



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

Financial Stability Report

Number 17

This page is intentionally left blank

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

Financial Stability Report

Number 17

January - December 2020

This page is intentionally left blank

PUBLISHER

© Central Bank of the Republic of Kosovo
Economic Analysis and Financial Stability Department
33 Garibaldi, Prishtina 10000
Tel: +383 38 222 055
Fax: +383 38 243 763

Website

www.bqk-kos.org

Email address

economic.analysis@bqk-kos.org

This page is intentionally left blank

ABBREVIATIONS:

ATM	ATM (<i>Automated Teller Machine</i>)
BSSI	Banking Sector Stability Index
CAR	Capital Adequacy Ratio
CBK	Central Bank of the Republic of Kosovo
CEE	Central and Eastern Europe
CIS	Commonwealth of Independent States
DFI	Direct Foreign investments
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
GDP	Gross Domestic Product
HHI	Herfindahl-Hirschman Index
IMF	International Monetary Fund
KAS	Kosovo Agency of Statistics
KCC	Kosovo Chamber of Commerce
KCGF	Kosovo Credit Guarantee Fund
KPST	Kosovo Pension Savings Trust
MFIs	Micro Finance Institutions
MoF	Ministry of Finance
MTA	Money Transfer Agencies
NFA	Net Foreign Assets
NIM	Net Interest Margin
NPISH	Non-Profit Institutions Serving Households
NPL	Nonperforming loans
ODC	Other Depository Corporations
POS	Point of Sales
pp	Percentage Points
PTK	Post and Telecommunications of Kosovo
RAE	Return on average equity
RLI	Rule of Law Index
ROAA	Return on average assets
ROE	Return on Equity
RWA	Risk Weighted Assets
SDR	Special Drawing Rights
SEE	South-eastern Europe
TPL	Third Party Liability
VAT	Value added tax

Note: Users of the data are required to cite the source.
Suggested citation: Central Bank of the Republic of Kosovo (2021),
Financial Stability Report No. 17, Prishtina.
Any needed correction will be made in the electronic version.

This page is intentionally left blank

CONTENTS:

1. Governor's Foreword -----	13
2. Summary of main risks and developments of financial stability -----	14
Box 1. Financial Stability Map -----	21
3. The external environment and developments in the domestic economy -----	24
3.1. Domestic economy -----	24
3.2. Financial position of enterprises -----	27
3.3. Financial position of households -----	30
4. Developments in the financial system -----	32
Box 2. Withdrawal of 10 percent of funds from the Kosovo Pension Savings Trust -----	32
4.1. Banking activity -----	37
Box 3. Bank Lending Survey -----	41
5. Risks of the banking sector -----	46
5.1. Credit risk -----	47
Box 4. Measures taken by the CBK to address the challenges posed by Covid-19 -----	48
Box 5. International Financial Reporting Standard (IFRS 9) and the provisioning of losses -----	50
5.2. Sustainability of profit and interest rate risk -----	55
5.3. Risk from the position in foreign currency -----	57
5.4. Capital -----	58
5.5. Financing and Liquidity Risk -----	61
5.6. Shock Absorption Capacity - stress-test analysis -----	64
6. Non-bank financial institutions -----	70
6.1 Pension Sector -----	70
6.2 Insurance Sector -----	72
6.3. Microfinance and financial auxiliaries sector -----	76
7. Financial infrastructure in Kosovo -----	81
7.1. Payment system -----	81
8. Macroprudence framework -----	84
8.1. Summary of developments in selected macroprudential indicators -----	84
8.2. Countercyclical Capital Buffer -----	84
8.3. Systemically important banks -----	86
9. Statistical Appendix -----	90

This page is intentionally left blank

LIST OF CHARTS AND FIGURES

Chart 1. Debt of enterprises and households	16
Chart 2. Annual change of new loans	16
Chart 3. Selected indicators of financial soundness	18
Graph 4. Financial stability map	22
Chart 5. Financial stability map	23
Chart 6. Real GDP growth rate and contributors to the growth	25
Chart 7. Index of sales and employees in the services sector	25
Chart 8. Inflation rate, annual change	26
Chart 9. Industrial turnover index	28
Chart 10. Retail trade turnover index	28
Chart 11. Annual change in the number of new enterprises	28
Chart 12. Enterprises debt	28
Chart 13. Loans approved and guaranteed by KCGF	29
Chart 14. Interest rates for enterprises	30
Chart 15. Households debt	30
Chart 16. Household deposits	31
Chart 17. Interest rates for households	31
Chart 18. The weight of financial system sectors to GDP	32
Chart 19. The share of respective sectors to total financial system assets	34
Chart 20. Ownership of financial system constituent sectors	35
Chart 21. Assets structure of the banking sector	37
Chart 22. Structure of liabilities and own resources of the banking sector	38
Chart 23. Stock of total deposits and new deposits	38
Chart 24. Net position to non-residents	39
Chart 25. Contribution of items to annual change of activity with non-residents	39
Chart 26. Annual growth of loans to enterprises and households	39
Chart 27. Stock of total loans and new loans to households and enterprises	39
Chart 28. Stock of loans by economic sectors	40
Chart 29. Loans to enterprises, share by maturity	40
Chart 30. Loans to household, share by maturity	41
Chart 31. Bank's credit standards applied when assessing credit applications of enterprises	41
Chart 32. Terms and conditions applied for loans to enterprises	42
Chart 33. Enterprises demand for loans	42
Chart 34. Banks credit standards applied when assessing households credit applications	43
Chart 35. Terms and conditions applied for loans to household	43
Chart 36. Household demand for loans	44
Chart 37. Change of credit standards and demand for loans, by maturity	44
Chart 38. Change of the banking sector financing	45
Chart 39. Aggregate index of the banking sector stability	46

Chart 40. Stability index of the banking sector, by risk criteria -----	46
Chart 41. Annual growth of loans stock and nonperforming loans -----	47
Chart 42. Restructured loans, by phases -----	47
Chart 43. Loans by new credit classification in three pillars-----	48
Chart 44A. Structure of loans classified by overdue payments, old method -----	49
Chart 44B. Structure of loans classified by overdue payments, new method-----	49
Chart 45. Nonperforming loans-----	52
Chart 46. NPL ratio to loans stock, by sectors-----	52
Chart 47. Share of restructured loans to total loans in the respective sectors-----	53
Chart 48. NPL to total loans ratio in the region countries -----	53
Chart 49. Annual change of NPL stock and coverage with provisions -----	54
Chart 50. Concentration of credit risk-----	54
Chart 51. Profit structure of the banking sector -----	55
Chart 52. Main contributors to the growth/decline of the profit -----	55
Chart 53. Interest revenue and expenses -----	55
Chart 54. Non-interest income and expenses -----	56
Chart 55. Income structure of the banking sector-----	56
Chart 56. Structure of the banking sector expenses -----	56
Chart 57. Profitability indicators of the banking sector-----	57
Chart 58. Assets and liabilities sensitive to interest rates-----	57
Chart 59. Opened positions in foreign currency to Tier 1 capital-----	58
Chart 60. Loans and deposits in foreign currency -----	58
Chart 61. Banking sector capitalization -----	58
Chart 62. Contribution of regulatory capital and RWA to capitalization ratio-----	59
Chart 63. Structure of regulatory capital -----	59
Graph 64. Leverage rate-----	60
Chart 65. RWAs to total assets ratio -----	60
Chart 66. Credit risk weighted assets-----	60
Chart 67. Asset classification by risk weight -----	60
Chart 68. RWA structure for credit risk, by risk weight -----	61
Chart 69. Structure of financing -----	61
Chart 70. Increase of banking sector loans and deposits-----	61
Chart 71. Structure of deposits -----	62
Chart 72. Structure of deposits, by maturity-----	62
Chart 73. Maturity structure of deposits and loans -----	63
Chart 74. Liquidity indicators-----	63
Chart 75. Liquidity reserves -----	64
Chart 76. Liquidity gap -----	64
Chart 77. Capital Adequacy Ratio -----	66
Chart 78. Stress test results for credit risk-losses and recapitalization-----	67

Chart 79. ST results for liquidity risk - scenario 1 -----	69
Chart 80. ST results for liquidity risk - scenario 2-----	69
Chart 81. Assets of the pension sector-----	70
Chart 82. Structure of pension sector investments-----	70
Chart 83. Contributions collected by pension funds-----	71
Chart 84. Financial performance of the Kosovo Pension Savings Trust -----	71
Chart 85. Financial performance of the Slovenian-Kosovo Pension Fund -----	72
Chart 86. Development indicators of insurance sector -----	72
Chart 87. Structure of assets of insurance sector, by ownership -----	73
Chart 88. Assets of insurance sector -----	73
Chart 89. Structure of assets of insurance sector -----	73
Chart 90. Liabilities and capital of insurance sector-----	74
Chart 91. Gross collected premiums-----	74
Chart 92. Received premiums and claims paid -----	76
Chart 93. Assets of microfinance sector -----	77
Chart 94. Structure of assets of microfinance sector -----	77
Chart 95. Loans to economic sectors, by maturity-----	78
Chart 96. Structure of loans to nonfinancial corporations, by economic sectors-----	78
Chart 97. Microfinance sector growth rate of loans to nonfinancial corporations -----	78
Chart 98. Microfinance sector leasing -----	79
Chart 99. Average interest rate on microfinance sector loans -----	79
Chart 100. Average interest rate on loans, by economic sectors -----	79
Chart 101. Microfinance sector income and expenses-----	80
Chart 102. Profitability indicators of microfinance sector -----	80
Chart 103. Indicators of credit portfolio quality -----	80
Chart 104. Lending gap -----	86
Chart 105. Countercyclical capital buffer -----	86
Chart 106. General scale of systemic importance -----	87
Chart 107. Criterion of size-----	87
Chart 108. Criterion of substitutability -----	88
Chart 109. Interconnectedness criterion -----	88
Chart 110. Criterion of interstate activity and complexity -----	88
Figure 1. Institutional interconnections of the Kosovo Financial System-----	36
Figure 2. Banking interconnections of the Kosovo banking sector -----	36

LIST OF TABLES

Table 1. Key risks and sustainability of the banking sector -----	15
Table 2. Selected macroeconomic indicators-----	24
Table 3. Debt to banks and performance of households-----	31

Table 4. Number of financial institutions -----	35
Table 5. Loans classification, provisioning and interest accumulation under IFRS 9 -----	51
Table 6. Results of stress test scenarios for credit risk-----	68
Table 7. Assumptions for liquidity risk scenarios-----	68
Table 8. Stress test scenario results for liquidity risk -----	69
Table 9. Gross written premiums by business classes -----	75
Table 10. Claims paid, by business classes -----	75
Table 11. Share of payment instruments to total IPS transactions -----	82
Table 12. Banking sector network -----	82
Table 13. Share of transactions value processed with cards by terminals to total card transactions value -----	83
Table 14. Indicators used to assess the systemic importance of banks in Kosovo-----	87

1. Governor's Foreword

The Central Bank of the Republic of Kosovo (CBK) presents to the public the 17th 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 in the first months of 2020 and the unprecedented economic and social crisis that resulted from efforts to manage the pandemic health crisis were translated into increased risks for economies and external financial markets. Numerous uncertainties that continue to accompany the potential end of the pandemic as a result of the difficulties with mass vaccination and the effectiveness of monetary, fiscal and financial packages to support the recovery may further undermine the stakeholders trust in the markets in the months to come.

The economic shock triggered by the Covid-19 pandemic turns out to be the highest ever in Kosovo's economy. Similar to the global dynamics, the economic recovery from this shock is subject to many uncertainties related to the duration of the pandemic and the chain effects of the persistence of the health crisis and political dynamics which have a direct effect on the effectiveness of the recovery plan.

The economic shock effect on the financial performance of economic agents poses the main risk to the financial system and its stability. Fiscal and financial measures taken by the Government of the Republic of Kosovo and the Central Bank of the Republic of Kosovo (CBK) have mitigated the immediate effect of the pandemic on the macroeconomic environment and financial stability.

In terms of dealing with the pandemic crisis, in 2020, the CBK has adapted the regulatory framework and taken prudential decisions in order to maintain financial stability and support borrowers and the country's economy.

However, in the medium term, there was an increase of vulnerabilities in financial stability as a result of growing debt levels and weakened solvency of the private sector and dynamics that are expected to be reflected in increased credit risk in the next period.

The banking sector soundness indicators in 2020 remained at high levels, which is comparable to the previous year, without any deterioration due to the pandemic crisis. Similarly, the liquidity position of the banking sector remained favourable, with an increase in key liquidity indicators in the reporting period.

In terms of financial system, the pension sector and the microfinance sector were characterized by a slowdown in activity, related to the negative effects that are mainly attributed to the Covid-19 pandemic. During this period, the banking sector, insurance sector and financial auxiliaries sector recorded an activity growth.

The CBK has continued its work in the field of macroprudence, by monitoring developments in macroprudential indicators in Kosovo. In order to promote financial stability, 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 enhanced actions in maintaining financial stability.

Fehmi MEHMETI

Governor

2. Summary of main risks and developments of financial stability

The spread of the Covid-19 pandemic has significantly increased the risks to financial stability. The economic shock triggered by the outbreak of pandemic was the highest ever in Kosovo's economy, and the recovery is being accompanied by many uncertainties related to the duration of the pandemic, the extent of preventive measures, as well as the effectiveness of measures in the economic recovery plan. The effect of the economic shock on the financial performance of economic agents poses the main threat to the financial system and its stability. The measures taken by the government as well as the Central Bank, in line with the measures taken globally, have mitigated the transmission of the immediate effect of the pandemic on the financial system. However, in the medium term, vulnerabilities in financial stability have grown due to the weakening of the solvency of the private sector, respectively the decline in turnover and household revenue level. Therefore, the aforementioned dynamics are expected to be reflected in an increased credit risk

Persistent uncertainties concerning the pandemic have increased the risks to the financial system and its stability. Restriction of citizens' movement and discontinuation of the regular operation of enterprises have affected and continue to affect their ability to generate revenue, which is expected to create difficulties in meeting financial obligations and increased lending. The impact is asymmetric between economic sectors, where certain sectors such as services sector have been affected more, which is also demonstrated by the turnover data of this sector and restructured loans. This situation has also affected employees and household revenues, as the decline in enterprises' activity has contributed to increased unemployment and

reduced revenue levels, which to some extent has been compensated by higher rate of diaspora remittances. Government aid measures as well as CBK regulatory easing, which were undertaken in a timely manner and in line with the relief measures undertaken globally, helped support the economy and maintain the stability of the financial system. The banking sector entered the phase of a pandemic with high levels of financial soundness indicators that it created over the years. Therefore, despite the decline in revenue of the sector affected by the slowdown in lending activity, relief measures / restructuring, increasing of non-performing loans, as well as higher provisioning expenses-financial soundness indicators remain at high levels for absorption of potential losses.

The internal and external macroeconomic environment was characterized by a significant increase in risks as a result of the Covid-19 pandemic, which were reflected in unfavourable developments for the financial system. The economic outlook and its impact on the financial system continue to be affected by a high degree of uncertainty, which is related to the duration of the pandemic. Measures taken to prevent the spread of the pandemic have led to a significant decline in economic activity in 2020 in all Eurozone member states and in the economies of the Western Balkan countries. The economy of the Eurozone, the main trading partner of Kosovo and the country with the highest origin of remittances, in 2020 has decreased by an average of 6.6 percent. The Western Balkans was characterized by an average economic decline of 5.6 percent, which was more pronounced in countries such as Montenegro and Bosnia and Herzegovina. Kosovo's economy, which is highly dependent on the diaspora and the export of travel services from diaspora visits to Kosovo, was significantly affected by the spread of the pandemic. The decline in investment as well as the decline in export services were the dominant components with an impact on the 3.9 percent decline in economic activity in 2020.

Table 1. Key risks and sustainability of the banking sector*

Risks	2018	2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020	Risk trend
Risks							
Macroeconomic risk	High risk	Average risk	Average risk	High risk	High risk	High risk	↓
Credit risk	Average risk	Average risk	Average risk	Average risk	Average risk	Average risk	↑
Income risk (profitability)	Low risk	Average risk	Average risk	Average risk	Average risk	Average risk	↑
Banking sector sustainability							
Capitalization	Low risk	Low risk	Low risk	Low risk	Low risk	Low risk	↓
Liquidity and financing	Low risk	Low risk	Low risk	Low risk	Low risk	Low risk	↑
	High sustainability Low risk	Average sustainability Average risk	Low sustainability Above average risk	Very low sustainability High risk			

Source: CBK.

* The methodology of building the table of risk and sustainability of the banking sector is based in part on the methodology of the Financial Stability Map of Kosovo (according to which the value of the relevant key indicators is scored in relation to its history) as well as the assessment and judgment of analysts.

The direction of the arrow suggests the risk / stability trend in the last period (last quarter), as well as the expectations for developments in the following one-year period.

The economic downturn caused by the Covid-19 pandemic represents the biggest challenge ever experienced in Kosovo's economy. Following the easing of restrictive measures taken in the second quarter, the pandemic continued to spread more rapidly in Kosovo in the second half of 2020 and 2021, increasing uncertainties about economic activity and consequently, financial system prospects.

The economic activity in Kosovo decreased by 1.3 percent in the first quarter, and by 9.3 percent and 7.3 percent, respectively, in the following quarters. In the fourth quarter, economic activity increased by 0.7 percent. KAS preliminary estimates for average GDP growth in 2020 suggest a decline of 3.9 percent. Economic activity is expected to recover towards pre-crisis levels, i.e. annual growth of 4.3 percent during 2021, but these expectations are subject to major uncertainties related to the duration of the pandemic and the degree of restrictive measures, vaccination program, economic recovery of EU countries, the effectiveness of the economic recovery plan, as well as the ability of the private sector to adapt business models to the new circumstances. Prolonged pandemic situation

increases the risk of economic recovery given the narrowing of fiscal space to support growth, as a result of lower revenues and higher expenditures in 2020 to mitigate the immediate effects of the pandemic crisis.

Government measures to address the crisis caused by the Covid-19 pandemic have increased the budget deficit as well as public debt. Budget revenues recorded an annual decline of 8.8 percent while expenditures increased by 6.5 percent. As a result, the budget deficit reached 7.2 percent of GDP. The public debt was characterized by an increase of 23.9 percent, which amounted to EUR 1.5 billion. GDP percentage wise, public debt reached 21.8 percent compared to 17.5 percent in December 2019. The increase in public debt is attributed to the increase in domestic debt of 21.5 percent (which reached EUR 961.9 million), and the increase in external public debt of 28.6 percent amounting to EUR 525.8 million.

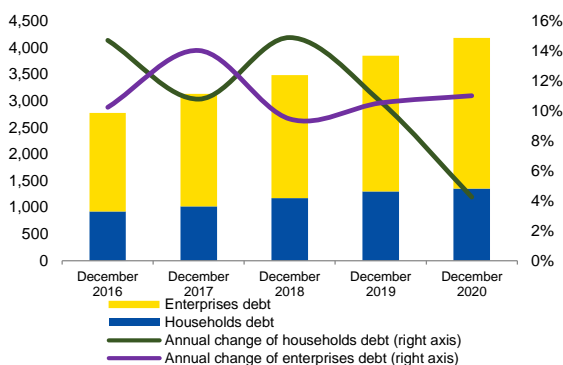
The upward trend of domestic debt of the private sector has slowed down, influenced by the slowdown in credit growth, while the external debt to enterprises has increased. Covid-19 pandemic halted the trend of double-digit

* The methodology for creating the risk table is based on the methodology of the Financial Stability Map of Kosovo. The table additionally includes the indicator of Credit Developments and that of Exposures. The Credit Developments Indicator includes sub-indicators such as: Credit -to- GDP gap, Growth of Private Sector Lending, Private Sector Lending to GDP ratio, and growth in specific sectors such as enterprises and households. While,

in the calculation of the Sustainability of the banking sector, in addition to the indicators of the Financial Stability Map, the Exposure indicator has been added, which measures the banking sector exposures to government securities, foreign currency loans, the share of non-residents' liabilities and open positions in foreign currency.

growth in private sector lending. The stock of enterprise loans from the banking sector reduced the growth to 7.2 percent from 9.8 percent a year earlier, mainly as a result of halving the growth of new loans to 4.4 percent (9.7 percent increase in 2019). Enterprise loans from other financial intermediaries, which have a low share in total loans, decreased by 1.9 percent. While the external debt of enterprises has increased by 26.0 percent, reaching 25.0 percent of total debt from 22.0 percent in 2019.

Chart 1. Debt of enterprises and households, in millions of EUR



Source: CBK.

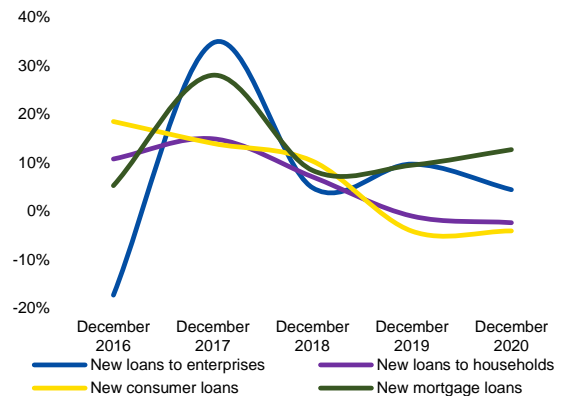
Banking sector loans to households slowed the growth to 7.1 percent from an annual growth of 10.4 percent a year earlier, as a result of the annual decline of 2.4 percent in new loans. While, loans from other financial institutions and external debt decreased by 9.2 percent and 19.9 percent respectively. In order to support the continuation of lending to the economy by the banking sector, operational and regulatory relief measures have been taken by the CBK, as well as support measures for access to finance. The role of the Kosovo Credit Guarantee Fund (KCGF) has been further strengthened and has a key role to play in the economic recovery plan.

According to the Bank Lending Survey,² the dynamics of lending activity to enterprises and households in the first half of the year was negatively affected by both supply and demand for credit, while in the second half of the year supply and demand improved. The main

² The Bank Lending Survey is conducted by the CBK to better explain and understand the dynamics of lending in the country. For more information,

factors that contributed to the improvement of credit supply were the support of enterprises by KCGF, the improvement of the outlook in global markets, as well as the relief measures taken to manage the effects of the pandemic (restructuring).

Chart 2. Annual change of new loans



Source: CBK.

Demand for loans improved, but with larger differences between segments. Among enterprises, demand from corporations declined, while for SMEs it increased to a degree sufficient to finance operating needs. Demand from households increased, but more pronounced for mortgage loans compared to consumer loans. Banks' expectations for lending dynamics in Q1 2021 were optimistic, under the assumptions of lending support by KCGF as well as economic recovery. However, banks reported increased risks in the operating environment of enterprises and households, and consequently increased credit risk.

The financial position of enterprises and households has deteriorated as a result of the Covid-19 pandemic. Increased weaknesses of the private sector and the progress of its recovery are expected to affect the risks to the banking sector.

Restrictive measures to contain the pandemic have affected the performance of enterprises, with a more pronounced impact on certain sectors such as services, construction and trade. Enterprises financial position indicators have deteriorated. The annual turnover of enterprises, according to reports in the Tax

the full report of the Bank Lending Survey and Inflation Expectations can be found on the CBK website, while a summary of it can be found in Box 3.

Administration of Kosovo, has decreased by 9.5 percent. Short-term statistics from KAS show a decrease in the industrial production volume index, the retail trade turnover index, as well as the services sector activity index. The financial position of households has also been affected. Unemployment has deepened further. The decline in enterprise revenues has contributed to the decline in revenues of employees in the private sector³, who have worked reduced hours or were forced to take unpaid leave.⁴ On the other hand, remittances have increased significantly in this period, as a contribution to the aggravated situation of households. The transfer of the effects of such deterioration of the financial position of the private sector to the banking sector has been managed in the short term through a moratorium and loan restructuring, and to a lesser extent through government assistance to the private sector. The household sector, despite the higher credit growth recorded in recent years, has been less sensitive to the pandemic crisis, judging by the need for loan restructuring. This is due to the fact that a large part of households have no debts to the financial sector (judging by the relatively low level of household loans to GDP of 19.6 percent, as well as from responses of households to an internal purpose survey commissioned by the CBK in March 2021, according to which 60.3 percent of respondents stated that they do not have loans), and the share that does may have been more concentrated towards workers with more stable public sector revenues and employees. This, together with remittances, savings in the form of deposits, and early withdrawal of funds from the Pension Trust, may have reduced the sensitivity of the household sector. However, the extension of the pandemic crisis in 2021 increases the risk of economic activity recovery and further increases the risk of declining debt solvency of the private sector.

The slowdown in lending activity and the increase in demand for provisioning

affected the slight decline in the performance indicators of the banking sector. The profit of the banking sector of Kosovo recorded an annual decline of 7.4 percent, mainly influenced by the increase in expenses for loan loss provisioning. Revenues were characterized by slower growth, while all categories of expenditures, except interest expenses, increased. The average return on assets and capital of the Kosovo banking sector dropped to 1.8 percent and 15.6 percent, respectively, from 2.2 and 18.9 percent in the previous year. The decline in the level of profit and profitability indicators of the sector was lower than the decline in the countries of the region, increasing the difference above the regional average of Kosovo's banking sector. Subsequently, banking sector revenues are expected to face pressure caused by the Covid-19 pandemic crisis. Weakening customers' solvency as well as the increased need to allocate expenses for provisioning to cover potential losses can affect both declining sector revenues and rising expenses.

The credit risk of the banking sector was characterized by the most significant increase as a result of the Covid-19 pandemic. The quality of the loan portfolio has started to deteriorate, reflected through the migration of loans from the first pillar with the highest quality credit classification towards the second pillar. The full materialization of the increase of credit risk in the balance sheet of banks, however, has been avoided through easing measures taken by the CBK, namely the moratorium, the suspension of regulatory provisions on provisioning and regular credit classification, as well as the restructuring of loans. The non-performing loan rate changed the downward trend it had in the last six years, rising to 2.7 percent in December 2020, from a historic low of 2.0 percent at the end of 2019. The increase is initially attributed to the methodological change in the rating of

³ In a survey, for domestic purposes commissioned by the CBK, for households in March 2021, 31.1 percent of respondents reported a decline in household revenue as a result of the crisis caused by Covid-19,

⁴ Kosovo Business Pulse Survey (World Bank Business Pulse Survey)

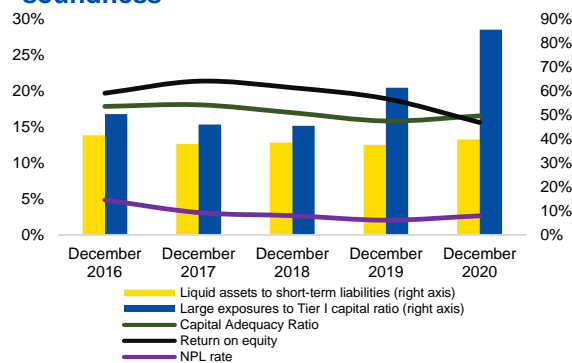
credit risk⁵ according to IFRS 9. As a result of this change, the NPL rate rose to 2.5 percent in February 2020. Subsequently, the increase in NPLs reflects the increased risk driven by the pandemic situation. The stock of non-performing loans at the end of the year recorded an annual increase of 39.8 percent and reached the value of EUR 85.9 million (from EUR 61.5 million in 2019). The request for loan restructuring, i.e. extension of the payment deadline as of June 2020 was 63.2 percent of total loans, 40.9 percent of which were approved. The percentage of restructuring at this stage was higher due to the aggravated economic situation of borrowers caused as a result of the total closure of the economy. While in the second phase of restructuring, which began in June, the percentage of restructured loans was lower, respectively at 11.5 percent of total loans in December 2020. The effects of the increased risk of the Covid-19 pandemic on the NPL rate are expected to be felt after the restructuring relief measures have been lifted, respectively at the end of 2021 when the relief measures of all restructured loans mature. Despite the very high expenses of provisioning in this period, the provisioning coverage ratio of the sector has decreased to 139.4 percent from the coverage of 163.5 percent in December 2019.

The banking sector entered the pandemic phase with satisfactory levels in key indicators of its health and financial performance, which continue to remain at high levels despite rising risks. The capital adequacy ratio increased by 0.7 percentage points to 16.5 percent, mainly as a result of capital increase (retained earnings). The CBK, as a preventive measure against the possible effects of the Covid-19 pandemic crisis on the capital position, had recommended not distributing the dividend to the banking sector.

The capitalization rate was higher for banks of systemic importance, but the difference between the individual bank rate and the sector average for banks below average has

reduced in this period. The good capitalization position of the sector is also reflected in the high share of Tier 1 capital of 88.7 percent, which fully consists of Tier 1 capital. The ratio of Tier 1 capital adequacy to risk weighted assets stood at 14.7 percent

Chart 3. Selected indicators of financial soundness



Source: CBK.

The continuation of the pandemic situation, however, is expected to increase the pressure on the sector's revenues, its profitability and the level of capital, as a result of the effect of the crisis on the country's economy and credit risk. Stress test analysis suggests that the sector is generally resistant to the more severe expected loss scenarios, with more pronounced sensitivity at the level of some banks which may face challenges in maintaining the level of capital at the required regulatory level.

The liquidity position of the banking sector remains favourable, characterized by an increase in key liquidity indicators.

The pandemic-induced crisis caused immediate pressure on liquidity management by the banking sector, however, as a result of the favourable liquidity position prior to the pandemic crisis, the sector found itself well covered and with sufficient reserves to overcome the immediate risk of crisis, as well as to continuously support the banking activity in the country. In order to better manage the situation, the CBK has accelerated the issuance of regulation on intraday and overnight loans, which banks can borrow from CBK in case of their difficulties in accessing short-term liquidity. On this occasion, the

⁵ Regulation on Credit Risk Management, April 2019.pdf (bqk-kos.org)

necessary preparations and technical developments were made for the execution of these instruments in case of need, although the level of liquidity in the banking sector has proven to be high and has faced the situation without the need for any special intervention by the CBK.

Liquid asset to short-term liabilities ratio improved to 39.8 percent compared to 37.6 percent in December 2019. Also, the ratio of liquid assets to total assets increased to 30.1 percent. Liquidity reserves of commercial banks continue to be at high levels, exceeding the required reserve held at the CBK by 82.3 percent. Deposits, which in December 2020 accounted for 81 percent of funding sources, recorded an annual increase of 12 percent, mainly due to the increase in transferable household deposits, driven by higher savings as a result of increased uncertainty, the withdrawal of 10 percent of pension savings and the higher level of remittances.

Uncertainties related to the duration of the pandemic, the vaccination program, and the level of government restrictive measures to protect against the spread of the virus remain present, and pose a challenge to the country's economy. In such circumstances, deposits are expected to slow growth as a result of the pandemic effect on the employment market and declining revenues, as well as in slowing down the economic activity of enterprises which will use the available funds to cover their liquidity needs.

CBK, although more limited in the spectrum of mechanisms for direct injection of liquidity in the market (in the absence of monetary policy, the CBK has at its disposal the Emergency Liquidity Fund instrument for direct injection of funds into the banking sector), it can meet potential liquidity needs through other mechanisms such as liquidity reserve management, interbank liquidity agreements as well as financing by parent banks.

The pension sector was characterized by the sharpest growth slowdown since its start of operation (2004), due to lower growth of new receivables and lower return on investment affected by the pandemic crisis, as well as premature withdrawal of 10 percent of trust funds from contributors. The assets of the sector recorded an annual increase of 1.2 percent, and reached the value of EUR 2.0 billion. New receivables halved the growth rate to 4.1 percent from 8.1 percent a year earlier, as a result of the effects caused by the spread of the Covid-19 pandemic, especially at the onset of the pandemic, when all non-essential enterprises activities were closed and movement restricted. Return on investment recorded an annual decline of 55.4 percent and dropped down to EUR 72.3 million. As a result of the spread of the Covid-19 pandemic, foreign markets suffered a significant decline in the first quarter of the year, where pension funds recorded significant losses. Also, during the second quarter of the year, the stabilization in foreign markets affected the sector to fully recover losses and realize the above positive return at the end of the year. In the framework of the economic recovery plan, the measure of providing the possibility of early withdrawal of 10 percent of pension savings from contributors, valid for application during the period December 2020 - April 2021, was approved. By the end of 2020, about 61.7 percent of contributors withdrew their savings totalling EUR 185.4 million. The withdrawal of funds will affect the performance of assets of the pension sector in 2021, but to a lesser extent.⁶

The insurance sector was characterized by an expansion of assets, a similar level of premiums, and a lower level of claims paid compared to the previous year. The spread of the Covid-19 pandemic had a more pronounced effect on the decline in the level of claims paid as a result of movement restrictions, and therefore had

⁶ According to the economic recovery plan, it is possible to allow the withdrawal of the amount of 10 percent of the funds saved in the pension funds for the contributors, based on their needs, which opportunity can be

used for a period of 4 months. For contributors with total savings below € 10,000, the government will reimburse the amount withdrawn of 10 per cent over a five-year period.

a positive impact on the financial performance of the sector. In 2020, the insurance sector premiums increased by 0.1 percent to EUR 99.3 million, while claims paid recorded an annual decline of 6.6 percent and decreased to EUR 51.5 million. Consequently, claims paid to written premiums ratio decreased by 3.7 percentage points, to 51.8 percent and the sector closed the year with a positive financial result of EUR 4.1 million, compared to a loss of EUR 4.7 million last year. The soundness indicators of the sector also increased, such as: the general level of capitalization, liquidity indicators (the ratio of cash and cash equivalents to reserves and to liabilities), as well as the value of technical provisioning for premiums and claims.

The microfinance sector recorded a significant growth slowdown, influenced by the slowdown in lending and leasing activity, as well as the implications of revoking the license of two microfinance institutions. The dependence of the sector on external sources of financing made the sector sensitive to developments in global financial markets, and therefore the global crisis caused by the Covid-19 pandemic affected the level of financing of the sector. Borrowings from the external sector, which represent the main source of the activity financing, recorded growth slowdown, affected also from the lower demand for financing sector's activity. Lending to the sector recorded an annual decline of 6.8 percent. The decline, which occurred for the first time in the last seven years, reflects not only the shocks to the sector from the Covid-19 pandemic, but also the revocation of the license of two microfinance institutions, whose assets are being deducted from the balance sheet items of the sector. Loans to households, which dominate the loan structure, recorded a more significant decline, respectively 9.2 percent decline compared to the increase of 21.9 in 2019. While non-financial corporate loans were characterized by a slight decline of 1.9 percent compared to 15.3 percent growth in the year 2019.

Interest rates, on average, stood at a similar level. The sector realized a profit at a significantly lower value compared to the trend of the past five years, as a result of lower interest revenue on loans and increased provision expenses. The level of non-performing loans increased to 3.0 percent compared to 2.6 percent in 2019, while their coverage with provisioning reached 142.2 from 117.0 percent in 2019.

The financial auxiliaries sector is the only sector that recorded a significant increase in activity and net profit during this period, as a result of the increase of its main source of revenue, namely transfers from abroad. This sector, with a low share of only 0.2 percent in the total assets of the financial system, consists of exchange bureaus and money transfer agencies (MTAs). Sector's assets recorded an annual increase of 13.2 percent, and net profit increased by 34.2 percent. The increase in sector activity has been influenced by the dynamics associated with the Covid-19 pandemic. Being unable to move as a result of the pandemic, migrants increased their assistance to their family members (remittances reached a record value of close to EUR 1.0 billion), most of which were sent through MTAs.

During 2020, in the face of the pandemic crisis, the CBK has adapted the regulatory framework and taken prudential decisions in order to maintain financial stability and support lenders and the country's economy. At the same time, the processes of advancing the financial infrastructure in support of the development of the financial system have continued. Immediately after the announcement of the pandemic situation, on March 16, 2020, the CBK decided to temporarily suspend the implementation of certain provisions of certain regulations on supervision of lending institutions, as a support against challenges posed by the Covid-19 pandemic to the economy of Kosovo and financial system. The measures taken by the CBK were in line with the emergency measures taken internationally to maintain

financial stability and support the economy and borrowers. These measures generally consisted of issuing a moratorium on loan payments, namely postponing the payment of credit obligations for 3 months; temporary suspension of the application of regular provisions in loan classification and provisioning; as well as permitting / instructing on loan restructuring for borrowers in financial difficulties. Further, the CBK has approved mitigation measures for loan restructuring for borrowers affected by the pandemic situation, which, according to the latest restructuring guide of February 2021, mature in full at the end of 2021.

Despite the closure of the economy and the restriction of movement as a result of the pandemic, the payment system operated uninterruptedly, providing the necessary security, efficiency and flexibility to participants, in order to maintain financial stability, early identification and addressing of potential problems.

