



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

Financial Stability Report

Number 18

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

Financial Stability Report

Number 18

January-December 2021

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

E-mail

economic.analysis@bqk-kos.org

ABBREVIATIONS:

ATM	Automated Teller Machines
BSSI	Banking Sector Stability Index
CAR	Capital Adequacy Ratio
CBK	Central Bank of the Republic of Kosovo
CEE	Central and Eastern Europe
CIS	Commonwealth of Independent States
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
FDI	Foreign Direct Investments
GDP	Gross Domestic Product
HHI	Herfindahl-Hirschman Index
IMF	International Monetary Fund
KAS	Kosovo Agency of Statistics
KCC	Kosovo Chamber of Commerce
KCGF	Kosovo Credit Guarantee Fund
KPST	Kosovo Pension Savings Trust
MFI	Micro Finance Institutions
MFLT	Ministry of Finance Labor and Transfers
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
RLI	Rule of Law Index
ROAA	Return on Average Assets
ROAE	Return on Average Equity
ROE	Return on Equity
RWA	Risk Weighted Assets
SDR	Special Drawing Rights
SEE	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 (2022),
Financial Stability Report No. 18, Prishtina.
Any needed correction will be made in the electronic version.

CONTENTS:

1. Governor's Foreword -----	11
2. Summary of main risks and developments of financial stability -----	12
Box 1. Financial Stability Map -----	22
3. The external environment and developments in the domestic economy -----	24
3.1. Domestic economy -----	25
Box 2. The impact of the war in Ukraine on the economic activity of Kosovo according to the base scenario and two alternative scenarios -----	27
3.2. Financial position of enterprises -----	30
3.3. Financial position of households -----	32
Box 3. Household indebtedness in Kosovo -----	35
4. Developments in the financial system -----	41
4.1. Banking activity -----	44
Box 4. Bank Lending Survey -----	49
5. Risks of the banking sector -----	54
5.1. Credit risk -----	55
5.2. Sustainability of profit and interest rate risk -----	60
5.3. Risk from the position in foreign currencies -----	64
5.5. Financing and Liquidity Risk -----	67
5.6. Shock absorption capacity - Stress-test analysis -----	71
Box 5. Climate change and its importance to financial stability -----	78
6. Non-banking financial institutions -----	83
6.2 Insurance sector -----	85
6.3. Microfinance sector and financial auxiliaries -----	90
7. Financial infrastructure in Kosovo -----	95
7.1. Payment system -----	95
8. Macroprudence framework -----	98
9. Statistical Appendix -----	101

LIST OF CHARTS AND FIGURES

Chart 1. Construction, producer and agricultural input price indices -----	15
Chart 2. Debt of enterprises and households -----	15
Chart 3. Annual change of new loans -----	16
Chart 4. Selected indicators of financial soundness -----	18
Chart 5. Financial stability map -----	22
Chart 6. Financial stability map -----	23
Chart 7. Real GDP growth rate and contributors to the growth -----	25
Chart 8. Index of sales and employees in services sector -----	25
Chart 9. Inflation rate, annual change -----	26
Chart 10. Industrial producer volume index -----	30
Chart 11. Retail turnover index -----	30
Chart 12. Annual change in the number of new enterprises -----	31
Chart 13. Enterprises debt -----	31
Chart 14. Loans approved and guaranteed by KCGF -----	32
Chart 15. Interest rates for enterprises -----	32
Chart 16. Households debt -----	33
Chart 17. Household deposits -----	33
Chart 18. Interest rates for households -----	33
Chart 19. The weight of financial system sectors to GDP -----	41
Chart 20. The share of respective sectors total financial system assets -----	41
Chart 21. Ownership of financial system constituent sectors -----	42
Chart 22. Share to asset structure -----	45
Chart 23. Share to liabilities structure and own resources -----	45
Chart 24. Stock of total deposits and new deposits -----	45
Chart 25. Net position to non-residents -----	46
Chart 26. Contribution of items to annual change of activity with non-residents - -----	46
Chart 27. Annual growth of loans to enterprises and households -----	47
Chart 28. Stock of total loans and new loans to households and enterprises -----	47
Chart 29. Stock of loans, by economic sectors -----	47
Chart 30. Loans approved and guaranteed by KCGF -----	48
Chart 31. Loans to enterprises, share by maturity -----	48
Chart 32. Loans to household, share by maturity -----	49
Chart 33. Aggregated index of the banking sector stability -----	54
Chart 34. Stability index of the banking sector, by risk criteria -----	55
Chart 35. Annual growth of loans and nonperforming loans -----	56
Chart 36. Restructured loans, by categories -----	57
Chart 37. Loans by new credit classification in three pillars -----	57
Chart 38. Structure of loans classified by past due payments -----	57

Chart 39. Nonperforming Loans-----	58
Chart 40. NPL to loans stock ratio, by sectors-----	58
Chart 41. Share of restructured loans to total loans in the respective sectors-----	58
Chart 42. NPL to total loans ratio, in the region countries -----	59
Chart 43. Annual change of NPL stock and coverage with provisions -----	59
Chart 44. Concentration of credit risk-----	60
Chart 45. Profit structure of the banking sector -----	61
Chart 46. Main contributors to the growth/decline of the profit -----	61
Chart 47. Interest income and expenses -----	61
Chart 48. Non-interest income and expenses -----	61
Chart 49. Income structure of the banking sector-----	62
Chart 50. Structure of the banking sector expenses -----	62
Chart 51. Profitability indicators of the banking sector-----	63
Chart 52. Assets and liabilities gap sensitive to interest rates-----	63
Chart 53. Opened positions in foreign currency to Tier 1 capital-----	64
Chart 54. Loans and deposits in foreign currency - -----	64
Chart 55. Banking sector capitalization -----	65
Chart 56. Contribution of Regulatory Capital and RWA to capitalization ratio-----	65
Chart 57. Structure of regulatory capital -----	65
Chart 58. Leverage rate-----	66
Chart 59. RWAs to total assets ratio-----	66
Chart 60. Risk-Weighted assets, share -----	66
Chart 61. Asset classification, by risk weight -----	67
Chart 62. RWA structure for credit risk -----	67
Chart 63. Structure of financing -----	68
Chart 64. Increase of banking sector loans and deposits-----	68
Chart 65. Structure of deposits-----	69
Chart 66. Structure of deposits, by maturity-----	69
Chart 67. Maturity structure of deposits and loans -----	69
Chart 68. Liquidity indicators-----	70
Chart 69. Liquidity reserves -----	71
Chart 70. Liquidity gap -----	71
Chart 71. Capital Adequacy Ratio -----	73
Chart 72. Stress test results for credit risk-losses and recapitalization-----	75
Chart 73. ST results for liquidity risk - scenario 1 -----	77
Chart 74. ST results for liquidity risk - scenario 2-----	77
Chart 75. Assets of the pension sector-----	83
Chart 76. Structure of pension sector investments-----	84
Chart 77. Contributions collected by pension funds-----	84

Chart 78. Financial performance of the Kosovo Pension Saving Trust-----	85
Chart 79. Financial performance of the Slovenian-Kosovo Pension Fund -----	85
Chart 80. Development indicators of the insurance sector-----	85
Chart 81. Structure of assets of insurance sector, by ownership-----	86
Chart 82. Assets of insurance sector-----	86
Chart 83. Assets structure of insurance sector-----	87
Chart 84. Liabilities and equity of insurance sector -----	87
Chart 85. Gross collected premiums -----	88
Chart 86. Received premiums and claims paid -----	89
Chart 87. Assets of the microfinance sector-----	90
Chart 88. Structure of assets of microfinance sector -----	91
Chart 89. Loans to economic sectors, by maturity-----	91
Chart 90. Structure of loans to nonfinancial corporations, by economic sectors-----	92
Chart 91. Microfinance sector growth rate of loans to nonfinancial corporations -----	92
Chart 92. Microfinance sector leasing -----	92
Chart 93. Average interest rate on microfinance sector loans -----	92
Chart 94. Average interest rate on loans, by economic sectors -----	93
Chart 95. Microfinance sector income and expenses -----	93
Chart 96. Profitability indicators of microfinance sector-----	93
Chart 97. Indicators of loans portfolio quality -----	94
Chart 98. Countercyclical capital buffer -----	99
Chart 99. Systemic importance scale and allocation of capital buffer 1 -----	100
Figure 1. Institutional interconnections of Kosovo's Financial System-----	43
Figure 2. Banking interconnections of Kosovo's banking sector-----	44

