 11.2 per cent, which also dominates the total RWA-s (chart 64).

Chart 64. RWA structure by risk weight

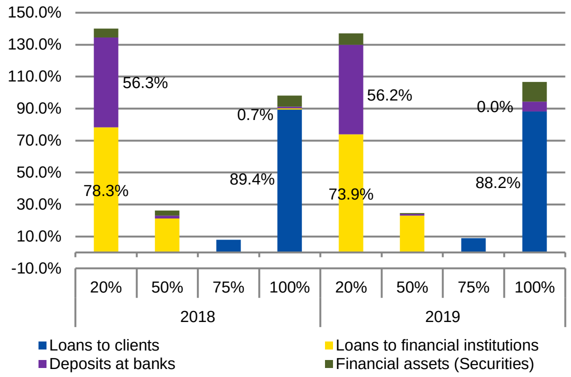


Source: CBK (2020)

About 88.2 per cent of total loans to the private and public sector are 100% risk-weighted, while 73.9 percent of loans to other financial institutions are mainly risk-weighted namely at 20% (chart 65).

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 digitized services. Banks in Kosovo have also been exposed to these developments, which in recent years have invested heavily in providing electronic banking services. The outbreak of the COVID-19 pandemic is expected to accelerate this trend. Therefore, the increase on use of digital services is expected to increase the degree of risk of errors in information technology systems and/or potential cyber-attacks, which means that the need for monitoring and assessment of the operational risk will increase as well.

Chart 65. Assets classification by risk weight



Source: CBK (2020)

Appropriate operational risk management is a very important issue from the point of view of financial stability as operational risk can simultaneously pose systemic risk due to losses and the panic that may be caused. In 2019, capital allocation requirements to cover potential operating losses stood at EUR 249.0 million, i.e. 3.3 percent higher compared to the previous year. However during 2019, the operational risk management is considered to be adequate, with no cases of its materialization, as well as by allocatingthe capital in accordance with regulatory requirements in orderto cover this risk.

5.5. Financing and Liquidity Risk

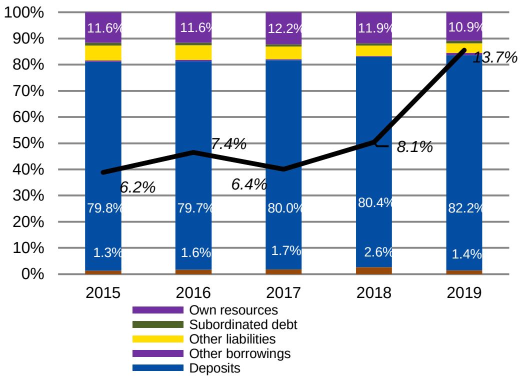
The main source of bank activities financing continues to be represented by deposits which marked an increase, mainly from households' deposits. Under the influence of low interest rates, the share of transferable deposits has increased which in combination with the increase in long-term lending, contributed to the accentuation of maturity mismatches between these items.

However, the main liquidity indicators give positive signs for the current situation of banking liquidity, where the high level of bank liquidity reserves held by the CBK, but also of total liquid assets, makes the sector more resistant to the potential adverse effects that may result from maturity mismatches between investments and financing. In the following period, the crisis triggered by the COVID-19 pandemic may increase the pressure on the liquidity situation of the sector through the effect of the slowdown in deposit growth as a result of the decline in economic activity and external sources of financing. At a time when requests for financing and liquidity from the private sector will increase, the pressure to manage liquidity from banks may increase. In the absence of mechanisms for direct liquidity injection into the market by the CBK, the need for liquidity and financing can be managed through reserve management, interbank liquidity agreements and external financing through parent banks.

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 December 2019, deposits accounted for 82.2 percent of the financing, while private sector (enterprises and households) deposits alone accounted for 85.6 percent of total deposits, indicating that inter-bank financing is at a very low level and that banks are hardly exposed to external sector financing (chart 66).

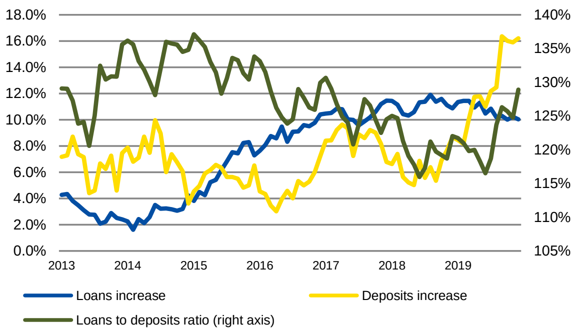
Chart 66. Structure of financing



Source: CBK (2020)

Deposits recorded an annual increase of 16.2 percent, reaching the amount of EUR 3.9 billion. While, private sector deposits alone amounted to EUR 3.3 billion, and increased at an annual rate of 14.2 percent. Banks continue to finance increased lending activity, mainly from deposits. This year, the deposits surpassed loans by 129.6 percent, an indicator that marked an increase of 6.8 percentage points from the previous year, driven by the larger expansion of deposits (chart 67).

Chart 67. Increase of banking sector loans and deposits

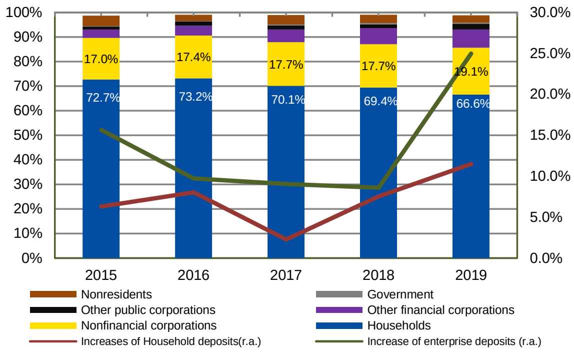


Source: CBK (2020)

Households' deposits, which represent the main source of financing, continued to increase despite the prevailing low interest rates in the market (chart 68).

The growth trend continued even this year, at an accelerated pace of 11.5 percent from 7.5 percent in December 2018. The household deposit stock amounted to EUR 2.6 billion.

Chart 68. Structure of deposits

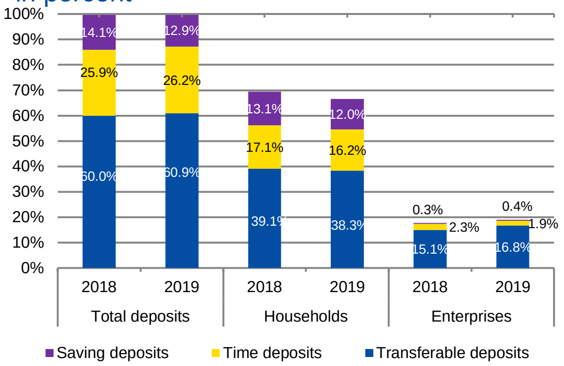


Source: CBK (2020)

Most of them were transferable deposits which, with their annual increase of 13.7 percent, contributed to the increase in total household deposits (chart 69).

Enterprise deposits accelerated the growth trend, with a 25.0 percent annual increase, supported by the positive financial performance of enterprises and the increase in the average interest rate on these deposits during this year.

Chart 69. Structure of deposits by maturity, in percent

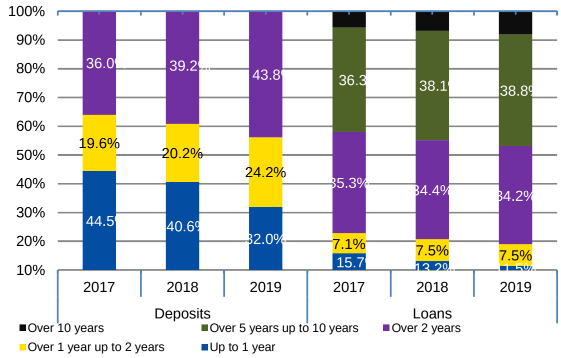


Source: CBK (2020)

The enterprise deposit stock amounted to EUR 744.9 million, with a share of 19.1 per cent in total deposits. The increase of enterprise deposits was mainly driven by the increase of transferable deposits by 29.4 percent, due to the base effect. Time deposits were characterized by a decrease of 6.7 percent, despite the slight increase of 0.15 percentage points of the average interest rate on these deposits during 2019, which reached 1.46 percent.

The structure of total deposits by maturity is dominated by transferable deposits, which marked an increase even this year, at an annual rate of 18.0 percent. Transferable deposits amounted to 60.9 per cent of total deposits in December 2019 (chart 69). Whereas, 38.3 percent of total deposits is composed of transferable deposits of households. Time deposits recorded a significant annual increase of 17.7 percent, while savings deposits recorded an annual increase of 5.9 percent, 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. However, the COVID-19 pandemic may also have a negative impact on time deposits and savings due to increased uncertainties in the possibility of earning income versus stagnation of activities in the economy, thus reducing the space for investing money in these instruments.

Chart 70. Maturity structure of deposits and loans



Source: CBK (2020)

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 40.6 percent to 32.0 percent, dominated the structure of time deposits. Whereas loans with maturity period of 'over 5 to 10 years' are the ones with the highest share (38.8 percent) in total loans and which expanded their share as of December 2019 (figure 70).

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, increased the needs for a stable bank financing. However, the increase in funding during the following year may be hampered by the decline in funding sources and the possibility of increased funding costs as a result of the COVID-19 pandemic.

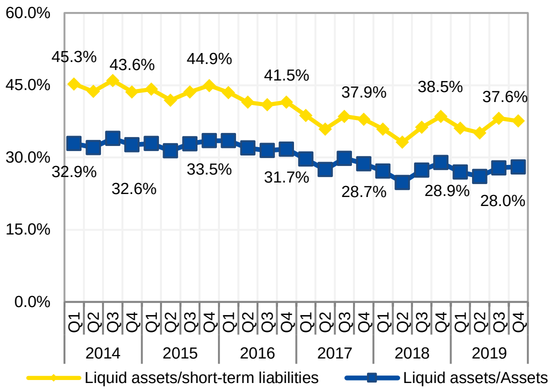
5.5.2 Liquidity risk

The banking sector continues to maintain a satisfactory liquidity position, despite the slight decline in the ratio of liquidity indicators. In December 2019 the ratio of liquid assets to short-term liabilities increased to 36.6 percent from 38.5 percent in December 2018. This result was driven by the higher increase of liquid assets versus the increase of short-term liabilities of 13.7 percent and 10.9 percent respectively.

Likewise, the ratio of liquid assets to total assets slightly decreased to 28.0 percent (28.9 percent in December 2018), as a result of higher increase of liquid assets versus total assets (chart 71).

However, the ratio of liquid assets to short-term liabilities higher than the regulatory minimum[34] indicates the potential for expansion of lending activity.