During this period, the CBK played an important supporting role for the economy through the efficient operation of the Bank Accounts Register, assisting institutions in the easy and safe distribution of funds as part of the fiscal emergency measures taken to support households and enterprises most affected by the pandemic situation, as well as in the distribution of 10 percent of pension trust funds to contributors.

Regulatory and financial infrastructure has continued to expand and advance. In September 2020, the CBK licensed a new bank for operation in Kosovo: "Banka Credins Kosova" JSC, thereby contributing to increased competition in the banking sector. In February 2020, the appropriate regulatory infrastructure of electronic money instruments was upgraded, which enabled the authorization of four registered non-banking financial institutions to provide electronic

payment services and issuance of electronic money. With the entry of these services in the market, the competition is expected to increase and at the same time efficiency in providing new electronic payment services and products, which are expected to reduce the use of cash.

The Covid-19 pandemic has accelerated the trend of technological advancement of the sector, increasing scope and use, with particular emphasis on electronic and automated services. The increase in the use of digitalized services at the same time has increased the risk of errors in information technology systems or potential cyber-attacks, thus increasing exposure to operational risk as well as the need for proactive oversight for protection against this risk.

Box 1. Financial Stability Map

The financial stability map⁷ presents the developments in main indicators of risks to the Kosovo financial stability (chart 4). The year 2020 was characterized by an increase of risk to the financial stability in almost all risk dimensions and relevant component indicators, where such developments were driven by the outbreak of the Covid-19 pandemic. The risk from the external and internal macroeconomic environment has increased significantly in 2020 (especially in the second quarter of the year), after the outbreak of the pandemic. The risk from the activity of economic agents such as enterprises and the government sector also increased, while the household indicator, on average, resulted in a declining risk due to the positive effect of the high growth of remittances during 2020. Internal indicators of the sustainability of the sector have reflected variable developments. The capitalization and profitability of the sector has been characterized with increased risk, while the risk from the structure of the banking sector has continued to decline gradually over the years. The liquidity and financing indicator, which was characterized by the highest risk rating in recent years, has recorded a decrease in risk in this period, supported by the withdrawal of 10 percent of trust funds and the transfer to citizens' bank accounts. Unlike last year, when the

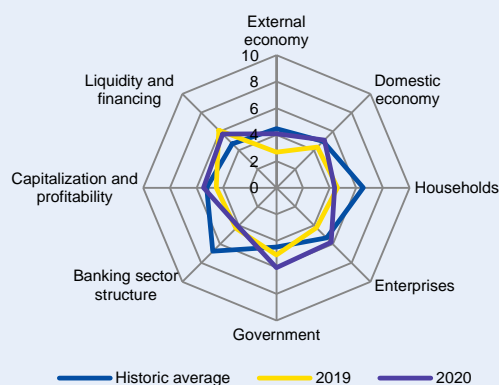
⁷ The Financial Stability Map (FSM) graphically presents the movement of the degree of risk in the main risk categories to financial stability in the banking sector of Kosovo, and enables comparison with the historical average degree of risk for the respective categories. The increase in the distance 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 complete methodology of the FSM model for Kosovo, which has undergone continuous revisions in the indicators and their method of calculation, is presented in the CBK Working Paper No. 6.

two indicators stood above the average historical risk level, in 2020 five indicators stood above this level (chart 5) which reflects the effects of the Covid-19 pandemic.⁸

The increased risk in the external economy indicator reflects the economic downturn of Kosovo's main trading partners. The outbreak of the Covid-19 pandemic and the restrictive measures applied during the year, and especially during the second quarter of the year in these countries, have triggered the highest economic recession recorded in the 15-year period covered by the financial stability map. Other indicators that contributed to the increased risk were rising unemployment in partner countries as well as pessimistic prospects for the enterprise cycle in Europe by the Organization for Economic Co-operation and Development in Europe. The fall in oil prices and the fall in key interest rates had a positive effect on risk mitigation.

Chart 4. Financial stability map



Source: CBK.

Risk from the domestic economy increased mainly as a result of the decline in GDP during Q2 and Q3, the highest level ever recorded in the economy of Kosovo. As a result, the output gap, which informs about the current economic growth in relation to its long-term potential, has gone into a negative territory.

External debt has increased in absolute terms, but the decline in GDP has led to its ratio to GDP to increase to a higher degree, contributing to an increase in the risk rating. However, the fall in consumer prices had a positive effect on risk mitigation.

The enterprise sector was characterized by the highest increase in risk, influenced by the negative performance in all indicators, a performance driven by the outbreak of the Covid-19 pandemic and accompanying restrictive measures. The biggest impact was the significant decrease in the activity

of the trade sector, the credit to GDP gap, and the decline in the industrial turnover index. Despite their low level, non-performing loans showed an upward trend compared to a year ago.

The risk from households remained at a level comparable to the last year. Indicators such as the credit- to- GDP gap and the quality of the loan portfolio recorded an increase in risk, the effect of which was almost completely compensated by the sharp increase in remittances. Risk from the government sector increased, influenced by the growth of risk in all component indicators. The main contribution was the decline in tax revenues influenced by preventive measures against the spread of the Covid-19 pandemic and fiscal measures such as tax relief, etc. Other indicators contributing to the increase of risk from the government sector, whose performance was mainly influenced by the Covid-19 pandemic, were the increase in the sovereign risk premium, the negative budget balance and the expansion of public debt.

As a part of internal indicators of sustainability of the sector, the capitalization and profitability indicator has recorded an increase of risk, influenced by the increased risk tendency in all constituent components. The increase in large credit exposures was the factor with the highest increased risk effect, followed by the decline in net interest revenue relative to assets; influenced by rising interest expense. Also, the net profit of the sector was lower, mainly influenced by the increase in expenses for provisioning. The level of non-performing loans, although at a low level, since the beginning of 2020 has recorded an upward trend as a result of the crisis caused by the Covid-19 pandemic. The structure of the banking sector has continued to gradually improve, influenced by the overall growth of competition. The risk rating continued to decline, as a result of positive developments in all constituent components.

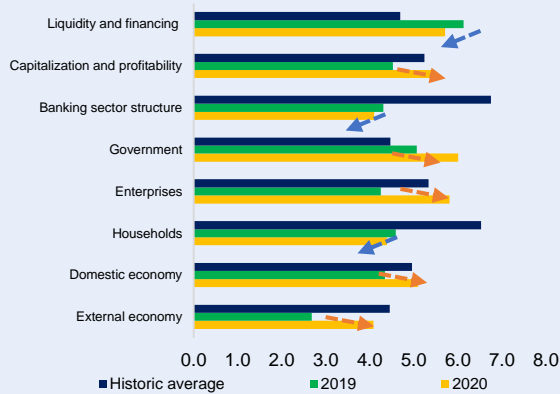
The most significant improvement was recorded in the component of negative deviation from the average capitalization rate of the sector, which implies that banks have converged towards the average capitalization rate of the sector, this as a result of the increase of the capitalization rate of smaller banks along with the decrease of the average capitalization rate of the sector.

⁸ The risk performance from indicators of Financial Stability Map and contribution of constituent components at relevant risk level is shown in Annex 1.

Other positive developments include higher diversification of the total credit portfolio, the decline in the concentration of enterprise loan portfolios, the higher diversification of banks' financing sources, and the continuing decline in the asset concentration of the three largest banks. The liquidity and financing indicator of the sector recorded a decrease in risk in almost all constituent indicators. The main contributing factor to the decline was the slowdown in lending growth on the one hand, and the growth of deposits on the other hand, where these developments contributed to the decline in the ratio of total loans to deposits in the sector. The narrowing of the liquidity gap and the increase of the liquidity ratio were other indicators that contributed to the reduction of risk.

The factors that recorded an increase in risk were the increase in the share of liabilities to the external sector in the sources of financing / liabilities of the sector, and the slower growth of household deposits compared to the growth rate a year ago. The average risk rating of liquidity and financing indicator, as a result of the decline in this period, narrowed the most significant deviation above the historical average level it had over the years, which largely reflects the nature of the components included in the indicator.⁹

Chart 5. Financial stability map



Source: CBK.

⁹ The loan / deposit rate indicator has followed a naturally increasing trend since the beginning of the operation of the sector, and recent periods reflect a higher ratio (higher risk rating). Similarly, the growth rate trend of household deposits was characterized by significant fluctuations over the

years, being higher at the beginning of the operation of the sector and naturally began to decline as a result of the development of the sector, but which again increased in recent periods.

3. The external environment and developments in the domestic economy

Global economic activity was characterized by an unprecedented shock in 2020. The health crisis triggered by the Covid-19 pandemic and the measures taken to maintain public health, mainly in the context of restricting movement and physical distancing, were reflected in a general decline in economic activity in almost all Eurozone countries.

The health, economic and social crisis triggered by the Covid-19 pandemic affected countries in the Western Balkans as well. The economic outlook and forecasts for the recovery process continue to be associated with a high degree of uncertainty, being subject to the conclusion of the health crisis (dynamics in the waves of virus spread and mass vaccination), the accompanying consequences on key stakeholders in the markets and the effectiveness of monetary, fiscal and financial incentive packages / measures.

Table 2. Selected macroeconomic indicators

Description	Real GDP				Unemployment rate				Inflation			
	2018	2019	2020	2021	2018	2019	2020	2021	2018	2019	2020	2021
Euro area	1.9	1.3	-6.6	4.4	8.2	7.6	7.9	8.7	1.8	1.2	0.3	1.4
Germany	1.3	0.6	-4.9	3.6	3.4	3.2	4.2	4.4	1.9	1.4	0.4	2.2
France	1.9	1.5	-8.2	5.8	9.0	8.5	8.2	9.1	2.1	1.3	0.5	1.1
Italy	0.9	0.3	-8.9	4.2	10.6	9.9	9.1	10.3	1.2	0.6	-0.1	0.8
Spain	2.4	2.0	-11.0	6.4	15.3	14.1	15.5	16.8	1.7	0.7	-0.3	1.0
Kosovo	3.8	4.9	-3.9	4.3	29.6	25.7	25.6	n/a	1.1	2.7	0.2	1.6
Montenegro	5.1	4.1	-15.2	9.0	n/a	n/a	n/a	n/a	2.6	0.4	-0.2	0.4
North Macedonia	2.9	3.2	-4.5	3.8	20.7	17.3	16.4	16.3	1.5	0.8	1.2	2.0
Bosnia and Herzegovina	3.7	2.8	-5.5	3.5	18.4	15.7	19.0	17.5	1.4	0.6	-0.6	1.2
Serbia	4.5	4.2	-1.0	5.0	13.3	10.9	13.3	13.0	2.0	1.9	1.7	2.2
Albania	4.1	2.2	-3.5	5.0	12.3	11.5	12.5	14.0	2.0	1.4	1.6	2.0

Source: IMF, WEO April 2021, KAS and CBK for Kosovo.

As a result of measures taken to combat the Covid-19 pandemic, the Eurozone economy in 2020 shrunk by 6.6 percent, due to the contraction of private consumption, investment and exports. The effects of the pandemic were felt especially in the second quarter of 2020, when there was a decline of 14.8 percent. The countries that recorded the deepest economic decline were Spain and Italy, of about 11.0 and 8.9 percent, respectively, while Germany recorded a decline of 4.9 percent (table 2). In the conditions of declining economic activity, inflationary pressures also remained weak, mainly due to the significant decline in global demand, which contributed to the fall in oil prices. To prevent the crisis from deepening, the governments of the Eurozone countries took fiscal and financial measures, aimed primarily at mitigating the negative effects of the pandemic on the labour market and supporting consumption and liquidity financing of enterprises. In parallel, the ECB maintained a relaxed monetary policy through a quantitative easing program.

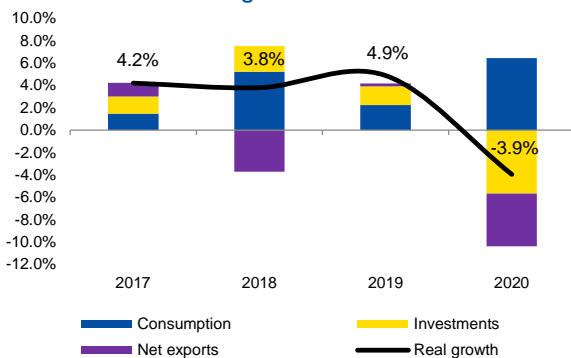
The economic activity in the Western Balkans countries was characterized by an average decline of 5.6 percent. Montenegro and Bosnia and Herzegovina recorded the highest decline in economic activity. In addition to the problems caused by the Covid-19 pandemic, increased political uncertainty in the Western Balkans countries is also expected to be reflected in further decline in the investors and consumers trust, thus affecting the progression of potential recovery of economic activity.

Unprecedented increase in external and internal risks as a result of the Covid-19 pandemic have influenced Kosovo to record the first GDP decline in 2020, while the first signals of 2021 suggest a gradual recovery that is subject to developments in the foreign economy and the eventual deterioration of the health crisis and potential restrictive measures within the country, pending mass vaccination.

3.1. Domestic economy

The outbreak of the Covid-19 pandemic has generated immediate difficulties for society and significant threats to the country's economy, dynamics that resulted in health, economic and social crisis. To manage the pandemic and the health crisis, similar to governments around the globe, the government of Kosovo has also imposed restrictive measures in terms of movement, travel, public and non-public activities, activities of some of the services of enterprises, etc. These restrictive measures translated into a slowdown in economic activity of 1.3 percent in the first quarter and a decline in economic activity of 9.3 percent and 7.3 percent in the second and third quarters of 2020. The fourth quarter appears to have recorded a recovery, with an increase of real GDP of 0.7 percent.

Chart 6. Real GDP growth rate and contributors to the growth



Source: KAS and CBK calculations.

Preliminary estimates of KAS, based on the sum of quarters, suggest that Kosovo's economy has marked a decline of 3.9 percent in 2020. Economic activity is expected to recover to pre-crisis levels in 2021, with a growth of about 4.3 percent.

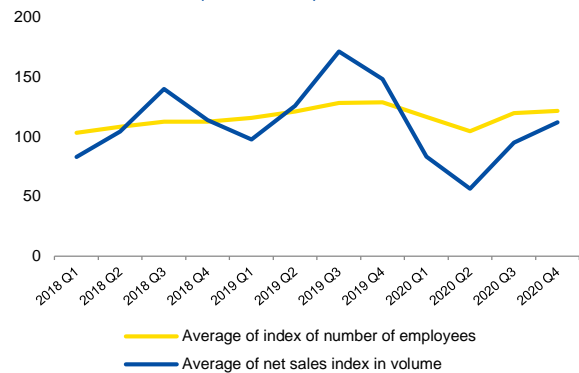
The components that contributed to the economic decline during 2020 were investments by 5.7 percentage points and net exports by 4.7 percentage points. The consumption component is estimated to have supported economic activity by 6.5 percentage points (chart 6).

On a sectorial basis, the sectors that recorded a decline in added value to GDP were the hotels and restaurants, transport and storage,

construction sector, administrative and support activities, trade, etc. Whereas, the sectors that recorded an increase in activity are health and social work sector, electricity and gas supply, processing industry, information and communication, extractive industry, etc.

The two important sectors of the country's economy, such as the services and industry sectors, turn out to have faced a sharp decline in activity and a decline in the employment rate, according to KAS, the dynamics were mainly influenced by the economic crisis triggered by the Covid-19 pandemic. **The average net sales index in the services sector appears to have decreased by 36.2 percent in 2020 (23.1 percent increase in 2019), and the average index of the number of employees has decreased by 6.4 percent (13.2 percent increase in 2019)** (chart 7).

Chart 7. Index of sales and employees in services sector (2015=100)

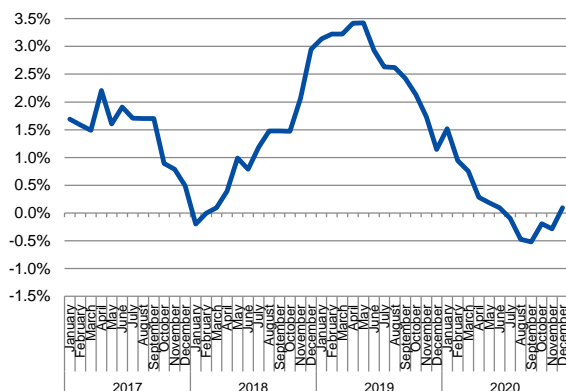


Source: KAS.

All sectors presented in this publication have recorded a decline in sales. The highest decline was recorded by hotels (-63.8 percent), followed by travel agencies (-59.9 percent), bars and restaurants (-34.9 percent), trade (-28.2 percent), transportation and storage (-27.3 percent), as well as information and communication (-4.4 percent). At the same time, the weighted average volume of industrial production turns out to have decreased by 0.9 percent (increase of 10.2 percent in 2019), while the number of employees turns out to have recorded an average decrease of 1.5 percent (increase of 10.1 in 2019).

The decline in aggregate demand and the dynamics of key goods prices in international markets were reflected in weak inflationary pressures in Kosovo. The average annual inflation rate in 2020, expressed through the Consumer Price Index (CPI), was 0.2 percent (2.7 percent in 2019) (chart 8).

Chart 8. Inflation rate, annual change



Source: KAS.

According to CBK forecasts, the inflation rate in 2021 will be 1.6 percent, while the expectations of commercial banks¹⁰ suggest an inflation rate of 0.9 percent in 2021.

The dynamics that characterized the fiscal sector during 2020 resulted in a decrease in budget revenues by 8.8 percent and an increase in budget expenditures by 6.5 percent. As a result of declining revenues and rising budget expenditures, the budget deficit has reached 7.1 percent of GDP. Public debt was also characterized with an increase of 23.9 percent, which reached a value of about EUR 1.5 billion. **As a percentage of GDP, public debt reached 21.8 percent from 17.5 percent in 2019.** The increase in public debt is attributed to the increase in domestic debt of 21.5 percent (which amounted to EUR 961.9 million), and increase in public external debt by 28.6 percent, reaching EUR 525.8 million. The higher growth of public debt in 2020 compared to previous years is mainly attributed to the increase in budget needs to cope with the

increased expenditures caused by the Covid-19 pandemic.

The economic and social crisis triggered by the pandemic has mostly affected the external sector of the economy. The current account deficit has increased by 20.4 percent in 2020, amounting to EUR 480.7 million. In relation to GDP, the current account deficit reached 7.1 percent (5.6 percent in 2019). The increase in the current account deficit is mainly attributed to the decline in services exports, while other components of the current account turn out to have mitigated the negative effects of the decline in services exports. The positive balances of primary and secondary revenue increased, while the trade deficit in goods was significantly lower.

The increase in exports of goods and especially the significant decline in imports due to the decline in aggregate demand in the country are translated into an annual decline in goods deficit of 9.4 percent¹¹ (4.5 percent increase in 2019), while the recorded value was about EUR 2.8 billion. The value of exports of goods was EUR 475.0 million, which corresponds to an annual increase of 23.8 percent (4.4 percent increase in 2019). The growth of exports of goods was more pronounced in base metals - as a category that dominates the structure of exports, followed by products of the chemical industry, vegetables, plastics and rubber, as well as processed foods, beverages and tobacco. On the other hand, the import of goods was characterized by a decrease of 5.7 percent and recorded a value of EUR 3.3 billion. The decline was mainly characterized by the import of mineral products (mainly petroleum products) and base metals, categories which demonstrate the decline in economic activity, in addition to being characterized by falling prices in international markets as a result of the Covid-19 pandemic. The import of means of transport as well as textiles and various textile items was also characterized by a significant decrease.

¹⁰ Banks report to the CBK on their quarterly and year-round inflation expectations.

¹¹ The source of data on the export and import of goods in Kosovo is the Kosovo Agency of Statistics.

In terms of the balance of payments, trade in services was the component that declined the most as a direct result of the restrictive measures taken to manage the health crisis. The services component is worth EUR 391.5 million, which is a decrease of 57.7 percent compared to 2019. The value of exported services was EUR 994.0 million or 40.7 percent less compared to 2019, while the value of imported services was EUR 602.5 million or 19.6 percent less compared to 2019. International travel restrictions, as one of the main measures taken to prevent the spread of Covid-19, as well as measures for compulsory isolation of EU citizens upon return have discouraged the diaspora from visiting Kosovo during 2020, which has deepened the economic crisis in the country especially in Q3 2020. As a result, exports of travel services marked a decline of 52.2 percent, and exports of construction services and exports of transport services declined by 46.1 and 29.7 percent, respectively. Similar dynamics characterized the import of services, with the largest decline recorded by travel services, computer services, transport services and construction services - associated with restrictive measures to contain the spread of Covid-19 virus.

Travel restrictions undertaken by both the Government of Kosovo and the governments of countries where Kosovo emigrants and seasonal workers are concentrated, as well as other restrictive measures to prevent the spread of the Covid-19 virus, were reflected in the decrease in the number of visits of the Kosovar diaspora during 2020 and, consequently, the increase in remittances such as workers' compensation and remittances. Revenue from workers' compensation¹², which is the main category of primary revenue, increased by 3.7 percent, **while remittances reached the value of EUR 980.1 million in 2020 and recorded an annual increase of 15.1 percent, reaching 14.4 percent of GDP.** Remittance inflows were characterized

by an increase throughout the year, with the exception of March and April when they declined. Remittances through money transfer operators increased by 60.0 percent, while remittances through banks increased by 14.9 percent. On the other hand, given the travel restrictions, remittances coming through the "informal channel" have decreased by 46.0 percent.

FDI in Kosovo reached the value of 341.7 million euro in 2020, which is 34.2 percent higher compared to the previous year.

The increase of FDI was recorded mainly in the sector of financial activities, energy, as well as mining and quarrying, while the real estate sector as the sector with the highest share in the overall structure of FDI, recorded a decrease of 10.1 percent. In the financial activities sector, FDI turns out to have increased its share to 24.7 percent in 2020, from 5.5 percent in 2019. The increase in investment in this segment is mainly related to the measures taken by the CBK to help the economy to cope as easily as possible with the challenges of the pandemic crisis. Specifically, in order to maintain sound levels of capital within the banking system and to support Kosovo's economy through lending, CBK has decided to suspend the distribution of dividends by banks for 2019 and 2020, which was reflected in the increase of the share capital of financial institutions and as a result, there was an increase in this position in FDI in the country.

3.2. Financial position of enterprises

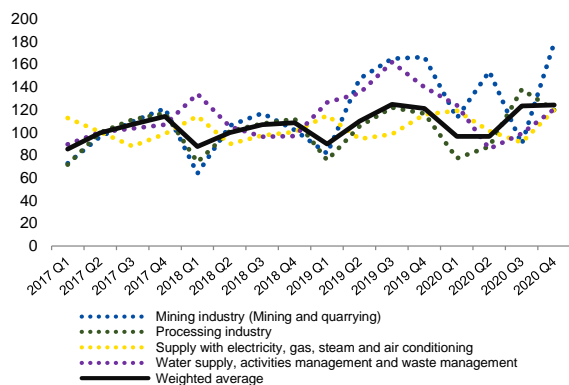
Developments in the economic and financial indicators of enterprises suggest a decline in the volume of industrial production and a decline of turnover in retail trade during 2020.

The weighted industrial production volume index, which represents the performance of enterprises in four sectors of industry, has been characterized by a decrease of 1.2 percent

¹² Employee compensation includes salaries, wages and other benefits received by resident workers abroad. This includes seasonal workers or other short-term workers (less than one year).

in 2020. A decrease was recorded in water supply (23.7 percent) and extractive industry (4.5 percent), while in the electricity supply sector and the processing industry, there was an increase of 2.0 and 0.8 percent respectively (chart 9).

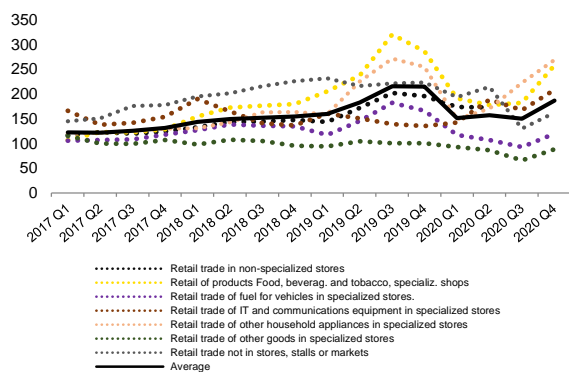
Chart 9. Industrial turnover index (2017=100)



Source: KAS.

The average turnover index in retail trade decreased by 16.5 percent, which is a higher rate of decline compared to the industry sector (chart 10).

Chart 10. Retail turnover index (2015=100)



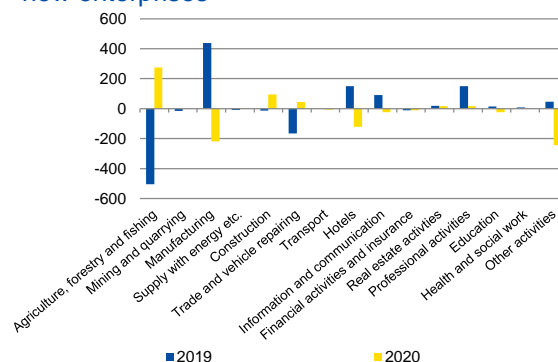
Source: KAS.

As a result of the deterioration of economic activity, entrepreneurial initiative turns out to have declined. In 2020, 9,805 new enterprises were registered or 2.0 percent less compared to 2020, while 1,326 enterprises were closed or 25.0 percent less compared to 2019.

The sectors that recorded the highest decline in the number of registered enterprises were mainly sectors that were most affected by government restrictive measures to contain the spread of the Covid-19 virus, while there

were also sectors in which the number of registered enterprises increased (chart 11).

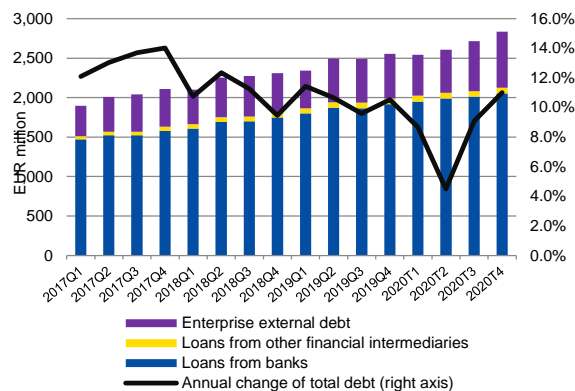
Chart 11. Annual change in the number of new enterprises



Source: KAS.

Enterprise debt to domestic and foreign financial institutions has continued to grow but at a slower pace. Total enterprise debt recorded an annual increase of 11.0 percent in 2020 (chart 12) and reached 41.7 percent of GDP.

Chart 12. Enterprises debt



Source: CBK.

Domestic debt, i.e. debt of enterprises to lending institutions in the country has increased by 6.8 percent (10.0 percent increase in 2019), as a result of the increase in bank loans by 7.1 percent, while loans to enterprises issued by other financial intermediaries recorded a decrease of 1.9 percent, but which remain insignificant in the total debt of enterprises to the financial sector (3.3 percent). On the other hand, the external debt of enterprises has increased by 26.0 percent, reaching 25.0 percent of total debt from 22.0 percent in 2019.

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 lending to enterprises by lending institutions in the country to GDP, reached 31.2 percent in 2020 (28.0 percent in 2019). This increase in the ratio of lending to GDP was mainly as a result of estimates of declining GDP, while lending increased slowly and consequently the credit to GDP gap was positive.¹³

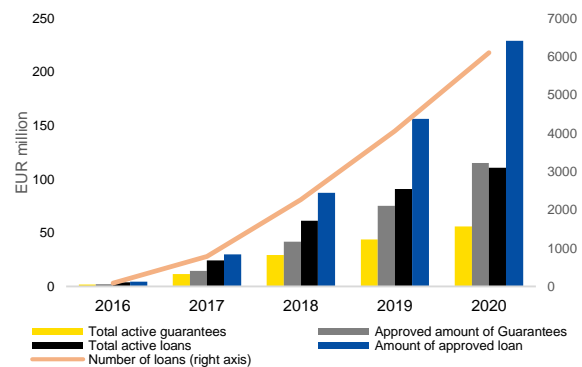
Net debt position of enterprises to the banking sector has increased. The deposits of the enterprises recorded a growth rate of 10.9 percent, while the growth rate of lending to the enterprise sector was 6.8 percent. These developments resulted in an increase in the debt position of enterprises to the banking sector by 4.3 percent (2.6 percent increase in 2019). In terms of foreign exchange, the enterprise sector has a net credit position to the banking sector, as a result of higher level of foreign currency deposits compared to loans. However, the foreign exchange position remains low as a result of the low share of loans and deposits in foreign currency, at 0.02 percent for foreign currency loans to total loans, and 3.1 percent for foreign currency deposits to total enterprise deposits.

New loans to enterprises increased by 4.4 percent in 2020 (9.7 percent increase in 2019). According to the purpose, new non-investment loans decreased by 12.8 percent and reduced their share in the structure from 39.7 percent to 33.2 percent of total new loans to enterprises. New investment loans increased by 15.3 percent and increased the share in the structure from 58.5 percent to 64.6 percent of total new loans to enterprises. In terms of maturity, loans with a maturity of more than 5 years accounted for about 27.1 percent of new loans (15.9 percent in 2019) and increased by 76.8 percent. Other loan categories declined. Loans over 2 years to 5 years, as the main category, reduced their

share from 52.0 percent to 44.7 percent in the overall structure of new loans to enterprises.

Small and medium enterprise borrowing is also supported by the Kosovo Credit Guarantee Fund (KCGF), the use of which has recorded a continuous growth trend. In December 2020, the number of loans guaranteed by KCGF was 6,103 while the approved amount of guarantees reached EUR 115.0 million. The structure of guaranteed loans is a representation of the general structure of loans in the banking sector, where loans to the wholesale and retail trade sector dominate, followed by the services and manufacturing sectors. The agriculture, forestry and fisheries sector accounted for 9.1 percent of the total guaranteed loan portfolio.

Chart 13. Loans approved and guaranteed by KCGF



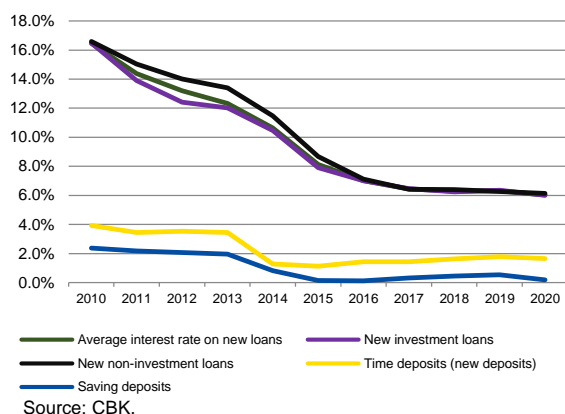
Source: KCGF.

The dynamics changed during 2020 and coping with the economic and social crisis as a result of measures taken to manage the health crisis have further strengthened the role of KCGF in supporting economic recovery by facilitating access to finance. To support the private sector needs for short-term liquidity and investment through the creation of guarantee windows for certain market segments most affected by the pandemic, in 2020, KCGF has signed an agreement with the Government of Kosovo to increase the guarantee capital by EUR 22.3 million. Also, other financial agreements were signed to increase the guarantee capital with the German Development Bank (KfW) in the amount of EUR 6.5 and 5.0 million, respectively.

¹³ Credit gap calculated with the Hodrick-Prescott filter.

Also, in 2020, using a focused approach to address the challenges posed by the pandemic crisis, the KCGF in cooperation with the Government of Kosovo and international donors launched the Economic Recovery Package. This package is a new guarantee line that aims to support access to finance for micro, small and medium enterprises through loan guarantee. This package has enabled KCGF to increase its credit guarantee coverage from 50 percent to 80 percent, providing more assurance to banks so that they will increase lending and reduce the lack of liquidity in the market. Under this package, five windows will operate which will address the needs of certain market segments, worth up to EUR 202 million for a period of one year. The Economic Recovery Package will mainly support lending in the manufacturing, agribusiness, services, trade sectors, with a particular focus on women in business, start-ups, and investments in energy efficiency.

Chart 14. Interest rates for enterprises



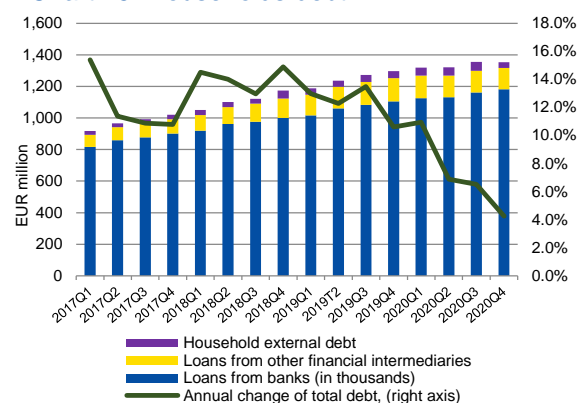
The cost of borrowing for the enterprise sector has decreased compared to the previous year.

The average interest rate on new loans of the banking sector for enterprises was 6.0 percent in 2020, which represents a slight decrease compared to the rate of 6.3 percent in 2019, mainly due to increased competitive pressures in the market (chart 14).

3.3. Financial position of households

The debt of households and enterprises, has grown but at a slower pace. Total household debt increased by 4.3 percent in 2020 and reached 19.3 percent of GDP. Domestic debt to the banking sector increased by 7.0 percent, while debt to microfinance institutions decreased by 9.2 percent.

Chart 15. Households debt



Source: CBK.

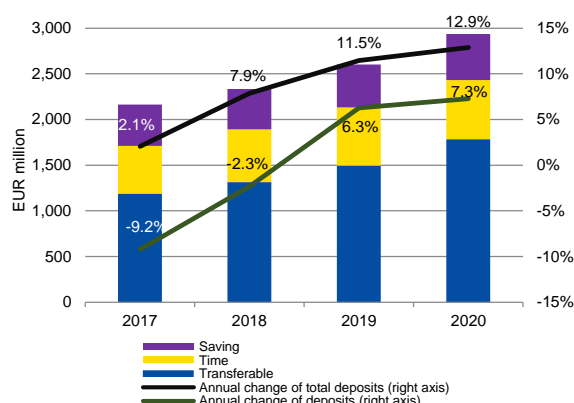
On the other hand, the external debt of households decreased by 19.9 percent and has a low share in the total debt of households (2.6 percent) (chart 15).

New loans issued by the banking sector to households declined. Overall, the growth of new debt to banks was lower by 2.4 percent compared to 2019. According to the purpose, new consumer and investment loans were lower by 4.0 and 52.1 percent, respectively, while mortgage loans increased by 12.7 percent. The decline in consumer loans caused the high share of these loans in total new loans to households to decrease to 70.5 percent, from 71.7 percent in 2019. **The net loan position of households versus the banking sector increased as a result of larger volume of deposits compared to loans.**

Household deposits amounted to EUR 2.9 billion¹⁴, representing an annual increase of 12.9 percent (chart 16). Also, loans continued to grow by 7.0 percent and reached the value of EUR 1.2 billion. As a result, the credit position, traditionally held by households towards the banking sector, increased by 17.2 percent.

¹⁴ Including foreign currency deposits, converted to euro equivalent.

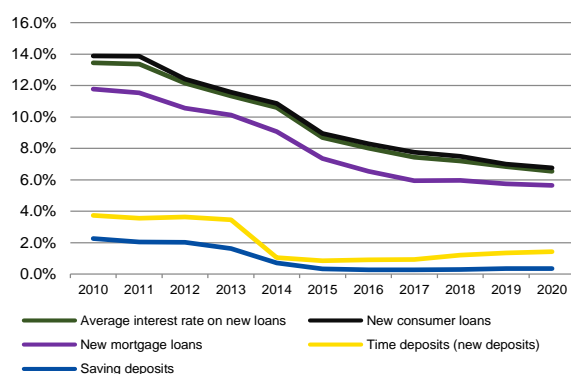
Chart 16. Household deposits



Source: CBK.

In terms of net foreign currency position, the household sector increased its foreign currency lending position by 12.7 percent, as a result of the increase in foreign currency deposits by 12.2 percent, while foreign currency lending with a share of only 0.2 percent of total loans to households, decreased by 11.3 percent. **Household savings, in the form of transferable deposits, time deposits and saving deposits increased.**

Chart 17. Interest rates for households



Source: CBK.

The increase in household deposits can be attributed, inter alia, to the increase of revenues in the economy (increase in remittances, withdrawal of 10 percent of pension savings in the KPST, spending limitations due to uncertainties caused by the

pandemic COVID-19), as well as the gradual increase of the interest rate on deposits, which has reduced the opportunity cost of maintaining savings and the maturity of assets, i.e. the increase of household savings, despite the decline in economic activity (chart 17).