LIST OF TABLES

Table 1. Key risks and sustainability of the banking sector -----	14
Table 2. Selected macroeconomic indicators-----	24
Table 3. Banks debt and households performance -----	34
Table 4. Number of financial institutions -----	42
Table 5. Assumptions for credit risk scenarios -----	76
Table 6. NPL rate of resilience coefficient -----	76
Table 7. Results of stress test scenarios for credit risk -----	76
Table 8. Assumptions for liquidity risk scenarios-----	77
Table 9. Results of stress test scenarios for liquidity risk-----	78
Table 10. Gross written premiums by business classes -----	88
Table 11. Claims paid, by business classes-----	89
Table 12. Financial result-----	90
Table 13. Share of payment instruments to total IPS transactions-----	96
Table 14. Banking sector network-----	96
Table 15. Share of transactions value processed with cards by terminals to total card transactions value -----	97
Table 16. Objectives, systemic risk assessment indicators and macroprudential policy instruments -----	99

1. Governor's Foreword

The Central Bank of the Republic of Kosovo (CBK) presents to the public the 18th issue of the Financial Stability Report (FSR). Employing 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 positive dynamics that characterized the global economy in 2021 with the improvement of the pandemic situation and the opening of economies, were reversed in the first months of 2022 with the outbreak of the war in Ukraine. In 2021, the eurozone and the Western Balkans recovered from the pandemic consequences, despite the remaining problems in supply chains as a result of the pandemic. Rapid growth in overall demand, supported by supportive fiscal and monetary policies, faced more restrained supply mainly as a result of remaining problems in supply chains and rising energy and commodity costs. These dynamics, supplemented by the significant increase in risks with the start of the war in Ukraine in February 2022, have created high uncertainties for macroeconomic prospects in the coming years. The war in Ukraine exacerbated inflationary pressures, leading to further price increases (energy, oil and food), deepening problems in trade (supply) and declining consumer trust. As a result, the forecasts of the main macroeconomic indicators for 2022 have been revised downwards, both for the eurozone and for the Western Balkans and Kosovo.

The rapid economic recovery in 2021, influenced by financial and fiscal support measures and

especially by the unprecedented support of the diaspora with the lifting of pandemic control measures, resulted in high GDP growth in the country. However, similar to global dynamics, the recovery of the economy from the pandemic shock and the increase in prices globally has been translated into high inflationary pressures in Kosovo as well, especially in the last quarter of 2021. These pressures were further exacerbated with the start of the war in Ukraine, through the indirect impact on the inflation rate and the effect on overall economic activity.

The war in Ukraine, in addition to interrupting the rapid post-pandemic growth trend, significantly increased the overall risks to financial stability. Macroeconomic challenges, with special emphasis on certain sectors, have increased due to the increase in the cost of inputs and the decrease in confidence, which factors are expected to be reflected in the decrease in general demand. The high inflation rate in 2022 is affecting the decline in the purchasing power of households, with special emphasis on those with lower incomes. In such circumstances of high inflation, slower economic growth, increased interest rates at the global level, as well as the more limited fiscal space to support the economy of Kosovo, the credit risk and liquidity risk of the banking sector are increasing and will be monitored more closely. While the progress of these developments is accompanied by high uncertainties, the financial system in Kosovo has adapted prudent operating approaches in relation to the circumstances, as well as created satisfactory reserves of capital and liquidity to cope with its increased operational risks in the following period.

Fehmi MEHMETI

Governor

2. Summary of main risks and developments of financial stability

The financial system successfully faced the biggest challenge in the history of its operation, caused by the pandemic crisis. As a result of the general improvement of the pandemic situation, the easing of the restrictive measures of movement as well as governmental and regulatory support measures, the economy, namely the financial system in Kosovo, marked a sharp recovery in 2021. However, the increase in energy and commodity prices, driven by the circumstances created by the pandemic, as well as the outbreak of war in Ukraine in 2022, have created great uncertainties for the future, significantly increasing the risks of the function for the economy and the financial sector for the following period. The direct exposure of Kosovo's financial system to Ukraine and Russia is very limited; however, the risks from the created circumstances are expected to be carried indirectly through the effect on inflation, the effect on the increase in the cost of financing, as well as through the effect on the general economic activity. While the progress of these developments is being accompanied by high uncertainties, the banking sector in Kosovo has adapted a prudent operating approach in relation to the circumstances and has created satisfactory reserves of capital and liquidity to cope with the increased risks of its operation in the following period.

The rapid economic recovery in 2021, influenced by the unprecedented support of the diaspora and financial and fiscal support measures, gave impetus to developments in the financial system, which was characterized by a double-digit expansion of assets. The improvement of the pandemic situation, as well as the easing of restrictive measures influenced the improvement of the performance of businesses, which influenced that the overall quality of loans does not

deteriorate despite the lift of the restructuring measures.

However, the outbreak of war in Ukraine interrupted the rapid post-pandemic growth trend and increased overall risks to financial stability. Furthermore, the main risk for financial stability in Kosovo comes from the macroeconomic environment. The operational challenges for businesses, with special emphasis on certain sectors, have increased due to the increase in the cost of inputs but also the decrease in reliability that is expected to be reflected in the decrease in demand. On the other hand, high inflation continues to affect the decline in the purchasing power of households, with special emphasis on those with lower incomes. In such circumstances of high inflation, slower economic growth with the possibility of recession, increased interest rates at the global level, as well as the more limited fiscal space to support the economy of Kosovo, the credit risk and liquidity risk of the banking sector are increasing and require close monitoring.

The external macroeconomic environment marked an improvement in 2021. The global and the eurozone economy marked a rapid recovery trend from the pandemic crisis as a result of the improvement of the pandemic situation, the easing of restrictive measures, and supportive fiscal and monetary policies. The Eurozone, the main trading partner of Kosovo and at the same time the region with the highest origin of remittances, in 2021 recorded economic growth of 5.3 percent. The private sector in the eurozone proved to be more resistant than expected, being characterized by lower losses than initial estimates, which was simultaneously reflected in a lower degree of deterioration of the credit portfolio of the financial sector. The countries of the Western Balkans also recorded a recovery in economic activity during 2021, with an average growth of 8.1 percent according to IMF estimates. However, signs of economic recovery in the eurozone and the Western Balkans faded in the last quarter of the year due to the spread of the new variant of the “Omicron”

coronavirus, the energy crisis and problems in supply chains driven by the pandemic. These challenges were significantly deepened with the start of the war in Ukraine, which influenced the further increase in prices (energy, oil and food), the deepening of problems in trade (supply) and the decline of consumer confidence. These developments are expected to have an adverse impact on economic activity, with indirect adverse impacts also on developments in the financial system.

The economy of Kosovo was characterized by a high increase in activity in 2021, after the deepest decline recorded in 2020. The main contribution to the increase was the record growth of exports and domestic demand, influenced by the record arrival of the diaspora in the country as a result of the easing of restrictive measures against the pandemic. However, the second half of 2021 was accompanied by increased inflationary pressures, weakening the economic outlook for the following year. KAS preliminary estimates suggest that annual GDP growth was 10.5 percent. The sectors that recorded the highest growth in value added were precisely the sectors that were most affected by the restrictive measures, such as hotels and restaurants, as well as transport and storage. The performance of the economy, namely the enterprise sector, significantly exceeded expectations, thus significantly reducing the materialization of expected risks in the credit portfolio and influencing the growth of lending activity. However, the increase in the general demand in the country, and especially the dynamics in the prices of the main goods in the international markets, were reflected in increased inflationary pressures in Kosovo. All price indices recorded growth. The average annual inflation rate, expressed through the Consumer Price Index (CPI), increased to 3.4 percent (from 0.2 percent in 2020), with a more pronounced upward trend in the last months of the year. The dynamics that are continuing to accompany the global economy and the prices of the main commodities in the international markets, as a result of the evident problems on

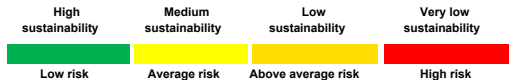
the supply side related to the pandemic, problems at the ports, failures/decrease in yield in crops due to climate change and consequences from the war in Ukraine, signal for increased inflationary pressures even during the second half of 2022. According to the basic scenario of the current CBK forecasts, the average inflation rate is expected to be 11.0 percent in 2022. The impact of the Ukraine war and the economic sanctions against Russia are expected to be reflected in further increases in energy, oil and food prices, with negative effects on consumer confidence and their purchasing power. Taking into account that the war in Ukraine is continuing and under the assumption that the geopolitical crisis caused will not end soon, the probability of the materialization of the worst scenarios of macroeconomic indicators has increased. Under the most severe scenarios, where the inflation rate shows higher growth than the base scenario, the economic outlook for Kosovo will be more pessimistic than the initial expectations for economic growth of 3.0 percent in 2022.