Chart 71. Liquidity indicators



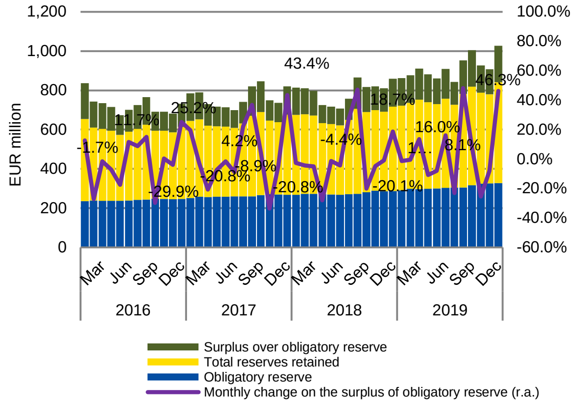
Source: CBK (2020)

Liquid assets growth during the period resulted from the increase of EUR 71.8 million in the balance of reserves with the CBK, or an annual growth of 21.0 percent, as well as increase in foreign governments and Republic of Kosovo bonds of 59.5 percent, or annual increase of 49.2 percent. Whereas, the treasury bills of the Republic of Kosovo marked a decrease of 49.6 percent, which did not greatly affect the stock of liquid assets due to the low share. The share of liquidity reserves with the CBK increased to 31.9 percent of liquid assets, continuing to be the main category.

Liquidity reserves of commercial banks continue to be at high levels, exceeding the required reserve held at the CBK by 57.0 percent. 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 percent (chart 72).[35] 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.

Chart 72. Liquidity reserves



Source: CBK (2020)

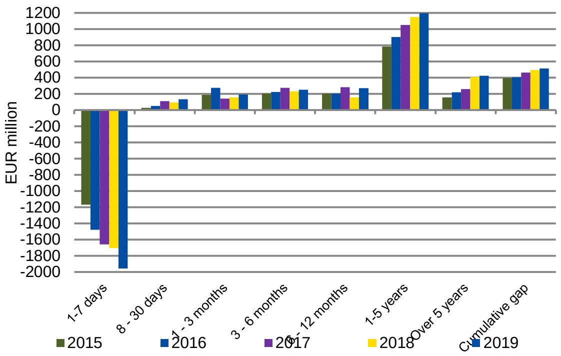
The low interest rate environment is stimulating households to relocate their deposits in favour of short-term maturity, which, in addition to the trend of accelerated long-term lending, resulted in highlighting the maturity mismatches between assets and liabilities in December 2019. Deposits of enterprises 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.

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

[35] Liquidity surplus is characterized by seasonality effects. The tendency to increase the level of excess liquidity reserves is observed during the third quarter months and in December of the respective years. Reserve surplus in the third quarter of this year was 49.0 per cent higher than in the second quarter, while in December the surplus was 18.7 per cent higher than in November.

The cumulative liquidity gap expanded to EUR 513.6 million from EUR 494.4 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. About 37.1 percent of total assets are categorized within the '1-5 years' maturity in relation to the liabilities of the same maturity, which account for only 12.6 percent of total liabilities.

Chart 73. Liquidity gap



*As of 2015 there is a of methodological change in calculation, where equity is not involved

The negative gap results only in the maturity ‘1-7 days’ maturity, amounting to EUR 1.96 billion. This category of maturity accounts for 70.8 percent of total liabilities, while assets comprise 20.7 percent. Consequently, maturity mismatches of the balance sheet items are most pronounced in the maturity categories '1-7 days' and '1-5 years' (chart 73). This situation poses a challenge to bank liquidity management and may, in the future, limit opportunities in favour of long-term lending.

5.6. Shock Absorption Capacity – stress-test analysis[36]

The ‘stress test’ analysis indicates the resilience of the banking sector to shocks in the loan portfolio and the liquidity position according to the scenarios assumed as a result of unfavourable macroeconomic developments and changes to market conditions. However, this publication does not include scenarios of macroeconomic and financial shock in the loan portfolio and capital position, as the current model of analysis is not calibrated to cover unprecedented crises such as the Covid-19 pandemic crisis. Specifically, the coefficient of elasticity of non-performing loans to GDP and output gap, which indicates the sensitivity of the loan portfolio to assumed macroeconomic developments, is modelled without including any crisis situation in the history of the banking sector in Kosovo.

An analysis of the sensitivity of non-performing loans based on data until December 2019, suggests that the threshold of the ratio of non-performing loans to total loans at the sector level is 16.3 percent, whereby the sector would need an additional EUR 208.5 million to cover this level of non-performing loans. The level of NPLs during the first half of 2020 was managed through the postponement of loan instalments as a mitigation measure undertaken by the CBK. By June 2020, 63.2 percent of total active loans applied for deferrals, of which 60.7 percent were approved.

5.6.1 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 daily basis

In this scenario, the withdrawal of deposits broken down by structure and entities is considered, at different levels of withdrawals

[36] 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.

on a daily basis (table 6) for five consecutive days. 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 percent 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 percent 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.

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 second day. On the fifth day, liquidity problems would appear in seven banks, including here banks of general systemic importance. The value of deficient liquid assets of these banks would reach EUR 136.8 million (chart 74, table 7). The level of total deposit withdrawal in the banking sector on the fifth day would reach 38.2 percent (chart 75, table 7).

Table 6. 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%

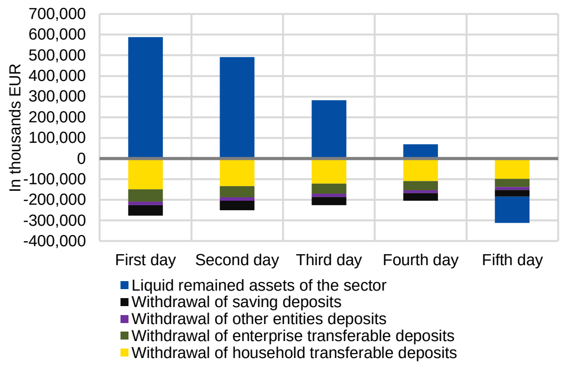
Source: CBK (2020)

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.

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 24.0 million (table 7). The results of this scenario generally

Chart 74. ST results for liquidity risk - scenario 1



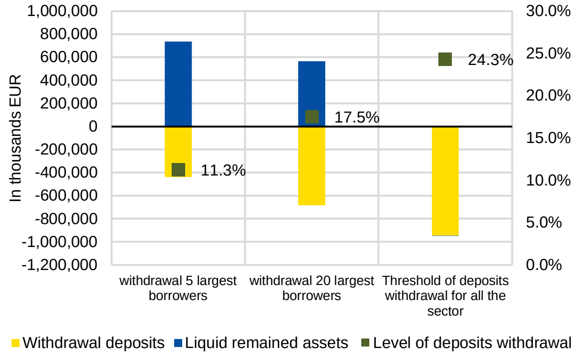
Source: CBK (2020)

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 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 24.3 percent 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 75 and table 7). Whereas at bank level, the bank with the lowest withdrawal threshold stands at 15.6 percent, while the bank with the highest threshold stands at 32.3 per cent (as a result of the high level of liquid assets owned by this bank).

Chart 75. ST results for liquidity risk - scenario 2



Source: CBK (2020)

Table 7. 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	7	-38.2%	(136,837)	125.3%
Scenario 2.1: Withdrawal of deposits from 5 largest borrowers	1	-11.3%	(1,829)	87.3%
Scenario 2.2: Withdrawal of deposits from 20 largest borrowers	2	-17.5%	(23,979)	93.9%
Threshold - Withdrawal of deposits to the critical level of liquidity		-24.3%	(39,076)	102.3%

Source: CBK (2020)

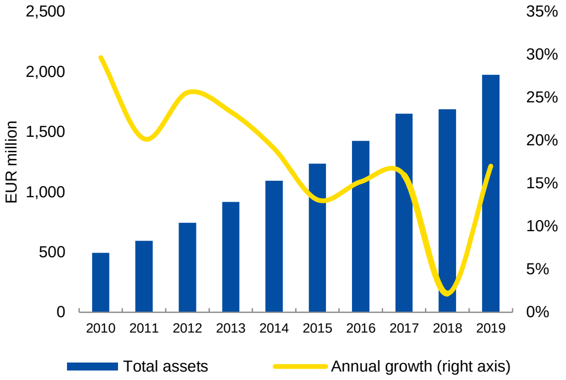
6. Non-bank financial institutions

6.1 Pension sector

Pension sector activity

Good financial performance as well as the stable incomes from the collected contributions influenced the further expansion of the activity of the pension sector during 2019.

Chart 76. Assets of the pension sector



Source: CBK (2020)

However, during the following year, the pension sector may be negatively affected by the spread of the COVID-19 pandemic. The return on investment may decline as a result of the uncertainty caused in external financial markets and the economic recession caused by the measures taken to combat COVID-19. Also, revenues from contributors are expected to be at a lower level as a result of the economic contraction in the country and the increase in the unemployment rate during the following year.

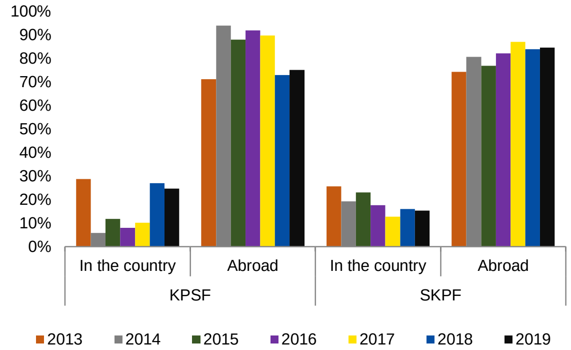
In 2019, the pension sector was characterized by an accelerated annual growth of assets of 17.0 percent, while the total value of assets of the sector reached EUR 1.98 billion (chart 76).

This increase is mainly attributed to the performance of the Kosovo Pension Savings Fund (KPST), which represent the largest share of the sector's assets (99.6 percent), while the remainder is managed by the Slovenian-Kosovo Pension Fund (KSFP). New collections marked an annual increase of 8.1 percent, the value of which reached EUR 186.6 million in 2019, while the return on investment during this period reached EUR 161.9 million (-84.9 million euros in 2018).

Structure of KPST assets continued to be dominated by investments in external markets. In 2019, the investment portfolio in foreign markets increased by 20.6 percent (decrease by 17.0 percent in the previous year).

As a result, investments abroad increased the share to 75.2 percent of total assets (73.0 percent in 2018), while investments in the country reduced the share to 24.8 percent (27.0 percent in 2018) (chart 77).

Chart 77. Structure of pension sector investments

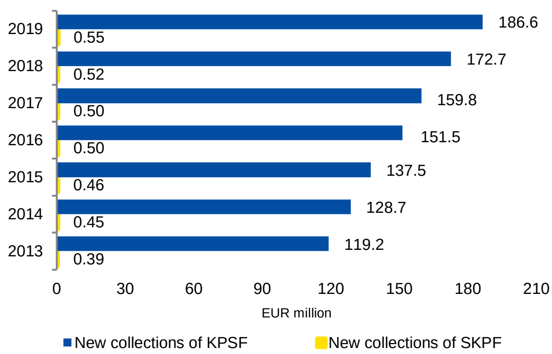


Source: CBK (2020)

Within domestic investments, the share of government securities of Kosovo Government 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 increased to 61.3 percent (46.0 percent in 2018), whereas the weight of certificate deposits increased to 38.1 percent (26.3 percent in 2019). The significant increase of these two categories to the total investments within the country is attributed to the allocation of EUR 120 million in the foreign market, which in 2018 were included in the cash category (they were means in transit - for investment abroad). Despite that the investments within the country marked a decline in this year at 24.8 percent from 27.0 percent as it was in the previous year, it still continues to be two times higher compared to two previous years (chart 77). The dynamics in KPST investments in Kosovo Government securities depend on the demand and the amount offered by the Government, as well as on the competition in auctions. At the end of December 2019, the value of KPST assets reached EUR 1.97 billion, which represents an annual increase of 17.0 percent (annual increase of 2.2 percent in 2018).