Overall, household deposits increased by 12.9 percent (11.5 percent increase in 2019). Time deposits increased by 2.2 percent, while the average interest rate on time deposits was 1.43 percent or 0.09 percentage points higher compared to the same period of 2019. Savings deposits also increased by 7.3 percent while the interest rate on savings deposits was unchanged (0.35 percent) compared to 2019. The cost of new household debt decreased slightly, influenced by competitive pressures and the decline in economic activity. The average interest rate on new consumer loans of 7.0 percent in 2019 dropped to 6.7 percent in 2020. Meanwhile, the interest rate on investment loans dropped to 9.7 percent from 10.6 percent in 2019. Household revenue sources showed an upward trend, with remittances increasing by 15.1 percent, while workers' remuneration¹⁵ recorded an annual increase of 3.7 percent. Until September 2020, the net monthly salary, according to the Labour Force Survey¹⁶, was in the range of EUR 400 to 500. Regarding the labour market, the labour force participation rate was 37.3 percent until September 2020, or 3.2 percentage points lower compared to the same period of 2019, so the non-activity rate has increased by 3.2 percentage points and has reached 62.7 percent. The employment rate has dropped to 27.8 percent which is 2.3 percentage points lower compared to the same period of 2019. The indicator of economic dependence, which represents the ratio between the total inactive population (over 15 years old) and employment, as of September 2020 has increased to 255.0 percent, from 253 percent in 2019. On the other hand, the unemployment rate remained unchanged (25.6 percent) compared to the same period of 2019.

Table 3. Debts to banks and performance of households

Description	2017	2018	2019	2020
Household debt to banks (EUR million)	900.6	1,001.1	1,104.7	1,182.2
Of which in foreign currency	3.0	2.6	2.6	2.3
Household deposits at banks (EUR million)	2,164.2	2,334.2	2,601.9	2,937.0
Of which in foreign currency	122.6	140.4	138.5	155.4
Net position to banks (credit position), EUR million	1,263.5	1,333.1	1,497.3	1,754.8
Average value of loans per employees	2,522.1	2,901.0	3,041.4	3,211.7
Economic dependence rate	250.0%	268.0%	253.0%	255.0%

Source: CBK.

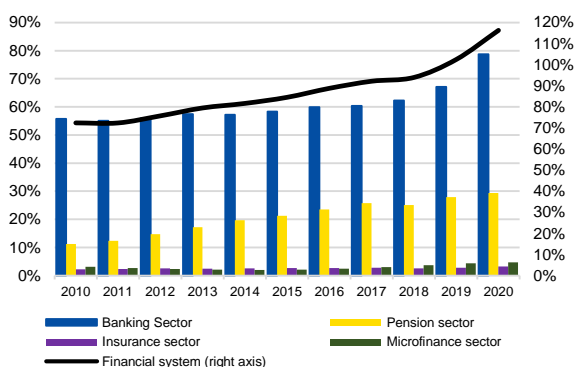
¹⁵ Revenue from compensation of employees - revenue of seasonal employees abroad as well as Kosovar employees working abroad for a period of less than one year.

¹⁶ Kosovo Agency of Statistics., <https://ask.rks.gov.net/media/5369/anketa-e-fuqisë-punëtorë-afp-2019.pdf>

4. Developments in the financial system

The financial system recorded an increase in activity during 2020, despite facing the challenges of the health and economic crisis triggered by the COVID-19 pandemic. All constituent sectors contributed to the growth, which was slower compared to the previous year. The value of financial system assets reached EUR 7.91 billion, which corresponds to an annual increase of 8.9 percent (increase of 14.9 percent in 2019). The degree of financial intermediation (ratio of assets to GDP) increased by 13.8 percentage points, to 116.2 percent, mainly due to the decline in GDP in 2020 as a result of the negative impact of COVID-19 on economic activity in the country and abroad (chart 18).

Chart 18. The weight of financial system sectors to GDP



Source: CBK.

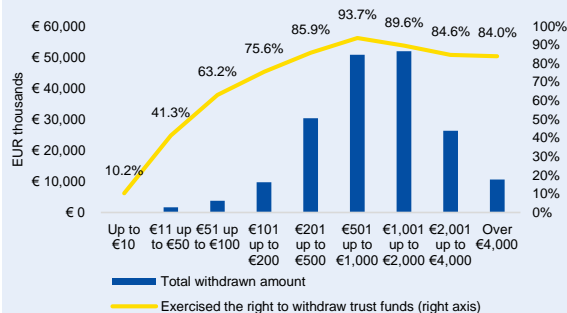
In terms of assets of the banking sector, the items that had the largest contribution to growth were loans and balances with the CBK, while the increase in assets of the microfinance sector is mainly attributed to the increase in the balance with commercial banks. The pension sector, despite the withdrawal of 10 percent of funds from contributors, recorded an increase in assets, enabled by the increase in contributions received during this period, as well as the positive return on investment. Insurance sector assets also expanded, with a more pronounced increase in the category of

deposits held in commercial banks, (mainly in the form of time deposits), followed by investment in Kosovo Government securities.

Box 2. Withdrawal of 10 percent of funds from the Kosovo Pension Savings Trust

Law no. 07 / L-016 on Economic Recovery- COVID-19, which entered into force on December 4, 2020, enabled the possibility to withdraw 10 per cent of pension savings for all contributing citizens, valid for application for the next four months. The Kosovo Pension Savings Trust (KPST) owns 99.6 percent of the pension sector assets, amounting to EUR 1.99 billion.

Chart 1. Withdrawal of 10% of Trust funds, December 2020



Source: KPST.

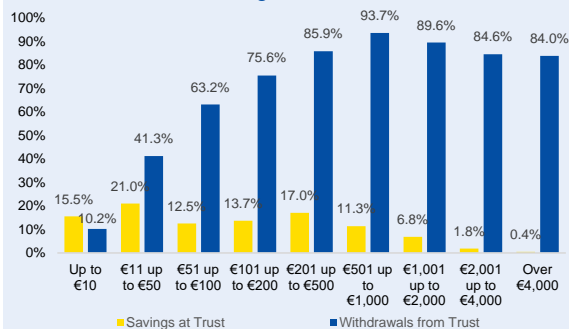
From the beginning of the application for withdrawal of funds until 31.12.2020, KPST has returned to citizens savings in the amount of EUR 185.4 million.¹⁷ So, by the end of December 2020, 397.6 thousand persons have exercised the right to withdraw their savings from 644.6 thousand in total, or in percentage about 61.7 percent of contributors have exercised this right. Whereas, until April 6, 2021, the last day for the application for withdrawal of funds from KPST, the amount withdrawn reached EUR 198.0 million, where about 66.3 percent of contributors used this right.

As shown in Chart 1, the right to withdraw funds from trust was largely exercised by contributors who had the highest level of savings contributions. About 93.7 percent of citizens with the right to withdraw from EUR 501 - 1,000 used this right. This category represents 11.3 percent of total trust savings (chart 2), and have withdrawn funds in the amount of EUR 50.8 million. Whereas, the citizens who could withdraw funds from EUR 11 – 50 had the highest share of 21.0 percent in the total trust saving, and

¹⁷ Contributions received and return on investment from assets invested in foreign and domestic market. The data were obtained from the Kosovo Pension Savings Trust.

this right was exercised only by 41.3 percent of the citizens.

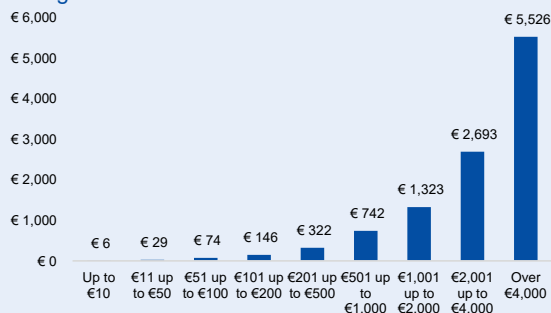
Chart 2. Citizens' savings at Trust, December 2020



Source: KPST.

Charts 1 and 2 indicate that vast majority of citizens (79.5 percent) were able to withdraw funds in the amount of less than EUR 500, while the rest consisting 20.5 percent over EUR 500.

Chart 3. Average withdrawal amount from Trust, by categories

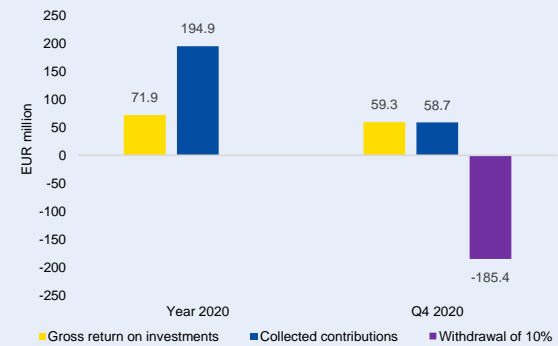


Source: KPST.

Chart 3 indicates the average amount which was withdrawn according to certain categories. The citizens who have applied for withdrawal of funds in the amount of up to EUR 10, on average, have collected the amount of EUR 6, while in the other extreme, the citizens who have had savings in the amount of over EUR 4,000, have collected, on average, the amount of EUR 5,526. It is worth mentioning that the average withdrawal from the trust by contributors was about EUR 466.22 per person, which is slightly higher than the average net salary in Kosovo for 2019, i.e. EUR 430.

In terms of the Law on Economic Recovery - Covid-19, funds withdrawn by participants who have savings of up to EUR 9,999 will be reimbursed in the form of refunds starting from 2023. Thus, around 346.6 thousand participants, who represent 59.1 percent of total contributors will be reimbursed for the withdrawn funds, the total amount of which reaches EUR 96.4 million.

Chart 4. Developments at KPST, during 2020



Source: KPST.

As a result of the withdrawal of 10 percent of pension funds, KPST recorded a significant slowdown in asset increase, namely annual asset increase of 1.1 percent in December 2020, which represents the slowest increase since the beginning of operation. However, the contributions collected during 2020 as well as the return on investment largely compensated the withdrawal of EUR 185.4 million during December 2020, therefore the KPST closed the year with a positive result (increase). Only in Q4 2020, KPST collected revenues in the amount of EUR 118.0 million (EUR 58.7 million from collected contributions and EUR 59.4 million return on investments) (chart 4). Whereas, throughout 2020, despite facing the Covid-19 pandemic and the negative effects caused on the financial markets, the conservative policies of the KPST resulted in a return on investment of EUR 71.9 million and collected contributions in the amount of EUR 194.4 million.

Effects of withdrawing trust funds on other financial sectors

Withdrawal of 10 percent of pension funds has significantly increased the assets of the banking sector, which in December increased by EUR 225.6 million compared to EUR 78.3 million in November 2020 (the average monthly increase during January-November 2020 was EUR 33.4 million). The level of deposits in December 2020 increased by EUR 215.4 million compared to EUR 66.9 million in November 2020 (the average monthly increase during January-November 2020 was EUR 21.4 million). The pronounced increase in deposits mainly reflects the performance of household deposits, which historically represent the main source of financing the activity of banks.

Chart 5. Assets reserve over or below the obligatory reserve



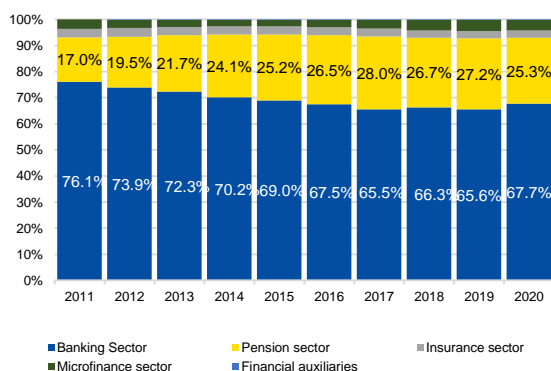
Source: CBK.

Moreover, in December 2020, the level of reserves above the required reserve was EUR 302.1 million higher, which is significantly higher than EUR + 179.6 million in the previous month, and EUR +186.6 million in the same period of previous year (chart 5).

The transfer of pension funds to citizens' bank accounts has also led to a significant increase in the number and value of transactions through the

The number of commercial banks operating in Kosovo increased to 11, as a result of licensing a new bank with foreign capital. While the number of microfinance institutions and non-bank institutions was reduced to 18, as a result of revoking the license of two institutions.

Chart 19. The share of respective sectors to total financial system assets



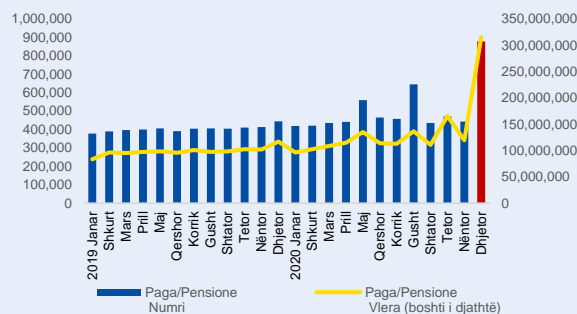
Source: CBK.

In the third quarter of 2020, the CBK licensed a new bank “Banka Credins Kosova” J.S.C. to operate in Kosovo. Its sole founder and

payment system which is operated and supervised by the CBK.

In December 2020, the number of transactions in the category 'salary/pension' reached 879.5 thousand (a monthly average of 472.5 thousand during January-November 2020), whereas the value of transactions amounted to EUR 316.0 million (a monthly average of EUR 119.9 million during January-November 2020) (chart 6).

Grafik 6. Vëllimi i transaksioneve të SPN-së paraqitur në numër dhe vlerë në kategorinë 'pagë pension'



Burimi: BQK.

shareholder is “Banka Credins Sh.A.” from Albania, which has been operating since 2003 and is one of the largest banks.¹⁸ The number of pension funds, insurance companies and insurance intermediaries remained unchanged from the last year (table 4).

Financial auxiliaries have the largest number of financial institutions, although their share in total financial system assets continues to be 0.2 percent (chart 19).

Foreign capital dominates most of the financial system sectors, particularly in the sectors that deal with lending (chart 20). The banking sector is dominated by EU-origin capital accounting for 55.8 percent of total banking sector assets. Domestic banks were characterized with the same presence as in the previous year recorded in the banking market of 13.3 percent. Banks with the origin from Turkey recorded a slight decline of their share in the market, with a share of 16.0 percent in 2020 (16.5 percent in 2019).

The increase in the competitiveness of services was reflected in the decrease of the degree of

¹⁸ Banka Credins Kosova is not included in the statistics reported on the sector of banks in 2020.

banking concentration¹⁹ from 56.8 percent in last year to 55.8 percent. The insurance sector continues to have a lower level of concentration as a result of a more balanced allocation of

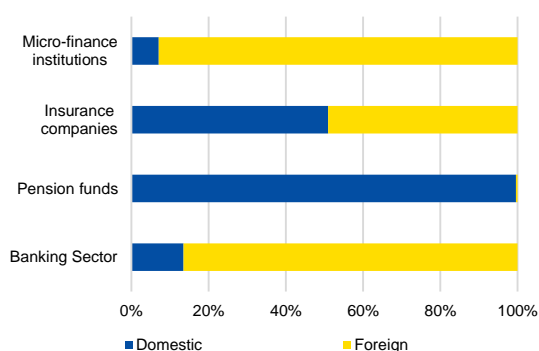
assets in the market. Moreover, the data indicate a further decline in concentration compared to the last year.

Table 4. Number of financial institutions

Description	2016	2017	2018	2019	2020
Commercial banks	10	10	10	10	11
Insurers	15	15	14	13	13
Pension funds	2	2	2	2	2
Financial auxiliaries	48	52	51	54	61
Insurance intermediaries	15	16	13	16	16
Microfinance institutions and- Banks	16	18	22	20	18

Source: CBK.

Chart 20. Ownership of financial system constituent sectors, December 2020



Source: CBK.

The insurance companies with domestic capital comprise 50.9 percent of the sector's total assets, from 49.9 percent in the previous year. Whereas, the companies with foreign capital with a share of 49.1 percent come from Austria, Slovenia and Albania (chart 20).

The financial system in Kosovo has a simple balance sheet structure, in relation to the traditional model of activities, with minimal linkage between the system sectors. During this year, the degree of interconnection of foreign banks with their parent banks has increased, driven by increased insecurities and at the same time the need to provide emergency liquidity lines, i.e. increase the absorption capacity for possible loss as a result of the pandemic crisis.

Interconnections between sector actors have not changed significantly in 2020. 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.

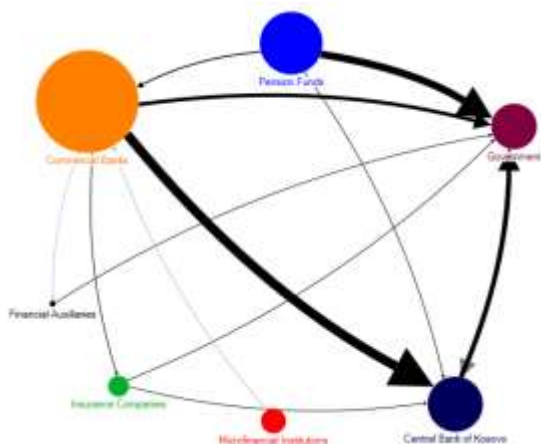
The most pronounced interconnection is between commercial banks and the CBK, which is represented in the form of deposits for the mandatory reserve and the excess of this reserve that banks must maintain at the CBK. Insurance companies and pension funds also hold claims in the form of deposits (current accounts) to the CBK, which together with commercial banks in December 2020 accounted for 51.0 percent of total CBK deposits.

Deposits that non-bank financial institutions hold in commercial banks represent significant inter-institutional exposure (excluding exposure to government) for some of these institutions. Insurance companies hold about 46.4 percent of their assets as deposits in commercial banks. Financial auxiliaries, in December 2020 reduced the balance sheet share with commercial banks in their total assets to 42.5 percent from 45.3 percent in the previous year. While, pension funds and microfinance had 6.5 percent and 10.7 percent,

¹⁹ Expressed as the ratio of assets of three largest banks versus all sector assets.

respectively, of their assets as deposits in commercial banks.

Figure 1. Institutional interconnections of the Kosovo financial system



Source: CBK.

Note: the size of each node (circle) reflects the total assets of each institution, excluding the Central Government which is based on the total liabilities it has in the form of securities to these institutions. Arrow direction means the requirement to the institution to which the arrow is directed while the thickness of the linking line and the arrow reflects the level or size of the link. The situation is as of December 2020.

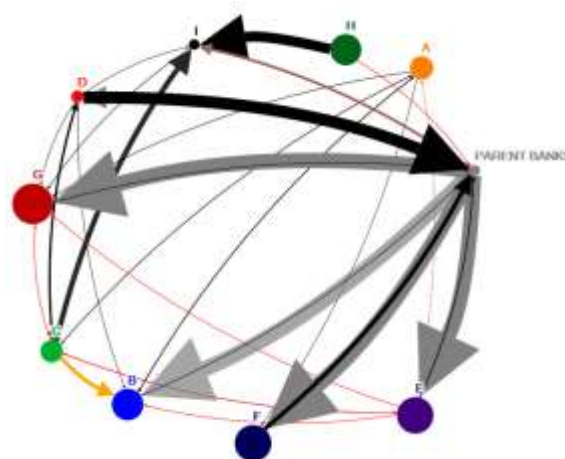
Thus, deposits of these institutions comprise 6.0 percent of total banking sector deposits. Consequently, the importance of the banking sector in maintaining the stability of the financial system is undisputed and the liquidity of the banking sector is an important factor in the stable functioning of 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.

The interconnection figure also includes the exposure of the financial system to the Central Government, expressed in the form of securities. The CBK is one of the main investors in government securities, through the secondary market, followed by pension funds and commercial banks. Other financial institutions also have claims on the Government in the form of government securities, while the government has claims

(exposure) only on the CBK and commercial banks through the deposits held in these institutions.

Interbank links are even more concentrated than inter-institutional ones, with some banks that are 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 strong links between the four banks in the country shown in the chart above are mainly represented in the form of financing sources such as deposits. The strongest connection is between bank H and bank I, due to the financial claims expressed as time deposits that bank H has to this bank, which is also a source of financing for the latter. At the same time, Bank C has a strong interconnection with banks I and B, in the form of claims against them as well as in the form of deposits. Compared to the previous year, the interconnection of some of the sector banks with their parent banks increased during this year, due to the claims for increasing the absorption capacity in case of deterioration of the loan portfolio due to the impact of the Covid-19 pandemic on the country's economy.

Figure 2. Banking interconnections of the Kosovo banking sector



Source: CBK.

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 2020.

The interconnections with the respective parent banks are more pronounced with banks G, F, E and B, mainly as liabilities in the form of deposits and interdependent debt. Whereas, bank D also has a strong link with the parent bank in the form of claims on it, respectively deposits in the parent bank and other branches of the group.

4.1. Banking activity

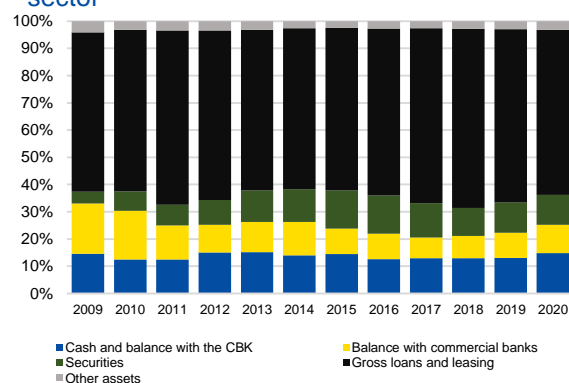
Banking sector activity during 2019 was characterized by an increase mainly driven by the increase of lending, and other balance sheet items such as cash and balances with the CBK, as well as balance with commercial banks. Banking sector assets increased by 12.4 percent, reaching an amount of EUR 5.35 billion. Lending activity slowed down, mainly due to the pandemic crisis and its effects on the economy.

In circumstances of relatively high growth of deposits collected during the year, as well as the inability to allocate funds to lending, banks placed funds in other balance sheet items. The category of cash and balances with CBK (annual increase of 27.0 percent) and the category of balances with commercial banks (annual increase of 27.1 percent) recorded a high annual growth. Within the category of cash and balances with the CBK, the reserves held by commercial banks in the CBK recorded an increase, while in the category of balances with commercial banks, there was an increase in the placement of funds in the external sector mainly in the form of transferable deposits. Uncertainties and limited opportunities for investment of assets caused for the Banks' reserves held in the CBK to increase by 34.6 percent compared to the previous year, despite the continuation of the negative interest rate applied by the CBK on the excess of the mandatory reserve.

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 21).

Chart 21. Assets structure of the banking sector



Source: CBK.

The stock of securities recorded an annual increase of 11.0 percent. Investments of the banking sector in Kosovo government securities decreased by 11.6 percent compared to the previous year, while investments in foreign government securities increased by 21.4 percent.

The banking sector activity continues to be mainly financed by household and non-financial corporations deposits, which this year recorded double-digit annual increase despite the Covid-19 pandemic crisis.

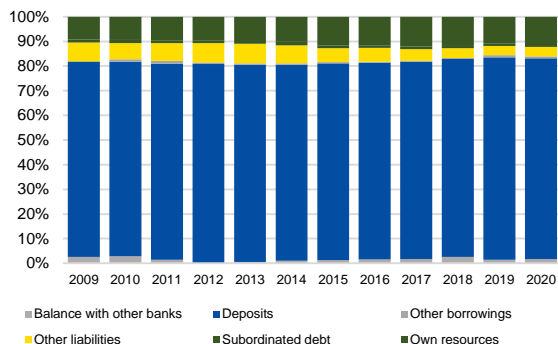
Total sector deposits recorded an annual increase of 11.5 percent and reached the level of EUR 4.36 billion, mainly influenced by the increase in transferable deposits of households and enterprises (public and private), as well as, at a lower level, savings deposits of households. In 2020, deposits represented 81.4 percent of the financing sources of banking sector (chart 22).

Household deposits, which comprise 67.4 percent of total deposits stock, recorded an increase of 12.9 percent (chart 23). The Covid-19 pandemic has increased the uncertainties about the level of income in households, thus affecting the funds available to overcome potential difficulties, namely the increase of transferable deposits.

Uncertainties about the progress of the pandemic, and consequently restrictive measures to prevent the spread of Covid-19 virus have also affected the lack of space for

consumption in this period, which has favoured the growth of deposits.

Chart 22. Structure of liabilities and own resources of the banking sector



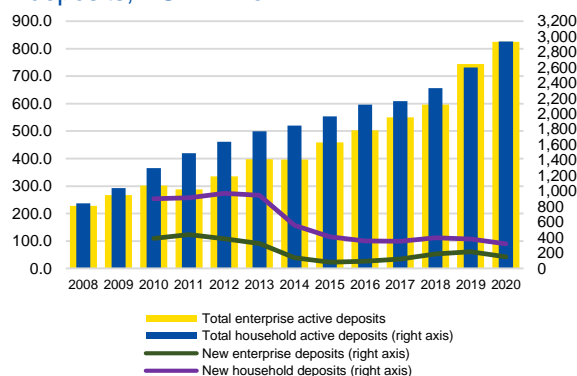
Source: CBK.

Remittances also play an important role in the dynamics of household deposits, the level of which continued to increase during 2020. Despite the much smaller number of visits of fellow citizen in the country, the increase in remittances was influenced by higher remittances sent through formal channels such as financial institutions. However, the persisting pandemic situation and its negative impact on economic activity and revenue levels, may be reflected in the lower level of deposit growth in 2021. Moreover, the effect of the pandemic on the economies of the countries, where most of the remittances come from, can be reflected in the level of remittances, with a follow-up effect on the dynamics of deposits.

2020 was characterized by an increase in deposits also from nonfinancial and public corporations, while the deposits of financial corporations recorded a decline influenced by pension fund deposits.

In terms of financial system, insurance companies increased the level of deposits held in local banks, due to the higher profitability of the sector during 2020 and the more limited opportunities to invest funds within the circumstances of uncertainties increased by the Covid-19 pandemic. Meanwhile, pension funds reduced time deposits in the banking sector, mainly due to the withdrawal of 10 percent of pension savings from contributors.

Chart 23. Stock of total deposits and new deposits, EUR million

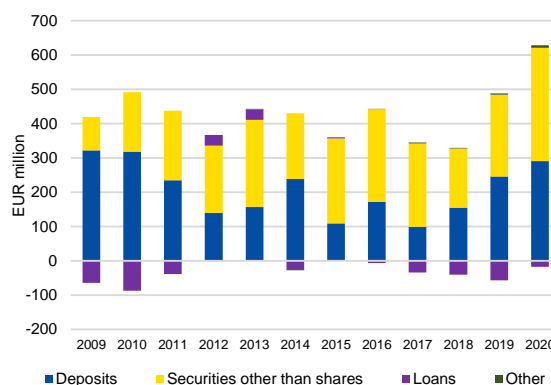


Source: CBK.

Due to the lower level of allocation of funds in lending activity, the microfinance sector increased deposits in the banking sector, but most of these deposits were in the form of transferable deposits. Deposits from nonfinancial corporations recorded a slower annual growth compared to the previous year mainly due to the decline in time deposits. The nonfinancial corporations' need to finance their business activities from deposits, as a result of a decrease in revenues or uncertainties in their realization due to the crisis caused by the Covid-19 pandemic, may have influenced this progress.

Exposure of the banking sector to the external sector continues to be low, but recorded a significant increase compared to the previous year.

Chart 24. Net position to nonresidents

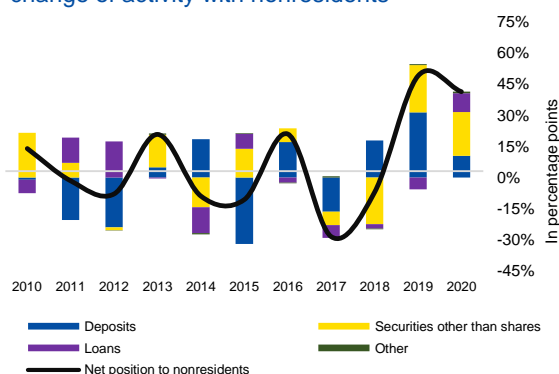


Source: CBK.

The net lending position to the external sector recorded a significant increase, by 41.5 percent, reaching the value of EUR 610.8 million (charts 24 and 25). 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 25. Contribution of items to annual change of activity with nonresidents



Source: CBK.

Claims on non-residents account for about 16.5 percent of total banking sector assets, where 89.2 percent of them are deposits and investments in securities.

Banking sector liabilities to non-residents account for 5.1 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 99.4 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.

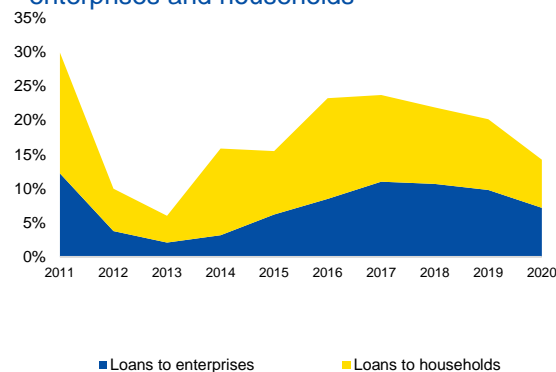
4.1.1 Credit developments

The banking sector's lending activity slowed down compared to the previous year, mainly due to the changing dynamics of the domestic and foreign economy, in dealing with the Covid-19 pandemic.

Lending by banks in 2020 expanded by 7.1 percent, while the value of total loans reached EUR 3.25 billion (chart 27). The growth dynamics during this year turns out to be slower compared to the double-digit growth of the last four years, a progress that according to the bank lending survey turns out to be

influenced by both credit supply and credit demand. The measures taken by the Government of Kosovo to prevent the spread of the Covid-19 pandemic were reflected in the increased risk perceived by banks, the deterioration of the domestic and global market outlook, the decline in the quality of the loan portfolio and the reduction of banks' risk tolerance.

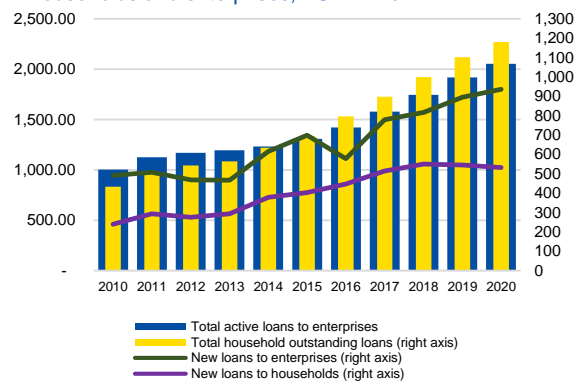
Chart 26. Annual growth of loans to enterprises and households



Source: CBK.

Whereas, in the second half of the year there was an easing of credit standards to some extent and an increase in credit demand, positively affected by the relaxation of preventive measures as well as measures taken by the CBK to suspend the payment of loan instalments and further restructuring of loans as a result of the pandemic. Banks also stated that the KCGF's lending support, increased competitive pressures and favourable access to finance also made a positive contribution.

Chart 27. Stock of total loans and new loans to households and enterprises, EUR million

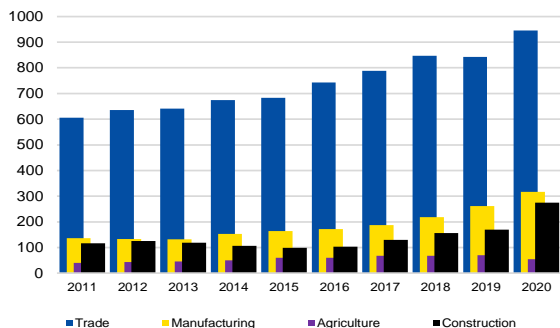


Source: CBK.

The stock of loans to enterprises increased by 7.2 percent and reached a value of EUR 2.05

billion. Whereas, new loans during 2020 amounted to EUR 935.5 million (chart 27), of which EUR 604.6 million were for investment purposes, while EUR 310.2 million were for non-investment purposes.

Chart 28. Stock of loans by economic sectors



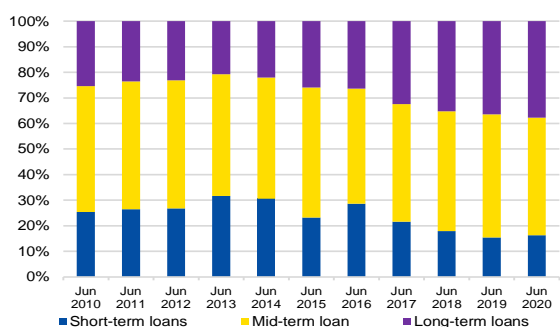
Source: CBK.

Bank lending has increased to almost all economic sectors, with the exception of agriculture, energy and mining, which were characterized by decline. The sectors that were credited the most were trade, construction and manufacturing.

Loans to the construction and manufacturing sector increased by 61.7 percent and 21.4 percent, reaching the value of EUR 275.4 and EUR 317.4 million, respectively.

However, the significant increase in lending to construction is attributed to re-categorization from a bank of a part of the loan portfolio from the item of other services mainly in that of construction, but also of manufacture and trade sector.

Chart 29. Loans to enterprises, share by maturity



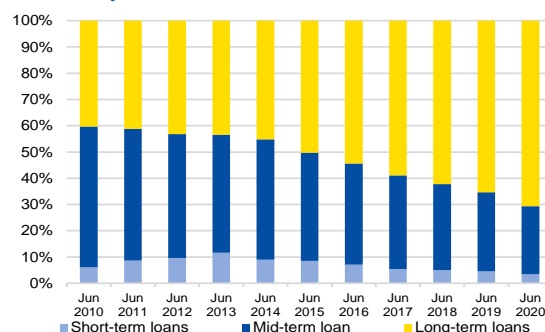
Source: CBK.

Loans to the trade sector, which dominates the structure of total loans, recorded an annual increase of 12.2 percent (chart 28). Meanwhile, the agricultural sector, which has a small share in the total stock of loans to enterprises, was characterized

by a decrease of 22.1 percent. Despite the on-going uncertainties about the pandemic and its effects on the economic recovery, it is expected that regulatory support measures to banks and support from the KCGF will contribute to increasing access to finance and ensuring liquidity of SMEs in general, especially the most affected sectors, to alleviate the difficulties from restrictions on their economic activity as a result of pandemic developments.

The upward trend of lending to households slowed down, influenced by the extra caution in lending to this sector as a result of the growing uncertainty over its solvency, also driven by the pandemic crisis. New consumer loans recorded a similar annual decline to the previous year, after a period of several years of double-digit growth. On the other hand, mortgage loans accelerated the growth, reflecting the largest lending space of this segment as well as the lowest risk due to collateral coverage (chart 2). The stock of total loans to households at the end of the year amounted to EUR 1.18 billion, representing an annual increase of 7.1 percent from 10.4 percent in the previous year (chart 26).

Chart 30. Loans to households, share by maturity



Source: CBK.

Loans with long-term maturity, which dominate the structure of total loans with a share of 49.6 percent,²⁰ recorded the highest annual increase of 13.5 percent. Their value amounted to EUR 1.61 billion. Loans with medium-term maturities declined slightly by 0.5 percent to EUR 1.26 billion. Medium-term loans are mainly dominated by loans to non-financial corporations (chart 29), while long-term lending is mainly a feature of the household loan portfolio segment (chart 30). According to the Bank Lending Survey (box 3), long-term loans to households were positively affected by both the credit supply and credit demand.

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

Box 3. Bank Lending Survey²¹

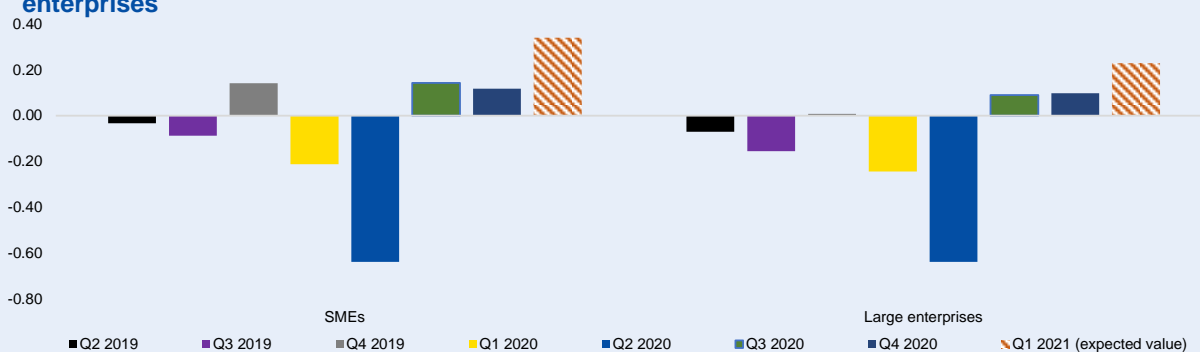
The latest results of the Bank Lending Survey²² reflect developments in bank lending activity during the period October - December 2020 (referred to as Q4 2020)²³, and expectations for lending activity for the period of January - March 2021 (referred to as Q1 2021).