The high economic growth has influenced the increase in budget revenues and the improvement of the budget balance in 2021, despite the annual increase in budget expenditures. Public debt, on the other hand, increased, as a result of fiscal support measures for the recovery from the pandemic crisis. While the end of the economic recovery support package from the pandemic will ease the budget burden, the implementation of the Economic Recovery package, as well as the new circumstances of high inflation and rising interest rates, are expected to increase the pressure on the fiscal sector in 2022. The budget deficit in 2021 was very low, falling to 0.9 percent of GDP from 7.2 in 2020. Public debt recorded an annual increase of 13.1 percent and reached 23.3 percent of GDP, from 22.4 percent in 2020. Public debt was financed both from internal sources, annual growth of 15.0 percent, and from external sources with growth of 9.6 percent. The dynamics of the fiscal sector during the following year are expected to be affected by

the high growth of inflation, which will be reflected both in the decrease in revenues due to the slowdown of economic activity, as well as the increase in budget expenditures due to support schemes for the citizens most affected by high inflation. In particular, the increase in

the cost of energy and budget expenditures for their subsidy will increase the budget burden. At the same time, the increase in interest rates at the global level is expected to shrink the liquidity and increase the cost of debt financing.

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

Risks	2019	2020	Q1 2021	Q2 2021	Q3 2021	Q4 2021	Risk trend
Risks							
Macroeconomic risk	High sustainability	Medium sustainability	Average risk	Average risk	High sustainability	Medium sustainability	↑
Credit risk	High sustainability	Medium sustainability	Average risk	Average risk	High sustainability	Medium sustainability	↑
Income risk (profitability)	Average risk	Average risk	Average risk	Average risk	High sustainability	Medium sustainability	↑
Sustainability of the Banking Sector							
Equity	High sustainability	High sustainability	High sustainability	High sustainability	High sustainability	Medium sustainability	↓
Liquidity and financing	Medium sustainability	Medium sustainability	High sustainability	High sustainability	High sustainability	High sustainability	↓
							

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 high growth of demand in the country in 2021 influenced the increase in imports and expansion of the current account deficit. The components that mitigated the negative effect of high import growth were exports of services and remittances; these components were characterized by the highest historical growth.

The improvement of the pandemic situation, as well as the easing of restrictive measures taken to manage the health crisis, enabled the large numbers of diaspora visits, after a period of isolation during which the diaspora has accumulated increased savings. This affected the record increase of the net export component of services to EUR 1.1 billion, namely 25.0 percent of the GDP value. Remittances also recorded significant annual growth of 17.7 percent, reaching 14.8 percent of GDP. The inflows of remittances have been characterized by high growth throughout the year, except for the last quarter when they

recorded a slowdown in growth. The contribution of the diaspora was also high in the sector of Foreign Direct Investments (FDI), through the purchase of real estate. As a result, FDI in the real estate sector almost doubled its share in total FDI from 58.2 percent to 92.6 percent in 2021. Other sectors that contributed to the annual growth of FDI of 20.1 percent were the information and communication, as well as construction sector.

The financial position of enterprises and households improved in 2021, but the high growth of inflation risks the deterioration of the financial situation, in particular for the construction and agriculture sectors - which were facing the highest increase in the price of inputs - as well as for households. The economic and financial indicators of enterprises suggest a significant increase in the volume of industrial production and turnover in retail trade during 2021, after the decline that characterized them in 2020.

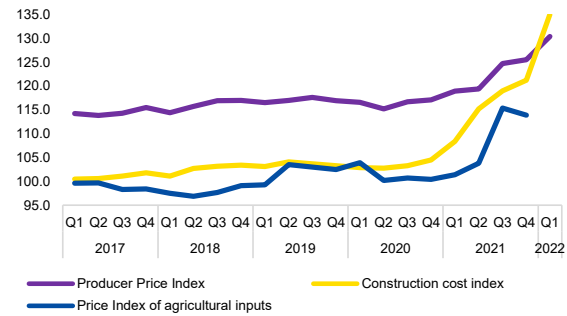
* The methodology for creating the risk table is based on the methodology of the Financial Stability Map of Kosovo. The table additionally includes the indicator of Credit Developments and that of Exposures. The credit developments indicator includes sub-indicators, such as: Credit-to-GDP gap; Growth of Private Sector Lending; Private sector lending to GDP ratio; as well as growth in specific sectors, such as enterprises and households. In the calculation of the Sustainability of the banking sector, in addition to the indicators of the Financial Stability map, the Exposures indicator also been added, which measures the exposures of the banking sector to government securities, foreign currency loans, the share of non-residents' liabilities, as well as the open currency positions.

The average net sales index in the services sector has increased by 68.3 percent following a significant decrease of 36.2 percent in 2020, while the average index of the number of employees has increased by 14.5 percent (6.4 percent decrease in 2020). The rapid economic recovery was also characterized by an increase in entrepreneurial initiative, where the net number of open businesses increased. The financial position of households also improved. While official labour market data is not available beyond Q1 2021, indirect indicators, such as income tax and pension contributions², remittances, and savings suggest an increase in funding sources. However, the high growth of inflation, especially in the second half of 2021 and accelerated in 2022, is expected to affect the weakening of the financial position of households, especially the part of them with lower incomes. Official data in Q1 2021 suggested that the unemployment rate was 25.8 percent, while the employment rate compared to the population was 29.3 percent. The average net salary turns out to be around EUR 400-500 per month, an almost unchanged level in more than the last five years. The new circumstances in the context of the increase in prices not only of basic products but also of other products and services, give signals for a decrease in purchasing power, with potential consequences in the deterioration of debt repayment capacity and an increase in credit risk in the banking sector. While enterprises are generally expected to pass on the effect of price increases to consumers, the risk is nevertheless threatened through the channel of the decrease in demand and upward pressure on wages. The construction sector is among the sectors with the highest increase in credit risk due to the high increase in the cost of inputs, as well as uncertainties about the movement of prices, a factor that has influenced the partial interruption or slowdown of works and sales.

The level at which the effects of the deterioration of the private sector financial position (in particular the construction and real estate sector) will be transmitted to the

banking sector will be more evident after the third quarter of 2022, due to the uncertainties surrounding the behaviour of the Kosovar diaspora and their high effect on the country's economy.

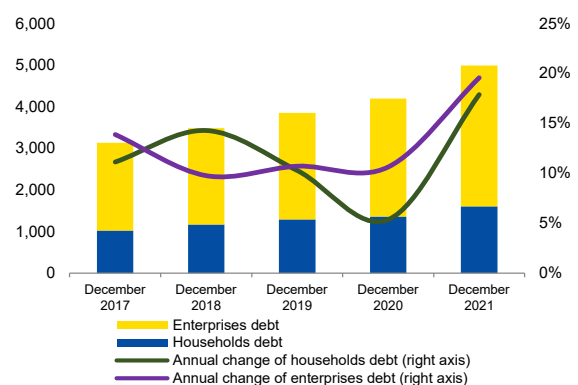
Chart 1. Construction, producer and agricultural input price indices



Source: CBK.

The household sector, despite the higher credit growth recorded in recent years, has been less sensitive to the pandemic crisis, judged on the basis of the need for loan restructuring, as well as the performance of NPLs. This is due to the fact that a large part of households does not have debt in the financial sector (judging by the relatively low level of household loans to GDP of 20.5 percent, as well as the responses of households in a survey for the purposes of the CBK in March 2021, whereby 60.3 percent of respondents declared that they have no loans).

Chart 2. Debt of enterprises and households, EUR million



Source: CBK.

The part that has loans is more concentrated towards employees with income in the public sector and more stable employees. This, along with remittance aids, is considered to have reduced the sensitivity of the household sector

² [Work-Report-January-December-2021.pdf \(atk-ks.org\)](#)

to loan defaults as a result of the pandemic crisis. However, the continuation of the war and the prolongation of the crisis beyond 2022 could weaken debt solvency, with effects on the higher growth of credit risk.