In 2019, the value of total assets of KPST reached EUR 8.3 million, marking an annual increase of 17.6 percent. New collections amounted to EUR 549.9 thousand euros, which correspond to an annual increase of 6.7 percent (chart 78).

Chart 78. Contributions collected by pension funds



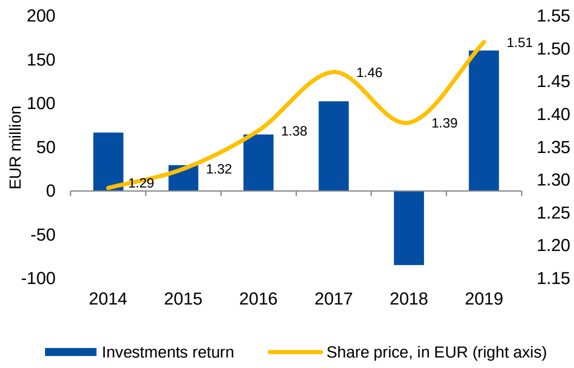
Source: CBK (2020)

Largest share of KPST assets continue to be invested abroad, respectively with 84.7 percent of total assets. The structure of investments abroad consists mainly of investments in the form of shares (77.3 percent), securities (15.0 percent), and cash (6.2 percent). On the other hand, investments in Kosovo decreased by 0.7 percentage points, with a share of 15.0 percent of total KPST assets. Limited opportunities to invest in the domestic market meant that KPST assets were distributed in Kosovo Government securities (75.5 percent), deposits in commercial banks (21.3 percent) and the rest held as cash ready in the treasury of KPST (3.2 percent).

6.1.1 Pension sector financial performance

The pension sector marked a positive financial performance in 2019, as a result of the highest return on investment in the external market.

Chart 79. Financial performance of Kosovo Pension Saving Fund

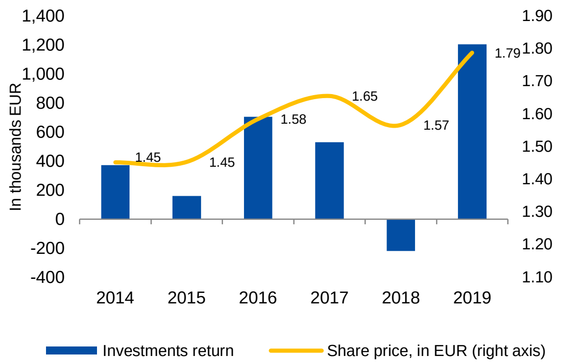


Source: CBK (2020)

KPST had a return on investment in the amount of EUR 160.7 million (graph 79). As a result of positive financial performance, KPST closed the last day of December 2019 with a higher share price compared to the same period of the previous year.

Specifically, the share price increased to EUR 1.51 compared to EUR 1.39 in December 2018. This high increase in profit was driven by many factors such as a more favourable economic environment in foreign markets (investments mainly concentrated in the United States) during 2019, lower risk of economic recessions, easing of US-China trade relations, satisfactory corporate profits, etc.

Chart 80. Financial performance of Slovenian-Kosovo Pension Fund



Source: CBK (2020)

KPST also marked a high return on investment in 2019.

In 2019, gross return on investments amounted to EUR 1.2 million, compared to negative return of EUR 221.0 thousand in the previous year (chart 80). As a result, the KPST share price on the last day of December 2019 increased to EUR 1.79, compared to EUR 1.57 in the previous period.

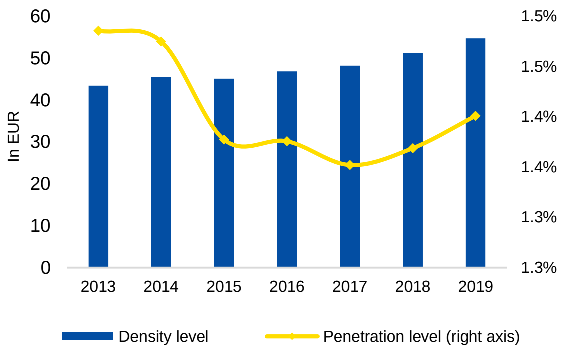
6.2 Insurance Sector

6.2.1 Activity of the Insurance Sector

The insurance sector in 2019 was characterized by increased activity and higher level of premiums collected. However, these developments were not reflected in the realization of profit mainly due to the increase in the level of damages occurred and other relevant expenses.

With a share of 2.7 percent in 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 in almost unchanged level in the last four years, of 1.4 percent, which is considered as relatively low compared with the countries in the region. On the other hand, the density level, which represents written premiums per capita, have marked an increase in years reaching EUR 54.8 by the end of December 2019 (graph 81).

Chart 81. Development indicators of insurance sector

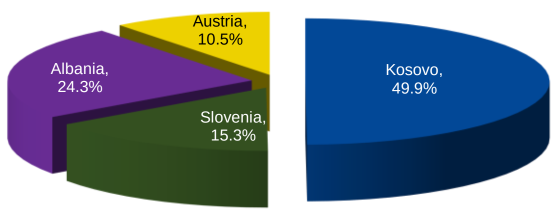


Source: CBK (2020)

The structure of the insurance sector continues to be dominated by 'non-life' insurer services, which represent 91.0 percent of the insurance market assets, while the remainder consists of the assets of the 'life' insurance companies. The number of insurance companies decreased compared to the previous years a result of revoking the license of one of the insurance companies. Consequently, the number of insurance companies decreased to 13 insurance companies, out of which 11 are 'non-life' insurance companies and 2 'life' insurance companies.

Almost half of the insurance market is represented by local insurance companies, and the other half by foreign-owned insurance companies.

Chart 82. Structure of assets of insurance sector, by ownership (December 2019)



Source: CBK (2020)

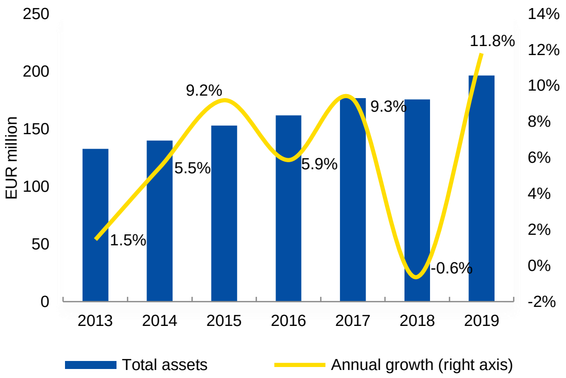
Revocation of the license of one of the insurance companies with foreign ownership during 2019 resulted in decrease in share of assets managed by foreign-owned insurance companies with 50.1 percent (52.3 percent 2018). Within assets with foreign ownership, the highest share was marked by Albania, followed by Slovenia and Austria (chart 82). While, the domestic capital insurance companies manage 49.9 percent of the sector's assets.

The insurance market in Kosovo is characterized by a low concentration, which is a precondition for enabling of greater competition in the market, though with an increasing tendency during this period. Herfindahl[37] index, calculated for gross written premiums in 2019 shows 930 points (in 2018 it was 870 points). While, the same index calculated on the basis

[37] 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.

of the insurance market assets shows lower values, namely 853 points for 2019 from 808 in the previous year.

Chart 83. Assets of insurance sector



Source: CBK (2020)

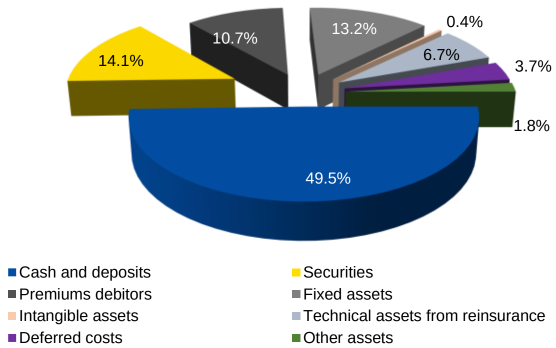
Similarly, the CR5[38] index for premiums in 2019, calculated in relation to GWP for the insurance sector results 54.7 percent (in 2018 it was 52.8 percent), while calculated in relation to assets ratio results with 50.8 percent (in 2018 it was 49.8 percent). By sectors, the concentration is higher in the 'life' insurance sector, as a result of the smaller number of insurance companies in this sector. The increase in concentration in both assets and premiums was mainly a result of the reduction in the number of insurance companies from 14 last year to 13 that currently are.

Insurance sector assets amounted to EUR 196.5 million marking an annual increase of 11.8 percent (chart 83). 'Non-life' insurer assets increased by 12.1 percent, whereas 'life' insurer assets marked an annual growth of 8.5 percent.

Within the assets, investments in securities of the government of Kosovo and receivables from the insured (debtors of premiums) were characterized by a significant increase in 2019.

However, 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 49.5 per cent. This asset structure suggests that the assets of the insurance companies contain a high percentage of high liquid assets.

Chart 84. Structure of assets of insurance sector (December 2019)



Source: CBK (2020)

The investment structure of insurance companies continues to be conservative. Investments in securities of the government of Kosovo increased the weight to 14.1 percent in 2019, from 13.2 percent in the same period last year (chart 84). Within its own liabilities and own resources, technical reserves lead over the general structure (chart 85).

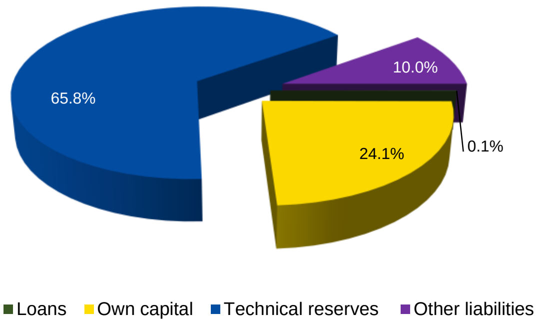
Technical provisions, which constitute majority of the liabilities of insurance companies during 2019, recorded an annual growth of 9.4 percent. Mainly, the increase in technical reserves was positively influenced by the annual growth of 10.0 percent of provisions for gross premiums, followed by reserves for gross damages, which marked an annual increase of 9.1 percent.

The value of the insurers' total capital increased by 7.6 percent thus reaching EUR 47.4 million. The capital growth is mainly attributed to the increase of paid-in share capital, which increased by EUR 10.2 million reaching to total amount of EUR 84.1 million. Whereas, the value of losses accumulated over the years by the sector amounted to EUR 38.8 million, neutralizing the further increase of

[38] 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.

total capital, together with the net losses incurred during 2019.