The dynamics of lending to **enterprises** during Q4 2020, based on the bank lending survey, results to have had a positive impact, albeit at a low level, both in terms of credit supply and credit demand. In terms of credit supply, banks have reported to have

eased to some extent the standards applied during the process of assessing the enterprises' applications for loans. Credit standards were similarly eased for both categories of enterprises (SMEs and large enterprises).

For the first quarter of 2021, banks are expected to further ease credit standards for both categories of enterprises, based on decisions to ease restrictive measures and consequently expectations for economic recovery of enterprises in the country (chart 31).

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



Source: CBK.

The main factors that influenced the easing of credit standards, according to the banks, were the support of lending to enterprises by the KCGF, improvement of outlook in global markets, as well as mitigation measures taken to manage the effects of the pandemic, such as the restructuring of loans due to the Covid-19 pandemic.

In terms of credit offer, banks reported that the terms and conditions applied by banks when granting loans to enterprises were slightly eased. The support of enterprises by KCGF, the good outlook of the local market, the increase of competitive pressures, as well as to a lesser extent the mitigation of measures against the spread of Covid-19 virus and the good perspective of the banking market in the country, contributed to the ease of lending terms. Specifically, the eased terms and conditions were applied to both categories of

enterprises, mainly through lower interest rates, while for SMEs there was also an increase in the size of loans (chart 32).

Banks stated that relying on the expectations of KCGF support to SMEs, increased competition pressures and mitigation measures taken to manage the Covid-19 effects on the economy, they expect a further ease of terms and conditions in Q1 2021. In this context, banks stated that they are expected to offer mainly eased terms and conditions to both categories of enterprises, especially to SMEs. Terms and conditions are expected to be eased through more favourable interest rates, increased loan size, extended maturities and lower collateral demands. Whereas, the increase of credit risk in the country and abroad, was considered as a factor that is expected to contribute negatively to the terms and conditions provided by the banking sector.

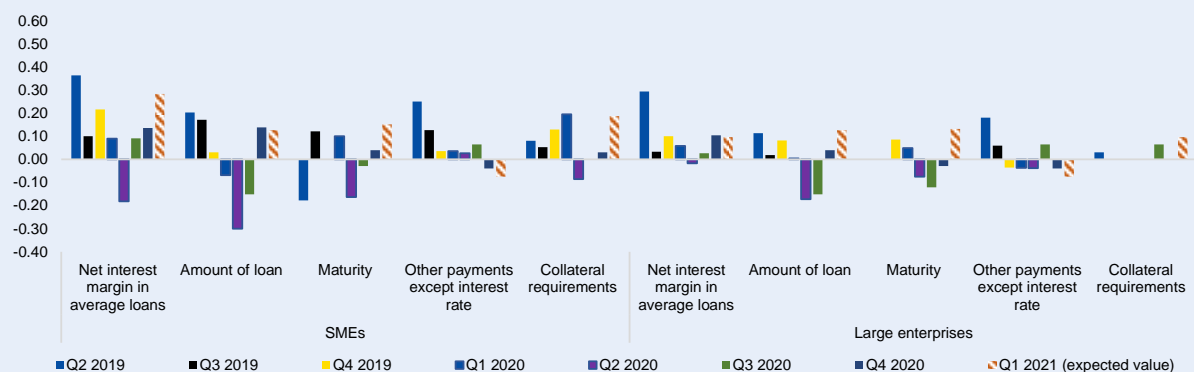
²¹ Bank Lending Survey is conducted by the Central Bank of the Republic of Kosovo with 9 banks operating in Kosovo and represent 99.9 percent of total sector lending. The survey is conducted on a quarterly basis. This survey covers the period October - December 2019 and expectations for the period January - March 2020.

²² Responses of individual banks were aggregated by using the appropriate weight of each single bank to total credit portfolio of the banking sector.

Positive values of the Credit Standards Index show ease of lending whereas negative values are characterized by a tightening of lending. Also, positive values of the Credit Demand Index show an increase of demand and the negative values show a decline. The most widely used methodology can be found in the Bank Lending Survey Report on the CBK website.

²³ 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.

Chart 32. Terms and conditions applied for loans to enterprises



Source: CBK.

During the reporting period, the demand of enterprises for bank loans turned out to have increased to some extent, although in the previous survey, banks had reported expectations for unchanged demand from the enterprise segment. The increase in demand for enterprises is attributed only to the demand from SMEs, while for large enterprises there was a decline in demand for loans but with a negative marginal index (chart 33). Furthermore, the quality of applications received improved, especially for SMEs. The ratio of non-performing loans to enterprises remained unchanged during Q4 2020 according to the statements of banks in the survey.

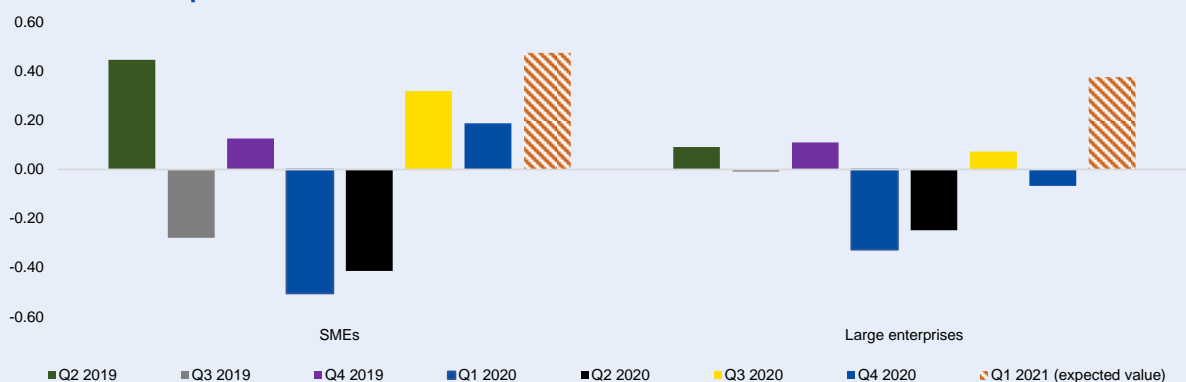
According to the survey, the increase in demand for loans from SMEs was largely influenced by the increase in demand for financing inventories and working capital, while the demand for financing fixed investments contributed negatively to the demand for loans.

Over the next quarter, banks expect an increase in activity for a large number of enterprises as a result

of easing the measures taken to prevent the spread of the Covid-19 virus. These expectations were reflected in banks' forecasts for changes in demand for loans during Q1 2021. Consequently, demand is expected to increase significantly by both categories, especially SMEs. The increase in demand for loans is expected to be influenced by the increase in demand of enterprises for financing inventories and working capital. Banks also expect an increase in demand for fixed investments, at a low level.

Regarding the quality of the corporate loan portfolio, banks expect the ratio of non-performing loans against total loans to increase to some extent over the next quarter. Regarding the timeline, the survey results show that the greatest demand during this period was for short-term loans. Demand for long-term loans also increased, but to a lesser extent. Whereas, the credit offer divided according to the maturity of the loans, remained almost unchanged for short-term loans and with a positive marginal index for long-term loans.

Chart 33. Enterprises demand for loans



Source: CBK.

In the next quarter, banks expect easing of credit standards for both terms, especially for long-term

loans. At the same time, in terms of demand, banks expect an increase in demand for loans for both

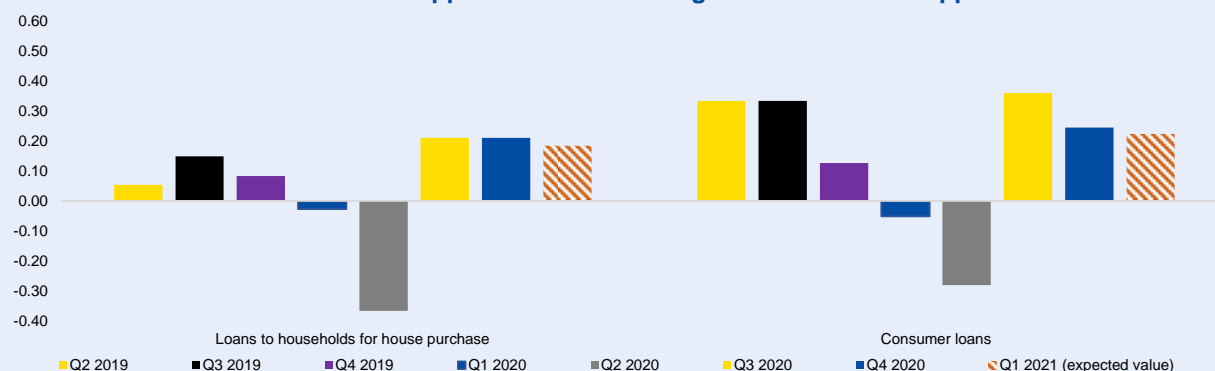
terms, characterized by a similar positive index (chart 37).

The dynamics of lending activity to **households** during the reporting period, according to the survey, were positively affected by both credit supply and demand. Considering that the measures preventing the spread of Covid-19 were eased to some extent during the fourth quarter and consequently the economic activity was normalized to some extent, the credit standards applied during the review of loan applications by households were eased for both types of loans at an approximate level (chart 34).

According to the bank lending survey, the factors that contributed positively to the credit standards applied during this quarter were the increase of competitive pressures, the favourable liquidity position of the sector and the access to financing, as well as the enhancement of the outlook of markets inside and outside the country.

Banks' expectations for Q1 2021 give indications for easing of credit standards to a level similar to that of Q4 2020. Easing at a large extent is expected to be applied to consumer loans.

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

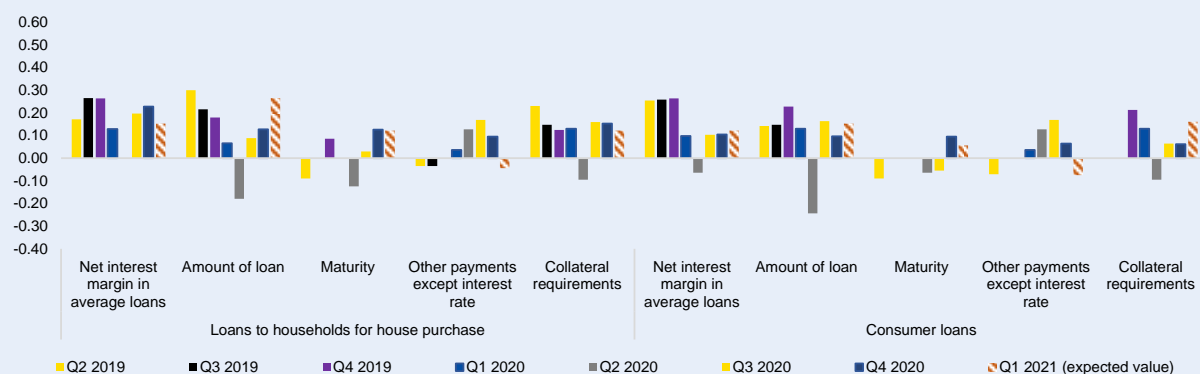


Source: CBK.

Terms and conditions for new loans to households were generally eased to some extent in the fourth quarter of 2020. The easing of terms and conditions was higher for loans for purchasing houses than for consumer loans. 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 and, to a lesser extent, increasing the approved amount and extending the maturity. Simultaneously, the reduction of

the interest rate had the highest positive index for new consumer loans during this quarter (chart 35). Increased competitive pressure, favourable cost of financing (favourable liquidity position of banks and favourable access to finance), lower risk perception due to the improvement of prospects in the market in general and the banking in particular, turn out to have been a key factor in easing lending terms and conditions for households during the fourth quarter of 2020.

Chart 35. Terms and conditions applied for loans to households



Source: CBK.

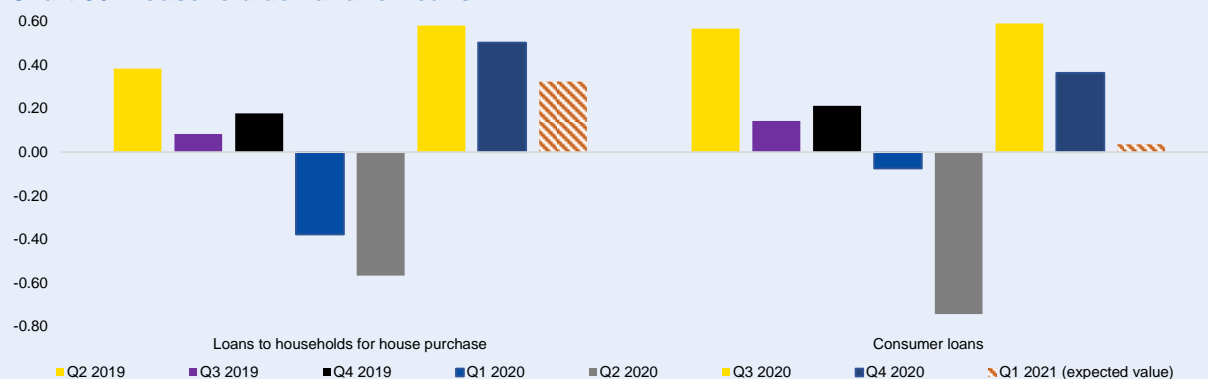
In the next quarter, the terms and conditions for loans to households are expected to be eased to some

extent. A greater ease is expected to apply to loans for purchase of houses, focused on increasing the

size of loans and lowering interest rates. While for consumer loans, banks expect to ease the terms and

conditions by reducing the collateral requirement and increasing the amount of loans.

Chart 36. Household demand for loans



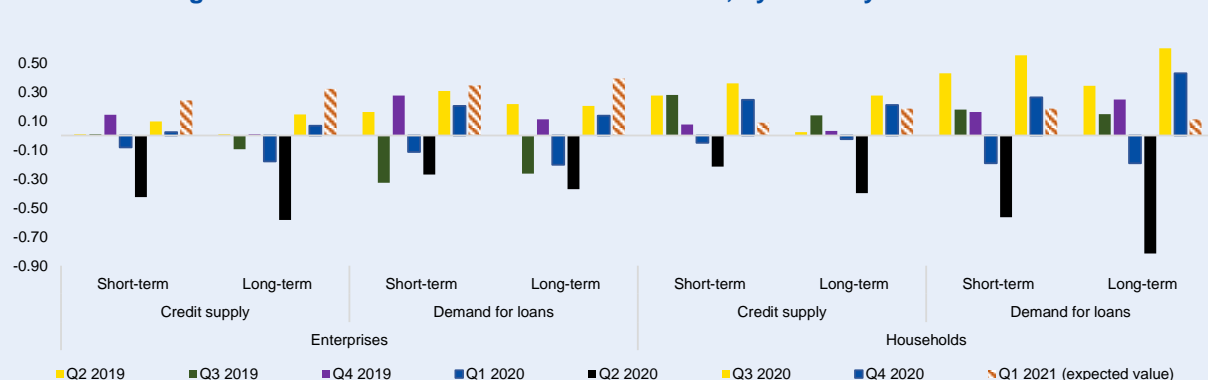
Source: CBK.

Banks reported a significant increase in the demand for household loans. Both categories of household loans recorded an increase in demand, but the demand for loans for purchasing of houses increased more than the demand for consumer loans (chart 36). The increase in demand from households is mainly attributed to the satisfactory prospect of the real estate market and the increase in consumer confidence in their loan repayment capabilities, and to a lesser extent the increase in the financing of other expenses. Also, the quality of applications received increased to some extent for both categories of loans to households, especially loans for house

purchase. According to the survey, the ratio of non-performing loans to total loans to households have increased, although at a low level, which for the following quarter is not expected to have significant fluctuation.

In the first quarter of 2021, banks expect demand for loans to increase to a certain extent for loans for purchase of houses, while the demand for consumer loan is expected to remain largely unchanged. The survey results suggest that banks attributed these expectations to increased borrowers' confidence and demand for financing other expenses.

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



Source: CBK.

Regarding the timeline, the survey results show that during Q4 2020 households had increased demand for both terms, however long-term loans had a higher positive index as opposed to short-term loans.

Also, loan supply divided by loan maturity turns out to have been eased at some extent for both terms with a related positive index. Unlike Q4 2020, banks expect that in the next quarter, the credit supply

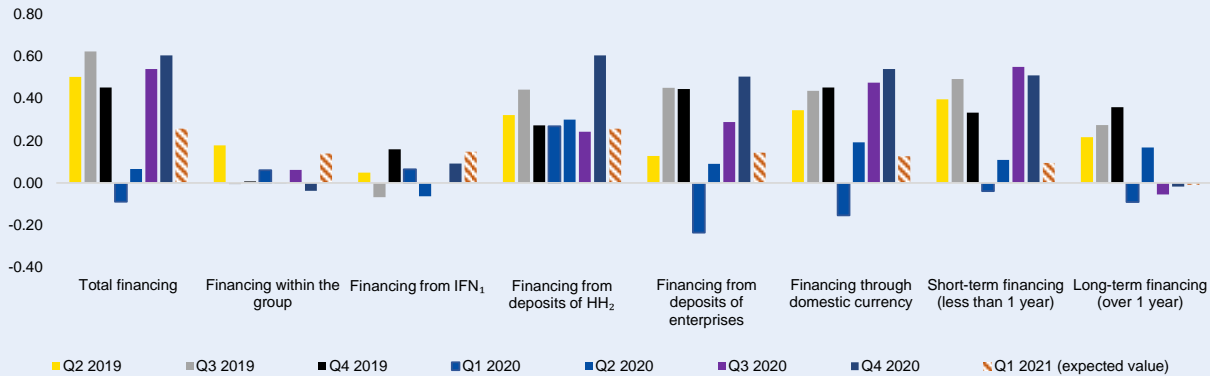
easing will be highly oriented towards long-term loans rather than short-term loans, which can be attributed to the easing of measures for the prevention of Covid-19 spread and supporting measures taken by the country's institutions. Whereas, the demand for loans is expected to have a higher growth for short-term loans than for long-term ones (chart 37). Banks reported significant increase in **access to finance** during the fourth quarter of 2020. Given the traditional model of the

banking sector in Kosovo, financing continued to be dominated by household and enterprise deposits. The results of the survey show that the bank financing during this quarter was influenced positively and at a high level by both household and enterprise deposits. Whereas other sources of funding did not change significantly. According to maturity, banks declared significant increases in short-term deposits, while the

long-term deposits had no significant changes in this quarter.

For the next quarter Q1 2021, banks expect increased access to finance, albeit at a significantly lower level compared to Q4 2020.

Chart 38. Change of the banking sector financing



Source: CBK.

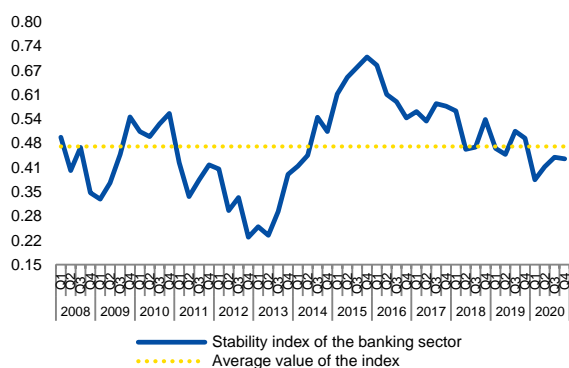
Financing through household deposits is expected to have a larger increase than through enterprises' deposits. Unlike the fourth quarter of 2020, in the next quarter two banks of systemic importance expect support in financing their banking activity by international financial institutions.

At the same time, one of the banks of systemic importance also stated that it expects support in financing from the parent bank, which resulted in a low positive index. In the following quarter, surveys signal expectations for continued dominance of short-term financing, while long-term financing is not expected to have any significant change (chart 38).

5. Risks of the banking sector

During 2020, the banking sector has operated in an environment with increased risks, as a result of the spread of the Covid-19 pandemic. However, the banking sector was well-positioned to withstand the increased risks, as a result of the favourable position in its soundness indicators, such as: good capitalization position, liquidity, high quality of loan portfolio and stable profitability. The banking sector stability index, which is elaborated below, assesses the internal conditions of the banking sector, reflecting its stability in the recent period in relation to the historical situation over the years.

Chart 39. Aggregated index of the banking sector stability



Source: CBK.

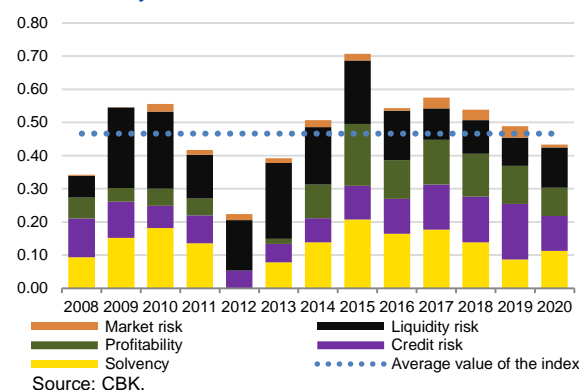
The index is built on the underlying financial stability indicators of the banking sector, taking values in the range from 0 to 1, where the highest values indicate a declining risk and vice versa. The index was calculated on quarterly basis to evaluate if there is an increase or decrease of risk sensitivity through this index.²⁴

Based on the aggregated overall index of the sector's stability, on average, there was an annual increase of the sensitivity to the risk (chart 39). The indicators associated with increased risk involved credit risk, profitability and market risk indicators. Meanwhile, a decrease in sensitivity was

recorded in the liquidity and capitalization risk indicators.

Increased sensitivity to credit risk is mainly attributed to the level of non-performing loans, which, although at a low historical level, have started to increase during this year (chart 40). The increase of the sensitivity to profitability risk is attributed to the lower profit generated by banks, which is a result of the higher increase in expenses versus revenue.

Chart 40. Stability index of the banking sector, by risk criteria



Source: CBK.

The indicator that measures the sensitivity to market risk, measured through the open position in foreign currency to Tier 1 capital, has increased. However, this indicator has a very low weight in the overall financial stability index.

While, the decline of the sensitivity to liquidity risk resulted from the higher growth of liquid assets compared to the increase of short-term liabilities. The decline of the sensitivity to risk arising from capital adequacy is attributed to the increase in the capitalization ratio, influenced by the higher increase in regulatory capital (profit accumulated from previous years) compared to the increase in risk-bearing assets, the pace of which slowed down as a result of the lending slowdown.

The overall aggregate index suggests an increase of sensitivity to risk, compared to the historical average of the index (2008–2019),

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

but also to the average of the last four years. Despite these developments triggered by the effects of the Covid-19 pandemic, the state of soundness indicators of the banking sector remains satisfactory as it suggests a capacity to withstand the risks that the sector may face.

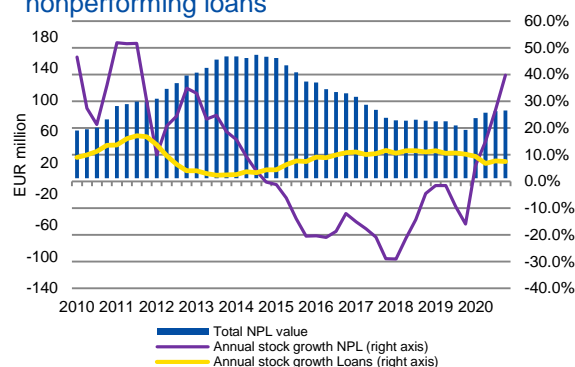
5.1. Credit risk

The spread of the Covid-19 pandemic has increased the credit risk of the banking sector. The increased risk is reflected in the migration of loans from the first pillar with the highest quality credit classification towards the second pillar, which recorded an increase in participation. Relief measures taken by the CBK, namely the restructuring of loans, contributed to the materialization of the increase of credit risk only partially by increasing the key indicator of loan portfolio quality at this stage - the rate of non-performing loans to total loans.

The NPL rate changed the downward trend it had in the last six years, increasing to 2.7 percent, from the historically low level of 2.0 percent recorded at the end of 2019. The increase is initially attributed to the methodological change in the evaluation of credit risk²⁵ under IFRS9, which entered into force at the beginning of the year.²⁶ As a result of this change, the NPLs rate increased to 2.5 percent in February 2020. Subsequently, the increase of NPLs reflects the increase of risk triggered by the pandemic situation. The stock of non-performing loans at the end of the year recorded an annual increase of 39.8 percent and reached the value of EUR 85.9 million (from EUR 61.5 million in 2019) (chart 41).

With the outbreak of the Covid-19 pandemic, the CBK took measures to alleviate the challenges posed by this situation.

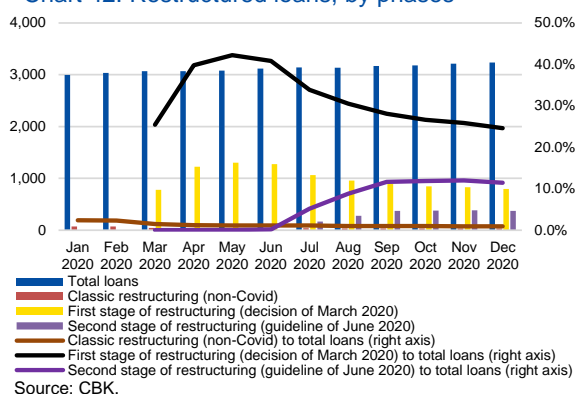
Chart 41. Annual growth of loans stock and nonperforming loans



Source: CBK.

Among them was providing the opportunity for loan restructuring, i.e., postponement of the deadline to pay the instalment, as well as loan restructuring by changing one or more terms of the contract (Box 4).

Chart 42. Restructured loans, by phases



Source: CBK.

The first phase of restructuring includes the moratorium on loan repayment for March - June 2020. The share of restructured loans in the first phase was higher, i.e., 40.9 percent²⁷ in June 2020, due to the borrowers' aggravated economic situation caused as a result of the total economic shutdown. In the second phase of restructuring, which started in June, the share of restructured loans was lower, respectively at 11.5 percent of total loans in December 2020 (chart 42).

The restructuring of loans during this period, as well as suspending the application of regular provisions of credit classification, has

²⁵ Regulation on Credit Risk Management April 2019.pdf (bqk-kos.org)

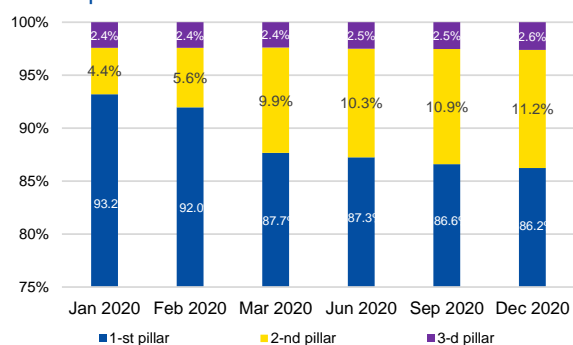
²⁶ Credit risk assessment, respectively credit classification and provisioning has undergone a methodological change, in accordance with the new Regulation on Credit Risk Management, approved in 2019 and implemented from the beginning of 2020. The new methodology is based

on the International Financial Reporting Standard 9 (IFRS 9) for credit risk assessment and measurement of reserves for expected credit losses (Box 2).

²⁷ The Chart reports the remaining balance of loans that have been restructured in the respective phase.

affected the increase of credit risk to not be fully reflected in the classification of loans into pillars by risk.²⁸ However, a migration of loans from the category with the highest quality of classification to the one with the lowest quality, respectively from Pillar 1 to Pillar 2 of credit classification occurs in the second half of the year. As of January of this year where the share of Pillar 2 loans was 4.4 percent, this share increased to 11.2 percent in December (chart 43).

Chart 43. Loans by new credit classification in three pillars



Source: CBK.

Box 4. Measures taken by the CBK to address the challenges posed by Covid-19

On 16 March 2020, the CBK decided to temporarily suspend the application of certain provisions of certain regulations on supervision of lending institutions, as a support against the challenges posed by the Covid-19 pandemic to the Kosovo's economy and financial system.

The measures taken by the CBK were in line with the emergency measures taken internationally to maintain the financial stability and support the economy and borrowers. The measures, which have implications for credit risk indicators, include:

1. Moratorium on loan repayment - suspension of loan instalment payments, without charging the penalty interest, for borrowers who have encountered financial difficulties as a result of decline in personal or business-generated revenues due to Covid-19. Initially the moratorium was approved from 16 March 2020 to 30 April 2020, which was then extended by three months until 16 June 2020.

2. Suspension of application of regular provisions in loan classification and provisioning²⁹, which enabled that during the period of loan moratorium and restructuring phase not to apply loan deterioration measures against borrowers and banks to not be charged with applications for additional provisioning for these loans.

3. Suspension of the provisions of the Credit Registry, which enabled in case of suspension of loan payments, not to classify loans and for borrowers not to suffer deterioration of credit rating in the Credit Registry.

4. Permitting borrower's loans restructuring, who according to the assessment of lending institutions, have been negatively affected by the Covid-19 pandemic. On 8 June 2020, the CBK approved the Guideline on Loan Restructuring due to Covid-19³⁰, which enabled borrowers' loans to be restructured so that borrowers in financial difficulties would be able to fulfil their obligations set forth in the contract. According to the Guideline, restructuring/mitigation measures include: a) facilitations made on loan terms by changing one or more of the terms of the contract, which are mainly related to the term (including grace period for the start of loan repayment), principal and interest rate (not including interest capitalization, which should not take place); b) taking of collateral or other assets (properties) for partial repayment of the loan; c) replacement of the original borrower or involvement of an additional borrower. The deadline to apply for loan restructuring was initially approved until 31 August 2020, to be subsequently extended until 30 September 2020. In February 2021, the CBK issued a new Guideline on Loan Restructuring due to Covid-19, according to which it became possible to apply for loan restructuring by 31 March 2021, with a maximum extension of the repayment period of 9 months. In addition to these regulatory measures, the CBK issued a **temporary measure to ban the distribution of dividends**, in order to maintain the generated profit to cover the applications for additional provisioning and possible credit losses.

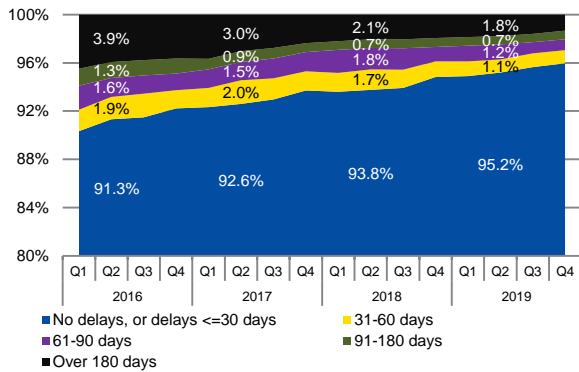
Changing the loans classification methodology makes it impossible to compare years of loan participation across loan pillars. Consequently, loans are presented separately as per the classification of arrears during the year for the current year as well as for previous years (chart 44A and 44B).

²⁸ The loan classification according to loan pillars has undergone a methodical change in 2020. From the previous classification into 5 categories (standard, watch, substandard, doubtful and loss), the banking sector in January 2020 has switched to the loan classification system in three pillars of loan classification.

²⁹ Suspension of all provisions of the Regulation on the Application of International Financial Reporting Standard 9, which relate to loan classification and provisioning.

³⁰ Guideline on Loan Restructuring due to Covid-19.PDF (bqk-kos.org).

Chart 44 A. Structure of loans classified by past due payments, old method

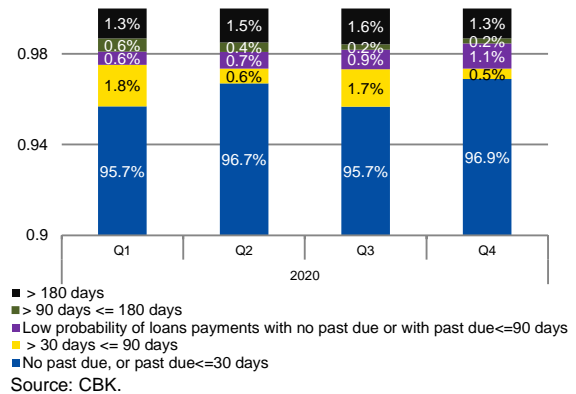


Source: CBK.

In the previous classification method, the last two categories, more specifically loans with arrears over 90 days and over 180 days, were deemed non-performing loans, while according to the new method, the last three categories, including the category with low probability of payment that have arrears of up to 90 days are deemed non-performing loans.

In December 2020, credit exposures without difficulty (with delays of less than 30 days) increased their share to 96.9 percent from 95.7 percent in March 2020. Loans in arrears of up to 90 days dropped their share to 0.5 percent of total loans, from 1.8 percent in March 2020. Whereas, non-performing loans (with low probability of repayment and without delays, as well as those with delays over 90 days) have increased their share to 2.7 percent from 2.5 percent in March 2020.

Chart 44 B. Structure of loans classified by overdue payments, new method



Source: CBK.

As noted above, the increase in credit risk as a result of the negative effects of the Covid-19 pandemic on the economy has not been fully reflected in the increase of non-performing loans due to loan restructuring measures. The deterioration of the key indicator of the loan portfolio quality, however, can be expected after the completion of the restructuring measures, which is at the latest by the end of 2021 under the assumption that there will be no extension of the restructuring deadline beyond that of March 2021.

Box 5. International Financial Reporting Standard (IFRS 9) and the provisioning of losses

In 2014, the International Accounting Standards Board (IASB) and other relevant bodies introduced a new standard based on the principles of financial reporting of financial assets and liabilities, which has implications on how banks have to calculate and report financial losses in their statements. This new standard, International Financial Reporting Standard 9, introduced the concept of 'expected credit losses' for calculating losses. As per the SNRF9, the Expected Credit Losses (ECL) framework has implications in the regulatory treatment of provisions by banks and in the regulatory capital framework.

The previous standard for calculating credit loss is based on the 'losses incurred' framework, which has recognized credit losses after the provision of evidence of those losses. Whereas, the 'expected credit loss' framework requires the calculation of credit losses on an on-going basis, taking into account past events, current conditions and expected events to determine the changes in the asset's credit risk and the value of losses expected from that asset at each reporting moment. The ECL approach that results from all possible events during the expected life of the financial instrument is a forward-looking approach, which enables more timely recognition of credit losses compared to the previous approach.

ECLs reflect the expected credit loss of the economic unit. The ECLs framework is applicable to all assets that are subject to accounting of impairment under the IFRS. The ECL-based credit risk management system should continuously and timely assess the quality of loans and other assets, including the determination of reserves adequacy for risk-related losses. Lending-related losses, the main asset of banks that will be subject to evaluation and reporting under IFRS 9, will be assessed and classified as follows:

Pillar 1 - Loans at the date of origination, as well as previous loans that did not experience a 'significant' increase in credit risk since the date of origination. At the time of origination/purchase of the loan, banks should calculate the expected credit loss that may be materialized from those exposures within 12 months after the origination and allocate the relevant provisioning. If, at the reporting date, the credit risk for a financial instrument has not increased significantly since its initial recognition, a bank shall measure the loss reserves for that

financial instrument at an amount equal to the expected twelve (12) month credit losses as set by IFRS 9 for impairment of financial instruments. In determining whether there a significant increase in credit risk has occurred since the date of origination, banks are to assess the change in the risk of default over the expected life of the exposure, i.e., the change in the probability of default. The revenue generated from interest for the Tier are calculated on the gross credit basis.

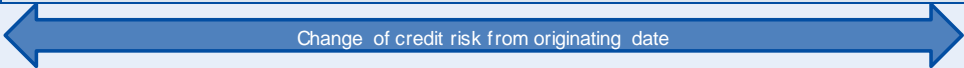
Pillar 2 - Loans which have experienced a significant increase in credit risk since the date of origination, and this risk is not considered low. For this class of loans, ECL are calculated for the entire duration of the loan. Interest revenue are calculated as in Tier 1.

Pillar 3 - Loans which have experienced an increase in credit risk to the point of being considered lost. ECLs are calculated for the entire duration of the loan. Interest revenue are calculated on a net basis (gross loans provision deductible).