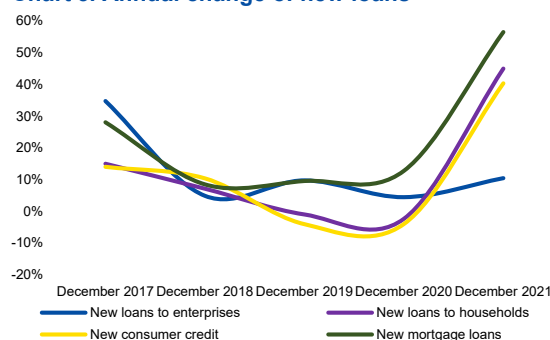
In 2021, the increase in economic activity was accompanied by an increase in the funding need and an increase in the level of debt for the private sector and households. Lending financing was mainly made from deposits, which recorded steady growth. The debt of enterprises to local and foreign financial institutions accelerated the upward trend and reached 43.3 percent of GDP value. The stock of corporate loans from the banking sector recorded an annual increase of 13.6 percent. Enterprise loans from other financial intermediaries, which have a low share in total loans, decreased by 17.8 percent. The external debt of

enterprises marked the highest annual increase of 36.9 percent and increased the share of enterprises in the debt structure to 28.6 percent from 25.0 percent in 2020. Household debt, as well as corporate debt, has grown at an accelerated pace. The total value of debt increased by 17.9 percent in 2021 and reached 20.5 percent of GDP. While the external debt of households has a low share, it was mainly the internal debt to the banking sector and that to the microfinance sector that recorded an increase of 18.5 percent, namely 15.8 percent. Lending to the economy in 2021 continued to be supported by operational and regulatory facilitation measures from the CBK, as well as support measures for access to finance. The Economic Recovery Package - launched in 2020 continued until the end of 2021 - enabled access to finance for micro, small and medium-sized enterprises by guaranteeing loans at a rate of 80%. The Kosovo Credit Guarantee Fund supported private sector lending in the field of energy and agriculture also through the Agro window, the window for supporting new businesses (Start-ups) as well as the regular guarantee window. In 2022, support for access to finance will continue through the Economic Recovery

package, namely the measure of subsidizing investment loans in the production sector and guaranteeing loans to increase access to finance.

The dynamics of lending activity during most of 2021 was determined mainly by movements in credit demand. However, bank sentiment indicates a halved credit demand in the second quarter of 2022, as well as uncertainty about the dynamics during the second half of the year. Interest rates on loans continued their downward trend as a result of increased competition, but the expected increase in the cost of financing may reverse this trend in 2022. The marked increase in credit demand from enterprises was driven by the demand for financing inventories and working capital and fixed investments, while for households, the demand for credit was influenced by the demand for financing consumption expenses.

Chart 3. Annual change of new loans



Source: CBK.

The stock of active loans in the country's banks reached EUR 3.75 billion, which represents twice the annual growth compared to the previous year of 15.5 percent. Banks during the second half of 2022 expect both a halved demand and increased vigilance in internal procedures for analysing credit requests. The average interest rates for new loans for enterprises and households recorded a slight decrease compared to the previous year, mainly as a result of increased competition pressures in the market. On the other hand, the average interest rate on term deposits increased, suggesting increased competition in holding deposits in conditions of high lending. Add to this the increase in interest rates at the global level in 2022, the expectations are that interest rates on deposits will continue to

increase, with a possible impact on the transfer of this added cost to consumers, respectively in the increase of interest rates on loans.

The release of provisions as well as the increase in activity both in terms of lending and transactions in the banking sector influenced the increase in the sector's profit and the improvement of performance indicators. The banking sector of Kosovo this year recorded the highest increase in profit since 2015. The reduction of the risk from the pandemic influenced the release of a part of the provisions allocated in the previous year. This, together with the faster growth of revenues in relation to expenses, influenced the annual profit growth of 47.1 percent. Non-interest income, namely fees and commissions, had the biggest contribution to the increase in revenues. The average return on assets and capital of Kosovo's banking sector increased to 2.3 percent, respectively 19.5 percent from 1.8 percent and 15.6 percent a year ago. The increase in the level of profit and profitability indicators of the sector was higher than the decrease in the countries of the region, increasing the difference over the average of the region that the banking sector of Kosovo has. Going forward, the banking sector's revenues are expected to face the pressure caused by the high rate of inflation recorded during the first six months of 2022. The weakening of the repayment ability of customers as well as the increase in the need for allocation of provisions to cover possible losses can affect both the decrease in the sector's revenues and the increase in expenses. Also, the increase in interest rates at the global level, and the slower rate of growth of deposits, in conditions of high lending, will increase the pressures of competition that will be transmitted with increased pressure on the interest margin of the sector.

The quality of the credit portfolio began to improve after the first quarter of 2021, being attributed to the increase in economic activity and the good performance of economic sectors. The stock of non-performing loans decreased

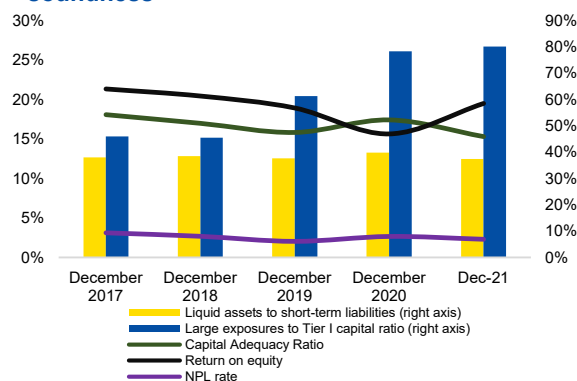
as of the second quarter, for both lending segments: households and almost all economic sectors. But, the optimism of the first half of the year was hit by rising inflation and increasing geopolitical tensions, a situation that was immediately followed by increased concerns about business activity in the sectors most sensitive to such circumstances and the weakening of the purchasing power of consumers and the deterioration of the standard of living, which developments have influenced the immediate increase in credit risk for the year 2022. The sector's NPL rate in 2021 reverted to pre-pandemic downward trends: at the end of the year, the NPL rate dropped to 2.3 percent from 2.7 percent a year earlier. The decrease in the rate of NPLs is mainly attributed to the high growth of lending, the effect of repayments by some large borrowers, as well as the decrease of new non-performing loans, with special emphasis on the summer months. The more favourable perception of credit risk on the part of banks also influenced the reclassification of credit exposures towards the lower risk category, which, together with the increase in new loans, influenced the decrease in the share of Pillar II loans towards the increase in the share of the category of loans of the Pillar I of credit classifications. The rapid economic recovery in 2021, together with the restructuring measures influenced the much lower materialization of credit risk than initial expectations. However, the quality of the credit portfolio of restructured loans is still accompanied by uncertainty, due to the higher credit risk of these loans, which at the end of the year accounted for almost half of the sector's non-performing loans. Furthermore, the end-of-year events such as the continued increase in inflation, initially driven by disruptions in supply chains as a result of the pandemic and reinforced by the Russia-Ukraine conflict, add to the need for increased surveillance and the undertaking of safeguards against the materialization of this risk in the capital position of the sector. In 2021, despite the gradual reduction of credit risk, the sector has continued with allocation of

provisions resulting in an annual increase in the coverage ratio with provisions to 151.0 percent from 139.5 percent in December 2020.

The banking sector overcame the pandemic crisis without significant difficulties, as well as with the ability to withstand high levels of lending in support of economic recovery thanks to the good capital position built over the years. However, the high lending growth has affected the decrease in the capital level of the sector, and the continuation of such credit growth rate will present the need for increase of capital in some of the banks. High lending activity throughout 2021 has increased risk-weighted assets on banks' balance sheets, resulting in the capital adequacy ratio (CAR) being lower by 2.1 percentage points, at 15.3 percent from 17.4 percent in the previous year. The cap rate varies between banks, in which case mainly the systemically important banks have a higher capitalization rate. At the sector level, the variance between the CAR of individual banks to the average of the banking sector has decreased (approximation of the CAR to the average of the sector). The capitalization position of the sector is reflected to be at an adequate level also by the ratio of Tier 1 capital to risk-weighted assets, which stood at 13.6 percent: although lower than last year, for the same reason, of the increase in risk-weighted assets that mainly consist of long-term loans. The continuation of lending to the economy at this accelerated rate in the future, however, will present the need to increase the level of capital by some banks that apply more aggressive lending strategies. Moreover, high inflation and the increase in interest rates at the global level are expected to increase the pressure on the sector's revenues, its profitability and the level of capital, through the effect of increasing the cost of financing as well as increasing the credit risk, which will increase the need for provisioning. The stress test analysis suggests that the sector in general would be able to withstand potential losses in two of the three designed scenarios of macroeconomic developments (the base scenario and the moderate scenario with

economic decline of 4.7 percent and inflation rate of 14.2 percent).