Chart 85. Liabilities and capital of insurance sector (December 2019)

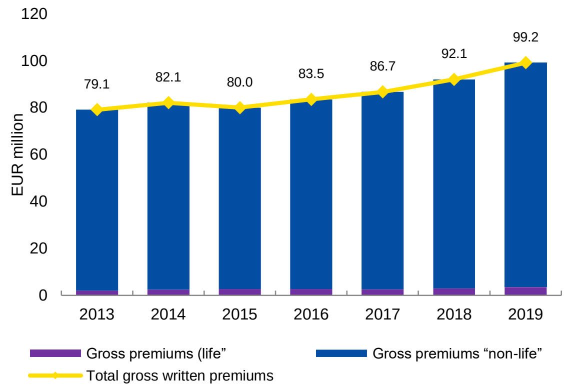


Source: CBK (2020)

The value of premiums written by insurance companies in 2019 amounted to EUR 99.2 million, an annual increase of 7.7 percent (chart 86). The structure of written premiums is dominated by 'non-life' insurance premiums which represent 96.5 percent of total written premiums.

The amount of EUR 95.7 million of written premiums by “non-life” insurers was for 7.4 percent higher than in 2018. Out of total 11 ‘non-life’ insurance companies during this year, 10 of them marked an increase at the level of gross written premiums, whereas only one insurance company was characterized by an annual decline of written premiums.

Chart 86. Gross collected premiums



Source: CBK (2020)

“Non-life” insurances continue to be dominated by compulsory insurance with a share of 59.9 percent in total gross written 'non-life' premiums, while voluntary insurance accounts for 40.1 percent of total gross written 'non-life' premiums”.

Table 8. Gross written premiums by business classes (EUR million)

Activity	2018	2019	Change	Share: 2018	Share: 2019
Total non-life	*89.1*	*95.7*	*7.4%*	*96.8%*	*96.5%*
Obligatory insurance					
MTPL	45.3	47.0	3.7%	49.2%	47.3%
TPL+	2.3	2.5	9.5%	2.5%	2.5%
Border insurance	7.4	8.0	7.0%	8.1%	8.0%
Voluntary insurances					
Accident and health	18.0	19.6	8.6%	19.6%	19.8%
Casco	4.5	5.4	21.4%	4.9%	5.5%
Loans and guarantees	3.6	4.5	25.0%	3.9%	4.5%
Property insurance	5.4	5.3	-1.1%	5.8%	5.3%
Insurance on financial losses	1.0	1.2	20.3%	1.1%	1.2%
Liability insurance	1.6	2.2	36.6%	1.7%	2.2%
Navy and transport	0.1	0.2	56.8%	0.1%	0.2%
Total life	*3.0*	*3.5*	*17.0%*	*3.2%*	*3.5%*
Total market	**92.1**	**99.2**	**7.7%**	**100.0%**	**100.0%**

Source: CBK (2020)

Table 9. Claims incurred, by business classes (EUR million)

Activity	2018	2019	Change	Share: 2018	Share: 2019
Total non-life	*42.3*	*47.2*	*11.6%*	*98.7%*	*98.5%*
Obligatory insurance					
MTPL	23.5	24.8	5.7%	54.8%	51.8%
TPL+	0.2	0.7	233.3%	0.5%	1.5%
Border insurance	2.3	2.8	20.8%	5.4%	5.8%
Aggreement MoU	*0.3*	*0.4*	38.7%	0.6%	0.8%
Voluntary insurances					
Accident and health	10.4	10.0	-4.5%	24.3%	20.8%
Casco	2.9	3.1	10.0%	6.7%	6.5%
Loans and guarantees	0.1	0.8	505.3%	0.3%	1.7%
Property insurance	2.5	3.6	42.1%	5.9%	7.5%
Overall liabilities	0.1	1.0	1153.7%	0.2%	2.1%
Total life	0.6	0.7	30.0%	1.3%	1.5%
Total market	**42.8**	**48.0**	**11.9%**	**100.0%**	**100.0%**

Source: CBK (2020)

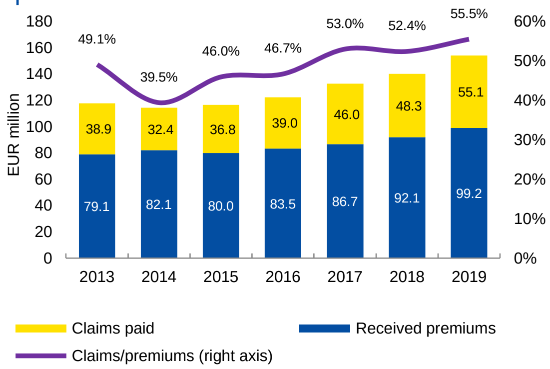
The share of compulsory insurance to total written premiums compared with last year marked a decline. This decline was affected by the lower level of receipts from “MTPL” and “Border Insurance Policies”. While, voluntary insurance marked an increase of 12.3 percent, increasing also share to total gross written premiums. The increase of the share of voluntary insurance in total gorss written premiums was influenced by the increase in premiums for products such as "Accident and Health", "Casco", "Loans and Guarantees" and other products that marked a slower increase (table 8).

In 2019, the value of written premiums from ‘non-life’ insurance amounted to EUR 3.5 million, representing a higher value for 17.0 percent compared to 2018.

Table 9 shows the statistics of the claims incurred during this period, which reached the value of EUR 48.0 million, compared to EUR 42.8 million last year. This increase in the value of damages incurred is attributed to obligatory and voluntary insurance products. In terms of obligatory insurance products, all its categories marked a more significant increase to the “MTPL” category. Whereas, as regards the voluntary insurance, excluding the category “accident and health”, all other categories, with special emphasis the category “property insurance’, increased.

Claims paid by the insurance sector, which includes insurance companies and the Kosovo Insurance Bureau (KIB) claims, marked an accelerated annual growth of 14.1 percent and reached the value of EUR 55.1 million in 2019. The higher increase in paid claims during 2019 along with the smaller increase in written premiums resulted in increase of the ratio of total damage claims paid towards written premiums (figure 87).

Chart 87. Received premiums and claims paid



Source: CBK (2020)

6.2.2 Financial performance of the insurance sector

Insurance sector this year closed with negative financial results of EUR 3.8 million, mainly as a result of the increase of claims incurred by “non-life” insurers.

"Life" insurance companies continue to generate positive financial results, of EUR 460.5 thousand compared to EUR 584.4 thousand in 2018. "Non-life" insurance companies recorded losses of EUR 4.2 million, compared to profits of EUR 1.0 million in 2018. This financial result reflects the highest increase in claims incurred by 14.2 percent, compared to the increase in net premium income by 3.7 percent, and at the same time, the annual increase in operating expenses of the sector by 6.5 percent.

One of the main factors in the losses realized during 2019 was the combined mass ratio of 104.0 percent, which represents the claims ratio of 55.7 percent and the expense ratio of 48.4 percent (excluding investment interest income), a report that suggests that for EUR 1 earned, the insurance market has spent EUR 1.04.

Based on the Regulation on investment of assets to cover technical and mathematical provisions, as well as the investment of the charter capital of insurance companies, the latter are obliged to hold sufficient assets to cover technical and mathematical provisions not less than the gross value of technical, respectively mathematical provisions.

The ratio between cash and cash equivalents to reserves declined at level of 96.6 percent in 2019 (from 97.2 percent last year), as well as the ratio between cash and cash equivalents to total liabilities decreased to 83.8 percent (from 87.3 percent in 2018).

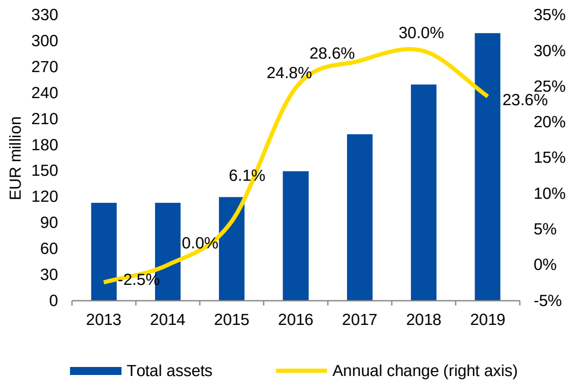
6.3. Microfinance sector and financial auxiliaries

6.3.1 Activity of microfinance sector

The microfinance sector assets marked a significant increase in 2019 as well, but the growth rate slowed down for the first time in the last five years.

The expansion of the activity is mainly based on the financing of the lending activity and leasing. Their financing continues to be supported mainly by external sector borrowings, and to a lesser extent by own capital. In the following year, the spread of the Covid-19 pandemic is expected to affect the growth rate of the financial sector by reducing the loan portfolio for enterprises and households, as a result of increased risk in the realization of income. The negative effects of the pandemic and the resulting economic crisis are expected to be reflected in the quality of the loan portfolio.

Chart 88. Assets of the microfinance sector



Source: CBK (2020)

Sector assets reached the value of EUR 309.1 million in 2019, which corresponds to an annual growth of 23.6 percent, representing a slowdown for the first time in the last five years (chart 88).

20 microfinance institutions[39] operate in the domestic market of which 12 are foreign-owned and represent 93.3 per cent of total sector assets. As a result of the revocation of the registration of two microfinance institutions, compared to last year, the level of market concentration has increased.

Herfindahl-Hirschman's index on assets resulted in 1,476 points in 2019, reflecting an increase in concentration from the same period of the previous year (1,376 points). While the share of assets of the three largest institutions in total sector assets increased to 55.4 percent, from 53.1 percent in 2018.

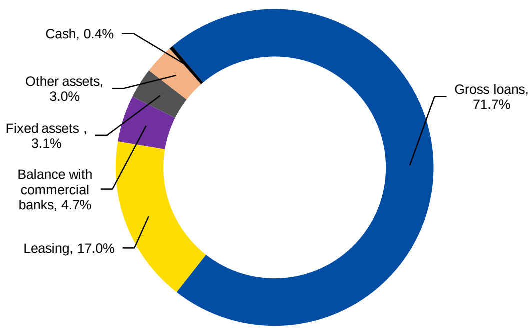
Loans comprise 71.7 percent of total sector assets. The second most important category by

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

weight is leasing with a share of 17.0 percent (chart 89).

Compared to the previous year, the weight of leasing in total sector assets has increased, compared to the decline in the loans category. Regarding liabilities, the activity of the microfinance sector is mainly financed by borrowings which account for 65.5 percent of total liabilities and equity, whereas financing from the external sector alone accounts for 65.3 percent of total liabilities and equity.

Chart 89. Structure of assets of microfinance sector (December 2019)



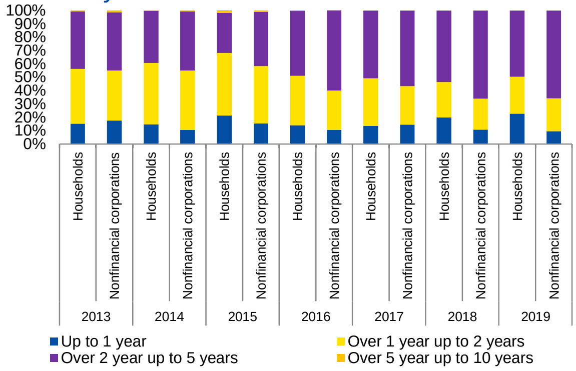
Source: CBK (2020)

Even during 2019, external sector borrowings continued to increase in double digits, but growth was significantly lower than the last year. The value of external sector borrowings amounted to EUR 197.0 million in 2019, indicating an annual increase of 17.0 percent (28.6 percent in 2018).