In the credit classification and calculation of ECLs, an important concept is that of 'significant' increase of risk. Banks need to have a clear policy including the well-developed criteria for what constitutes a 'significant' increase in credit risk for different types of lending exposures. Banks should consider information that goes beyond historical and current data to take account of the relevant forecasting information including macroeconomic factors that are relevant to the exposure being assessed in accordance with the IFRS framework. 12-month ECLs and lifelong ECLs are also key concepts. The ECLs generally reflect the management expectations for deficiencies in the generation of contracted revenues. 12-month ECLs are part of the lifelong ECLs, associated with the probability of credit default in the following 12 months. 12-month ECLs do not include the lack of revenue in the next 12 months, but full credit loss effect throughout the lifetime of the loan, rated with the probability that the loss will occur in the next 12 months. Thus, the difference is that 12-month ECLs do not constitute credit losses of loans that are expected to default in the next 12 months, because if such loans, which have experienced a significant increase in credit risk, are identified, then ECL for the entire term of the loan must be calculated. Whereas, ECLs for the entire loan term are the present value of the expected credit loss in case the credit exposure defaults during the loan term.

Table 5. Loans classification, provisioning and interest accumulation under IFRS 9

CAR 9	Class 1 Performing	Class 2 doubtful	Class 3 nonperforming
Classification (criteria of decision)	Considerable increase of risk since the originating	*Considerable increase of risk since the originating *Qualitative factors suggest for a considerable increase of the risk, which yet has to be defined as such * Past due over 30 days	*Considerable financial difficulty of the borrower * Past due over 90 days *Bank has given ease due to financial difficulties
Allocation of provisions	Expected losses of loans for 12 months		HPK for total loan extension
Interest income	Retained gross amount	Retained gross amount	Net amount (gross value of loan deducted for provisions)



Source: Bank for International Settlements - BIS (May 2020)

ECLs for the entire loan term represent weighted average loss, weighted with probability of occurrence. Due to the fact that ECLs build on the time value of money, credit loss (or cash flow shortfalls) occur even when the bank expects to be paid in the future, but at later time than the contracted payment date. Banks should disclose the information based on which they assess the ECLs and the change in credit risk, because unlike the previous method that is based mainly on objective/quantitative criteria to define the respective defaults and losses (days in arrears), the current model requires qualitative assessment, in addition to the quantitative model of days in arrears, by which 'the bank considers that the borrower is unable to fully repay the credit liabilities to the bank',

Timely recognition of credit loss and allocation of relevant provisioning are important for the sustainability of the banking sector, due to the close interconnection between the capital position and the provisions, which is reflected in the Basel framework for capital.

Due to regulatory changes and changes in the accounting approach of the treatment of provisions between different jurisdictions, as well as the uncertainty of the effect of the application of IFRS 9 on the capital position, the Basel Committee on Banking Supervision has established transitional provisions for the application of IFRS 9. The timing

of application of IFRS 9 has varied from country to country. The full implementation of IFRS 9 in Kosovo has been mandatory since the beginning of 2020.

IFRS 9 in the context of the Covid-19 -Covid-19 pandemic outbreak resulted in significant adverse effects on the economy and increased risk to the financial system. To limit the movements in regulatory capital and financial statements of lending institutions as a result of the application of IFRS 9 in the face of extreme uncertainty caused by Covid-19, the regulatory institutions have taken relief measures by enabling financial institutions to suspend the use of IFRS 9 and apply the transitional provisions of IFRS 9 set out in the regulatory capital framework. Regulatory authorities have responded in due time by publishing guidelines on how to apply IFRS 9 during the mitigation phase. These guidelines recommend banks to avoid pro-cyclical assumptions in their IFRS 9 models, in order to avoid pro-cyclical effects on credit tightening.

In its Credit Restructuring Guideline, the CBK has instructed Lending Institutions to apply the guiding principles 'IFRS 9 and Covid-19' for the application of the ECL under IFRS 9 published on 27 March 2020 by the IFRS Foundation.³¹

This Guideline requires lending institutions to exercise sound judgment in the application of International Financial Reporting Standard 9

³¹ ifrs-9-ecl-and-coronavirus.pdf

(IFRS 9) especially during this time when there is a considerable uncertainty situation going on.

In the current economic environment, the ECLs assessment should take into account the temporary nature of the Covid-19 impact, the best information available, the relevant fiscal support measures and the use of scenarios to support the credit risk analysis, including the unfavourable scenario in the current situation. Simultaneously, lending institutions should bear in mind that IFRS 9 is based on principles and should therefore not be applied mechanically and avoid automatic application. As an example, the moratorium should not automatically result in the fluctuations of credit risk exposures in phase 2 as this does not necessarily mean that there has been a significant increase in credit risk.

In conclusion, mitigation measures, including loan restructuring, have been an essential support for the banking sector and borrowers in overcoming the short-term problems posed by the Covid-19 pandemic. However, the postponement of loans has transferred the risk into the future because the total debt of the borrowers has increased. According to IFRS 9, banks have calculated revenues from loan interest, which, in case of non-performance, increase the risk in the medium term. The restructurings aim at creating additional facilitations for new borrowers to negotiate loan terms most appropriately to their solvency, but which nevertheless contribute to transferring the risk from short-term to medium-term.

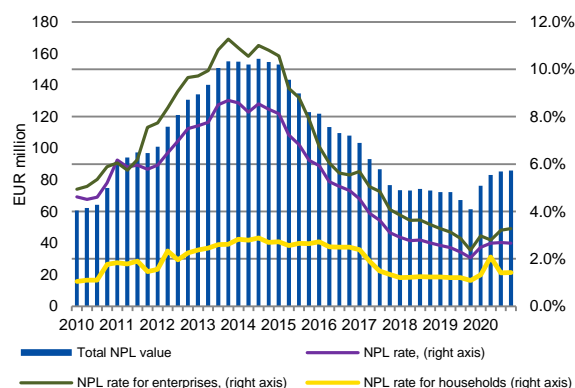
Source: Bank for International Mediation (BIM), ECB and CBK.

Households and the enterprise segment recorded an increase in non-performing loans. The ratio of non-performing loans to households stood at 1.4 percent from 1.1 percent in the previous year.

The double-digit growth of lending to the household segment in recent years is expected to eventually reflect the growing problems in loan repayment, given that the sources of revenue have grown at a much slower pace than lending. The value of non-performing loans for this segment increased by 95.8 percent, but the increase in lending of 49.9 percent has mitigated the effect of this increase in the NPL rate, which continues to be below the level of non-performing loans for the enterprise segment (chart 45). In the first

phase of the restructuring, namely the moratorium, about 33 percent of household loans were restructured, while in the second phase the share was significantly lower, i.e., only 1.8 percent at the end of December 2020.

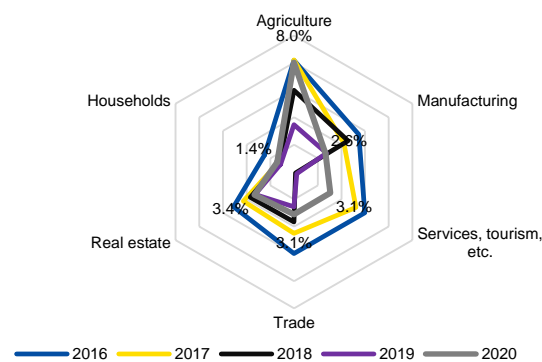
Chart 45. Nonperforming loans



Source: CBK.

The enterprise segment recorded the highest deterioration in credit quality, where the NPL rate reached 3.3 percent from 2.4 percent in the previous year. The value of non-performing loans in this sector increased by 28.0 percent, while loans decreased by 7.6 percent.

Chart 46. NPL ratio to loans stock, by sectors



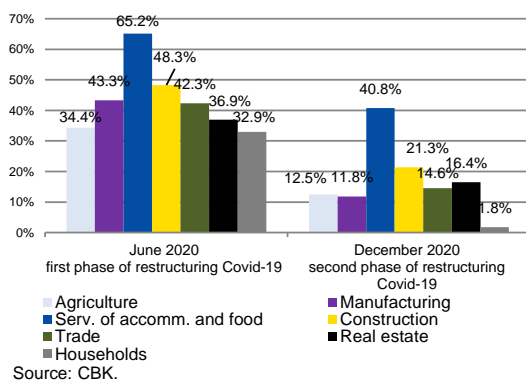
Source: CBK.

Developments in the quality of the loan portfolio of economic sectors were diverse, influenced by the asymmetric effect of the pandemic crisis between sectors. The trade sector, which represents the most credited sector, recorded an increase in the NPL rate by 0.5 percentage points. The agricultural sector, which is characterized by the highest rate of NPLs, recorded a further increase of this rate by 4.6 percentage points and reached 8.0 percent. The service and tourism sector also recorded an increase in the NPL rate, from 0.2

percent to 3.1 percent. Meanwhile, the manufacture sector recorded an improvement of the NPL rate by 0.1 percentage points (chart 46).

Chart 47 shows the loan restructurings by economic sectors. The average of restructured loans to the enterprise sector was 45 percent of the total loans of this sector in the first phase of restructuring, while in December 2020 the share of restructured loans was 16.8 percent. The sectors most affected by the restrictive measures applied to mitigate the spread of Covid-19 also have the highest share of restructured loans, with the most affected sector being the accommodation and food services sector with a total of 65.2 percent of loans restructured in the first phase of restructuring, and 40.8 percent in the second phase, respectively at the end of 2020. The next sectors to follow are the construction and real estate sectors. The trade sector, which has the largest share in the total credit structure, in the first phase of restructuring had 42.3 percent of restructured loans to total loans intended for trade, while the remaining balance of restructured loans in the second phase, respectively at the end of December 2020, was 14.6 percent in relation to the total loans of this sector.

Chart 47. Share of restructured loans to total loans of the respective sectors

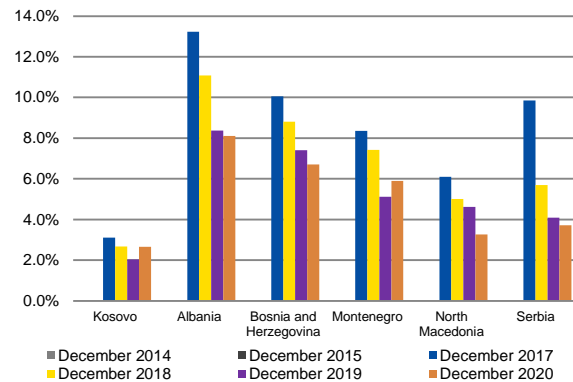


The quality of the loan portfolio is expected to deteriorate as a result of the effects of the economic crisis driven by the persistence of Covid-19 pandemic and uncertainties about vaccination. The full

effects of the crisis in the loan portfolio are expected to be seen after the completion of the mitigation phase, namely the loan restructuring as a result of Covid-19, which will be fully completed in December 2021 once the mitigation measures mature for all restructured loans. Interruptions in the normal operation of enterprises in certain economic sectors have already damaged the financial position of enterprises and households, which is also reflected in the need for loan restructuring. Moreover, the uncertainties created by the increase of cases in the so-called 'second wave' of facing the virus, and eventual preventive measures may slow down the economic recovery during 2021. Therefore, this situation may be reflected in the decline of the loan portfolio quality with a more pronounced effect in certain sectors that are more sensitive to these developments.³²

Kosovo's banking sector continued to position itself at the best level in the region in terms of loan portfolio quality. Over the years, Kosovo has the lowest ratio of non-performing loans compared to region countries, which have undergone a multi-year phases of improvement of the loan portfolio quality (chart 48).

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



However, it is expected that this trend will change direction for all countries, as a result of the consequences of the Covid-19 pandemic. Montenegro and Kosovo have already recorded an increase in the NPL rate. The magnitude of

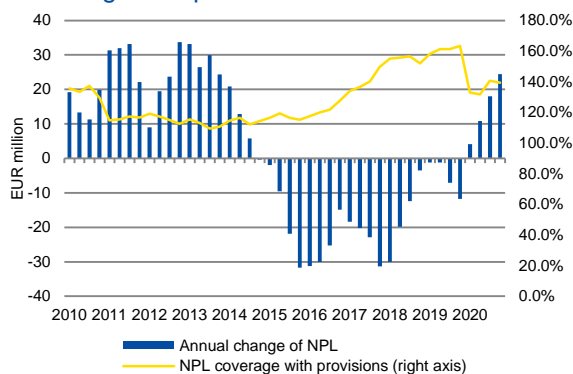
³² Data for Bosnia and Herzegovina are from June 2020.

the deterioration of credit quality will largely depend on the manner the pandemic is managed, the duration and extent of measures to prevent it, the application of support measures by governments and relevant authorities, and the specifics of countries' economic structure.

The Provisioning coverage ratio of the sector decreased to 139.4 percent compared to 163.5 percent in December 2019. The decrease in the provision rate is a result of the highest increase in the value of NPLs (chart 49).

The value of provisions is expected to increase in the following period as a result of increased credit risk. The CBK has permitted banks to suspend the regular provisioning method that was based on the principles of IFRS-9, until the end of November of this year, due to the situation created by the Covid-19 pandemic.

Chart 49. Annual change of NPL stock and coverage with provisions



Source: CBK.

Despite this decision, the banking sector has allocated the highest rate of provisioning, in which case the rate of provisioning (expenses for loan provisioning) for the sector, on average, was twice as high in December 2020 compared to the previous year.

5.1.1 Large credit exposures

The credit exposure rate recorded a higher increase to 85.5 percent compared

³³ 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.

³⁴ Ratio of total exposure to the number of exposures.

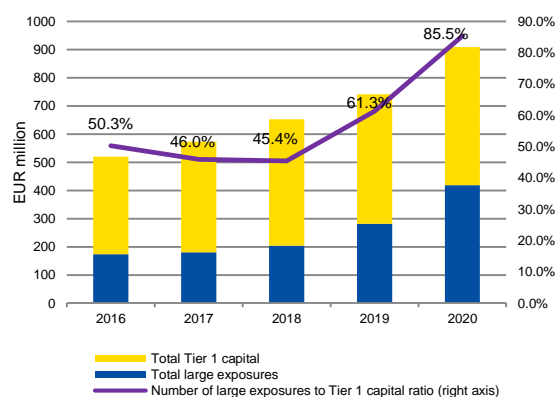
to 61.3 percent in the previous year, although it continues to be significantly below the maximum regulatory level.³³

The annual increase in the value of large exposures by 48.6 percent along with the slower growth of Tier 1 capital by 6.5 percent influenced the increase in the exposure rate (chart 50).

The concentration of credit risk, expressed as the ratio between the value of large exposures to the number of these exposures, has decreased. The average value of large exposures³⁴ decreased to EUR 9.3 million from EUR 10.1 million as a result of the increase in the number of large exposures.

The ratio of the three largest exposures to total major credit exposures recorded a slight decrease from 41.8 percent to 41.6 percent. The rate of large credit exposures in 2020 has increased as a result of increased exposures by banks that have no general systemic importance.³⁵

Chart 50. Concentration of credit risk



Source: CBK.

Results of the sensitivity analysis of the sector to shocks in the three and five largest exposures of banks, indicate in general the sensitivity of the sector to 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

³⁵ Large exposures reported by bank branches are not included in the analysis, for the first time this time, because they are not eligible according to the Regulation in force. Operating in the capacity of a foreign bank branch, these institutions 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, and regardless of this, it cannot exceed over EUR 25 million.

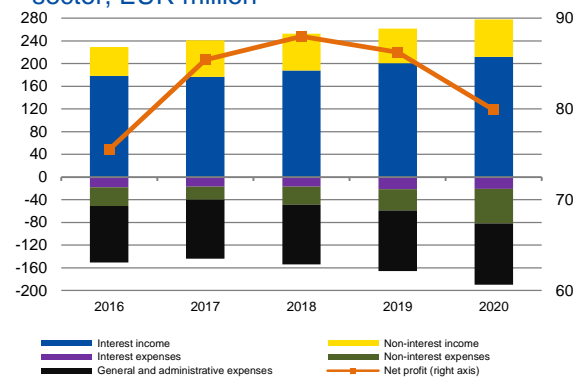
may increase the risk in terms of performance of these exposures and this situation increases the need for pro-active and dynamic approach in the management and treatment of large exposures.

5.2. Sustainability of profit and interest rate risk

Kosovo's banking sector maintained its profitability position despite facing the pandemic challenge. The increase in expenses for provisioning mainly contributed to lowering the profit of banking sector by 7.4 percent compared to the previous year. Revenues were characterized by slower annual growth than expenses, where except the interest expenses, all other categories of expenses recorded an increase.

The value of net profit decreased to EUR 79.9 million from 86.2 million in the previous year (chart 51). The main contributors to the increase in expenses, and at the same time the decrease in profit, were the expenses for loan loss provisions, reflecting the increase in credit risk affected by the Covid-19 pandemic.

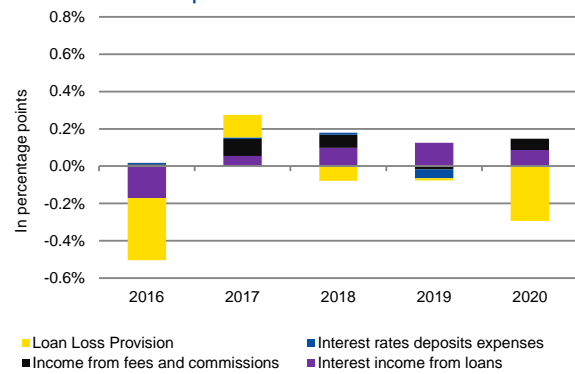
Chart 51. Profit structure of the banking sector, EUR million



Source: CBK.

The provision rate, expressed as the ratio of expenses for provisioning to net loans, almost tripled to 1.2 percent in 2020 from 0.4 percent of the sector average for the period 2017-2019, as a response of banks to increased credit risk and expectations for the increase in loan applications after the completion of the loan restructuring phase.

Chart 52. Main contributors to the growth / decline of the profit

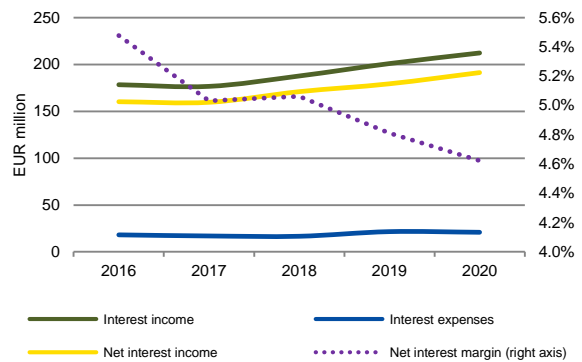


Source: CBK.

Interest expenses on deposits increased by 1.1 percent. The impact of the increase in interest expenses on profit reduction was much lower compared to the impact of the increase in non-interest expense (chart 52).

Net revenue from the interest for the banking sector increased by 6.6 percent as a result of the highest increase of revenue from lending activity. However, the net interest margin decreased to 4.6 percent from 4.8 percent in the previous year, as a result of the higher growth of the stock of interest-earning assets, an increase of 11.0 percent respectively (chart 53).

Chart 53. Interest income and expenses



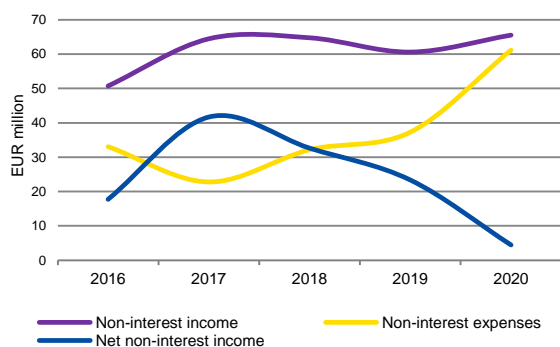
Source: CBK.

Total interest revenue increased by EUR 11.3 million (or 5.6 percent). Whereas only interest revenue on loans increased by EUR 6.9 million (or 3.6 percent), and were among the main contributors to the generation of profit.

Non-interest revenue (fees and commissions as well as other operative revenue) increased by 8.1 percent, amounting to EUR 65.5 million (charts 54 and 55).

Non-interest expenses increased by 64 percent to EUR 61.1 million, mainly as a result of expenses for provisioning which increased significantly by EUR 23.3 million. Expenses on fees and commissions increased by 2.3 percent, respectively EUR 0.5 million.

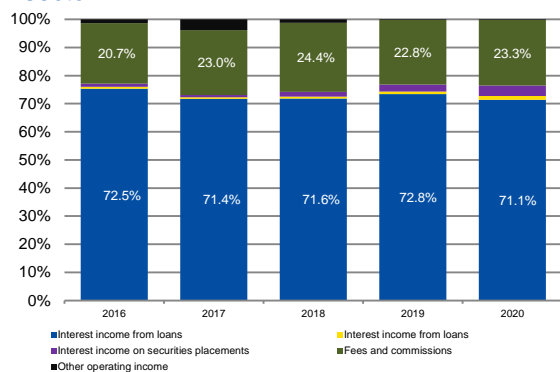
Chart 54. Non-interest income and expenses



Source: CBK.

General and administrative expenses increased by 0.9 percent, influenced by staff expenses and other non-interest expenses (chart 56).

Chart 55. Income structure of the banking sector



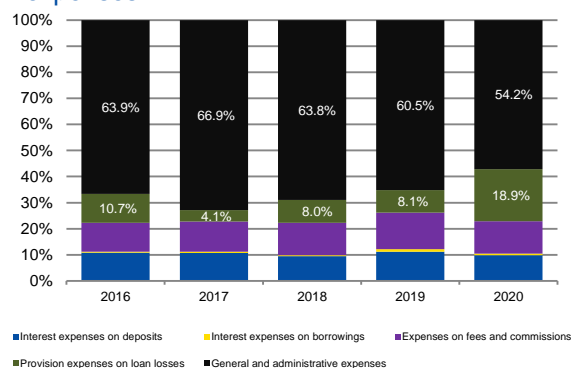
Source: CBK.

Banking sector profit is expected to face the on-going pressure caused by COVID-19 pandemic crisis. Uncertainties about the impact that this situation will have on the solvency of customers as well as the increasing need to allocate expenses for provisions to cover potential losses, can affect both the decline in revenues of the sector and the increase of expenses.

With the completion of the mitigation measure such as the moratorium, the migration of loans from the first pillar to the second pillar of the credit classification has increased, thus

increasing the exposure to credit risk. However, the effects of increased credit risk will be even more pronounced after the completion of another CBK's mitigation measure, such as loan restructuring.

Chart 56. Structure of the banking sector expenses



Source: CBK.

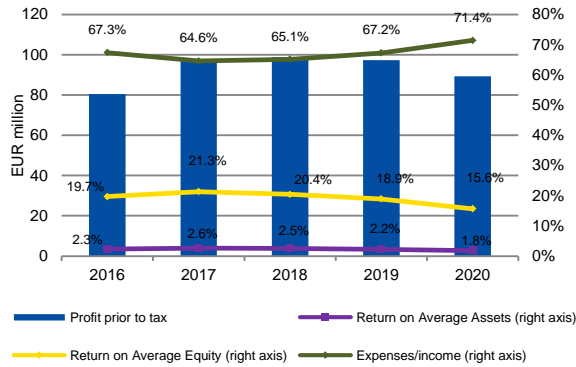
The deterioration of the credit portfolio of customers will affect the revenue of the sector through the decrease of the interest revenue from the loans, respectively through the non-collection of the principal as well as the deduction of the accrued interest, due to the expected increase of NPLs. Applications for provisioning are also expected to increase vis-à-vis the increase in credit risk. Hence, the negative effect on the profit position is expected to be felt both in terms of revenues and expenditures.

The possible positive impact of the Covid-19 pandemic on the performance of banks may be the intensification of banks' efforts to digitalize services, as well as the increase in demand or use of these services by customers. As a result, the sector can benefit from increased cost management efficiency and reduced operating costs.

Profitability indicators declined as a result of declining profits, however, they still remain at the highest level in the region. Kosovo's banking sector return on average assets and return on average equity dropped to 1.8 percent, respectively 15.6 percent from 2.2 percent and 18.9 percent in the previous year (chart 55). These levels are well above the region's average, which recorded a rate of return on assets of 0.9 percent and a rate of return on equity of 7.1

percent. Countries of region experienced the highest decline in profitability indicators during this year, increasing the difference between the average of Kosovo and these countries.³⁶

Chart 57. Profitability indicators of the banking sector



Source: CBK.

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.

The cumulative gap between interest sensitive assets and liabilities in 2020 was positive and expanded further to EUR 918.6 million, as a result of the highest growth of interest sensitive assets, in all maturities except in maturity "1-5 years" where asset growth was slower and was exceeded by liabilities.

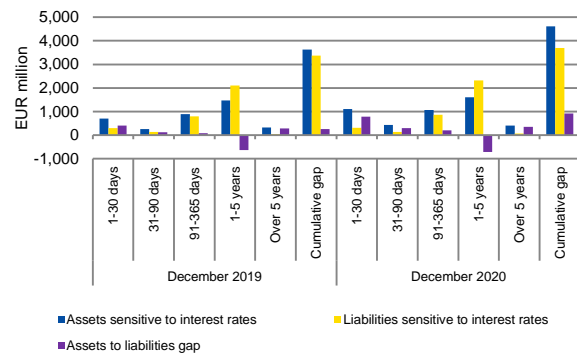
However, the balance sheet of the banking sector in Kosovo is mainly characterized by fixed interest rates (83.1 percent of loans are at fixed rates). Therefore, the sector is affected by interest rate fluctuations, mainly in the maturity of these positions. In the short-term, the possible increase in financing costs may increase the sector's expenditure pressure, as the loans, being the main asset category, are contracted at a fixed interest rate and have a

longer maturity. If we analyse only loans and deposits, which constitute the largest part of banks' balance sheets, the cumulative gap between them is negative due to the higher level of deposits in addition to loans, especially for the group with a maturity of '1-5 years'.

Compared to the previous year, the positive gap between assets and liabilities expanded for all maturities while the negative gap for the category with maturity '1 to 5 years' expanded further as a result of the increase in deposits with this maturity (chart 58).

The expansion of mismatches in these categories of maturities between assets and liabilities may increase the risk exposure to interest rate fluctuations for the respective time periods, as it may increase the balance of expenditures incurred for refinancing of assets in relation to revenues that will be generated from reinvestment of funds in these terms.

Chart 58. Assets and liabilities gap sensitive to interest rates



Source: CBK.

5.3. Risk from the position in foreign currency

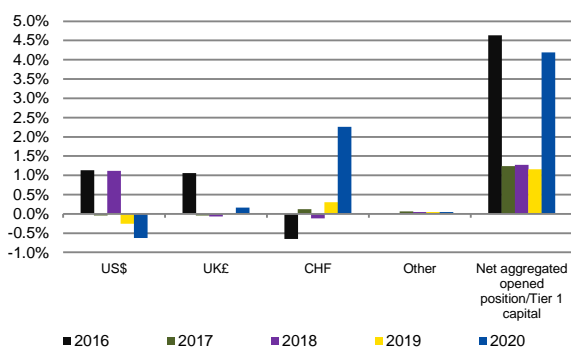
Banking sector exposure to the risk of changes in foreign exchange rates increased compared to the previous year.

The aggregate net open position for all foreign currencies increased to EUR 21.6 million equivalent from 5.6 million, consisting of 4.2 percent of Tier 1 capital compared to 1.2 percent in 2019 (chart 59).

Data for Bosnia and Herzegovina reflect the situation in June 2020 due to the lack of more recent data.

³⁶ Region countries include Albania, Serbia, Bosnia and Herzegovina, North Macedonia and Montenegro. The source of information is the IMF Financial Health Indicators database and the respective central banks.

Chart 59. Opened positions in foreign currency to Tier 1 capital



Source: CBK.

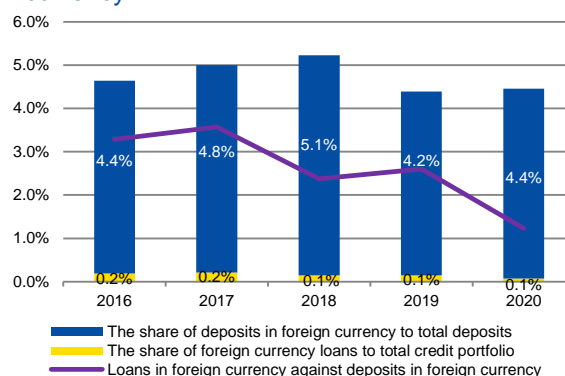
By specific currencies, the net positive position against Tier 1 capital increased for the Swiss franc, due to the increase in assets in this currency. The net position for the British pound also expanded, but as a result of the reduction of liabilities in this currency. This means that the banking sector is more exposed to the risk of possible depreciation of these currencies against the euro. For the U.S. dollar, the net open position is negative, which means that banks have more liabilities in this currency than assets.

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 at a marginal level. Loans in foreign currency account for only 0.1 percent of total loans, and recorded a decrease of EUR 2.0 million in the foreign currency credit portfolio compared to the same period of the previous year. Foreign currency deposits also have a low share, at 4.4 percent,

while they increased by EUR 25.1 million from the previous year (chart 60).

Chart 60. Loans and deposits in foreign currency

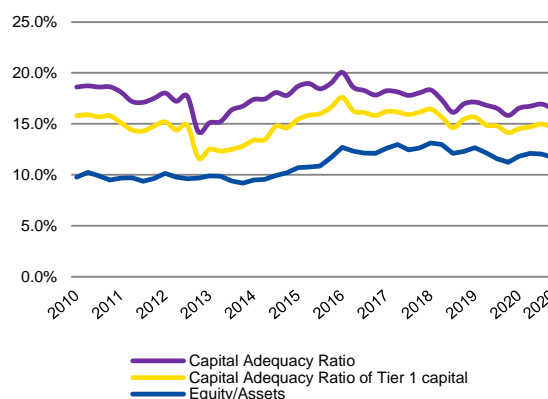


Source: CBK.

5.4. Capital

The banking sector continues to be well-capitalized, with capital ratios above the required regulatory levels.³⁷ The Capital Adequacy Ratio (CAR) increased by 0.7 percent, to 16.5 percent at the end of 2020.

Chart 61. Banking sector capitalization



Source: CBK.

The capital ratio varies among banks, where banks with systemic importance have a higher capitalization rate. At the sector level, the variance between the CAR of individual banks against the banking sector average has declined (CAR approximation to the sector average). The good capitalization position of the sector is also reflected in the Capital Adequacy Ratio of Tier 1 to risk weighted assets, which stood at 14.7 percent, with an

³⁷ The Capital Adequacy Ratio should always be above the 12 percent level of risk weighted assets. Tier 1 capital should always be at least 4.9 percent

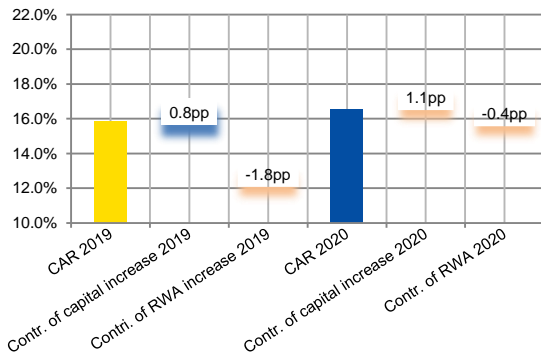
of RWAs, while Tier 1 regulatory capital should be at least 9 percent in relation to RWAs.

annual increase of 0.5 percentage points (chart 61).

The capital ratio varies among banks, where banks with systemic importance have a higher capitalization rate. At the sector level, the variance between the CAR of individual banks against the banking sector average has declined (CAR approximation to the sector average). The good capitalization position of the sector is also reflected in the Capital Adequacy Ratio of Tier 1 to risk weighted assets, which stood at 14.7 percent, with an annual increase of 0.5 percentage points (chart 61).

The increase of CAR and CAR1 by 0.7 and 0.5 percentage points, respectively, is attributed to the higher positive effect of capital growth of 7.2 percent, with an increasing contribution of 1.13 percentage points to the capital adequacy ratio. Risk weighted assets recorded an annual increase of 2.6 percent and contributed negatively to the CAR by 0.40 percentage points (chart 62).

Chart 62. Contribution of Regulatory Capital and RWA to capitalization ratio

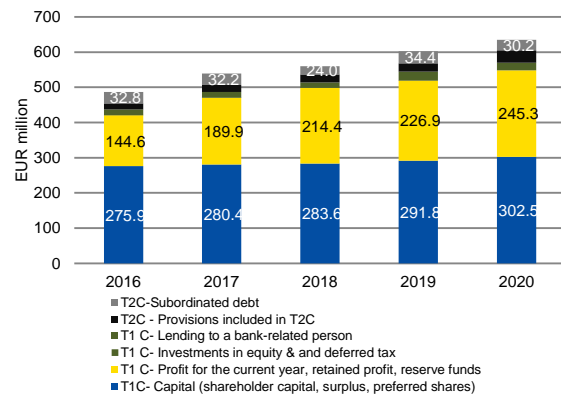


Source: CBK.

Compared to the previous year, the annual growth rate of RWAs was almost four times lower, as a result of the slowdown in lending activity due to Covid-19 pandemic. While regulatory capital recorded an annual increase of 3.0 percentage points higher than the increase of the previous year, influenced by the higher profit retained from previous years.

The banking sector has a strong regulatory capital base, of which 88.7 percent is Tier 1 capital. The retained capital has a high share of Tier 1 capital (41.7 percent), which suggests that banks are oriented in creating capital mainly within their activity (profit capitalization).

Chart 63. Structure of regulatory capital



Source: CBK.

In the context of the total regulatory capital, the share capital, profit retained from previous years, and provisioning recorded an increase. Only interdependent debt was characterized by a decline (chart 63). The distribution of the dividend was temporarily suspended by the CBK as a safeguard to strengthen the capital position, in order to increase the capacity to cope with the potential losses caused by the Covid-19 pandemic as well as to support lending activity. In December 2020, the financial leverage indicator (Tier 1 capital ratio versus exposures after regulatory corrections)³⁸ stood at 10.0 percent (chart 64).

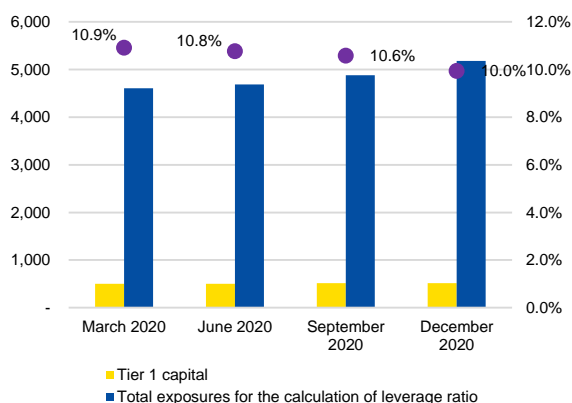
This ratio stands high above the minimum suggested by the Basel III framework for financial leverage, and suggests good capital position.

In the context of risk weighted assets, credit risk weighted assets recorded a slower growth rate of 2.5 percent from 12.5 percent in the previous year, as a result of the slowdown in lending activity.

³⁸ According to Basel III, the leverage rate is calculated as the ratio between Tier 1 capital and exposures following regulatory changes. This rate should

be equal to or above 3 percent. The CBK commenced as of 2020 calculating this rate according to the Basel III standard.

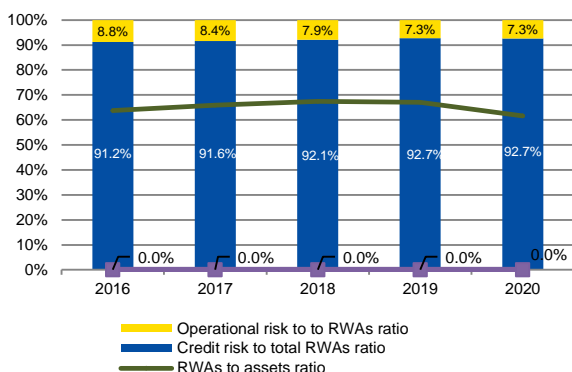
Chart 64. Leverage ratio



Source: CBK.

Operational risk weighted assets increased by 3.6 percent from 3.3 percent. The share of risk weighted assets remains similar, with 92.7 percent of RWAs weighted for credit risk, 7.3 percent for operational risk and a very low share of 0.0002 percent for market risk (chart 65).³⁹

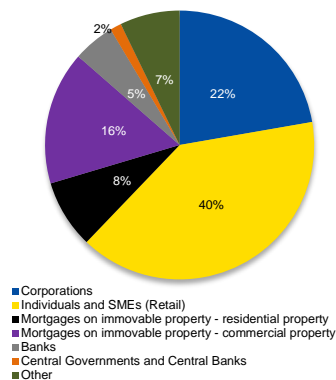
Chart 65. RWAs to total assets ratio



Source: CBK.

Credit risk-weighted assets amounted to EUR 3.3 billion (3.2 billion in 2019). These assets are dominated by retail loans at 39.9 percent, followed by exposures to corporates with 22.3 percent. Mortgage loans supported by commercial and residential real estate have a share of 16.1 and 8.2 percent respectively. Exposure to other banks, governments and central banks was relatively low at 5.0 percent and 1.4 percent respectively.