Chart 4. Selected indicators of financial soundness



Source: CBK.

While in the severe scenario of stagflation (which by definition is possible, but has a very low probability of occurrence), namely economic decline of 11.6 percent and inflation of 20.0 percent, the sector would face problems in its capital position. Almost all banks would face the need for recapitalization as a result of large losses and high provisioning requirements.

The high growth of deposits from the private sector in 2021 as well as the accumulated liquidity of banks enabled the high growth of lending, while maintaining the stable position of the sector's liquidity. The main indicators of liquidity, despite the downward trend, remained at high levels at the end of the year. However, the pressures on financing costs are expected to increase as a result of global developments in interest rates, which will directly and indirectly affect financing costs for the banking sector of Kosovo. The good liquidity position was supported throughout 2021 by the continuous growth of deposits, and in particular household deposits. As the main source of funding for the sector, household deposits were mainly supported by remittances through formal but also informal channels (high diaspora flux with the relaxation of travel restrictions). The ratio of liquid assets to short-term liabilities in December 2021 decreased to 37.4 percent compared to 39.6 percent in 2020. However, the tight liquidity ratio, which included only

highly liquid assets (cash and cash equivalents, current accounts and placements), relative to short-term liabilities, rose slightly to 30.6 percent from 30.5 percent a year ago, due to higher growth in highly liquid assets of 13.2 percent. The liquidity reserves of commercial banks continue to be at high levels, exceeding the required reserve held at the CBK by 68.3 percent. However, the increase in inflation has increased uncertainties about the progress of economic developments and has influenced the tightening of monetary policy in many countries in 2022, which will be reflected in the increase in the cost of financing the parent banks, and which will indirectly be transferred to an increased cost of financing for the banking sector of Kosovo. Moreover, the trend of deposit growth has slowed down and may slow down further under the new circumstances of rising cost of living and declining economic activity, which will add pressure on the banking sector's funding and liquidity position, both in terms of maintaining the level of deposits as well as in terms of the cost of their maintenance.

The pension sector in 2021 marked an accelerated increase in activity, surpassing the growth of the pre-pandemic period, after the high shock it suffered in 2020 precisely as a result of the pandemic crisis as well as the early withdrawal of 10 percent of the trust funds from the contributors. The increase in the vaccination rate and the rapid recovery of the global economy influenced the good performance of the markets, which was reflected in the increased return on investments of the sector. New collections also increased, influenced by the rapid recovery of economic activity in the country. However, new geopolitical tensions in 2022 have increased uncertainties about the performance of the economy and global financial markets. Add to this the expected tightening of monetary policy by most

central banks of developed countries, the performance challenges of Kosovo's pension sector have increased significantly for 2022. The value of the sector's assets reached EUR 2.36 billion at the end of 2021, which corresponds to an annual growth of 18.2 percent. The gross return on investments reached a record value since the start of operation of EUR 228.4 million, and a record increase in the price per unit. New collections increased by 9.8 percent, surpassing the growth level of the pre-pandemic period. The positive dynamics in the global markets influenced the increase in the share of investments in foreign markets, which decreased last year in favor of the growth of domestic investments, but which is still lower compared to the pre-pandemic situation. At the beginning of the second quarter of 2021, the deadline for the support measure for early withdrawal of 10 percent of pension savings by contributors ended. The amount of funds withdrawn was EUR 198.1 million, of which EUR 101.7 million will be compensated by the Government of Kosovo.³

The insurance sector was characterized by the expansion of assets in 2021, as well as increases in premiums written and claims paid to levels higher than pre-pandemic levels. The profit of the sector marked an increase compared to the historical average, despite the increase in the level of claims paid. The value of premiums written by insurers in 2021 marked an annual increase of 18.2 percent. Claims paid, including the claims of the Kosovo Insurance Bureau (KIB), increased by 24.4 percent. As a result of the higher increase in claims paid in relation to premiums collected, the claims/premium ratio increased by 2.6 percentage points, to 52.0 percent. The sector closed the year with a positive financial result of 6.9 million euros, compared to 2.3 million euros last year, as a result of the significant increase in collected premiums as well as the reduction of operating expenses. At the sector level, during 2021 there

³ According to the economic recovery plan, it was enabled to allow the withdrawal 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 4-

month period. For contributors with total savings below 10,000 euros, the government will compensate the withdrawn amount of 10 percent within five years.

was an increase in financial health indicators such as the general level of capitalization, liquidity indicators, as well as the value of technical provisions for premiums and claims. However, problems with the level of capitalization in two companies continue, which were inherited from years ago. These companies continue to be below the minimum legal requirements for capital and eligible assets to cover technical provisions.

The microfinance sector recorded an acceleration of growth, influenced by the recovery of credit and leasing activity. The improvement of the pandemic situation and the increase in demand in the country influenced the increase in external financing of the sector. But the sector's dependence on external sources of financing made it sensitive to developments in global financial markets. The war in Ukraine and the tightening of monetary policies to control inflation are expected to increase the cost of financing this sector. Loans from the external sector, representing 60.1 percent of the sector's liabilities and capital, recorded an annual increase of 3.6 percent (a decline of 0.4 percent a year ago). Loans to both households and non-financial corporations marked a significant increase in 2021 (16.7 percent, respectively 17.8 percent). Interest rates, on average, decreased to 19.4 percent from 20.3 percent a year ago. The sector generated the highest annual profit since the beginning of its operation, in the amount of 14.1 million euros, on the account of the accelerated decrease of expenses as a result of reducing the provisions, as well as the increase of revenues, mainly revenues from non-interest. The level of non-performing loans to total loans remains low and has further decreased by 0.6 percentage points, to 2.4 percent. While the coverage level of non-performing loans with provisions in December 2021 stood at 141.6 percent, for 1.4 percentage points.

The improvement of the pandemic situation as well as the lifting of the restrictive measures of movement as a result of the increase in vaccination

affected the increase in diaspora tourism and consequently the decrease in the participation of remittances sent through financial auxiliaries, which affected the decrease in the profit of this sector which last year, when diaspora travel was limited, it was the sector with the highest growth. This sector, with a low share of only 0.3 percent in the total assets of the financial system, consists of exchange offices and money transfer agencies (MTA). The sector's assets recorded higher annual growth, 16.5 percent compared to 13.2 percent, but net profit decreased to 3.2 million euros, which represents an annual decrease of 24.4 percent compared to the growth of 34.2 percent last year.

The macroprudential supervision of the financial sector by CBK has continued, along with continuing efforts to complete the legal basis for exercising the macroprudential policy mandate and narrowing the data gap for a more qualitative assessment of systemic risk. In order to strengthen the legal basis of the CBK in the exercise of the macroprudential mandate, 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 and delegates authority to the CBK to issue relevant regulatory instruments. In the meantime, the Macroprudential Advisory Committee, as an internal body of the CBK, has held regular quarterly meetings, examining selected indicators for the assessment of systemic risk, which in general in 2021 have suggested the stability of the sector. The assessment of systemic risk, among other things, is subject to significant data gaps, and efforts to close the data gap have continued. In this respect, the regulation for reporting in the credit register of Kosovo has been revised, in which the requirements for reporting additional indicators have been added.

In 2021, the CBK has continued the close monitoring of the effects of the pandemic situation in the financial sector,

continuing certain regulatory measures to facilitate overcoming the difficulties encountered by the private sector, such as restructuring. Whereas, in relation to the circumstances of the recovery of economic activity and the performance of the banking sector, the restriction on the distribution of dividends has been removed. The last guideline for the restructuring of loans affected by the pandemic situation was published in February 2021, according to which the deadline for restructuring has been extended and it has been determined that the restructuring will mature in full at the end of 2021. In December 2021, the participation of active loans that have been restructured resulted in 19.3 percent of total loans.