The value of total microfinance sector loans in 2019 amounted to EUR 221.6 million, which represents an annual increase of 20.5 percent comparing to increase of 27.7 percent in the same period last year. Moreover, this is the fifth consecutive year of double-digit increase in lending activity by microfinance institutions. The increase in lending was mainly 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 during the year and retained profit from the past years).

In the last four years, microfinance institutions were more oriented towards lending to households, although lending to non-financial corporations increased significantly as well. Specifically, loans to households in 2019 accounted for 67.5 percent of total loans of the microfinance sector and marked an annual increase of 23.3 percent (31.7 percent annual increase in 2018). 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 2019.

Chart 90. Loans to economic sectors, by maturity



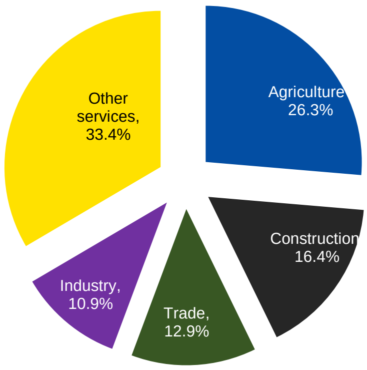
Source: CBK (2020)

Loans to nonfinancial corporations represent 32.5 per cent of the total stock of active loans. In 2019, these loans were characterized by an annual growth of 15.3 percent (20.6 percent annual growth in 2018). Similar to household loans, loans granted to nonfinancial corporations continue to mainly have maturities 'over 2 to 5 years' with a share of 65.7 percent (chart 90).

The structure of lending to non-financial corporations by economic activity remains similar to previous years. Unlike the banking sector, where loans to agriculture represent the category with the lowest participation, with microfinance institutions the agriculture enjoys the highest support, accounting for 26.3 per cent of total loans to non-financial corporations. Other categories with high access to microfinance financing are loans intended for construction sector, trade and industry (chart 91). However, compared to the share in banking market, loans towards the trade sector in microfinance sector have a lower weight.

In terms of performance, loans to the industry sector recorded the highest annual growth. Agriculture and construction sector also had a significant increase in lending. Lending towards the trade sector marked a significant slowdown of growth compared to the last year (chart 92).

Chart 91. Structure of loans to nonfinancial corporations, by economic sectors (December 2019)

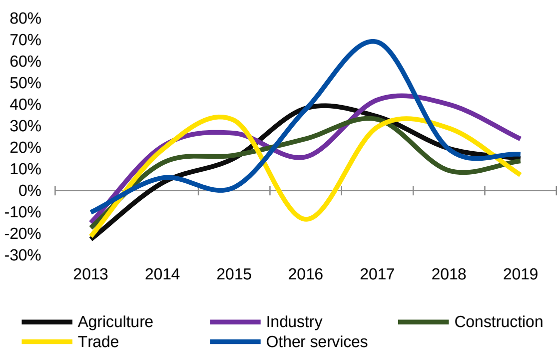


Source: CBK (2020)

Leasing activity in microfinance institutions marked a significant increase. The value of microfinance sector leasing increased to EUR 52.7 million, an annual increase of 38.5 percent (chart 91). The largest contribution to the increase in total leasing was made by leasing to non-financial corporations, which are the dominant category, whose value increased by 46.2 per cent compared to that of the last year.

Leasing designated for households has a share of 46.6 percent in the general structure of total leasing.

Chart 92. Microfinance sector growth rate of loans to nonfinancial corporations, by economic sectors

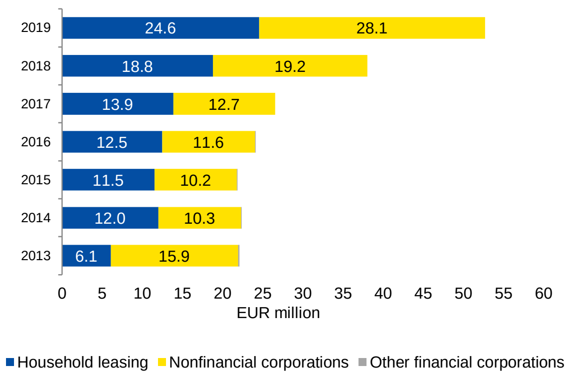


Source: CBK (2020)

Within the leasing designated for households, mortgage leasing, which represents the dominant category, marked an increase of 15.7 percent.

Other leasing within households marked a significant annual increase of 51.0 percent, however, the share in total leasing is limited. Leasing designated for households continues to be dominated by long-term leasing with maturity 'over 10 years' with a share of 48.4 percent, followed by leasing with maturity 'over 5 up to 10 years' with a share of 32.8 percent.

Chart 93. Microfinance sector leasing

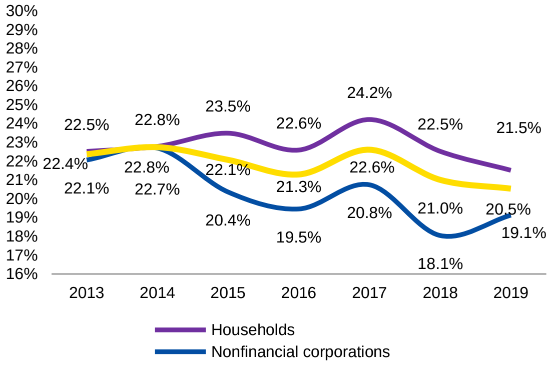


Source: CBK (2020)

Within leasing designated for non-financial corporations, other leasing, which dominate leasing designated for non-financial corporations, were characterized by an increase of 43.0 percent. Equipment leasing also marked an increase from EUR 2.3 million in 2018 to EUR 3.8 million at the end 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 89.1 percent, followed by leases with a maturity of '1 to 2 years' with a share of 4.6 percent.

The average interest rate on microfinance sector loans marked a slight decrease, down to 20.5 percent at the end of 2019 (chart 94). The decrease in the average interest rate on loans was recorded in the household sector, whereas interest rates on loans for non-financial corporations marked an increase.

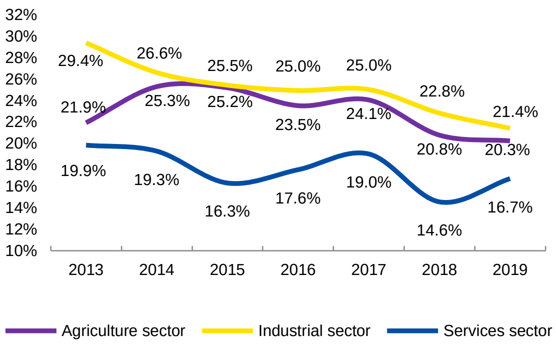
Chart 94. Average interest rate on microfinance sector loans



Source: CBK (2020)

The average interest rate on loans to households decreased to 21.5 percent at the end of 2019. While, the average interest rate on loans to nonfinancial corporations increased to 19.1 percent (chart 94). Within these loans, the services sector holds the lowest average interest rate of 16.7 percent, however compared to the last year, it marked an increase of 2.2 percentage points. The average interest rate on loans to the industrial sector dropped by 1.4 percentage points, standing at 21.4 percent at the end of 2019.

Chart 95. Average interest rate on loans, by economic sectors



Source: CBK (2020)

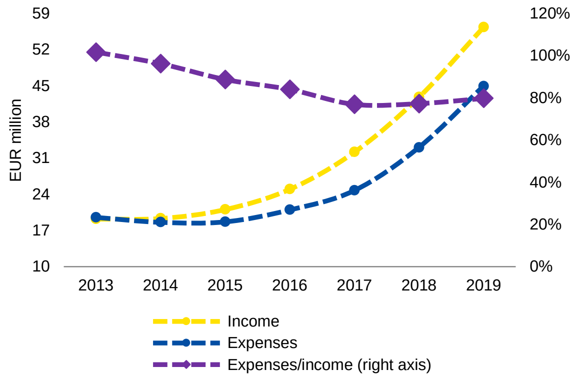
Also, the average interest rate on loans to the agricultural sector declined by 0.5 percentage points, to 20.3 percent at the end of 2019 (chart 95).

6.3.2 Performance of the microfinance sector

The microfinance sector has been characterized by a better financial performance, low level of non-performing loans and satisfactory coverage with provisions. In 2019, the realized profit reached a record value of EUR 11.5 million, compared to the profit of EUR 9.7 million in the same period a year earlier. The profit increase was a result of higher level of collections compared to the level of expenditure realized.

Microfinance sector income reached the value of EUR 56.4 million, which is higher for EUR 13.6 million compared to the last year (chart 96). This growth of incomes was mainly as a result of interest income on loans. Expenditures in the sector amounted to EUR 44.9 million, for EUR 11.9 million higher compared to the previous year. This increase in expenditures was mainly due to the increase in expenditures for provisioning for possible loan losses and personnel expenses.

Chart 96. Microfinance sector income and expenditures

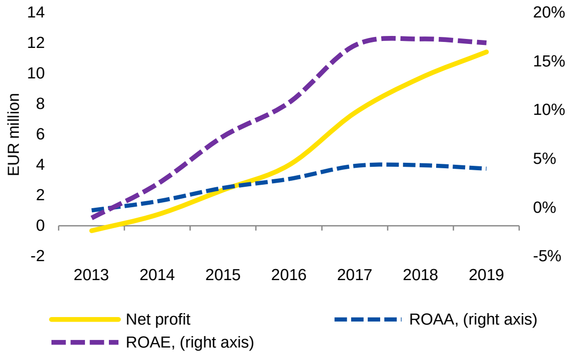


Source: CBK (2020)

The ratio of expenditures to microfinance sector income marked a significant increase of 2.4 percentage points as a result of the higher annual increase in expenditures compared to the increase in income. At the end of 2019, this indicator stood at 79.7 percent from 77.3 percent at the end of previous year.

Profit realized during 2019, although at record value, failed to affect the improvement of profitability indicators. Return on Average Assets (ROAA) stood at 4.0 percent (4.3 percent in 2018), while Return on Average Equity (ROAE) stood at 16.9 percent (17.3 percent in 2018) (chart 97). This dynamic mainly reflects the significant expansion of assets in recent years compared to the performance of realized profit.

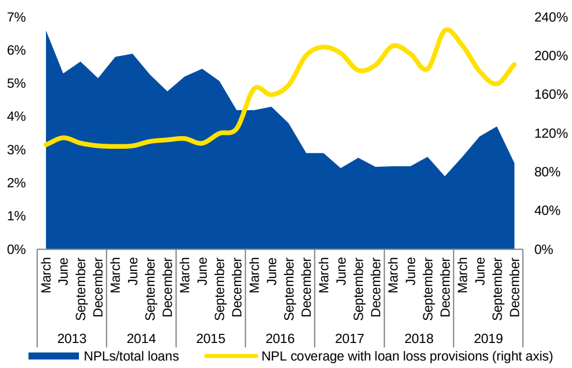
Chart 97. Profitability indicators of microfinance sector



Source: CBK (2020)

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 98).