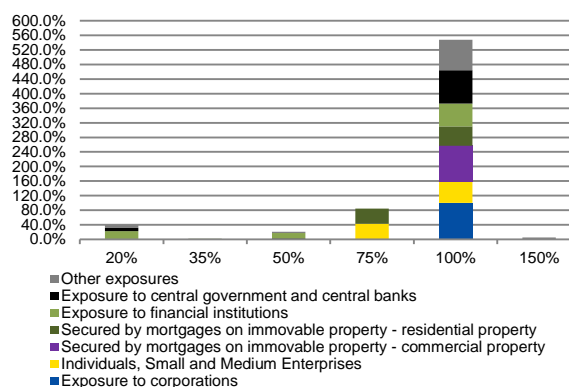
Chart 66. Credit risk-weighted assets, share



Source: CBK.

Other remaining exposures constitute 7.2 percent of the exposures, which include local authorities, public sector, development banks, and international organizations (chart 66).

Chart 67. Assets classification by risk weight



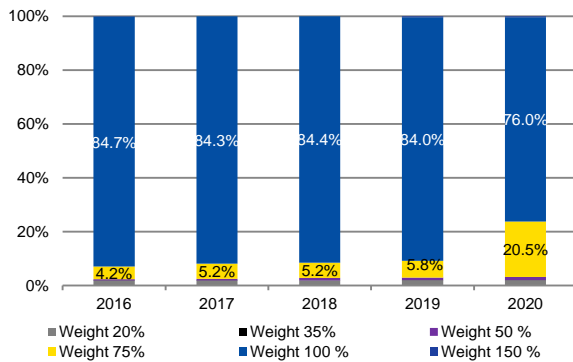
Source: CBK.

By risk weight, the category weighted by 75 percent, which includes retail exposures and residential property mortgage loans (chart 67), recorded the most significant increase in this period (by EUR 469.4 million). Assets with a risk weight of 150 percent also increased by 27.8 percent (or by EUR 2.5 million).

While 100 percent risk-weighted assets, which have the highest share in credit risk-weighted assets, decreased by 14.0 percent, thereby reducing the share by 8 percentage points. This development may suggest lower risk appetite for banks in the period of high uncertainty caused by the Covid-19 pandemic (chart 68).

³⁹ Market risk-weighted assets were reported for the first time in 2020, according to the new reporting format required by the CBK.

Chart 68. RWA structure for credit risk, by risk weight



Source: CBK.

5.5. Financing and Liquidity Risk

The pandemic-driven crisis initially increased the pressure on liquidity management from the banking sector; however, due to the favourable position of the liquidity situation before the pandemic crisis, the banking sector was well covered and with adequate reserves to continuously support the banking activity in the country. The good liquidity position was further supported by the continuous growth of deposits, in particular household deposits, which are also the main source of sector financing. However, uncertainties related to the duration of the pandemic, the vaccination program, and the level of government restriction measures for the protection against the spread of the virus continue to apply, and pose a challenge to the country's economy. Although more limited in the spectrum of mechanisms for direct liquidity injection in the market (in the absence of monetary policy, the CBK has at its disposal the Emergency Liquidity Fund instrument for direct injection of funds in the banking sector), can fulfil the potential liquidity needs through other mechanisms such as liquidity reserve management, interbank liquidity agreements and financing by the parent bank.

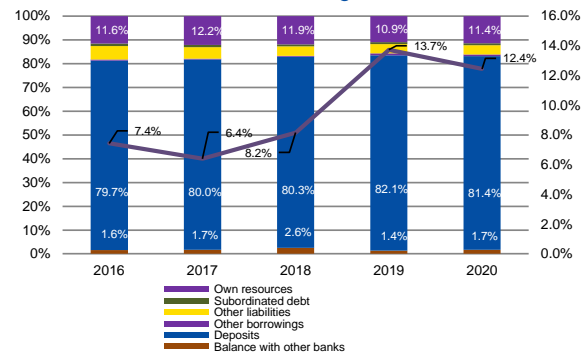
Under the influence of the pandemic situation as well as low interest rates, the share of transferable deposits has expanded, which in combination with the increase in long-term lending contributed to the emphasis on

maturity mismatches between these items. However, the main liquidity indicators give positive signals for the current state of bank liquidity, where the high level of liquidity reserves of banks held in the CBK but also of total liquid assets, makes the sector more resistant to possible negative effects that may result from maturity mismatches between investments and financing.

5.5.1 Bank financing

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

Chart 69. Structure of financing

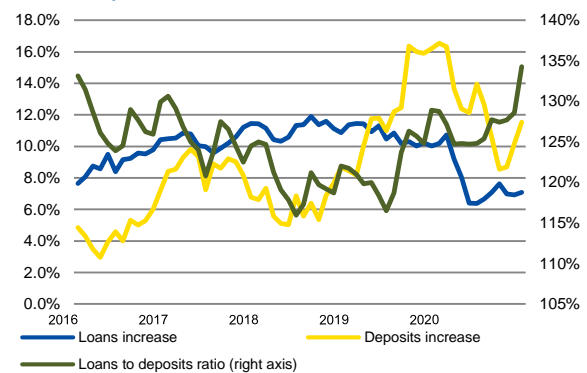


Source: CBK.

Interbank financing is at a very low level, so banks are very little exposed to external sector financing (chart 69).

This year, deposits exceeded loans by 134.3 percent, an indicator that increased by 5.4 percentage points from the previous year, under the influence of higher deposit growth (chart 70).

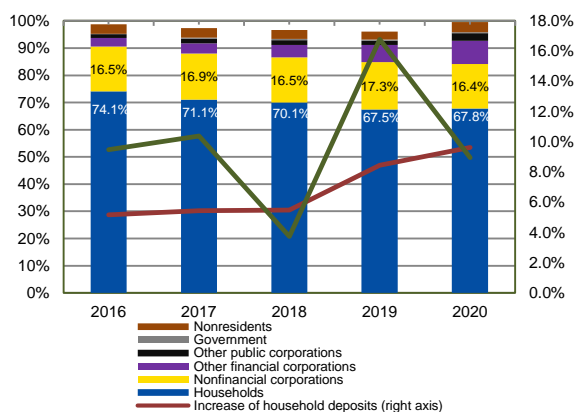
Chart 70. Increase of banking sector loans and deposits



Source: CBK.

The increase in household deposits in these circumstances of economic downturn and uncertainties about developments in the pandemic period reflect preferences for savings to the detriment of consumption and investment. Whereas, the increase of deposits in the last month of the year is mainly attributed to the approved withdrawal of 10 percent of pension savings.

Chart 71. Structure of deposits



Household deposits accelerated the growth trend to 13.2 percent from 11.5 percent in 2019 (chart 71). The stock of household deposits amounted to EUR 3.0 billion. Most of them were transferable deposits, which following their annual growth of 19.0 percent contributed to the growth of total household deposits (chart 72).

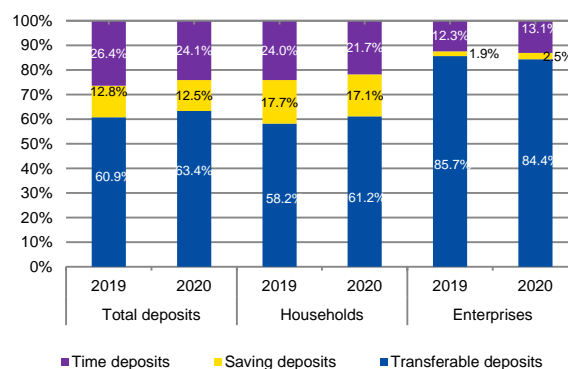
Enterprise deposits slowed the annual growth trend to 16.2 percent (29.3 percent annual growth in 2019), which may have been caused by the restrictions on their business activity due to the preventive measures against Covid-19 pandemic, especially in the second quarter of 2020.

The stock of enterprise deposits reached the value of EUR 968.9 million, with a share of 21.9 percent in total deposits.

The growth of enterprise deposits was mainly influenced by the growth of transferable deposits of 14.4 percent, due to the baseline effect. On account of uncertainties in generating revenue due to their economic activity limitations by the Covid-19 pandemic,

the greatest support was relied upon transferable deposits to cover their liquidity needs versus holding assets in the form of time deposits.

Chart 72. Structure of deposits, by maturity

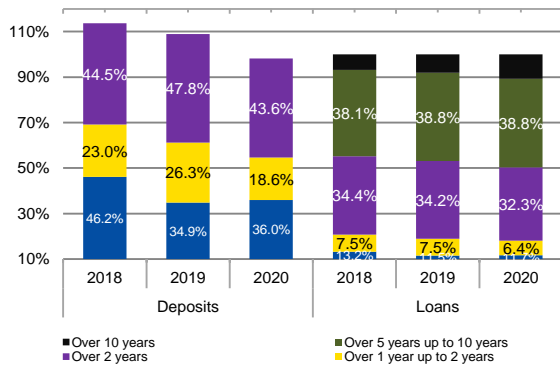


The structure of total deposits by maturity is dominated by transferable deposits, which recorded an increase even this year, at an annual rate of 17.5 percent. Transferable deposits amounted to 63.4 per cent of total deposits in 2020 (chart 72). Whereas, 41.5 percent of total deposits is composed of transferable deposits of households. Time deposits recorded an annual increase of 3.1 percent, while savings deposits 10.2 percent.

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 ‘over 2 years’, although with a decreased share from 47.8 percent to 43.6 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 of 38.8 percent in total loans (chart 73).

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, increases the need for more prudent supervision of stable financing of banks, especially in this period of uncertainty over the return to normality of economic activity and recovery of the country.

Chart 73. Maturity structure of deposits and loans



Source: CBK.

5.5.2 Liquidity Risk

The banking sector continues to maintain a satisfactory liquidity position, demonstrating the capacity to support lending activity as well as the high capacity to face the potential risks. In 2020, the ratio of liquid assets to short-term liabilities increased to 39.8 percent compared to 37.6 percent in 2019. This result was driven by the higher increase of liquid assets versus the increase of short-term liabilities of 20.6 percent and 13.8 percent, respectively. Also, the narrow liquidity ratio, which includes only very liquid assets, in relation to short-term liabilities, increased to 30.7 percent from 30.1 percent in the previous year.

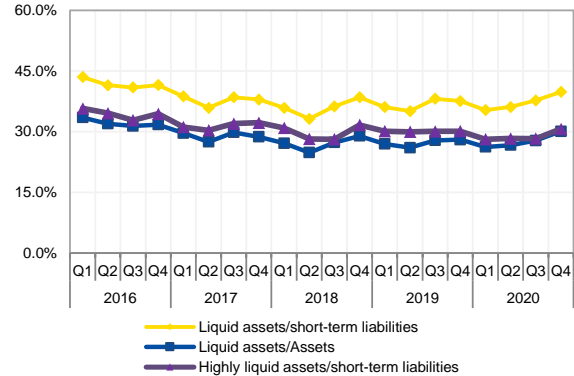
The ratio of liquid assets to total assets increased slightly to 30.1 percent (28.0 percent in 2019), as a result of the higher growth of liquid assets versus total assets (chart 74). The higher liquidity ratio (ratio of liquid assets to short-term liabilities) than the regulatory minimum⁴⁰, indicates the potential of the sector for financing the expansion of lending activity.

Liquid assets growth during the period resulted from the increase of EUR 143.4 million in the Central Bank’s liquidity reserves, or an annual growth of 34.6 percent. Moreover, the increase of transferable deposits by EUR 88.5 million, or annual increase by

⁴⁰ The ratio of liquid assets to short-term liabilities is defined in the Regulation on Liquidity Risk Management at 25% (Article 17. Liquidity rate).

56.8 percent, followed by the increase in cash by EUR 22.6 million or 10.9 percent, as well as Government of the Republic of Kosovo bonds by EUR 14.6 million or annual increase by 8.1 percent contributed to the increase of liquid assets.

Chart 74. Liquidity indicators



Source: CBK.

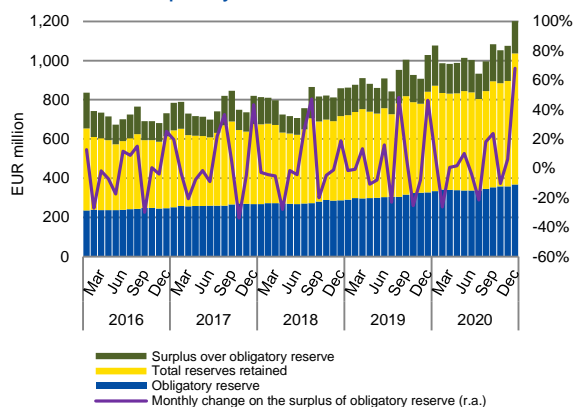
Whereas, the treasury bills of the Republic of Kosovo recorded a decrease of 49.7 percent, which did not greatly affect the stock of liquid assets due to the low share in liquid assets (1.6 percent). Deposits and placements with local banks recorded a decrease of 75.5 percent, or EUR 20.0 million.

Liquidity reserves of commercial banks continue to be at high levels, exceeding the required reserve held at the CBK by 82.3 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 75).⁴¹ 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.

⁴¹ 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.

Chart 75. Liquidity reserve



Source: CBK.

The low interest rate environment in recent years has stimulated households to relocate their deposits in favour of short-term maturity, which in addition to the upward trend of long-term lending has resulted in highlighting the maturity mismatches between assets and liabilities.

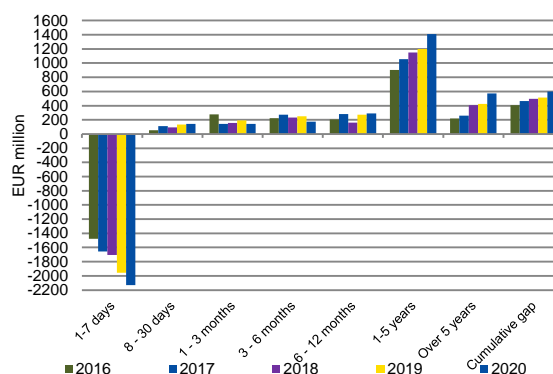
Maturity mismatches between investments and financing are increasing in the times where the transferable deposits are increased and the credit maturities are extended, a move that increases liquidity risk exposure.

The cumulative liquidity gap in 2020 expanded to EUR 597.7 million from EUR 513.6 million a year earlier. This result was mainly due to the more pronounced expansion of the positive gap between assets and liabilities of maturity of "1 to 5 years", due to the higher growth of loans within this maturity. About 36.1 percent of total assets are categorized within the '1-5 years' maturity in relation to the liabilities of this term that account for only 10.2 percent of total liabilities.

The negative gap results in the '1-7 days' maturity, amounting to EUR -2.13 billion. This category of maturity accounts for 73.2 percent of total liabilities, while assets comprise 23.8 percent. Consequently, maturity mismatches of the balance sheet items are most pronounced in the maturity categories '1- 7 days' and '1-5 years' (chart 76). This situation poses a

challenge to bank liquidity management for the increase of long-term lending.

Chart 76. Liquidity gap*



Source: CBK.

5.6. Shock Absorption Capacity - stress-test analysis⁴²

To test the resilience of the banking sector to the economic crisis as a result of the Covid-19 pandemic, scenarios were calibrated based on possible one-year forecasts. However, developments and consequently assumptions have been followed by great uncertainty, because the measures taken by local authorities to mitigate the crisis have isolated the direct effects of the pandemic on the balance sheets of the banking sector. In this publication, the drafting of scenarios will not include macroeconomic shocks to 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 elasticity coefficient of non-performing loans to GDP and output gap, measuring the sensitivity of the loan portfolio to economic activity, is modelled based on data that do not include any crisis situation in the history of the banking sector in Kosovo.

Consequently, sensitivity scenarios based on realistic occurrence assumptions were constructed in this publication. The exercise focuses on defining some norms of shocks to the quality of the loan portfolio, starting from judgments based on information received from

⁴² 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.

the banking sector to the private sector performance, namely the data on enterprise turnover during 2020. In this exercise, three scenarios at the sector level are considered, but with different effects on individual banks due to the balance sheet structure and financial performance.

This analysis does not include the assumption of changes in interest rates. Practice shows that in times of crisis the new loans will be considered at higher risk and therefore rise in interest rates can be expected. However emergency intervention of CBK and government institutions, as well KCGF's with mitigating measures to boost lending means lowering interest rates or keeping them at existing levels. Consequently, in the compiled scenarios it is assumed that these two effects are mutually exclusive and interest rates will have no significant movement.

According to the results of test shocks to the credit portfolio and capital position of the banking sector in general, it could withstand shocks in three design scenarios (table 6). However, at the banking level, some of them would face the need for additional capital to withstand shocks in their loan portfolio.

Results from test shocks to the liquidity position suggest that the banking sector has the financial capacity to handle the assumed situations of withdrawal of a significant amount of deposits. In all assumed scenarios, the liquidity position of most banks results to be stable, excluding the assumption of withdrawals of 38.5 percent of deposits at the end of the fifth consecutive day, where seven banks would turn out to have lack of liquid assets (table 6).

5.6.1. Assessment of resilience to credit portfolio shocks and capital position

The stress-test analysis for credit risk assesses the resilience of the banking sector, for the period of one year based on the situation of that year, to possible shocks in the loan portfolio

and the capital position, which may occur due to unfavourable developments. Analysis was carried out through the application of the three scenarios that have as a starting point the hypothetical determination of the failure levels of existing loans.⁴³

In all three scenarios, the credit growth is assumed to be 12.4 percent, based on forecasts for growth of economic activity during 2021. In this regard, it is expected that both CBK easing measures and government support measures, such as the Package of Economic Recovery will have an impact.

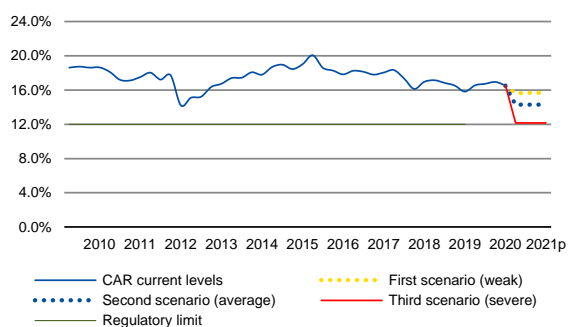
The first scenario assumes an increase of the non-performing loan ratio by 3 percentage points. It is also assumed that higher profit will be generated as interest revenues on loans may increase due to lending growth. In this case, the profit would increase by 1.4 percent in addition to the increase in lending, and after the deduction of unrealized interest due to the increase in NPLs. In this scenario, the sector turns out to be resistant to the growth of NPLs, in which case the capitalization rate would drop to 15.7 percent from the current level of 16.5 percent. Deterioration of the capital position would affect two banks, one of them being a branch of the bank which is not subject to the minimum capital requirement of 12 percent. Whereas, in two of the banks there is an increase in the capitalization rate, because the expected revenues to be generated in the following year are greater than the requirements for the expected additional provisioning, as well as due to the inclusion of generated profit in the current year in the calculation of capital level, under the assumption that dividend would not be allocated. (chart 77, table 6).

In the second scenario, the non-performing loan ratio is assumed to increase by 5 percentage points. The profit will experience a shock as a result of the increase in the default rate of existing loans. These assumptions are reflected in the

⁴³ The provision ratio according to the credit pillars for each bank, to calculate the additional provisions needed with the increase of NPLs, is determined to be the same as the average provision ratio of the sector.

calculation of profit for a period of one year so that the net profit after tax generated for 2020 is taken as a basis, increased by a certain degree along with the increase of lending, but then reduced by revenues that will not be generated due to the increase of the NPL rate.⁴⁴

Chart 77. Capital Adequacy Ratio, by scenarios



Source: CBK.

Profit would decrease at an annual rate of 4.1 percent, due to the increase in un-accrued interest due to the increase of NPLs. The sector's losses would amount to EUR 112.4 million (chart 78). These losses will be charged directly to equity, reducing the capital adequacy ratio to 14.3 percent. Four banks would be undercapitalized, including one bank of general systemic importance, for which the capital adequacy ratio would drop to 11.1 percent. The additional funds needed to raise capital to the minimum required level will amount to 19.5 million euros.

In the third scenario the sensitivity of the banking sector to more extreme negative developments is evaluated, respectively increase of non-performing loans ratio by 8 percentage points. The assumption is based on the supposition of the continuation of the pandemic crisis, followed by further restrictions as a result of delays in providing the vaccine and uncertainties about its receipt, and consequently delays in immunizing the population. This situation can be characterized by increased uncertainties in the generation of revenue and further weakening of the solvency of borrowers. The analysis does not consider the option of realizing collateral or increasing

capital from other sources, as the efficiency and the option of realizing these actions is very uncertain in times of crisis. The profit will be subject to shocks as a result of the increase in the default rate of existing loans, decreasing by 12.3 percent.

The sector's losses would amount to EUR 186.4 million (chart 78). The high level of provisioning held to cover the default of existing loans makes the sector resistant to the assumed shocks in this scenario. The post-shock capitalization rate is found to be 12.2 percent (table 6).

However, the number of banks having issues with the capital position would increase to six, of which, the same systemically important bank as in the second scenario, whose CAR would drop to 9.0 percent. The additional funds needed to raise capital to the minimum required level would amount to EUR 60.4 million (chart 78, table 6).

5.6.1.1 Exposure default risk scenario by economic sectors

Developments in the quality of the loan portfolio of economic sectors were diverse, influenced by the asymmetric effect of the pandemic crisis among sectors.

To assess the possible effects of loan defaults on economic sectors in the capital position of banks, the decline in corporate turnover for these sectors during 2020 was taken into account. The declining turnover rate of economic activities was applied to existing loans for relevant sectors, assuming that the same level of existing loans of the respective sectors could potentially default.

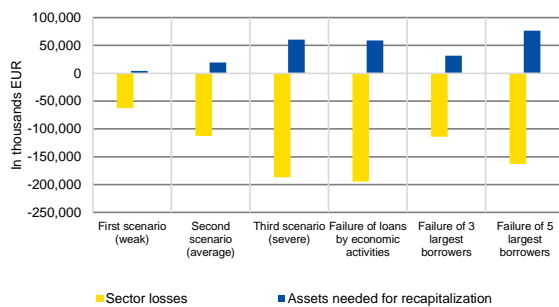
The results of the sensitivity test based on these assumptions suggest that the sector loan portfolio would deteriorate by 8.3 percentage points. The sector's losses would amount to EUR 194.5 million and the sector would not be able to meet regulatory capital requirements, with a capitalization rate that would drop to 11.9 percent (table 6, Chart 78).

⁴⁴ The estimation of 'lost' income as a result of the increase in NPLs was initially done by calculating ex-post the total interest rate on the loan for each bank, which was then multiplied by the value added of NPLs.

The loan defaults by sectors for each bank is asymmetric due to their different exposure in the respective sector and the asymmetric effect of the pandemic crisis between sectors. The most affected sectors, based on the annual turnover of enterprises, turn out to be the services and accommodation sector, the trade sector and the real estate sector.

Therefore, the banks that are most exposed to lending to these sensitive sectors are more sensitive to their capital position. Two of the six banks that are under-capitalized after the shock have a higher relative exposure to the services sector and will consequently result in a capital ratio of 10.8 percent and 7.5 percent.

Chart 78. ST results for credit risk-losses and recapitalization



Source: CBK.

While another bank that is also quite exposed to lending to the services and accommodation sector, is resistant to testing, due to the high level of absorption capacity through profit and the high level of provisions held.

5.6.1.2 Risk scenario from failure of large credit exposures

In this scenario, the banks' resilience to the possible defaults of the three and five largest borrowers is assessed. The assumption of failure of the three largest borrowers would cause the level of capitalization at the sector

level to drop to 14.5 percent and the loss to reach 113.8 million euros (chart 78 and table 6).⁴⁵ Three banks would face high losses, including a bank of general systemic importance, whose CAR would drop to 10.9 percent.

The default of the five largest borrowers would further aggravate the situation in these three banks, as well as another bank that would also be under-capitalized. Losses would amount to 162.8 million euros and the sector CAR would drop to 13.2 percent. The four under-capitalized banks would need an additional € 76.6 million to raise capital (chart 78 and table 6). The results of this scenario suggest that the sector is sensitive to large exposures, the performance of which should be closely monitored in the current crisis conditions. It is also noted that the increase in the concentration of credit exposures in conditions of further deepening of the economic crisis would put the sector in an unsatisfactory position.

5.6.1.3 Capital capacity of banks to absorb the growth of non-performing loans

The banking sector is able to withstand a ratio of NPLs to total loans of up to 11.6 percent without the need to inject additional capital to keep the sector CAR at the required regulatory level. Also, the resistance levels of each bank's NPLs before capital problems emerge are high for most banks. Exceptions are one bank that could withstand a NPL rate increase of only 1.7 percent before being undercapitalized and a systemically important bank which could withstand a NPL rate increase of only 7.1 percent. The highest level of withstanding the NPL rate increase is 18.9 percent of the total loan portfolio, before the bank is presented with the need for additional capital.

⁴⁵ Large exposures reported by bank branches are not included in the analysis, as they do not qualify as such according to the regulation in force. Operating as a branch of foreign banks, these institutions are not subject to

regulations restricting the ratio of exposures to the tier 1 capital of the bank but to the tier 1 capital of the parent banks, and nevertheless, can not exceed the amount of 25 million euros.

Table 6. Results of stress test scenarios for credit risk

Description	Number of banks with CAR<12%	Capitalization rate			NPL rate			Additional assets needed for recapitalization (EUR thousands)
		higher level	lower level	sector level	higher level	lower level	sector level	
		higher level	lower level	sector level	higher level	lower level	sector level	
Current levels (prior to shocks)		66.2	11.9	16.5	3.4	0.0	2.6	
Scenarios results								
Severe scenario: NPL decline rate for 3pp, credit growth for 12.4%, profit increase for 1.4%	2	30.7	9.9	15.7	6.4	3.0	5.6	4,248
Second scenario: NPL growth rate for 5pp, credit growth for 12.4%, profit decline for 4.1%	4	29.8	8.7	14.3	8.4	5.0	7.6	19,526
Severe scenario: NPL growth rate for 8pp, credit growth for 12.4%, profit decline for 12.3%.	6	28.5	7.0	12.2	11.4	8.0	10.6	60,351
Shocks in credit portfolio by economic activities: Failure of a percentage of loans based on the activities turnover	6	31.1	6.7	11.9	12.4	2.1	10.9	58,977
Failure of three largest borrowers	3	20.5	5.3	14.5	12.6	2.6	7.9	31,796
Failure of five largest borrowers	4	20.5	3.4	13.2	14.8	2.6	10.0	76,555

Source: CBK.

5.6.2 Assessing the resilience to liquidity position shocks

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

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

Scenario 1: Withdrawal of deposits on a daily basis

In this scenario, the withdrawal of deposits broken down by structure and entities is considered, at different levels of withdrawals on a daily basis (table 7) 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 of non-liquid assets would be only 1 per cent of these assets within a day.

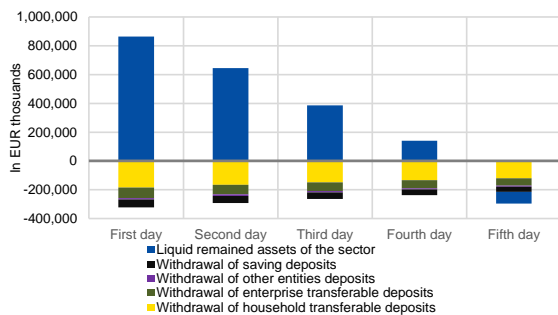
Table 7. Assumptions for liquidity risk scenarios

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.

Due to the uncertainties and panic created in the first days of lockdown from the measures taken due to the spread of the Covid-19 pandemic, depositors tended to withdraw their funds from the banking sector which caused a reduction in monthly deposits and a temporary reduction of liquidity. However, the decline had a short two-month effect and at a low level with a monthly decline of approximately 0.6 percent, which did not present any difficulties for the banking sector. While the banking sector in Kosovo has no history of previous financial crises and the practice of the pandemic did not give us high levels of deposit withdrawals, then more extreme levels were assumed to assess the banking sector's capacity to cover losses if such a situation were to occur and this level of deposit withdrawals would materialize. These more extreme levels are based on the experiences of countries in the region, which have experienced significant deposit withdrawals in the past.

Chart 79. ST results for liquidity risk - scenario 1



Source: CBK.

Scenario results suggest that most banks could withstand withdrawal of deposits at defined levels on a daily basis until the second day, whereby one

Table 8. 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	-38.5%	(156,833)	121.2%
Scenario 2.1: Withdrawal of deposits from 5 largest borrowers	1	-9.9%	(8,987)	82.7%
Scenario 2.2: Withdrawal of deposits from 20 largest borrowers	2	-16.4%	(35,399)	89.1%
Threshold - Withdrawal of deposits to the critical level of liquidity		-29.2%	(83,018)	105.2%

Source: CBK.

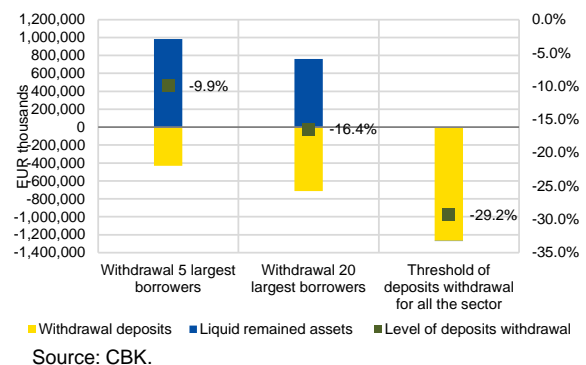
5.6.2.1 The resistance level of withdrawal of deposits before the liquidity position reaches critical levels Liquidity problems for the entire banking sector would arise in case of withdrawal of 29.2 percent of deposits within one day, which implies that the banking sector may be able to

bank would appear with liquidity needs. 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 156.8 million (chart 78, table 8). The level of total deposit withdrawal in the banking sector on the fifth day would reach 38.5 percent (table 8).

Scenario 2: Withdrawal of deposits by the largest depositors

The liquidity position of banks turns out to be able to withstand deposit withdrawals by the five largest depositors, with the exception of only one bank.

Chart 80. ST results for liquidity risk - scenario 2



Source: CBK.

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 35.4 million (chart 79, table 8). The results of this scenario generally suggest that the banking sector of Kosovo does not have a significant concentration of funding source, namely deposits.

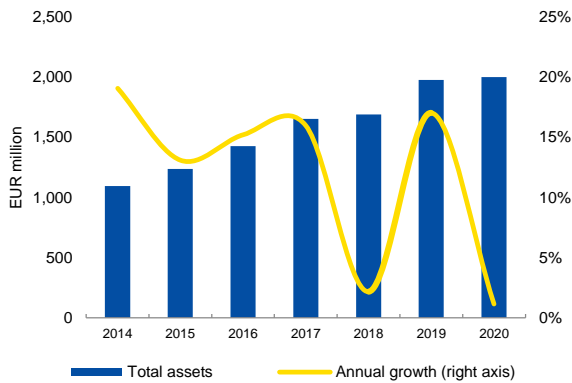
withstand the withdrawal of close to one quarter (1/3) of total deposits without needing extra liquid assets (chart 79 and table 8). Whereas at bank level, the bank with the lowest withdrawal threshold stands at 14.5 percent, while the bank with the highest threshold stands at 37.6 per cent (as a result of the high level of liquid assets owned by this bank).

6. Non-bank financial institutions

6.1 Pension Sector

Pension sector in 2020 recorded a slower asset growth, mainly attributed to negative effects of the pandemic Covid-19 and measure for withdrawal of 10 percent of the trust funds by contributors.

Chart 81. Assets of the pension sector



Source: CBK.

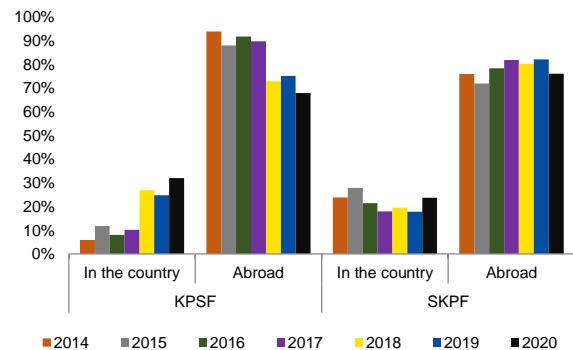
Pension sector was characterized by slowing growth of 1.2 percent annually, while the total value of the sector's assets amounted to EUR 2.0 billion at the end of 2020 (chart 81). The performance of the assets of the pension sector was affected by the slowing growth of the contributions received during the year, as well as lower returns on investment compared to 2019. However, the sector maintained a positive growth rate, despite the uncertainties raised by the pandemic situation and its effects on foreign markets and the domestic economic crisis, as well as the measure approved under the Law on Economic Recovery that enabled the withdrawal of 10 percent of pension savings for contributors.

The increase in activity in the pension sector 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 (SKPF). New collections recorded an annual increase of 4.1 percent (8.1 percent in 2019), the value of which reached 194.9 million euros at the end of the year. The slowdown in

the growth of contributions from contributors was attributed to the effects caused by the pandemic on the economy, translating into declining economic activity and declining employment rates. The pension sector closed 2020 with a positive return on investment, although lower return compared to the previous year. This dynamic was mainly influenced by the negative return on investment recorded during the first quarter of 2020 (the effects of the pandemic on financial markets in this period), a decline that was offset in the following quarters of the year.

The assets structure of KPST continues to be dominated by investments in the foreign market, although compared to the previous period there has been a decrease in share. At the end of 2020, the investment portfolio in foreign markets dropped to 1.35 billion euros, representing an annual decline of 8.6 percent (annual growth of 20.6 percent in 2020).

Chart 82. Structure of pension sector investments



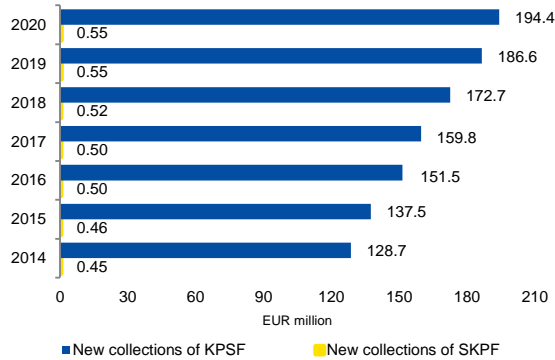
Source: CBK.

Investments abroad in December 2020 had a share of 68.0 percent of total KPST assets (75.2 percent in 2019). While, domestic investments recorded an increase in the share of total KPST assets to 32.0 percent at the end of 2020 (24.8 percent in 2019). The value of domestic investments reached 637.7 million euros, which represents an annual increase of 30.7 percent (chart 82).

Within domestic investments, the 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 70.7 percent (61.3 percent in 2019), whereas the weight of Certificate deposits decreased to 20.3 percent (38.1 percent in 2019).

Chart 83. Contributions collected by pension funds



Source: CBK.

Compared to the previous period, investments in the domestic securities market recorded a significant increase (by 50.8 percent), which reflects the higher demand of the Government of Kosovo for additional funds to finance fiscal packages to help citizens and businesses that have been affected by the Covid-19 pandemic. Whereas, placements in deposit certificates decreased by 30.2 percent, which reflects the withdrawal of pension savings from citizens at the end of December 2020. As a result of these developments, in December 2020 the value of KPST assets amounted to EUR 1.99 billion, which represents an annual increase of 1.1 percent (annual increase of 17.0 percent in December 2019).

At the end of 2020, the value of total assets SKPF amounted to 8.5 million euros, marking an annual growth of 3.5 percent. New receipts amounted to EUR 554.1 thousand euros, corresponding to an annual increase of 0.8 percent (chart 83).

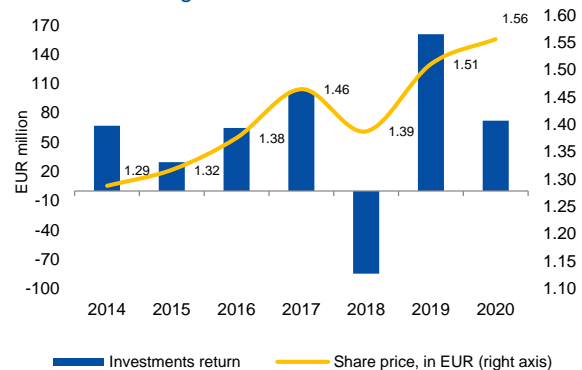
The majority of SKPF assets continue to be invested abroad, respectively 76.3 percent of total assets. The structure of investments abroad consists mainly of investments in the form of shares (84.5 percent), securities (13.5 percent), and commercial papers (1.5 percent). On the other hand, investments in Kosovo increased by 5.9 percentage points, with a share of 23.7

percent of total SKPF assets. Investments in the domestic market were distributed in securities of the Government of Kosovo (52.6 percent), deposits in commercial banks (3.5 percent), cash in the treasury of SKPF (13.8 percent), and others (30.1 percent).