The financial infrastructure has continued to advance. Digitization initiatives have significantly intensified, driven by the pandemic crisis. With the growth of digitalization, the exposure to operational/cyber risk has also increased uniformly, which increases the need for investment in pro-active surveillance to protect against this risk. Despite the closure of the economy and the restriction of movement as a result of the pandemic, the payment system has operated without interruption, providing the appropriate security, efficiency and flexibility for participants, in order to maintain financial stability and identify and address potential problems early.

The rapid trend of virtual infrastructure development has continued, also driven by the circumstances created by the pandemic situation. Banks have increased the overall efforts for digitization and automation of services, in order to provide opportunities for the realization of services while maintaining the health of customers. Most banks have increased the limit of contactless payments that can be made through bank cards. E-banking bank accounts, through which banking services are performed 'online', have continued to grow. The banking infrastructure has also expanded in the context of the network of the number of ATMs and the number of devices for payment through cards - POS. The increase in the use of digitized services has simultaneously increased the degree of risk to errors in information technology systems or possible cyber attacks, thus increasing the exposure to operational risk as well as the need for pro-active supervision to protect against this risk.

Box 1. Financial Stability Map⁴

Financial stability map⁵ presents the developments in the main risk indicators to the financial stability of Kosovo (chart 4). On average, 2021 has been characterized by a decrease in the risk to financial stability in almost all dimensions of risk and the relevant component indicators, as a result of the recovery of economic activity from the pandemic crisis. The risk from the external and internal macroeconomic environment marked a significant decrease. The activity of economic agents was also characterized by a decrease in risk: the enterprise sector marked a halving of the risk rating, while the government and household sector were characterized by a decrease, but at a lower level. Indicators of stability of the banking sector have reflected declining risk. Accordingly, the indicator of Capitalization and profitability, and the indicator of Liquidity and financing of the sector are characterized by lower risk, while the indicator of the structure of the banking sector has marked a slight increase, changing the direction of the gradual decline that has been observed over the years.

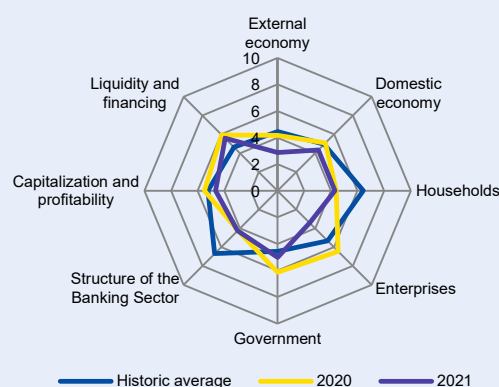
Unlike in 2020, when five of the indicators remained at a risk level above the historical average, in 2021, only the indicator of the Government, and that of Liquidity and Financing, remained above this average, despite the fact that during the year the risk decreased (chart 5).⁶

The significant recovery of economic activity and the increase in employment in Europe in 2021, namely in the economies of Kosovo's main trading partners and the countries with the highest presence of the Kosovar diaspora, has contributed to the decline in the overall risk from the **external economy indicator**. The increase in the positive sentiment of companies as well as the decrease in interest rates as a result of the relief measures for overcoming the pandemic crisis also contributed positively to the decrease in risk. The oil price sub-indicator had a negative contribution, which was characterized by an increase throughout the year. The dynamics in the sub-indicators of the foreign economy for 2022 suggest an increase in risk in all the sub-indicators of this category, as a result of the negative effects of

significant inflationary pressures caused by both the pandemic crisis and the war in Ukraine.

The recovery of economic activity in Kosovo in 2021 influenced the growth of the positive output gap, making the main contribution to the overall decline in risk in the **domestic economy indicator**. The increase in external debt in relation to GDP, the negative expansion of the current account deficit as well as the increase in consumer prices contributed negatively to the risk rating of the domestic economy. The performance of these sub-indicators for 2022, as well as expectations for slower economic growth, suggests an increase in the overall risk from the domestic economy for 2022.

Chart 5. Financial stability map



Source: CBK.

Enterprise sector was characterized by the highest decrease in risk, influenced by the positive performance in all indicators, this performance was driven by the lifting of restrictive measures of the pandemic, as well as support measures for businesses which influenced the recovery of economic activity in the main sectors with the greatest weight in the country's economy. The increase in lending to the enterprise sector as well as the facilitating measures for the return of loans from businesses (restructuring) influenced the improvement/decrease of the risk from the sub-indicator of the credit gap of businesses and the quality of the credit portfolio. The other sub-indicators, at the same time with greater weight in reducing the risk, included the increase in the industrial turnover index, the increase in the turnover index in the service sector, the increase of the added value in GDP from the trade sector as well

⁴ The calculation of the indicators is based on the GDP amount until March 2021, and does not include the last revision of the GDP in April 2021.

⁵ The Financial Stability Map (FSM) graphically presents the movement of risk degree in the main categories of risk to financial stability in the banking sector of Kosovo, as well as enables comparison with the historical average risk rating for the respective categories. The increase in the distance from the center of the map for 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 indicators and their calculation method, is presented in CBK Study Material No. 6.

⁶ The progress of the risk from the Financial Stability Map indicators and the contribution of the constituent components to the corresponding level of risk is presented in Appendix 1.

as the positive net balance for opening new businesses.

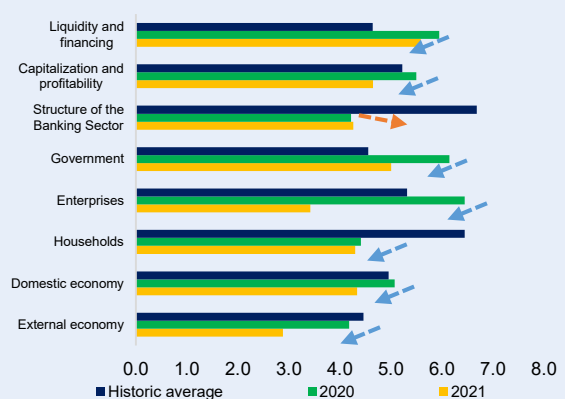
The risk from **households** marked a slight decrease, completely influenced by the significant increase in remittances from immigrants. Sub-indicators such as the credit gap to GDP and the quality of the credit portfolio marked a slight increase in risk, while information on other important sub-indicators such as the labor market/unemployment and affordability of expenses were deficient for 2021. Inflation performance in 2022 represents an increased risk for the activity of the private sector and the financial situation of households. Therefore, the expectations are for an increase in the risk from these indicators for 2022.

The risk from the **government sector** decreased, mainly as a result of the increase in tax revenues, which reached the highest historical level, and influenced the improvement of the ratio of tax revenues to GDP. Another sub-indicator with a contribution to the decrease in risk from the government sector was the improvement of the budget balance to the GDP, as well as the cost of debt. Whereas, the only sub-indicator that contributed to the increase in risk was the expansion of public debt. In 2022, public debt is expected to expand further as a result of relief measures to overcome the challenges of high price growth. The increase in interest rates at the global level is also expected to affect the increase in the cost of debt. The slowdown in economic growth may affect the lower level of tax revenues. Consequently, expectations for the performance of these indicators suggest that the risk from the government sector for 2022 may increase.

Within the internal sector stability indicators, the **indicator of capitalization and profitability** has marked the most significant decrease in risk, mainly influenced by the increase in the sector's profit, which resulted in an increase in the ratio of profit to the sector's assets. The increase in profit also influenced the increase in the share capital to assets ratio of the sector. Other sub-indicators such as Capital Adequacy, large exposures as well as the quality of the credit portfolio also contributed to a decrease in risk, while the decrease in net interest income in relation to assets was the only indicator contributing to risk increase.

The indicator of liquidity and financing of the sector marked a decrease in risk in almost all component sub-indicators. The main contribution to the decrease was the increase in household deposits. The only sub-indicator with increased risk contribution was the widening of the liquidity gap as a result of the high credit growth, which was mainly financed by the increase in short-term credit sources (deposits). The decrease in the average risk rating of the liquidity and financing indicator in this period narrowed the most significant deviation above the historical average level that this indicator had over the years, which largely reflects the nature of the components included in the indicator.⁷

Chart 6. Financial stability map



Source: CBK.