Chart 98. Indicators of credit portfolio quality



Source: CBK (2020)

The level of non-performing loans in 2019 stood at 2.6 percent (2.2 percent in 2018). Whereas, their coverage by provisions in 2019 reached 190.9 percent (226.0 percent in 2018).

The sector of financial auxiliaries comprises the largest number of financial institutions in the country but manages only 0.2 per cent of total assets. This sector consists of the exchange bureaus and money transfer agencies (MTAs). The value of financial auxiliaries assets in 2019 amounted to EUR 16.7 million, representing an annual increase of 5.8 percent.

Financial auxiliaries' income marked an annual increase of 7.9 percent reaching the amount of EUR 8.3 million. The income structure of the financial auxiliaries is dominated by incomes from transfers (share of 68.1 percent), which were characterized by an annual increase of 1.1 percent. Expenditures marked an annual increase of 10.3 percent, reaching EUR 5.1 million. Net profit realized by these financial institutions in 2019 amounted to EUR 3.3 million, representing an annual increase of 4.5 percent.

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, namely the Interbank Payment System (IPS), operated and supervised by the Central Bank of the Republic of Kosovo.

The number of transactions processed by IPS in 2019 reached to EUR 12.4 million (11.5 million in 2018), marking an annual increase of 8.1 percent. In the same period, total transactions realized amounted to EUR 14.14 billion, representing an annual increase of 9.1 percent. Priority massive payments and regular massive payments represented around 78.4 percent of the total interbank transactions executed (table 10). Priority massive payments represent about 4.9 million transactions executed (39.1 per cent of total transactions) and are mainly payments by governmental institutions (such as salaries and pensions). Similarly, regular massive payments represent about 4.9 million transactions executed (or 39.3 per cent of total transactions) and are mainly payments received by governmental institutions and include payment of taxes, fees, customs, etc. While, 0.6 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 10).

Table 10. Share of payment instruments to total transactions of IPS, in percentage

Description	Number of total transactions		Value of total transactions	
	2018	2019	2018	2019
Regular	13.4%	12.9%	11.3%	10.9%
Prioritized	1.0%	3.2%	36.6%	39.5%
Regular-massive	40.2%	39.3%	5.7%	5.8%
Prioritized-massive	40.2%	39.1%	8.1%	8.4%
Giro payments	5.0%	5.2%	9.1%	8.6%
Securities	0.0%	0.0%	6.4%	5.2%
Direct debiting	0.0%	0.0%	0.0%	0.0%
Bank-Bank	0.1%	0.0%	22.7%	21.5%
Returned	0.1%	0.3%	0.1%	0.1%

Source: CBK (2020)

Regarding the value of transactions, priority payments are the category with the highest share in executed transactions, amounting to EUR 5.58 billion, followed by bank-to-bank category, amounting to EUR 3.04 billion during 2019. The number of total valid bank accounts[40] in 2019 reached 2.15 million, representing an annual increase of 4.7 percent.

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 2019, the number of total E-banking accounts reached 303.6 thousand[41] (table 11). The structure of E-banking accounts continues to be dominated by individual accounts with a share of 84.3 percent to total E-banking accounts, followed by business accounts with a share of 15.7 percent.

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

[41] Upon the entry into force of the Regulation on Reporting Payment Instruments Statistics in 2018 changed the methodology for reporting the number of accounts accessible online. This number represents the number of current accounts that have access to e-banking, whereas according to the earlier methodology, all accounts, including current, saving and term deposit accounts, were reported.

Table 11. Banking sector network

Description	2016	2017	2018	2019
Number of bank branches	45	45	46	47
Number of bank sub-branches	207	183	166	159
ATM number	522	512	491	497
POS number	10,589	11,501	13,183	13,769
Number of E-banking accounts	230,905	301,841	250,733	303,602

Source: CBK (2020)

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 2019 compared to last year. As regards the cards, the number of debit cards reached 1,108,355 while credit cards reached 184,718. The number of debit cards was characterized by an annual increase of 9.5 per cent, while credit cards marked an annual increase of 6.5 per cent.

According to the operators, Visa Cards (60.8 per cent) followed by Master Cards (37.0 per cent) had the highest share to the total cards, while the local cards had a share of 2.2 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) marked an increase compared to last year; however, there is a decrease compared to 2016 and 2017 (table 12).

Table 12.Share of transactions value processed with cards by terminals in total card transactions value, in percent

Description	2016	2017	2018	2019
ATM withdrawals in cash	63.4%	61.9%	58.9%	59.5%
ATM deposits	26.5%	29.3%	30.9%	29.9%
Credit transfers through ATMs	0.0%	0.0%	0.1%	0.1%
POS cash withdrawals	0.3%	0.2%	0.2%	0.2%
Card payments through POS	9.9%	8.5%	9.8%	10.3%

Source: CBK (2020)

The number of withdrawals through ATMs has increased to 17.2 million (15.2 million in 2018), with a turnover of EUR 2.75 billion (2.36 billion in 2018). The share of cash withdrawals through ATMs to total card transactions stood at 59.5 per cent in 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 29.9 per cent of the total value of card transactions through terminals, compared to 26.5 per cent three years ago (table 12). During the same period, the number of payments through cards at POS terminals reached 13.6 million, in the amount of EUR 476.8 million. Value of payments through POS to total card transactions in 2019 reached 10.3 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 CBK the authority to issue relevant regulatory instruments.

8.1. Summary of developments in selected macro-prudential indicators

During 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 nonperforming 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 nonperforming 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 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 2019, the banking sector appears to have five 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 Supervision[42] suggest monitoring of several assessing parameters if lending is growing beyond sustainable fundamentals and consequently is affecting the accumulation of systemic risk. In addition to assessing the parameters according to the relevant guidelines, relevant authorities shall assess the relevance of applying countercyclical capital requirements.

The CBK, in the Macro prudence Policy[43], 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 countercyclical 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 sector[44] 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 nonbanking 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 2019 stood at 45.8 per cent. The credit gap outcomes at the end of 2019 suggest that the private sector in Kosovo has never gone through an 'over lending' period.

However, the faster growth of credit-to-GDP ratio in recent years resulted in the credit-to-GDP gap reaching 0.261 per cent in December 2019, widened in a positive direction compared to the previous year (0.200 per cent in December 2018) (chart 99).

The positive widening of the credit-to-GDP gap implies that lending is growing at a faster rate compared to the gross domestic product, namely the increase in lending to the private sector does not sufficiently justify the growth of the gross domestic product. However, in the case of Kosovo the significant credit growth in the last years compared to the rhythm of the GDP growth should not be considered to be excessive. This is due to the fact that the financial sector in Kosovo is still in the early

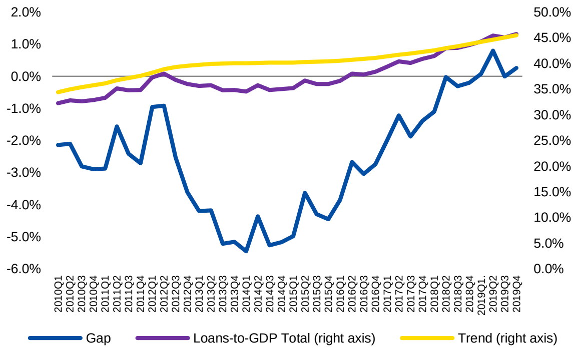
[42] Bank for International Settlements (2010).Guidance for national authorities operating the countercyclical capital buffer, the Basel Committee on Banking Supervision, December.

[43] CBK (2018).*Macro prodence Policy, Prishtina, June.*

[44] 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.

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.

Chart 99. Lending gap

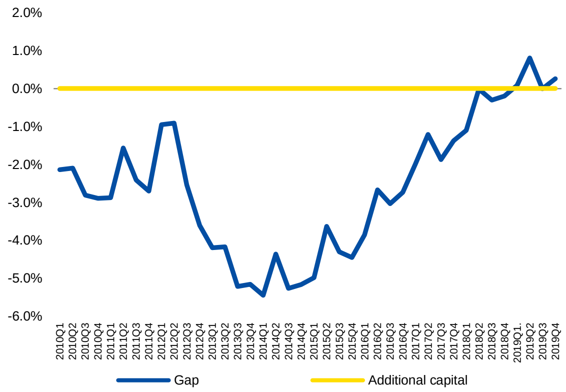


Source: CBK (2020)

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 March 2019 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 100).

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.

Chart 100. Countercyclical capital buffer



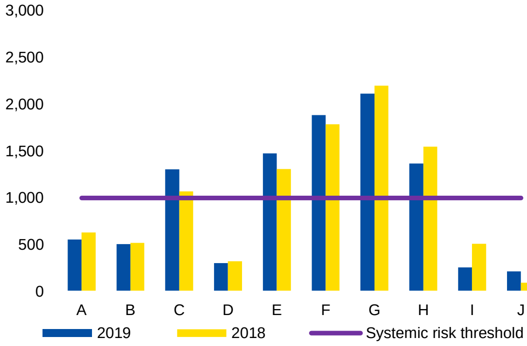
Source: CBK (2020)

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 13). General results of the model, with data of December 2019, suggest that five banks are of general systemic importance (chart 101).

Chart 101. General scale of systemic importance



Source: CBK (2020)

Table 13. Indicators used to assess systemic importance of banks in Kosovo[45]

Kriteri	Indikatorët
Madhësia (pesha 25%)	Asetet (pa provizione)
Zëvendësueshmëria (pesha 25%)	Vlera e transaksioneve në raport me gjithsej vlerës së transaksioneve të sektorit përmes sistemit të pagesave
	Pjesëmarrja në gjithsej kreditë ndaj ekonomive familjare
	Pjesëmarrja në gjithsej kreditë ndaj korporatave jo-financiare
	Pjesëmarrja në gjithsej depozitat e ekonomive familjare
Ndërlidhshmëria (pesha 25%)	Pjesëmarrja në gjithsej kreditë ndaj korporatave tjera financiare dhe plasmaneve në bankat tjera (duke mos përfshirë bankat amë)
	Pjesëmarrja në gjithsej depozitat e korporatave tjera financiare dhe huazimeve tjera (duke përfshirë edhe depozitat e bankave tjera)
	Pjesëmarrja në letrat me vlerë
Aktiviteti ndërshtetëror dhe Kompleksiteti (pesha 25%)	Kërkesat ndaj sektorit të jashtëm
	Detyrimet ndaj sektorit të jashtëm
	Pjesëmarrja e zërave jashtë-bilancor

Source: CBK (2019)

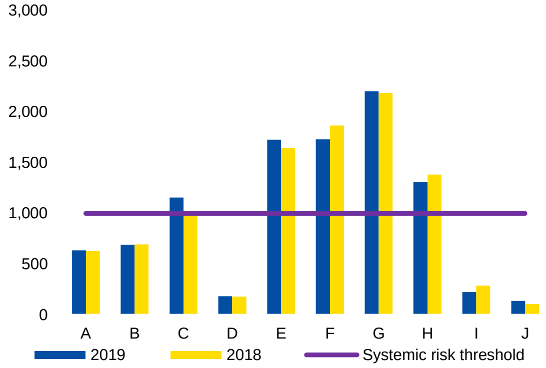
All five banks of general systemic importance have resulted in systemic importance in all constituent criteria (table 13). The overall scale of systemic importance ranges from 1,305 base points to 2,115 base points, which represents a slight decrease of the upper level compared to December last year.