6.1.1 Pension sector financial performance

The pension sector closed 2020 with positive financial performance despite the negative effects caused by the Covid-19 pandemic, offsetting losses incurred in the first quarter during the following quarters of the year.

Chart 84. Financial performance of Kosovo Pension Saving Trust



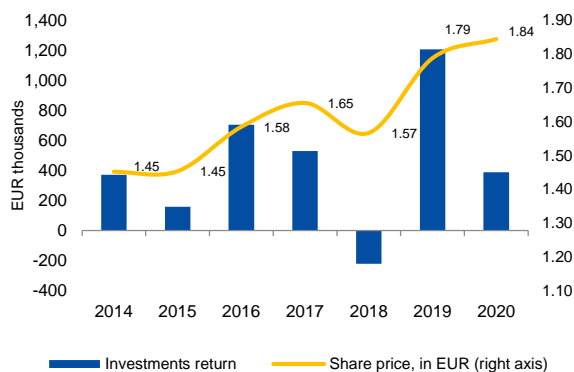
Source: CBK.

KPST had a positive return on investment in the amount of 71.9 million euros (160.7 million euros in 2019) (chart 84). The lowest return on investment, among other things, came as a result of the negative performance, respectively losses of 90.4 million euros in Q1 2020 (negative effects of Covid-19 in international financial markets), but which was offset in the following quarters of the year, respectively by gross return of 162.3 million euros during the period April-December.

Positive financial results were also reflected in the level of KPST share price, which on the last day of the year was 1.56 euros, compared to 1.51 euros on the last day of 2019. Significant increase in generated profits, especially during the second quarter of 2020, was reflected in a significant recovery of losses incurred during the first quarter of this year. This increase was mainly attributed to the rapid recovery of stock

markets (especially U.S. ones). The stabilization of stock markets was positively influenced by the expansionary policy of the FED, global fiscal intervention, increasing business sentiment and consumer credibility as well as the combination of financial instruments, conservative asset managers (multi-asset) and tradable funds.

Chart 85. Financial performance of Slovenian-Kosovo Pension Fund



Source: CBK.

SKPF was also characterized by a positive return on investment and an increase in the share price.

SKPF recorded a positive return on investment in 2020 in the amount of 388.8 thousand euros (chart 85). During the first quarter of 2020 alone, SKPF had recorded a negative return of 910.0 thousand euros, a dynamic that improved during the following quarters of the year. The share price on the last day of the year was 1.84 euros, compared to 1.79 euros on the last day of 2019.

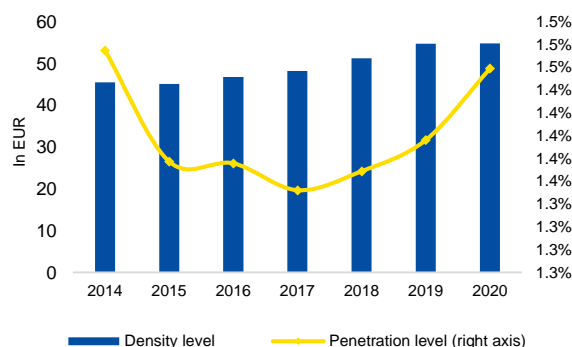
6.2 Insurance Sector

6.2.1 Activity of the insurance sector

The insurance sector in 2020 was characterized by an increase in assets, maintaining the level of premiums collected from the previous year and reducing the level of claims paid. The outbreak of the Covid-19 pandemic had a more pronounced effect on the decline in the level of claims paid (due to restrictions on movement), thus

influencing the insurance sector to make a profit in 2020.

Chart 86. Development indicators of insurance sector



Source: CBK.

With a share of 2.8 percent in the total assets of the financial system, the insurance sector is the fourth largest sector.

The level of intermediation and density of the insurance sector has remained similar to last year, with marginal changes compared to recent years. Expressed through gross written premiums in relation to GDP, sector mediation continues to be relatively low compared to the average of European Union countries, at 1.46 percent (1.40 percent in 2019). The level of density, measured through written premiums per capita, remains similarly low, which in 2020 recorded the value of 54.82 euros (54.77 euros in 2019).⁴⁶

The structure of the insurance sector continues to be dominated by 'non-life' insurer services, which represent 91.4 percent of the insurance market assets, while the remainder consists of 'life' insurer assets. The number of insurers remained unchanged over the same period last year, at 13, of which 11 are 'non-life' insurers and 2 'life' insurers.

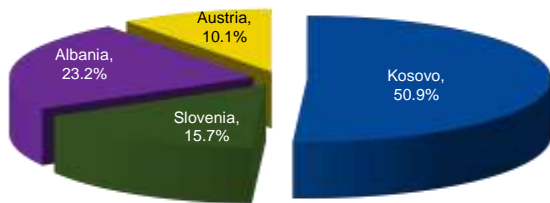
Half of the insurance market is represented by local insurers (about 51.0 percent), while the rest by insurers of foreign origin. Within companies with foreign capital, insurers from Albania have the highest share in assets, followed by insurers

⁴⁶ According to statistics published in the Insurance Europe database, the level of density during the period 2009-2018 in 32 European countries was 1,904 Euros (written premiums per capita), while the level of market

penetration (intermediation) during this period stood at 7.25 percent. <https://www.insuranceeurope.eu/insurancedata>

from Slovenia and insurers from Austria (chart 87).

Chart 87. Structure of assets of insurance sector, by ownership (December 2020)



Source: CBK.

The insurance market in Kosovo has a low concentration, which is a prerequisite for the functioning of greater competition in the market. Herfindahl Index⁴⁷ calculated for gross written premiums in 2020 shows 925 points (930 points in 2019). Whereas, the same index calculated taking into account the assets of the insurance market shows lower values, respectively 845 points for 2020 from 853 points in 2019.

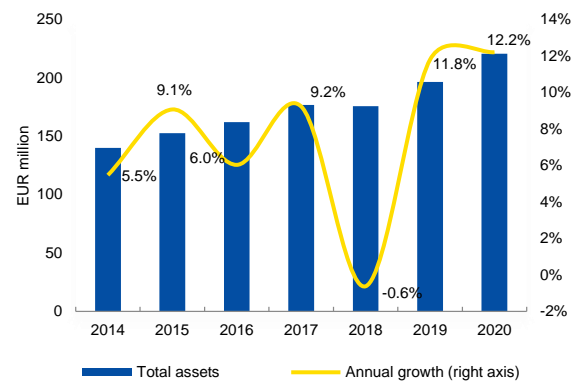
At the same time, the CR5 index⁴⁸ for premiums, calculated in relation to the GWP for the insurance sector, resulted in 55.1 percent in 2020 (54.7 percent in 2019), while calculated in relation to assets, it results in 50.1 percent (50.8 percent in 2019). By sectors, the concentration is higher in the 'life' insurance sector, as a result of the smaller number of operators in this sector.

Insurance sector assets amounted to EUR 220.5 million marking an annual increase of 12.2 percent (chart 88). 'Non-life' insurer assets increased by 12.7 percent, whereas 'life' insurer assets recorded an annual growth of 7.2 percent.

Within assets, the most significant increase was recorded in the category of deposits held in commercial banks, mainly in the form of time

deposits. The next position with the highest growth was the investment in securities of the Government of Kosovo. Meanwhile, the position of property investments, cash and deposits with the CBK decreased compared to last year.

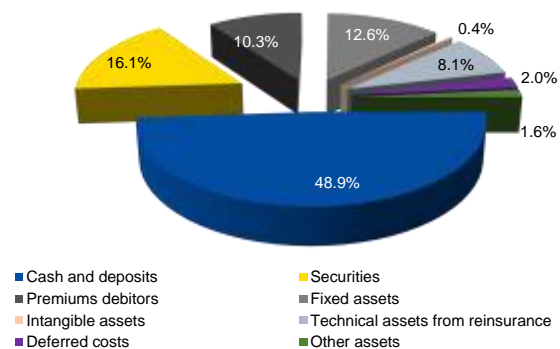
Chart 88. Assets of insurance sector



Source: CBK.

The investment structure of insurers is concentrated only on investments within the country. The investments in securities of the Government of Kosovo increased the share in insurance industry investments to 16.1 percent in 2020, from 14.1 percent in the same period last year (chart 89).

Chart 89. Structure of assets of insurance sector (December 2020)



Source: CBK.

Within liabilities and own resources, technical reserves continue to be the dominant category (chart 90). In 2020, Technical reserves recorded an annual increase of 7.6 percent, mainly influenced by the annual increase of

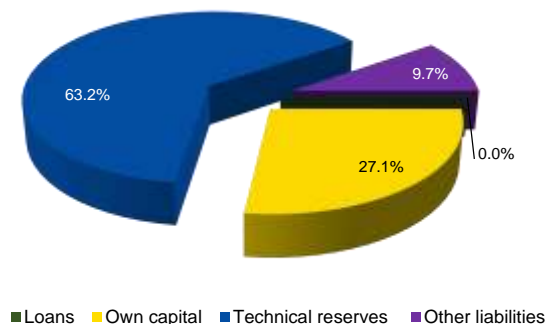
⁴⁷ Herfindahl index is calculated by the following formula: $HI = \sum_{i=1}^n (s_i)^2$, where S is the share of the company in total assets (gross written premiums) of the insurance market, n is the total number of institutions in the respective sector. If the index ranges between 1,000 to

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

⁴⁸ 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.

10.3 percent of reserves for gross premiums. Gross claims reserves recorded an annual increase of 6.4 percent.

Chart 90. Liabilities and capital of insurance sector (December 2020)

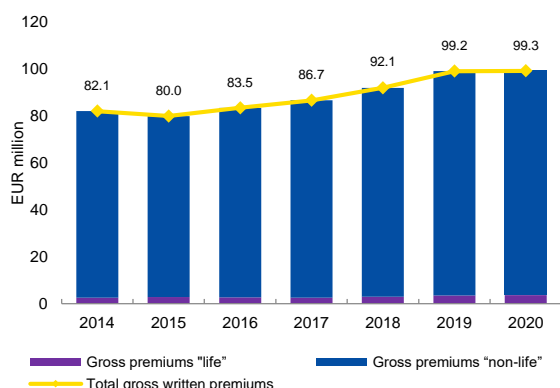


Source: CBK.

The capital of the insurance sector recorded a significant increase of 26.1 percent, reaching 59.7 million euros at the end of 2020. The capital increase is mainly attributed to the increase of 7.1 million euros of paid-in share capital, which at the end of the year reached the value of 91.3 million euros. Increasing impact, but to a lesser extent had the profit realized during the year. Whereas, the value of losses accumulated over the years, of 43.6 million euros, had a negative effect on the further increase of total insurance capital.

The value of premiums written by insurers in 2020 amounted to EUR 99.3 million, maintaining the level of receipts of the previous year (annual increase of only 0.1 percent).

Chart 91. Gross collected premiums



Source: CBK.

The structure of written premiums is dominated by "non-life" insurance premiums which represent 96.4 percent of total written premiums (chart 91). The value of premiums written by "non-life" insurance reached 95.7 million euros, similar to last year. The spread of the Covid-19 pandemic has largely halved the number of policies sold, particularly border policies. However, the increase in premium prices for compulsory third party liability insurance at the end of 2019 has affected the maintenance of the overall level of premiums collected during 2020, despite the decline in the number of policies sold. "Non-life" insurance continues to be dominated by compulsory insurance with a share of 62.3 percent in the total gross written "non-life" premiums, while voluntary insurance accounts for 37.7 percent of total gross written "non-life" premiums.

In 2020, compulsory insurance products recorded an annual increase of 3.9 percent, and their share in total "non-life" premiums increased compared to the previous year. The increase in the share of compulsory insurance was mainly influenced by "MTPL" products. While, voluntary insurance recorded an annual decrease of 5.9 percent, at the same time their participation in the total "non-life" premiums recorded a decrease. The decline in the share of voluntary insurance in the total gross written "non-life" premiums was influenced by the contraction of premiums for the products "Accident and Health", and "Loans and Guarantees" (table 9)

Whereas, the value of written premiums from "life" insurance reached 3.6 million euros, which is a higher value of 3.5 percent compared to 2019.

Claims paid by the insurance sector, including insurer companies and the Kosovo Insurance Bureau (KIB) claims, decreased by 6.6 percent, dropping to 51.5 million euros from 55.1 million euros in 2019.

Table 9. Gross written premiums by business classes (EUR million)

Activity	2019	2020	Change	Share: 2019	Share: 2020
<i>Total non-life</i>	95.7	95.7	0.0%	96.5%	96.4%
<i>Obligatory insurance</i>					
MTPL	47.0	53.8	14.6%	47.3%	54.2%
TPL+	2.5	1.8	-29.8%	2.5%	1.8%
Border insurance	8.0	4.1	-48.3%	8.0%	4.1%
<i>Voluntary insurances</i>					
Accident and health	19.6	16.4	-16.3%	19.8%	16.5%
Casco	5.4	5.5	1.2%	5.5%	5.5%
Loans and guarantees	4.5	4.4	-2.1%	4.6%	4.5%
Fire and other damages in property	5.3	6.1	14.8%	5.3%	6.1%
Overall liabilities	3.5	3.6	4.6%	3.5%	3.7%
<i>Total life</i>	3.5	3.6	3.5%	3.5%	3.6%
Total market	99.2	99.3	0.1%	100.0%	100.0%

Source: CBK.

Table 10. Claims paid, by business classes (EUR million)

Activity	2019	2020	Change	Share: 2019	Share: 2020
<i>Total non-life</i>	47.2	45.1	-4.5%	98.5%	98.0%
<i>Obligatory insurance</i>					
MTPL	25.5	25.9	1.6%	53.3%	56.4%
TPL+	0.7	0.1	-86.1%	1.5%	0.2%
Border insurance	2.8	2.2	-21.3%	5.8%	4.8%
Aggreement MoU	0.4	0.3	-26.6%	0.8%	0.6%
<i>Voluntary insurances</i>					
Accident and health	9.9	9.8	-1.1%	20.8%	21.4%
Casco	3.1	3.2	0.8%	6.5%	6.9%
Loans and guarantees	0.8	1.8	123.8%	1.7%	3.9%
Property insurance	3.6	1.5	-58.5%	7.5%	3.2%
Overall liabilities	0.3	0.3	-15.8%	0.7%	0.6%
<i>Total life</i>	0.7	0.9	25.6%	1.5%	2.0%
Total market	47.9	46.0	-4.1%	100.0%	100.0%

Source: CBK.

Of the total amount of claims paid, 46.0 million euros (47.9 million euros in 2019) were claims paid by insurers, while 5.5 million euros (7.1 million euros in 2019) claims paid by the KIB. Claims paid by reinsurers account for 10.7 percent of the total amount of claims paid by insurers (15.5 percent in the previous year). Restrictive measures within the country and the closure of non-essential economic activities reduced the damages incurred and consequently those paid. Also, the ban and restrictive measures of entry/exit in the territory of Kosovo, have influenced to reduce the number of arrivals of compatriots, which was reflected in the decline in the number of border policies sold.

The value of claims paid by "non-life" insurance decreased to 45.1 million euros from 47.2 million euros in 2019. Whereas, the amount of claims paid by "life" insurance increased to 902.2 thousand euros from 718.3 thousand euros in 2019, respectively annual growth of 25.6 percent (table 10).

The decrease in the level of claims paid under non-life insurance was affected by both voluntary and compulsory insurance claims payments. The amount of claims paid by voluntary insurance decreased to 16.6 million euros, an annual decrease of 7.0 percent, mainly affected by the product "Fire and other property damage". Meanwhile, claims paid by compulsory insurance, which have the largest

share in the total portfolio of claims paid, recorded a slower annual decline of 3.1 percent, falling to 28.5 million euros.

As a result of developments in the revenues and expenditures of the sector, respectively the similar level of premiums collected and the more pronounced decrease in claims paid, the ratio of claims paid to written premiums decreased by 3.7 percentage points to 51.8 percent (chart 38).

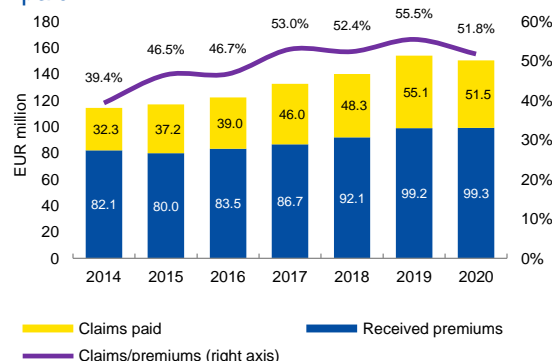
6.2 Financial performance of the insurance sector

The insurance sector closed this year with a positive financial result of 4.1 million euros, unlike last year where it had a negative financial result of 4.7 million euros. "Non-life" insurers recorded profits in the amount of 3.9 million euros, compared to losses in the amount of 5.2 million euros during 2019. While, "life" insurers realized lower net profit, in the amount of 263.8 thousand euros compared to 460.5 thousand euro profit in 2019. The positive financial result of the sector reflects the higher decline in expenditures, as a result of reduced level of claims incurred (annual decline by 9.1 percent), and reduced operating expenses (annual decline by 12.9 percent). On the other hand, revenues, which have as their main source the level of written premiums, remained at a level almost similar to last year (97.7 thousand euros more receipts than in 2019).

The combined ratio of the sector also reflects the improvement of the financial position. In December 2020, this ratio remained at 97.6 percent, reflecting the claims ratio to net earned premiums of 53.3 percent and the expense ratio to net earned premiums of 44.4 percent, excluding investment interest revenue. According to this report, the insurance market for 1 euro earned has spent 0.976 euros.

The sector increased the level of liquidity compared to the situation at the end of last year. The ratio between cash and cash equivalents to technical reserves stood at 102.9 percent (96.6 percent in 2019), as a result of the higher annual growth of cash and cash equivalents of 14.7 percent, compared to the lower increase of 7.6 percent of technical reserves. The ratio between cash and cash equivalents to total liabilities also increased, to 89.1 percent from 83.8 percent in 2019.

Chart 92. Received premiums and claims paid



Source: CBK.

6.3. Microfinance and financial auxiliaries sector

6.3.1 Activity of the microfinance sector

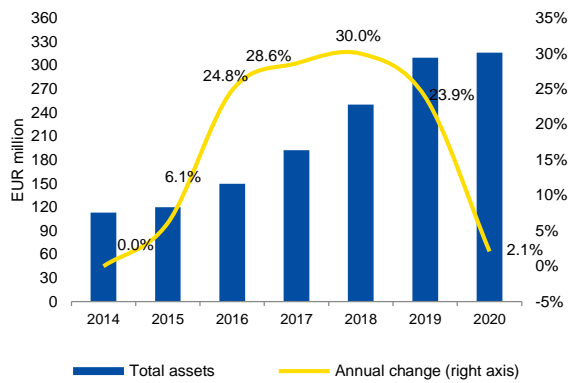
The microfinance sector recorded a significant slowdown in activity growth compared to previous years, which was attributed to lending and leasing activity. The slowdown in the growth of microfinance sector assets is mainly a result of the revocation of the licenses of two microfinance institutions.⁴⁹ The performance of the microfinance sector activity was also influenced by the negative effects of the Covid-19 pandemic on the overall economic activity in the country.

The microfinance sector is mainly financed by borrowings from the external sector, while the activities financed by this sector are lending to households and non-financial corporations

⁴⁹ The financial statements of these institutions will be reflected in the financial statements of the sector until the repayment of the total outstanding loan portfolio.

(private sector), and leasing activity for these two categories. The spread of the Covid-19 pandemic has led to a slowdown in leasing activity and a contraction in active lending, for the first time in seven years for the latter.

Chart 93. Assets of the microfinance sector



Source: CBK.

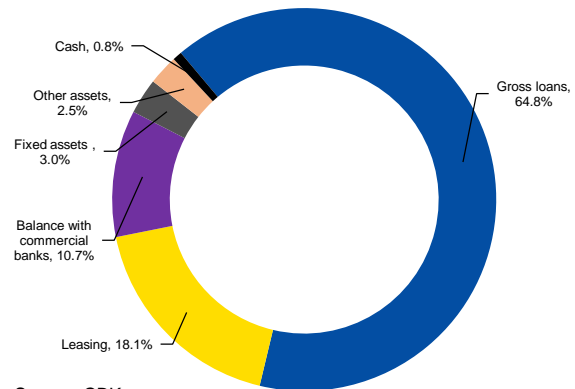
The assets of the sector reached the value of 316.2 million euros in 2020, which corresponds to an annual growth of 2.1 percent, which represents the lowest growth rate in the last six years. (chart 93). There are 20 microfinance institutions operating in the local market,⁵⁰ of which 12 are foreign owned and represent 93.0 percent of total sector assets.

The Herfindahl-Hirschman index for assets resulted in 1,487 points in 2020, which represents a slight increase in concentration from the same period of the previous year (1,478 points). Whereas, the share of assets of the three largest institutions in the total assets of the sector increased to 56.1 percent, from 55.3 percent in 2019, an increase that can be attributed to some extent to the revocation of the registration of two microfinance institutions in the last year.

Loans account for 64.8 percent of the sector's total assets. The second most important category in terms of weight continues to be leasing, with a share of 18.1 percent (chart 94). Compared to the previous year, the share of leases in total assets of the sector has increased against the decline in the share of loans.

In terms of liabilities, the activity of the microfinance sector is financed mainly by borrowing, which accounts for 63.9 percent of total liabilities and capital, while financing from the external sector alone accounts for 62.4 percent of total liabilities and capital.

Chart 94. Structure of assets of microfinance sector (December 2020)



Source: CBK.

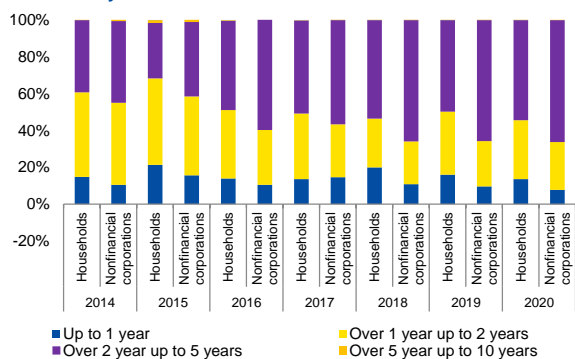
Compared to last year, external sector funding decreased by 0.4 percent, to € 197.2 million at the end of 2020. The decline in external sector funding occurred for the first time in six years, interrupting the double-digit growth rate during this period, which reflects the decline in demand for financing sector activities as a result of the Covid-19 pandemic.

Total loans issued by the microfinance sector in 2020 decreased to the value of euro 205.0 million, which represents an annual decrease of 6.8 percent (annual increase of 19.6 percent in 2019). The decrease in active loans, which occurred for the first time in the last seven years, reflects not only the shocks that the sector has received from the Covid-19 pandemic, but also the revocation of the licenses of two microfinance institutions. The most significant decline in active loans was characterized by households, 9.2 percent decline compared to the annual growth of 21.9 in 2019, compared to non-financial corporations which recorded an annual decline of 1.9 percent from 15.3 percent annual growth in 2019. The value of loans to households decreased to euro 134.4 million at the end of the period, while for nonfinancial corporations it decreased to 70.6 million euros. According to

⁵⁰ This includes ten non-bank financial institutions that carry out lending, leasing and factoring activities.

the maturity, loans to households and non-financial corporations with a maturity of 'over 2 to 5 years' dominate the structure of these loans, followed by those with a maturity of "over 1 to 2 years" (chart 95).

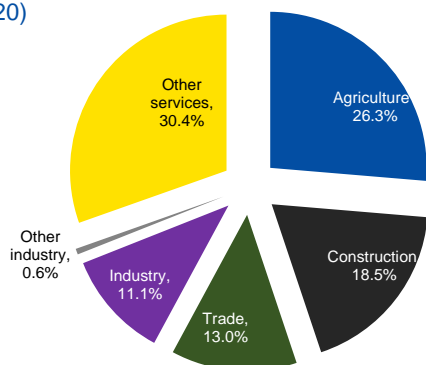
Chart 95. Loans to economic sectors, by maturity



Source: CBK.

The structure of lending to non-financial corporations by economic activity remained similar to previous periods.

Chart 96. Structure of loans to nonfinancial corporations, by economic sectors (December 2020)



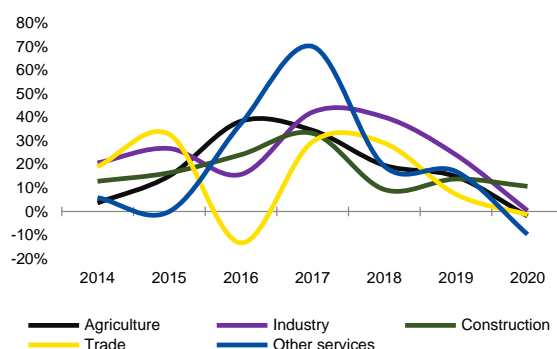
Source: CBK.

Lending to the agricultural sector continues to have a larger share in loans issued by the microfinance sector, followed by loans to the construction, trade and industry sectors (chart 96).

The new situation created after the outbreak of the Covid-19 pandemic has also affected the lending to almost all economic activities financed by microfinance institutions (chart 97). Excluding lending to the construction and industry sectors, which increased, other sectors were characterized by an annual decline in lending.

The unprecedented health and economic crisis caused by the Covid-19 pandemic also affected leasing activity, which slowed down its annual growth to 8.8 percent from 38.5 percent the previous year. The leasing stock amounted to euro 57.3 million (chart 98). Leasing to nonfinancial corporations, which has a share of 68.0 percent in total leasing, had the largest contribution to the total leasing growth.

Chart 97. Microfinance sector growth rate of loans to nonfinancial corporations, by economic sectors



Source: CBK.

This category of leases recorded an annual increase of 11.7 percent and reached a value of 31.4 million euros. According to the maturity of leases for non-financial corporations, most of them are dominated by medium-term leases 'over 2 to 5 years' with a share of 75.5 percent, followed by leases with a maturity of 'over 1 to 2 years' with a share of 17.7 percent.

Meanwhile, leasing to households recorded a slower growth of 5.4 percent, reaching 25.9 million euros at the end of 2020. Within leasing to households, 'mortgage leasing', which represents the dominant category, recorded an annual increase of 6.3 percent in 2020 (15.7 percent annual growth last year).

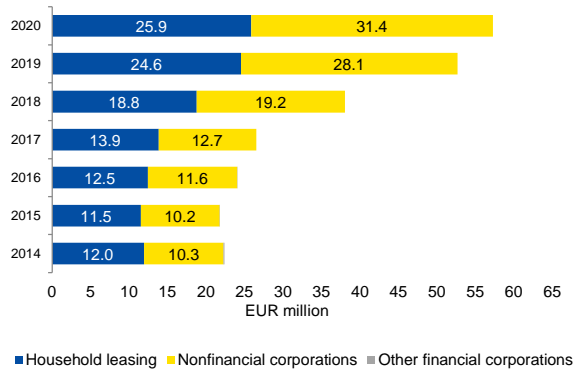
Leasing to households continues to be dominated by long-term leasing 'over 10 years' which has a share of 51.8 percent, followed by leasing with a maturity of 'over 5 to 10 years' with a share of 32.2 percent.

Interest rates on microfinance sector loans generally did not change significantly compared to last year. The average interest rate on loans dropped to

20.3 percent from 20.5 percent in December 2019 (chart 99).

The decline in the average interest rate on loans was characterized by the non-financial corporate sector, while interest rates on loans to households tended to increase.

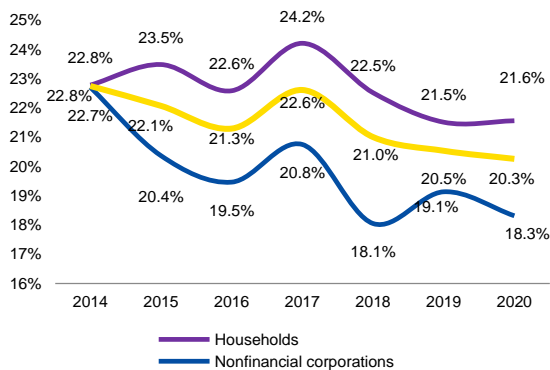
Chart 98. Microfinance sector leasing



Source: CBK.

The average interest rate on loans to households increased to 21.6 percent at the end of 2020. Whereas, the average interest rate on loans to nonfinancial corporations decreased to 18.3 percent (chart 99).

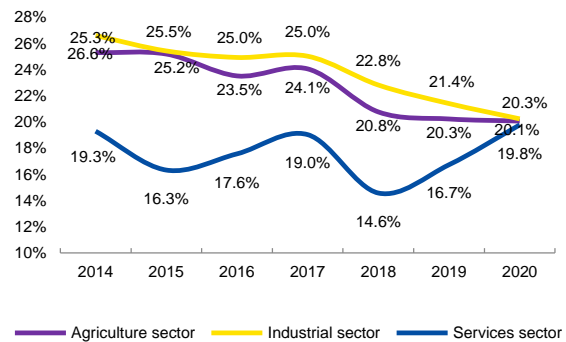
Chart 99. Average interest rate on microfinance sector loans



Source: CBK.

Within loans to non-financial corporations, the average interest rate decreased for the agriculture and industry sector, while it increased for the services sector, which has the most favourable interest rate. Meanwhile, loans to the industrial sector continue to have the highest interest rate of 20.3 percent despite the decline of 1.2 percentage points from last year (chart 100).

Chart 100. Average interest rate on loans, by economic sectors



Source: CBK.

6.3.2 Microfinance sector performance

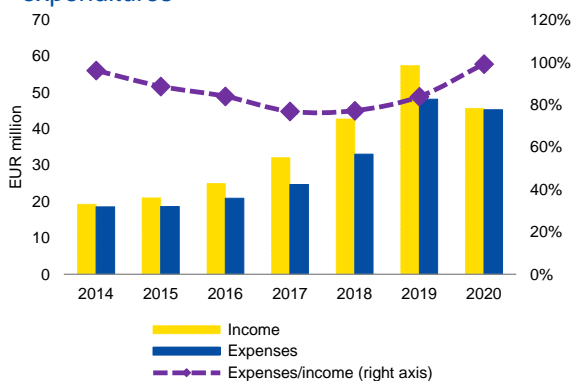
The microfinance sector realized significantly lower profit compared to the trend of the past five years. In 2020, the sector realized a profit of 0.3 million euros, which is significantly lower than the realized profit of 9.3 million euros last year. The more accelerated decline in revenues compared to the decline in expenditures has resulted in a significant decrease in profit (chart 101).

Revenues of the microfinance sector decreased to the value of euro 45.6 million, a decrease of 20.6 percent compared to the previous year, mainly as a result of the decline in interest revenue on loans, which reflects the contraction of lending activity during 2020. Expenditures of sector amounted to euro 45.3 million, which is an annual decrease of 6.0 percent.

The decrease in expenditures came as a result of the reduction of interest expenses, as a result of the reduction of borrowings from the external sector (which in recent years had recorded a significant increase), and the reduction of other operating expenses. Whereas, the only category that increased was that of non-interest expenses, which reflects the higher level of provision for possible loan losses.

Ratio of expenditures to revenues of the microfinance sector recorded a significant increase, by 15.4 percentage points, as a result of the higher decline in revenues versus the slower decline in expenditures. In 2020, this indicator stood at 99.3 percent, from 83.9 percent in the previous year.

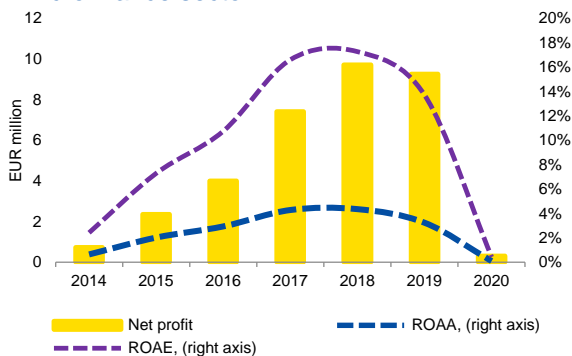
Chart 101. Microfinance sector income and expenditures



Source: CBK.

The financial results during 2020 were also reflected in other profitability indicators of the sector, which recorded a significant decrease compared to the previous period. Return on Average Assets (ROAA) stood at 0.1 percent (3.2 percent in 2019), while Return on Average Equity (ROAE) at 0.4 percent (13.7 percent in 2019) (chart 102).

Chart 102. Profitability indicators of microfinance sector



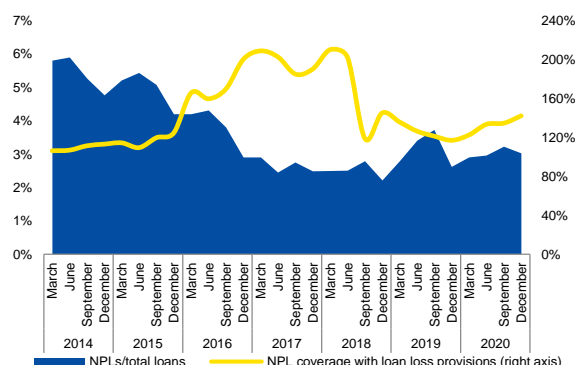
Source: CBK.

The microfinance sector continues to have a relatively low level of non-performing loans and good provision coverage (chart 103). The level of non-performing loans in 2020 stood at 3.0 percent (2.6 percent in 2019), while their coverage with provisions reached 142.2 percent (117.0 percent in 2020).

The financial auxiliaries sector accounts for the largest number of financial institutions in the country, although it manages only 0.2 percent of total assets. This sector consists of exchange bureaus and money transfer agencies (MTA). The value of assets of financial auxiliaries in 2020 reached 18.9 million euros, which represents an annual increase of 13.2 percent. Revenues of

financial auxiliaries recorded an annual increase of 20.0 percent and reached the value of 10.0 million euros.

Chart 103. Indicators of credit portfolio quality



Source: CBK.

The revenue structure of financial auxiliaries is dominated by transfer revenues (76.1 percent share), which were characterized by an annual increase of 34.1 percent.

Expenditures recorded an annual increase of 10.9 percent, reaching the value of 5.6 million euros. The net profit realized by these financial institutions in 2020 reached 4.4 million euros, which represents an annual increase of 34.2 percent. The increase in the activity of the sector, which was reflected in the revenues and profit realized during 2020, has been influenced by the dynamics related to the Covid-19 pandemic. The closure of land and air borders, which prevented the arrival of the diaspora and aggravated the economic situation of the population, influenced the diaspora to increase assistance to family members through formal channels. As a result, remittances reached a record value of almost 1.0 billion euros, most of which were sent through MTAs, affecting the growth of their activity.

7. Financial infrastructure in Kosovo

7.1. Payment system

The payment system has an important role in the financial system and economy of a country, taking into account that its efficient and secure operation is a very important factor in maintaining and promoting the financial stability of the country. During 2020, in coping with the Covid-19 pandemic crisis, the biggest challenge ever experienced by the financial system of Kosovo, the payment system has proven stability, security and high efficiency in fulfilling its function. There is a single interbank payment system in Kosovo, the Interbank Payment System (IPS), operated and supervised by the Central Bank of the Republic of Kosovo. During the pandemic period, the payment system, despite the restriction of movement and change of working hours of the participants, was constantly active and accessible to the participants, ensuring the smooth processing and settlement of all transactions of citizens, enterprises and government. This has proven the stability, security and efficiency of the system even in terms of remote operation. It has also been proven that the payment system provides the necessary flexibility for the specific needs of the participants, such as increasing the number of clearing and cooperation sessions, to enable early identification and addressing of potential problems.

The Bank Account Register, a system maintained by the CBK, in which all bank accounts are registered by banks, has also proven to be efficient during this period, assisting institutions in the easy and secure payment of funds under fiscal emergency measures undertaken by the government, as well as the measure of withdrawing 10 percent of pension savings under the Economic Recovery plan.

The pandemic situation has mainly affected the developments in the second quarter of the

year, respectively the period March - May 2020. During this period, there was a significant decrease in the volume and value of processed transactions, with the minimum level reached in April, when the number of transactions decreased by about 36 percent, with a decrease in value of about 33 percent. This decline started the recovery in May and reached close to the level of the usual trend during June, when the restrictive measures taken by the government were largely eased. Whereas, in December, the number of processed transactions increased by 45.3 percent, while their value increased by 15.9 percent, which reflects, among other things, the withdrawal of 10 percent of pension savings from citizens.