The structure of the banking sector changed the direction of gradual improvement over the years, marking a slight increase in risk. The general sub-indicator of competition, namely the assets of the 3 largest banks to the assets of the sector, marked an improvement, contributing to the reduction of risk. The sub-indicator of the diversification of the general credit portfolio and the diversification of the portfolio of business loans were characterized by positive developments. Whereas, the sub-indicators that contributed to the increase in risk included the negative deviation of the capitalization rate against the average capitalization rate of the sector, as well as the decrease in the degree of diversification of the banks' funding sources.

⁷ The loan/deposit rate indicator has followed a natural upward trend since the beginning of the sector's operation, and in recent periods we reflect a higher ratio (higher risk grade). Similarly, the trend of the growth rate of household deposits has been characterized by significant fluctuations

throughout the years, being higher at the beginning of the sector's operation and naturally starting to fall as a result of the sector's development, but which has increased again in recent periods.

3. The external environment and developments in the domestic economy

The Eurozone is characterized by the recovery of economic activity during 2021, as a result of the improvement of the pandemic situation, the lifting of restrictive measures as well as the supportive fiscal and monetary policy. Signs of recovery have faded in the last quarter of the year as a result of the spread of the new variant of the "Omicron" coronavirus, the energy crisis and ongoing evident problems in supply chains resulting in inflationary pressures.

Similar to the Eurozone, the countries of the Western Balkans also recorded a recovery of economic activity during 2021, a recovery that turns out to have lost its pace in the last quarter of 2021.

While pandemic-related risks lifted in late 2021, the outlook for 2022 and beyond in the medium term suggests increased risks stemming from the war in Ukraine. These risks, reflected mainly through the increase in energy, oil and food prices, problems in trade (supply) and the decline in consumer confidence, are expected to negatively affect overall economic activity.

Table 2. Selected macroeconomic indicators

Description	Real GDP				Inflation			
	2019	2020	2021	2022	2019	2020	2021	2022
Euro area	1.6	-6.4	5.3	2.8	1.2	0.3	2.6	5.3
Germany	1.1	-4.6	2.8	2.1	1.4	0.4	3.2	5.5
France	1.8	-8.0	7.0	2.9	1.3	0.5	2.1	4.1
Italy	0.5	-9.0	6.6	2.3	0.6	-0.1	1.9	5.3
Spain	2.1	-10.8	5.1	4.8	0.7	-0.3	3.1	5.3
Kosovo	4.8	-5.3	10.5	2.5	2.7	0.2	3.4	8.1
Montenegro	4.1	-15.3	12.4	3.8	0.4	-0.2	2.4	6.8
Republic of North Macedonia	3.9	-6.1	4.0	3.2	0.8	1.2	3.2	6.9
Bosnia and Herzegovina	2.8	-3.1	5.8	2.4	0.6	-1.1	2.0	6.5
Serbia	4.3	-0.9	7.4	3.5	1.9	1.6	4.1	7.7
Albania	2.1	-3.5	8.5	2.0	1.4	1.6	2.0	5.5

Source: IMF, WEO April 2022, KAS and CBK for Kosovo.

The Eurozone has recorded an increase in economic activity of 5.3 percent in 2021 (Table 2). The recovery of the economy is mainly supported by domestic demand, as a result of the improvement of the pandemic situation, the lifting of restrictive measures as well as the supportive fiscal and monetary policy. The economies of the eurozone were characterized by a rapid recovery in the first nine months of 2021, a dynamic that suffered a slowdown in the last quarter of the year as a result of the spread of the new variant of the "Omicron" coronavirus and the return of measures in various countries. Also, the rapid economic recovery of the first nine months of the year resulted in a high increase in general demand, a dynamic that failed to be accompanied by supply, which resulted in an increase in

commodity prices in international markets. The short-term outlook for the eurozone economies worsened further in the first quarter of 2022, with the start of the war in Ukraine, a conflict that is expected to have severe economic damage with consequences for global economic activity. The war in Ukraine and its economic fallout have spread rapidly through international commodity markets and financial linkages, making it difficult to coordinate policies vis-à-vis addressing two key challenges in the coming months: inflationary pressures and supporting the economic recovery. Through the direct consequences it has on both consumer confidence and the prices of major commodities such as gas and oil, wheat, corn, fertilizers, etc., the war in Ukraine, sanctions against

Russia as well as still evident problems in supply chains resulted in worsening projections for future economic prospects in both developed and developing countries. For 2022, the IMF has revised down the real GDP growth projection to 2.8 percent, while it has revised up the inflation projection to 5.3 percent.

In line with the changed risk dynamics, the ECB has decided to gradually reduce net asset purchases, which may end in the third quarter, and has signaled a tightening of monetary policy despite the risk that such a step will affect the weakening of further economic activity.

The countries of the Western Balkans also recorded a recovery in economic activity during 2021, except for the last quarter of the year when growth slowed down. IMF estimates suggest that economic activity in the region has recorded an average increase of 8.1 percent in 2021. With the increased uncertainties as a result of the war in Ukraine and the measures taken in the form of sanctions, similar to the eurozone, the region is also expected to face a slowdown in economic growth of only 2.9 percent, while inflation is expected to reach 6.9 percent from 2.9 percent in 2021.

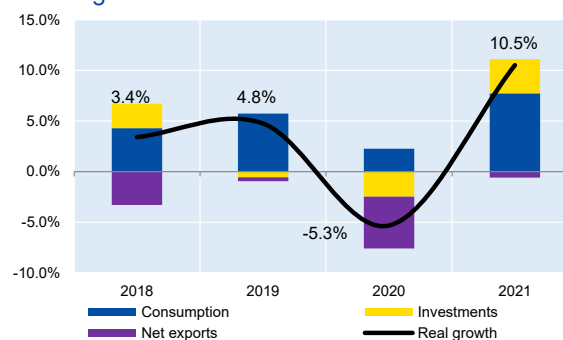
3.1. Domestic economy

Kosovo has recorded a high increase in economic activity during 2021, after the contraction with which it was characterized in the pandemic year 2020. **The preliminary estimates of KAS suggest that the economy of Kosovo has recorded an increase of 10.5 percent in 2021 (chart 7).**

The high growth of economic activity was a result of the amelioration of the health crisis, the effects of fiscal and financial stimulus policies and the high rate of income generated by the diaspora, income that supported consumption and investment. The amelioration of the health crisis enabled the gradual lifting of pandemic control measures, thus supporting free, dynamic movement that was accompanied by high growth in domestic demand and exports. The contribution of

export of goods and services to GDP growth was 17.0 percentage points, consumption 7.7 percentage points and investments 3.4 percentage points.

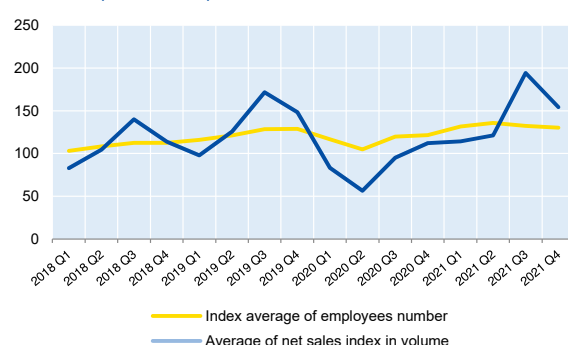
Chart 7. Real GDP growth rate and contributors to the growth



Source: KAS and CBK calculations.

On the other hand, very high growth was also noted in the import of goods and services, with a negative contribution to GDP growth of 17.6 percentage points, causing net exports to have a slight negative contribution of 0.6 percentage points.

Chart 8. Index of sales and employees in services sector (2015=100)



Source: KAS.

On a sector basis, the sectors that recorded the highest increase in added value included the sector of hotels and restaurants, transport and storage, trade, processing industry, construction, etc. The marked increase in economic activity in these sectors is also presented in the short-term statistics of services, where a marked increase in activity and an increase in the employment rate were observed, dynamics mainly influenced by the easing of restrictive measures. **The average index of net sales in the service sector increased by 68.3 percent in 2021 (36.2 percent decrease in 2020), while the average index of the number of**

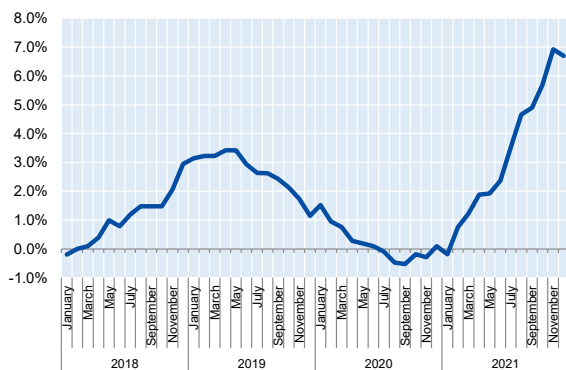
employees increased by 14.5 percent (6.4 percent decrease in 2020) (chart 8).