However, in general, banks of general systemic importance have increased the rate of systemic points, compared to the decrease in the rate of points of banks that have not proved to be of general systemic importance. Respectively, this difference was more emphasized in the criteria of interconnection and interstate activity/complexity, and less emphasized in that of size. Only the criterion of substitutability had an increase in the rate of points in banks of non-systemic importance compared to a decrease in the rate in banks of general systemic importance.

Size criterion - Five banks, which are of general systemic importance, were found to be systematically important in the size criterion (chart 102).

The degree of systemic importance in this criterion extends from 1,150 base points to 2,206 base points. Two of these banks were characterized by a decrease in systemic importance in this criterion compared to the previous year, while the other three marked an increase.

Chart 102. Criteria of size



Source: CBK (2020)

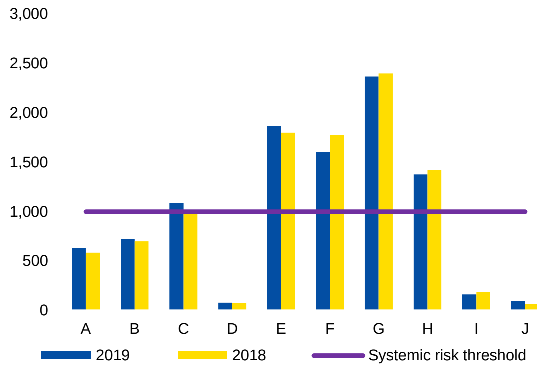
Criterion of substitutability– Substitution criterion - five banks of general systemic importance turned out to be systemically important in the criterion of substitutability. The degree of systemic importance in this criterion extends from 1,088 base points to 2,378 base points (chart 103).

Most banks have marked an increase in the systemic rate in this criterion in comparison to last year; however, that was more evident in banks which did not turn out to be of general systemic importance. This was evidenced in each of the subcategories. In general, the aggregate rate of points in non-systemic banks increased compared to the aggregate decline of points in banks of general systemic importance. This trend was observed in the sub-categories of lending to non-financial corporations and households, household

[45] 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".

deposits, as well as participation in interbank transactions - where there was a faster growth in small banks compared to the growth rate in large banks.

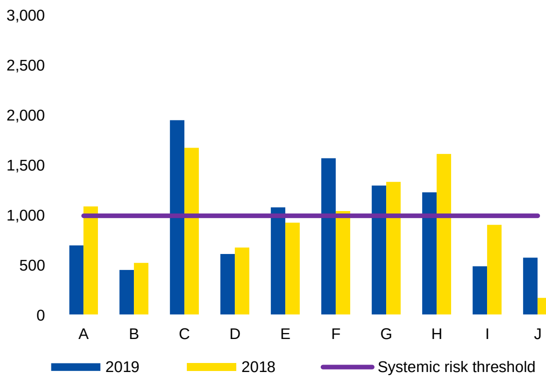
Chart 103. Criteria of substitutability



Source: CBK (2020)

Criterion of interconnectedness – This criterion is characterized by the largest fluctuations as banks can easily change their balance sheet with financial institutions, as well as investments in securities. In December 2019, five banks of general systemic importance resulted in systemic importance in the criterion of interconnectedness.

Chart 104. Interconnectedness criteria

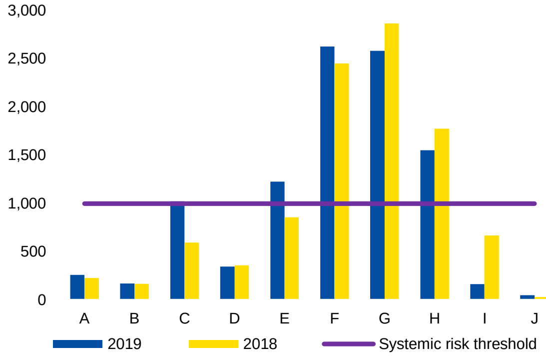


Source: CBK (2020)

The degree of systemic importance in this criterion extends from 1,083 base points to 1958 base points (chart 104). Banks of general systemic importance increased the points ratio significantly compared to the decrease of the points ratio of banks which did not turn out to be of general systemic importance. This came as a result of more pronounced interaction with banks and institutions abroad by large banks, compared to the lower level among small banks.

Criterion of inter-state activity and complexity – The five banks of general systemic importance have turned out to be of systemic importance in the criterion of interstate activity. The degree of systemic importance in this criterion extends from 1,021 base points to 2,626 base points (chart 105).

Chart 105. Criteria of interstate activity and complexity



Source: CBK (2020)

Compared to the previous year, the degree of systemic importance has increased as a result of the increase of liabilities to the external sector by banks of general systemic importance, mainly in the form of deposits to non-residents and credit lines.

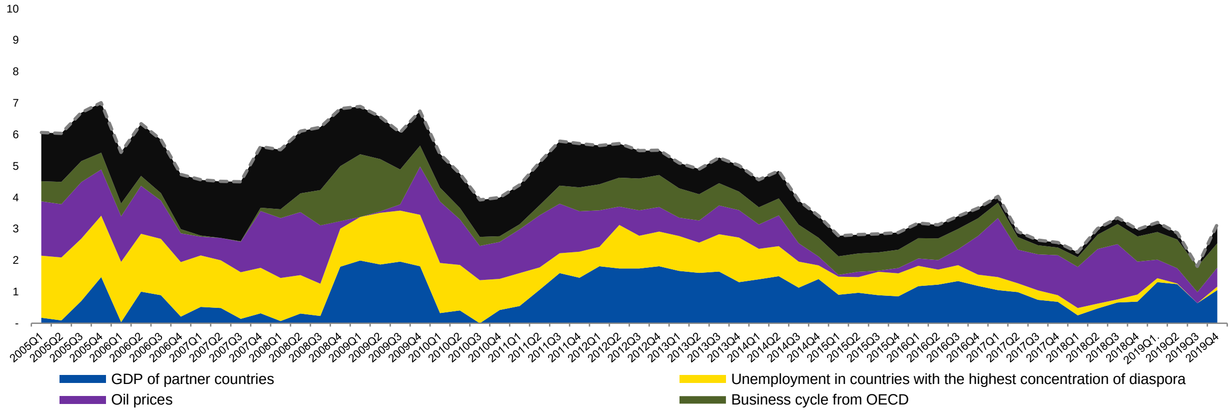
It should be noted that the sector has proven over the years that it is quite well capitalized and the application of capital supplements for systemically important banks, on Tier 1 capital as recommended by Basel and ABE, would not exceed the current level of regulatory capital of the banking sector in Kosovo.

Therefore, the model currently serves only to monitor the dynamics of systemic importance and more informed and adequate supervision of institutions in accordance with their systemic importance, and does not represent a recommendation for applying the capital supplement for institutions of domestic systemic importance.

9. Statistical Appendix

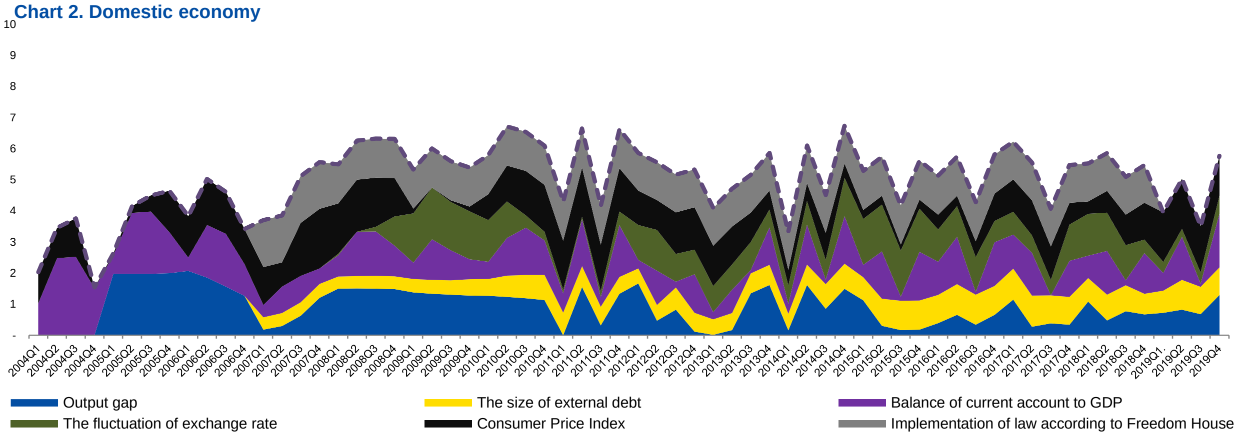
Appendix 1. Financial Stability Map – Dynamic of risk change of indicators and contribution to the risk of the appropriate components

Chart 1. External economy



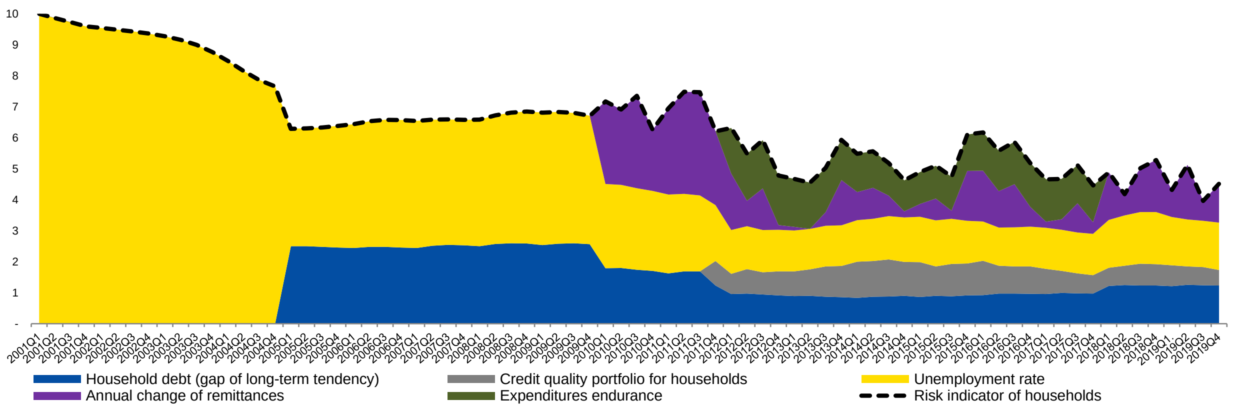
Source: CBK (2020)