The number of transactions processed by the IPS in 2020 reached 13.0 million (12.4 million in 2019), which represents an annual increase of 4.7 percent (8.1 percent in the previous year). Whereas, in the same period, the value of total transactions decreased to 14.0 billion euros (14.1 billion euros in 2019), which represents an annual decrease of 1.0 percent (annual increase of 9.1 percent in 2019). Regular mass payments and mass priority payments represented about 79.2 percent of the total number of completed interbank transactions (table 11). Mass priority payments represent about 6.1 million transactions completed (46.8 percent of the total number of transactions) and are mainly payments from government institutions (such as salaries and pensions). Whereas, regular mass payments represent about 4.2 million transactions realized (or 32.4 percent of the total number of transactions) and are mainly payments in which the beneficiaries are government institutions and include the payment of taxes, duties, customs, etc. While 0.6 million are Giro payments mainly dedicated to public utility payments (bills of public utility companies, government institutions such as the customs service and the Kosovo Property Agency) (table 11).

Table 11. Share of payment instruments in total IPS transactions, as a percentage

Description	Number of total transactions		Value of total transactions	
	2019	2020	2019	2020
Regular	12.9%	12.5%	10.9%	10.8%
Prioritized	3.2%	3.4%	39.5%	38.4%
Regular-massive	39.3%	32.4%	5.8%	5.3%
Prioritized-massive	39.1%	46.8%	8.4%	11.7%
Giro payments	5.2%	4.6%	8.6%	7.8%
Securities	0.0%	0.0%	5.2%	5.8%
Direct debiting	0.0%	0.0%	0.0%	0.0%
Bank-Bank	0.0%	0.0%	21.5%	20.0%
Returned	0.3%	0.2%	0.1%	0.1%

Source: CBK.

In terms of transaction value, priority payments are the category with the highest participation in completed transactions, category that reached the value of 5.38 billion euros, followed by the bank-bank category, which reached the value of 2.81 billion euros by the end of 2020. Total number of valid bank accounts⁵¹ in 2020 reached 2.29 million, which represents an annual increase of 6.5 percent. The increase in the number of bank accounts was also influenced by the early withdrawal of 10 percent of pension savings, the execution of which is conditioned to be done only through active bank accounts in banks registered in Kosovo.

The rapid and secure trend of virtual infrastructure development has continued, driven by the circumstances created by the pandemic situation. Banks have increased the

general efforts for digitalization and automation of services, in order to provide opportunities for the implementation of services while maintaining the health of customers. Most banks have increased the limit of non-contact payments that can be made through bank cards. E-banking accounts, through which banking services are performed 'online', have continued to grow. By the end of 2020, the total number of E-banking accounts reached 411.3 thousand⁵² (table 12), which represents an annual increase of 21.8 percent. The structure of E-banking accounts continues to be dominated by individual accounts with a share of 86.8 percent of total E-banking accounts, followed by business accounts with a share of 13.2 percent.

Table 12. Banking sector network

Description	2017	2018	2019	2020
Number of bank branches	45	46	47	50
Number of bank sub-branches	183	166	159	149
ATM number	512	491	497	513
POS number	11,501	13,183	13,769	13,421
Number of E-banking accounts	301,841	250,733	337,693	411,346

Source: CBK.

The total number of cards (debit and credit cards) that provide cash withdrawal services and various payments increased by 6.5 percent. The number of debit cards recorded an

annual increase of 8.4 percent and reached 1,201,902, while the number of credit cards decreased by 5.2 percent and decreased to 175,205.

⁵¹ Total number of bank accounts includes: number of current, savings and other bank accounts.

⁵² With the entry into force of the 'Regulation on reporting payment instruments statistics' from 2018, the methodology of reporting the number of accounts accessible from the internet has changed. This number

represents the number of current accounts that have access to e-banking, while according to the previous methodology all accounts have been reported, including current, savings and time accounts.

Visa cards (55.4 percent) followed by the Master Card (41.6 percent) had the highest share among cards by operators, while local cards had a share of 3.0 percent. The banking infrastructure in the country has been expanded in the context of the Automated

Teller Machine (ATM) network, while in the context of the number of POS (Point-of-Sale) devices it has been reduced compared to the previous period. (table 13).

Table 13. Share of transactions value processed with cards by terminals to total card transactions value

Description	2017	2018	2019	2020
ATM withdrawals in cash	61.9%	58.9%	59.5%	62.7%
ATM deposits	29.3%	30.9%	29.9%	27.3%
Credit transfers through ATMs	0.0%	0.1%	0.1%	0.0%
POS cash withdrawals	0.2%	0.2%	0.2%	0.1%
Card payments through POS	8.5%	9.8%	10.3%	9.8%

Source: CBK.

The number of deposits in the banking sector through ATMs during this period amounted to 2.0 million transactions worth 1.25 billion euros. As a result, 27.3 percent of the total value of card transactions through terminals belonged to ATMs with deposit function (table 13).

In the same period, the number of payments through card sales points at POS terminals reached 14.3 million in the amount of 447.8 million euros. The value of payments through POS to total card transactions in 2020 had a share of 9.8 percent.

8. Macroprudence framework

In 2016, the Central Bank of the Republic of Kosovo, in accordance with Law No. 03/L-209 on the Central Bank, which mandates the CBK to draft and implement policies to maintain financial stability in the country, has adopted the Macroprudence Policy.

In order to strengthen the legal basis of the CBK in exercising its mandate for macroprudence, the new draft law on banks that is expected to be processed for approval, defines the CBK as the sole authority responsible for macroprudential supervision of banks. The new law also gives the CBK the authority to issue relevant regulatory instruments.

8.1. Summary of developments in selected macroprudential indicators

In 2020, overall dynamics in selected macroprudence indicators in Kosovo were characterized by stability, resulting in parameters well above the regulatory requirements, despite coping with the Covid-19 pandemic.

Financial intermediation in the country continues to expand, specifically, lending growth, although at a slower pace compared to the previous period. The quality of the loan portfolio of the banking sector continued to be high, although it has shown an upward trend in the last year, after the outbreak of the Covid-19 pandemic. The share of non-performing loans (NPLs) in total loans has increased marginally, but compared to the level of countries in the region, Kosovo has the lowest level of NPLs in the region and below the European Union average. In addition to the good quality of the loan portfolio, the level of coverage of non-performing loans with provisions is also high.

The banking sector as a whole but also systemic banks in particular continue to remain well-capitalized and liquid during this period. Capital adequacy ratios for the banking sector and systemic banks stand well above regulatory requirements. The good

capitalization of the banking sector is also supported by the analysis of the allocation of additional capital in relation to the degree of systemic importance of banks.

Similar to capital adequacy ratios, the ratio of the total leverage of the banking sector and of 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 that was above regulatory requirements. The concentration of large exposures in the banking system, although tending to increase, is not at a high level.

Profitability indicators, in particular Return on Average Equity (ROAE), remained at a satisfactory level, while the Credit to GDP gap, although it expanded in 2020, 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 2020, the banking sector appears to have five banks of systemic importance.

Even the general analysis of health indicators of the insurance sector, as potentially important indicators for macroprudence, suggests that Kosovo's financial stability is not threatened by the insurance sector, given the small weight of the sector in the financial system. Also, the interconnection between the insurance and microfinance sectors and other segments of the financial system is still low, which minimizes the possibility of risk distribution between different segments of the financial system of Kosovo.

8.2. Countercyclical Capital Buffer

Countercyclical Capital Buffer aims to strengthen financial stability by protecting the banking sector against losses that may be caused by the accumulation of cyclical systemic risk in an economy, as well as by influencing the provision of credit supply sustainability throughout the financial cycle. Countercyclical Capital Buffer is part of the Basel III regulatory framework and at the same time

one of the main instruments of macroprudential policy to address the cyclical dimension of systemic risk.

By increasing capital requirements at a time when lending is growing beyond the fundamentals of the economy (growing at a rate faster than a country's gross domestic product and perceived as excessive lending growth), this instrument aims to increase the sustainability of the sector (banks' solvency) to cope with financial stress situations that may result from the accumulation of risk as a result of excessive lending growth. At the same time, this instrument helps to boost lending in times of financial stress, by releasing the capital reserves accumulated during the credit growth phase and good economic conditions, in order to avoid carrying the negative consequences of the credit decline in the total financial system and the economy of the country.

For the calculation of counter-cyclical capital buffer, the guidelines of the Basel Banking Supervision Committee⁵³ suggest monitoring some parameters for assessing whether lending is growing beyond sustainable fundamentals and is consequently affecting the accumulation of systemic risk. In addition to evaluating the parameters according to the relevant instructions, the relevant authorities should judge the relevance of the application of counter-cyclical capital requirements.

CBK, in Macroprudence Policy⁵⁴, lists the instrument of counter-cyclical capital requirements as a potential instrument of the intermediate objective of macroprudential policy to reduce and prevent excessive credit growth and leverage. According to the Basel Guidelines, the main parameter for determining the rate of counter-cyclical capital buffer is the credit gap to gross domestic product (GDP) in Kosovo, along with other relevant indicators that will inform the final decision on the possible activation of the instrument.

⁵³ Bank for International Settlements (2010). Guidelines for national authorities operating counter-cyclical capital buffer, Basel Committee on Banking Supervision, December.

⁵⁴ CBK (2018). Macroprudence Policy, Prishtina, June.

Below is presented the so-called model for assessing the demand for counter-cyclical capital for the banking sector of Kosovo. The deviation of the credit to GDP ratio from its long-term trend is the main parameter of the model. The calculation of the credit gap to GDP is done based on the Basel Guidelines and the unified calculation practices from most countries in the world based on the recommendations from the empirical research, through one-sided Hodrik-Prescott filter (λ 400,000).

In lending were included loans to the private sector⁵⁵ by banks as well as non-bank financial institutions. The latter, although with a low share in total lending, are growing at a higher growth rate and expanding their share in certain sectors. Therefore, the inclusion of non-banking sector loans, despite having a low share and currently without any significant effect on the credit gap result, ensures consistency in the calculation method with other countries, as well as 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 2020 stood at 50.5 percent. The results of the credit gap at the end of December 2020 suggest that the private sector in Kosovo has passed into the so-called 'over lending' period. The 'over lending' period has started since the third quarter of 2020, which is mainly due to the economic contraction in 2020 (due to the Covid-19 pandemic), while lending has maintained a positive growth rate.

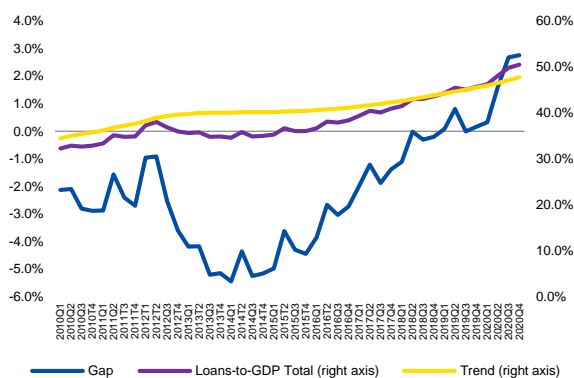
As a result, in 2020, the credit gap to GDP results in 2.767 percent, widening in the positive plane compared to the same period of the previous year (+0.168 percent) (chart 104).

The positive widening of the credit gap to GDP in recent periods means that lending is growing at a faster pace than the gross domestic product. However, in the case of Kosovo, the sharp increase in lending in recent

⁵⁵ The non-inclusion of 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 public sector lending or the financial sector.

years compared to GDP growth rate should not be considered to be excessive. This is due to the fact that the financial system in Kosovo is still in the early stages of development and Kosovo's economy is in the phase of increasing financial intermediation and convergence with other countries; as well as the short history of the banking sector with uniformity of financial developments, without any period of stress, makes it difficult to adequately assess the lending cycle in the country and to signal the accumulation of systemic risk.

Chart 104. Lending gap



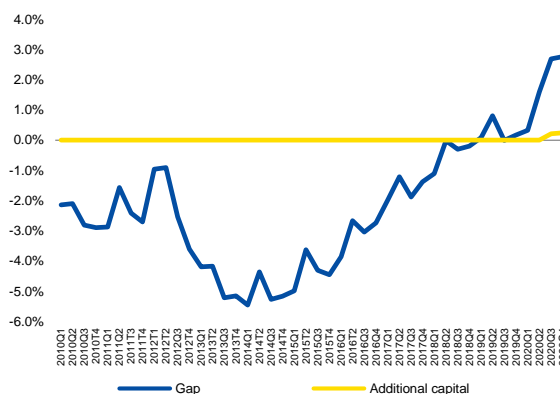
Source: CBK.

Consequently, in giving a judgmental assessment of the credit cycle, other financial and economic indicators, and in particular the judgment of experts, must be considered. However, additional counter-cyclical capital is an adequate instrument to address the credit gap, in order to strengthen the banking sector's ability to withstand financial cycles.

The calculation of the required capital buffer was made according to the relevant instructions by the Basel Committee in which case the demand 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 above the value of 2 to 10 percentage points it is required to keep the additional capital up to the maximum level of 2.5 percent. According to the results as of December 2020, there is a need for potential counter-cyclical capital demand (chart 104). If the gap increases above 2 to 10

percentage points additional capital is required up to a maximum level of 2.5 percent. But considering that we are in extraordinary conditions, due to the Covid-19 pandemic, we do not really have a period of "over-lending", but unprecedented economic contraction in the country, while lending continues to grow - albeit at a slower pace than in 2019 (chart 105)

Chart 105. Countercyclical capital buffer



Source: CBK.

Also, other relevant indicators are monitored on a regular basis in addition to the credit gap, which together with qualitative information and relevant expert judgement, are allocated special weight in forming the final judgment about developments in the field of systemic risk and credit -to- GDP ratio. These indicators, among others, include the dynamics of general credit growth and growth in specific sectors, credit exposures in specific sectors, the collateral-to-loan ratio, the debt- to-income ratio, etc.

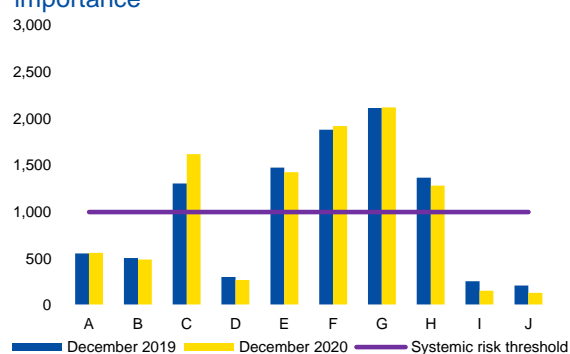
8.3. Systemically important banks

The model for identifying systemically important banks is an important tool for continuous assessment of the structural and cross-sectoral dimension of systemic risk associated with systemically important banks (table 14). The overall results of the model, with data from December 2020, suggest that five banks are of general systemic importance, similar to last year (chart 106).

Table 14. Indicators used to assess the systemic importance of banks in Kosovo⁵⁶

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

Source: CBK.

Chart 106. General scale of systemic importance


Source: CBK.

All five banks of general systemic importance have resulted in systemic importance in all constituent criteria (table 14). Whereas, banks which did not turn out to be of general systemic importance, did not turn out to be such in any of the indicators. The overall scale of systemically important ranges from 1,283 basis points to 2,120 basis points. This represents a slight decrease of the lowest degree of systemically important (decrease of 22 basis points), while the upper systemic degree remained almost similar to last year (increase of 5 basis points).

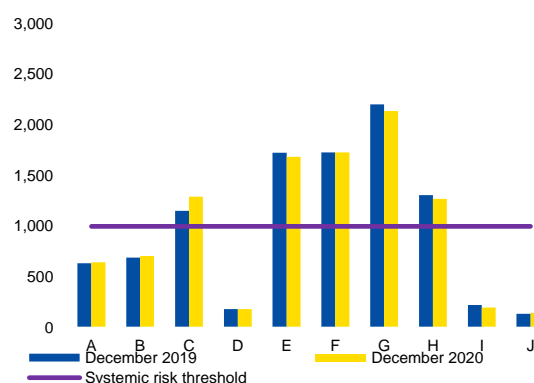
In general, general systemically important banks have increased the rate of systemic points, against the decline of the rate of points of banks that did not turn out to be of general systemic importance in 2020 compared to the previous year.

This increase in the points of banks of general systemic importance was expressed only in the

interconnection indicator, in which there was a fairly high margin difference. While in other indicators, that of size, substitutability, and interstate activity & complexity; there was an increase in the rate of points in banks of non-systemic importance, versus a decrease in the rate in banks of general systemic importance. But the difference in base points was quite low.

Criterion of size -

The degree of systemic importance in this criterion extends from 1,272 basis points to 2,139 basis points.

Chart 107. Criteria of size


Source: CBK.

Four of the five systemically important banks were characterized by a decrease in systemic importance in this criterion compared to the previous period (chart 107).

Substitutability criterion - The degree of systemic importance in this criterion extends from 1,125 basis points to 2,351 basis points (chart 108).

Most banks have recorded an increase in the systemic rate in this criterion compared to the

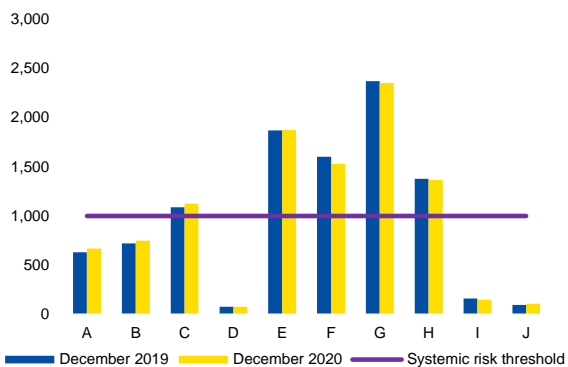
⁵⁶ For the theoretical base and the complete methodology of assessing Banks of Systemic Importance, please refer to the CBK working paper No

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

previous period, but which was more pronounced in banks which did not turn out to be of general systemic importance.

This was reflected in all relevant 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.

Chart 108. Criteria of substitutability

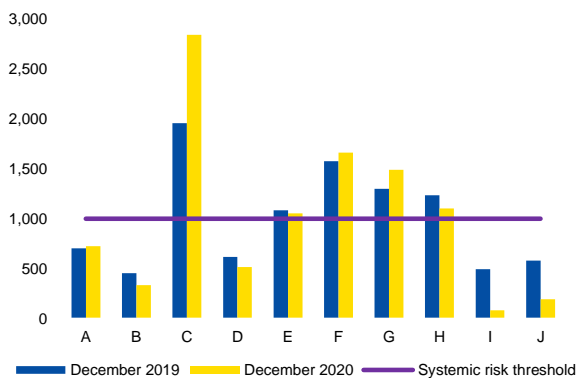


Source: CBK.

This dynamic was observed in the subcategories of lending to non-financial corporations and households, deposits from households, as well as participation in interbank transactions - where there was a faster growth in small banks compared to the growth rate in large banks.

Interconnectedness criterion - 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.

Chart 109. Interconnectedness criteria



Source: CBK.

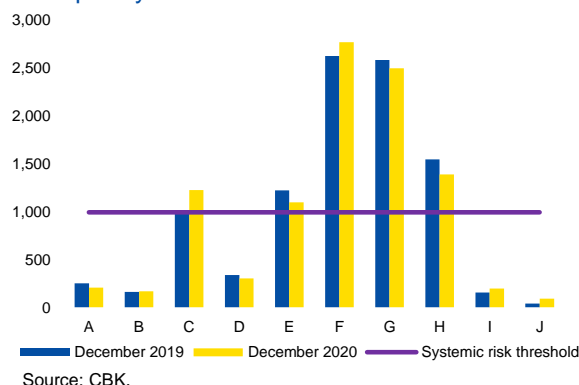
The degree of systemic importance in this criterion extends from 1,053 basis points to 2,841 basis points

(chart 109). Banks of general systemic importance increased the points ratio significantly against the decrease of the points rating 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 financial institutions by large banks, compared to the lower level of interaction by small banks.

Criterion of interstate activity and complexity - The degree of systemic importance in this criterion extends from 1,101 basis points to 2,768 basis points (chart 110). Compared to the previous period, the rate of systemic importance has decreased compared to the increase of the rate from non-systemic banks.

This came as a result of higher interaction with the external sector by non-systemic banks compared to interaction by banks of general systemic importance.

Chart 110. Criteria of interstate activity and complexity



Source: CBK.

In general, it should be noted that the sector has proven over the years that it is quite well capitalized and the application of capital buffer 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.

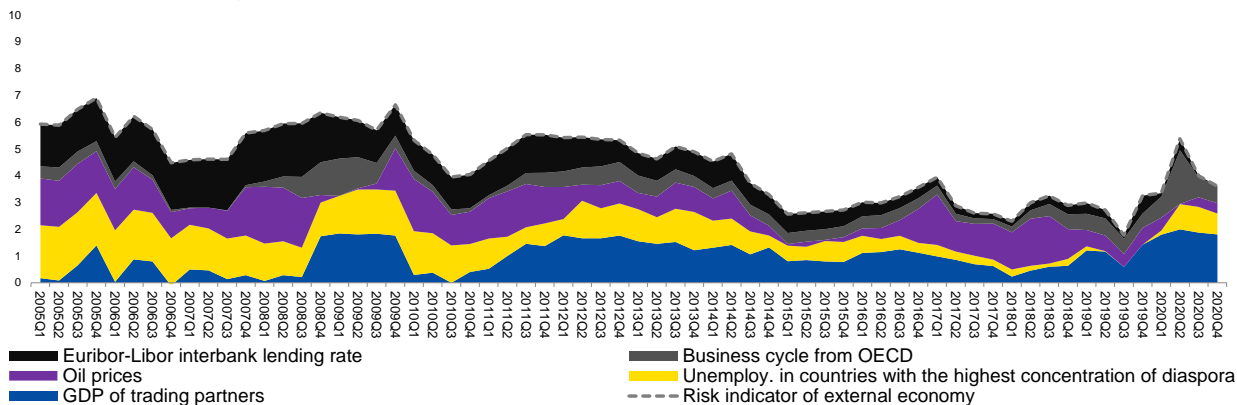
Therefore, the model currently serves only to monitor the dynamics of systemic importance and the most informed and adequate supervision of institutions in accordance with their systemic importance, and does not represent a recommendation for applying the capital buffer for institutions of domestic systemic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

9. Statistical Appendix

This page is intentionally left blank

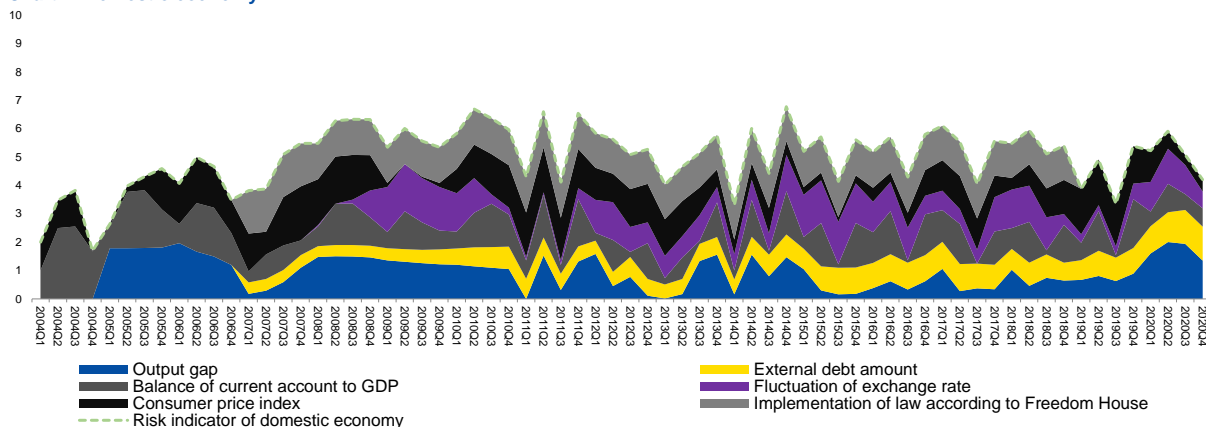
Appendix 1. Financial Stability Map - Dynamics of change of risk indicators and contribution to risk by relevant components

Chart 1. External economy



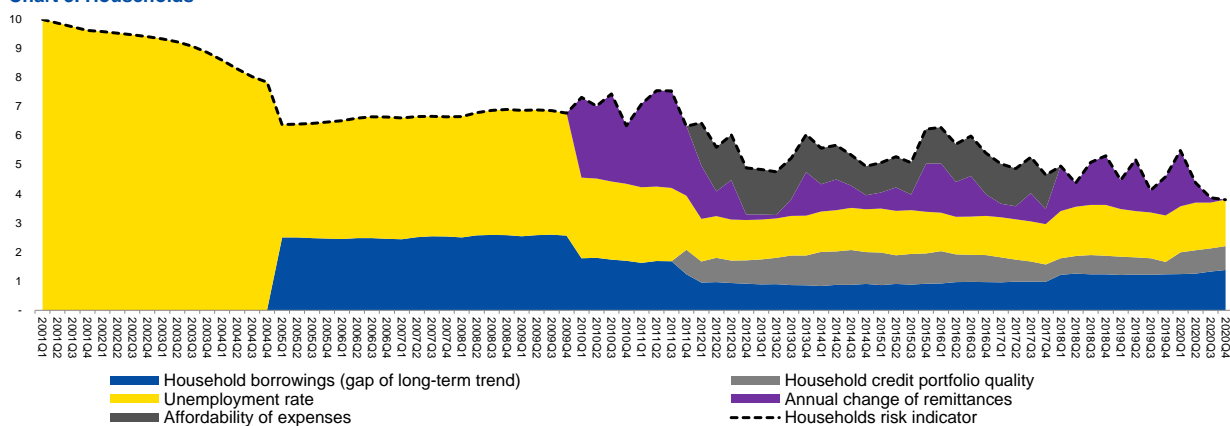
Source: CBK.

Chart 2. Domestic economy



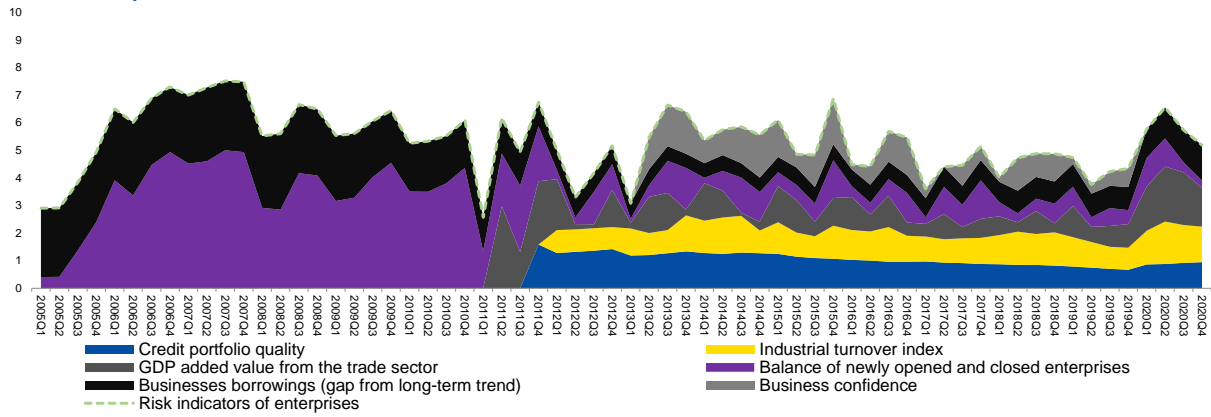
Source: CBK.

Chart 3. Households



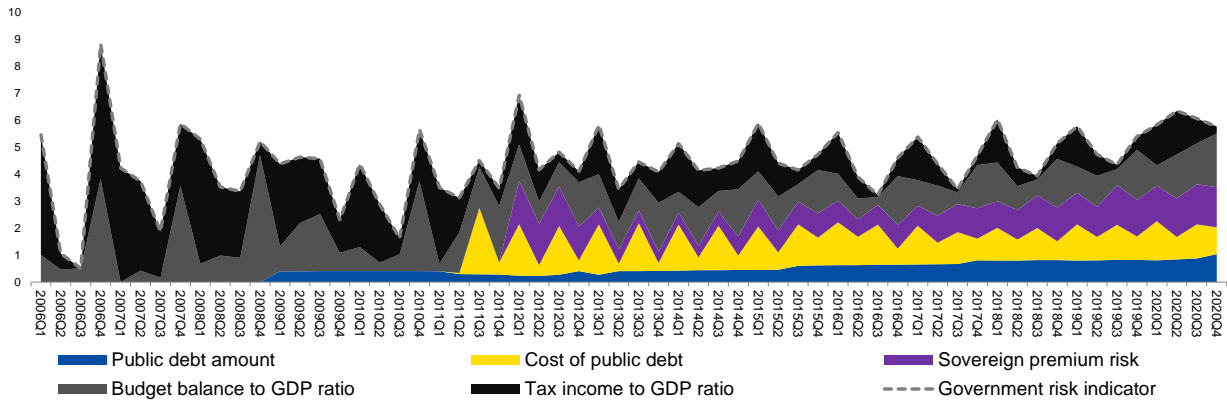
Source: CBK.

Chart 4. Enterprise Sector



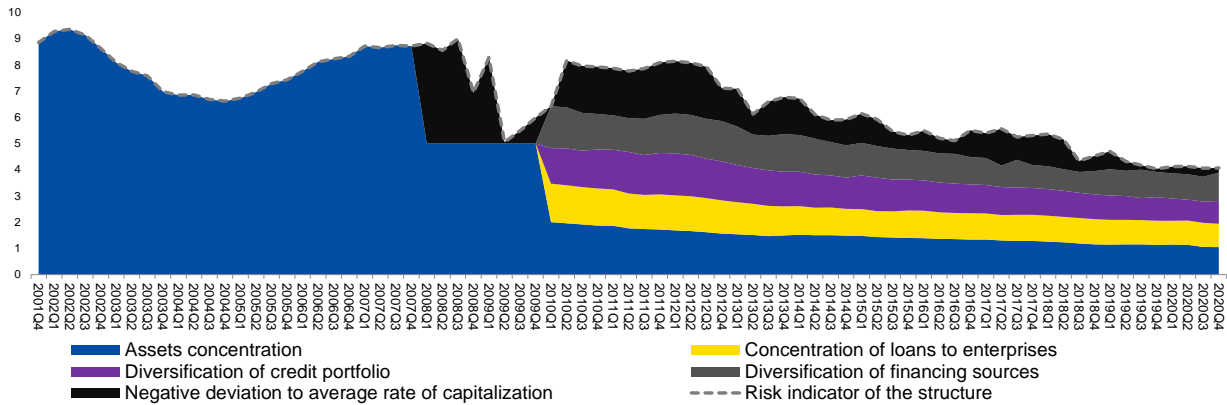
Source: CBK.

Figure 5. Government sector



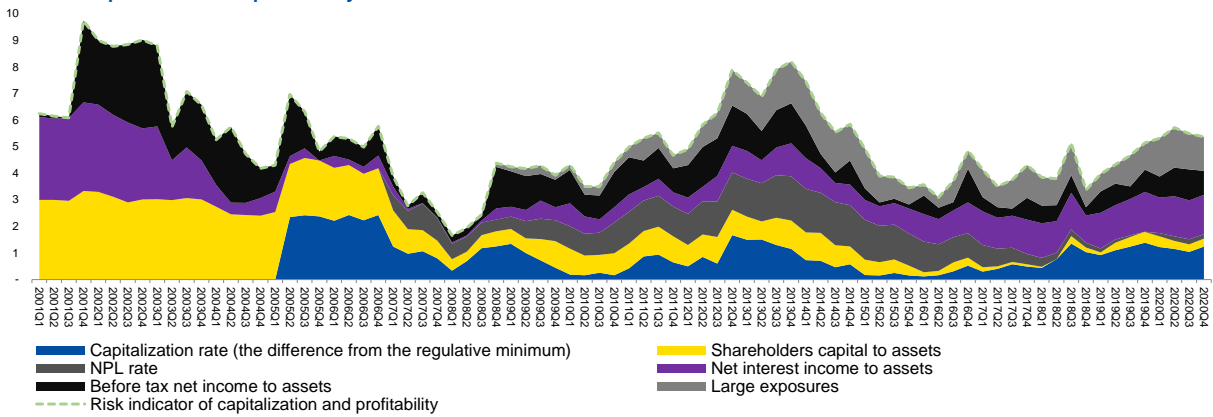
Source: CBK.

Chart 6. Structure of the Banking Sector



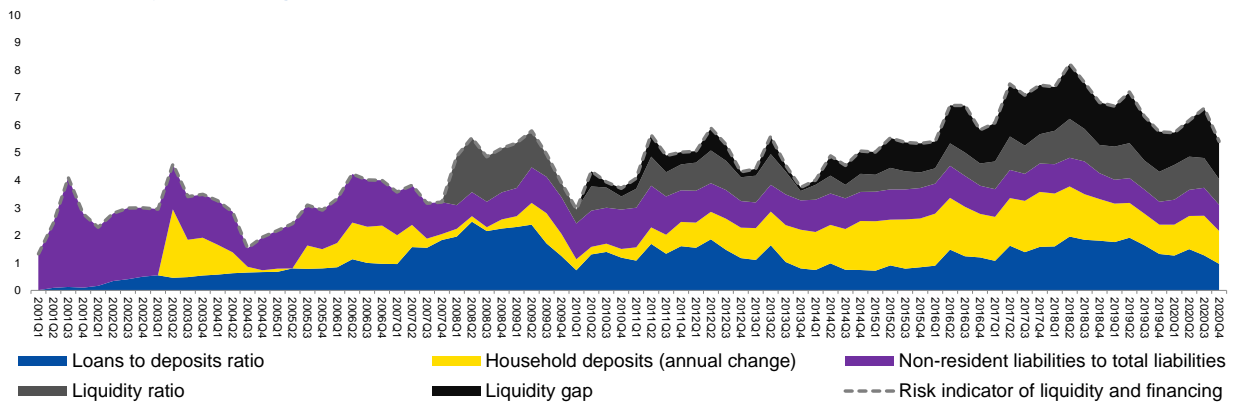
Source: CBK.

Chart 7. Capitalization and profitability



Source: CBK.

Chart 8. Liquidity and financing



Source: CBK.

Table 1. Financial sustainability indicators, as a percentage

Banking sector	Core set	December 2017	December 2018	December 2019	December 2020
Capital Adequacy	Regulatory capital to risk-weighted assets	18.1	17.0	15.9	16.5
	Regulatory Tier I capital to risk-weighted assets	16.2	15.5	14.2	14.7
	Nonperforming loans net of provisions to capital	1.2	1.5	1.5	4.5
Assets quality	Nonperforming loans to total gross loans	3.1	2.5	1.9	2.5
Sectoral distribution of loans to total loans	Other financial corporations	0.2	0.2	0.2	0.2
	Public nonfinancial corporations	0.00	0.00	0.00	0.00
	Other nonfinancial corporations	63.6	63.4	63.3	63.3
	Households	36.2	36.3	36.4	36.4
	NPISH	0.01	0.01	0.03	0.03
	Nonresidents	0.0	0.0	0.0	0.1
	Total	100.0	100.0	100.0	100.0
Earnings and profitability	Return on assets (ROA)*	2.8	2.3	2.1	1.7
	Return on equity (ROE)*	22.1	18.3	17.2	14.0
	Interest margin to gross income	65.1	78.4	80.6	79.2
	Noninterest expenses to gross income	45.3	48.2	48.1	46.1
Liquidity	Liquid assets (core) to total assets	25.4	29.0	28.8	30.1
	Liquid assets (broad) to total assets	30.1	23.8	23.3	23.2
	Liquid assets (core) to short-term liabilities	32.2	32.2	31.2	31.1
	Liquid assets (broad) to short-term liabilities	37.9	38.5	37.6	39.8
Sensitivity to market risk	Net open position in foreign exchange to capital	1.2	3.8	4.7	3.5
	Encouraged set				
	Capital to assets	12.6	12.2	11.2	11.7
	Large exposures to capital	81.7	65.9	81.8	89.5
	Personnel expenses to noninterest expenses	40.3	44.0	43.5	43.3
	Spread between reference lending and deposits rates	5.5	4.5	4.8	4.7
	Customer deposits to total (noninterbank) loans	119.5	122.8	129.2	133.9
	Foreign-currency-denominated liabilities to total liabilities	3.9	5.0	4.4	4.2

*Net income before tax is considered.

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



Street Garibaldi, No.33, Prishtina, Republic of Kosovo

Tel: +383 38 222 055; Fax: +383 38 243 763

Web:www.bqk-kos.org