Chart 2. Domestic economy



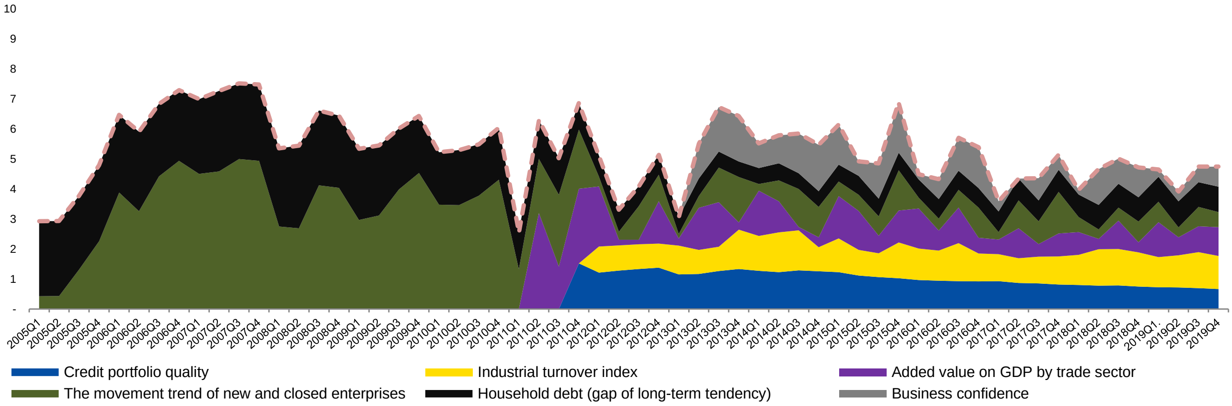
Source: CBK (2020)

Chart 3. Households



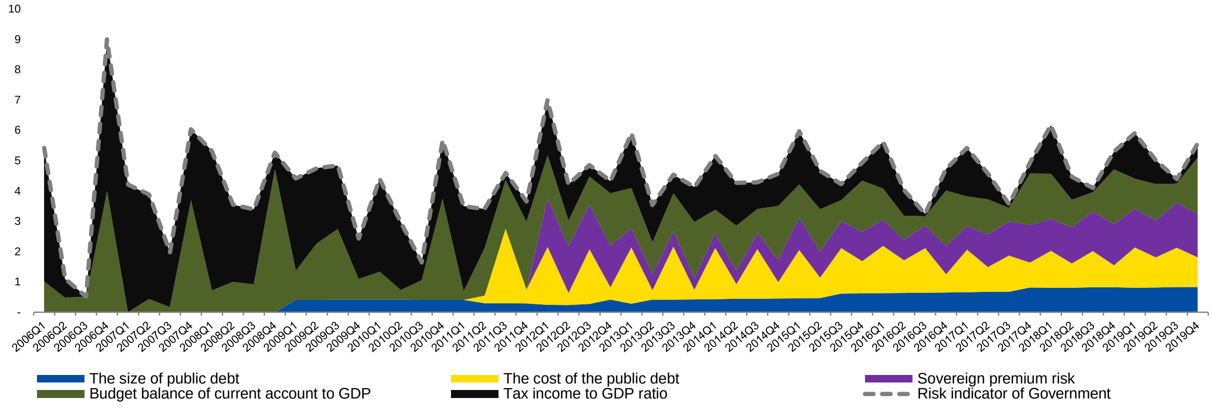
Source: CBK (2020)

Chart 4. Enterprise Sector



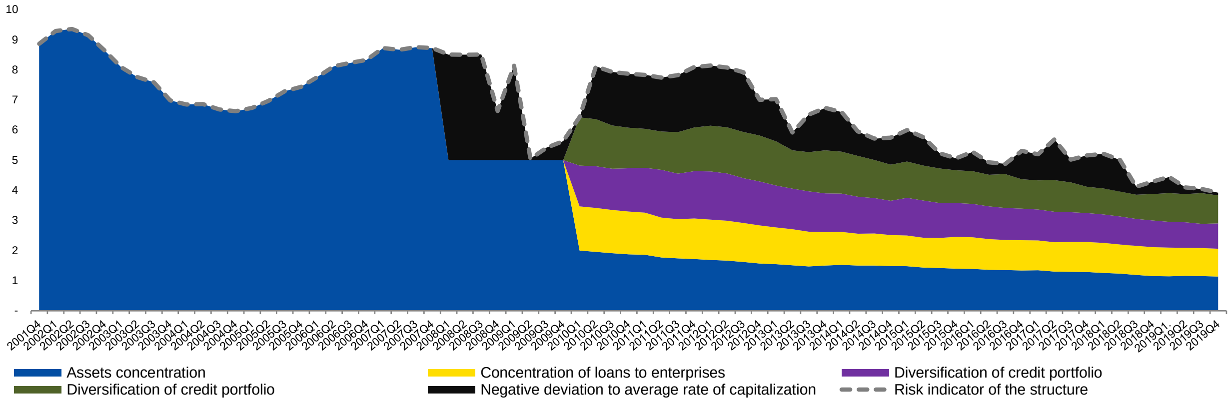
Source: CBK (2020)

Chart 5. Government Sector



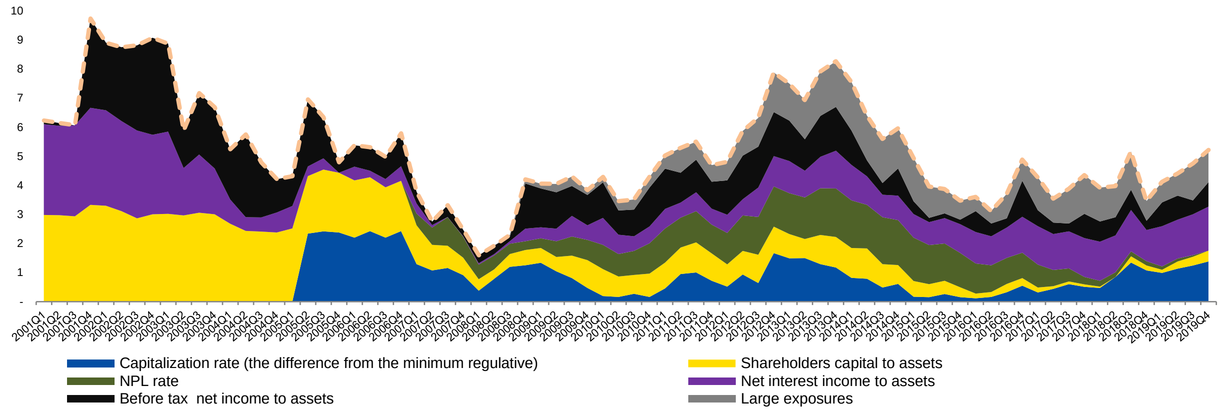
Source: CBK (2020)

Chart 6. Structure of the Banking Sector



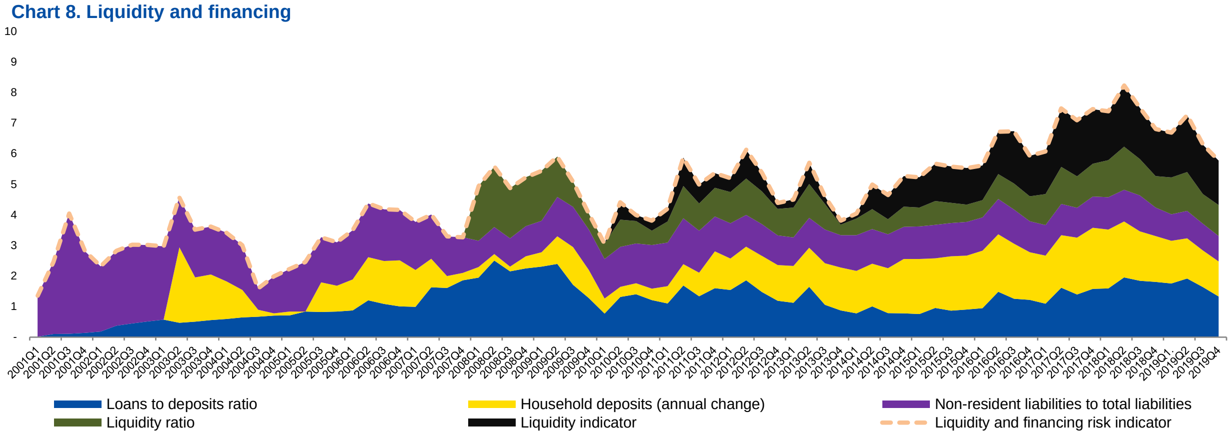
Source: CBK (2020)

Chart 7. Capitalization and profitability



Source: CBK (2020)

Chart 8. Liquidity and financing



Source: CBK (2020)

Table 1.Financial soundness indicators, in percentage

Banking sector	Core set	December 2016	December 2017	December 2018	December 2019
Capital Adequacy	Regulatory capital to risk-w eighted assets	**17.9**	**18.1**	**17.0**	**15.9**
	Regulatory Tier I capital to risk-w eighted assets	**15.9**	**16.2**	**15.5**	**14.2**
	Nonperforming loans net of provisions to capital	**2.2**	**1.2**	**1.5**	**1.5**
Assets quality	Nonperforming loans to total gross loans	**4.9**	**3.1**	**2.7**	**2.0**
Sectoral distribution of loans to total loans	*Other financial corporations*	**0.4**	**0.2**	**0.2**	**0.2**
	Public nonfinancial corporations	**0.00**	**0.00**	**0.00**	**0.00**
	Other nonfinancial corporations	**63.9**	**63.6**	**63.4**	**63.3**
	Households	**35.7**	**36.2**	**36.3**	**36.4**
	NPISH	**0.02**	**0.01**	**0.01**	**0.03**
	Nonresidents	**0.02**	**0.02**	**0.01**	**0.03**
	Total	**100.0**	**100.0**	**100.0**	**100.0**
Earnings and profitability	Return on assets (ROA)*	**2.4**	**2.8**	**2.3**	**2.1**
	Return on equity (ROE)*	**19.9**	**22.1**	**18.3**	**17.2**
	Interest margin to gross income	**68.1**	**65.1**	**78.4**	**80.6**
	Noninterest expenses to gross income	**49.6**	**45.3**	**48.2**	**48.1**
Liquidity	Liquid assets (core) to total assets	**26.3**	**25.4**	**29.0**	**28.8**
	Liquid assets (broad) to total assets	**31.7**	**30.1**	**23.8**	**23.3**
	Liquid assets (core) to short-term liabilities	**34.5**	**32.2**	**31.7**	**31.2**
	Liquid assets (broad) to short-term liabilities	**41.5**	**38.2**	**40.0**	**38.7**
Sensitivity to market risk	Net open position in foreign exchange to capital	**4.4**	**1.2**	**3.8**	**4.7**
	Encouraged set				
	Capital to assets	**12.1**	**12.6**	**12.2**	**11.2**
	Large exposures to capital	**66.9**	**81.7**	**65.9**	**81.8**
	Personnel expenses to noninterest expenses	**36.4**	**40.3**	**44.0**	**43.5**
	Spread betw een reference lending and deposits rates	**6.0**	**5.5**	**4.5**	**4.8**
	Customer deposits to total (noninterbank) loans	**125.8**	**119.5**	**122.8**	**129.2**
	Foreign-currency-denominated liabilities to total liabilities	**4.1**	**3.9**	**5.0**	**4.4**

*Net income before tax is considered.
Guide: Financial Soundness Indicators, Compilation Guide, IMF (2006)

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