All sectors reported sales growth. The highest growth was noted in hotels (174.5 percent), followed by travel agencies (133.0 percent), bar-restaurants (120.4 percent), transport and storage (53.3 percent) and trade (35.2 percent).

The expected stabilization of economic activity in 2022, from the unprecedented post-pandemic growth recorded in 2021, was made difficult by the start of the war in Ukraine. The increased risks as a result of the war affected the prospects for economic growth, the level of inflation and financial conditions in the region, the eurozone and beyond. CBK's projections suggest a GDP growth of around 3.0 percent, a slowdown attributed mainly to lower growth of domestic demand.

In other more severe scenarios, where the geopolitical crisis is not resolved quickly and inflationary pressures increase further, the economic perspective for Kosovo will be more pessimistic and the year may end with stagflation.

Chart 9. Inflation rate, annual change



Source: KAS.

The increase in general demand as a result of the economic recovery as well as the dynamics in the prices of the main goods in the international markets during 2021 were reflected in inflationary pressures in Kosovo. The average annual rate of inflation in 2021, expressed through the consumer price index (CPI), was 3.4 percent (0.2 percent in 2020) (chart 9). The main

components that contributed to this increase were transport and food prices with 1.2 and 1.0 percentage points respectively.

The economic recovery that was accompanied by the opening of the economy, as expected, was followed by a continuous increase in prices throughout the year. Also, another determining factor in inflationary dynamics during 2021 was the high increase in the prices of basic goods and intermediate inputs and energy in global markets, causing the impact of external inflationary pressures to be reflected in all other price indices in place. The production price index recorded an increase of 4.9 percent, followed by the construction cost index with 10.9 percent and the import price index, which recorded the highest increase of 11.1 percent. The perspective of potential developments in the price level is accompanied by many uncertainties, mainly subject to the continuation of the war in Ukraine: the magnitude of the impact of this crisis on the prices of the main goods in the international markets such as oil, gas and food; transmission mechanisms of tighter monetary policies; the impact of economic sanctions against Russia such as the boycott of gas imports from eurozone countries - depending on how much will be achieved to ensure coverage of their high dependence on Russian gas. These dynamics that are expected to determine the trajectory of inflation in the Eurozone will also be reflected in the economy of Kosovo. According to CBK forecasts, based on the basic scenario, the average annual inflation rate in 2022 is expected to be 10.4 percent, while the expectations of commercial banks⁸ suggest a higher level of inflation compared to the previous year. Taking into account the high uncertainties caused by the war crisis in Ukraine, CBK has designed two additional scenarios for the real GDP rate and the inflation rate, presented in Box 1.

⁸ Banks report to the CBK on their inflation expectations quarterly and for the whole year.

Box 2. The impact of the war in Ukraine on the economic activity of Kosovo according to the base scenario and two alternative scenarios

The war in Ukraine has influenced the increase of risks for the economic perspective both for the Eurozone, as well as for the region and Kosovo. Kosovo has very low exposure to countries involved in the conflict, so the direct impact of the war on our economy remains limited. However, the consequences that the war is producing, especially in terms of the amplification of inflationary pressures and the imbalance of general demand, have also been reflected in the country's economy. Taking into account the high uncertainties caused by the war in Ukraine, both in terms of the behavior of international markets and the expected monetary policies to avoid the expected stagflation, CBK has revised the economic forecasts accordingly and has designed two additional more severe scenarios that will be analyzed below.

The base scenario is built on the assumptions that the negative impacts of this war are temporary and that global supply chains are not significantly affected. In the projections made at the beginning of 2022, a slowdown in the growth of economic activity and a normalization in the five-year average growth of 3.3 percent for 2022 (10.5 percent in 2021) are foreseen. However, the increase in general macroeconomic risks with the start of the war and the consequences it has produced especially through increased inflationary pressures, have resulted in the revision of the basic projection to 3.0 percent. As for inflation, CBK initially predicted an inflation rate of 5.1 percent for 2022. The change in dynamics and the continuous increase of all price indices in the country has forced the CBK to revise the base scenario to 11.0 percent for 2022 and 6.2 percent for 2023.

The increase in the prices of basic goods in the international markets in a magnitude that has continuously exceeded the expectations of the ECB and the banks of the Western Balkan countries has significantly increased the perception of the general macroeconomic risk in the country. As a result, CBK has designed two alternative scenarios of the economic perspective for 2022 and 2023 (moderate scenario and severe scenario). In these scenarios, it is assumed that the war will last longer than in the base scenario, extending into 2023.

Moderate scenario. The impact of the war in Ukraine combined with additional sanctions against Russia and the embargo of Russian gas and oil by EU countries is expected to create significant supply constraints. Such a lack of supply is expected to influence the much higher increase in the prices of basic goods in the following months (food, oil and gas), with negative consequences in industrial production as well. The slowdown of economic activity in the eurozone, in addition to the direct impact on external demand, will also be reflected in domestic demand, since it is expected to affect one of the main sources of financing economic activity - income from the diaspora.⁹

As for the price projection, the simulations were carried out based on assumptions based on the communication of central banks, international financial institutions and reports of other relevant agencies such as the Food and Agriculture Agency of the United Nations (FAO). In Kosovo, interviews with stakeholders relevant to the price of bread, sunflower oil and oil, as the products most affected by the consequences of the war in Ukraine, were also taken as a basis. Under the moderate scenario, the price of bread would be 9.3 percentage points higher compared to the base scenario in 2022. Furthermore, Ukraine and Russia are the main producers of sunflower oil in the world. Limitations in supply from other producing or intermediary countries in these products to maintain the general demand in their countries has influenced further growth of these basic products. According to the moderate scenario, the price of edible oil would be 58.2 percentage points higher compared to the base scenario. As for oil derivatives, the price would be 23.2 percentage points higher compared to the base scenario. The plans of the US administration are to encourage the growth of domestic production and until this growth happens, it has decided to supply the market with about 1 million barrels of oil on a daily basis from the strategic reserves. This released amount of state reserves, which is the largest amount historically, will be realized by the end of the year and is expected to restrain the increase in oil prices. Given the continuation of the war in Ukraine, farmers there will have poorer yields in the next year, so it is assumed that the price of bread, sunflower oil, but also oil in 2023 would increase even more (table 1).

⁹ Income from the diaspora is in the form of remittances, investments (mainly in real estate) but also the expenses that the diaspora made during their stay in Kosovo.

Table 1. Assumption of certain prices in the moderate scenario (values are in euros)

Description	Bread	Sunflower edible oil	Diesel
2021	0.45	1.75	1.20
2022	0.50	2.90	1.80
2023	0.55	3.20	2.50

Source: CBK.

Severe scenario. In addition to the assumptions included in the moderate scenario, in the severe scenario, a greater and continuous increase in prices is simulated as a result of the war and the intensification of risks. The scenario of the continuous reduction of stocks and reserves in the years included in the scenarios as a result of the risk of not being able to replace the basic products from Russia and Ukraine in the coming months (gas, oil and the main inputs in agriculture) is looking increasingly more plausible. As a result, the market will balance at higher price levels and in a general inflationary environment, even greater effects of the second round of inflation materialize. In the framework of this scenario, it was assumed that the price of bread would be for 27.9 percentage point higher compared to the base scenario, while the price of edible oil and oil would be 66.9 and 43.5 percentage points higher than in the base scenario (table 2).

Table 2. Assumption of certain prices in the severe scenario (values are in euros)

Description	Bread	Sunflower edible oil	Diesel
2021	0.45	1.75	1.20
2022	0.60	3.30	2.70
2023	1.00	3.60	4.00

Source: CBK.

If these assumptions were to materialize, inflation would reach very high levels in 2022 in both scenarios, but it would decrease progressively in 2023 to the level of 3.2 percent in the moderate scenario and to the level of 4.3 percent in the severe scenario. The level of inflation is significantly higher compared to the base scenario since the basket of the Kosovar consumer has a high share of the categories which are recording a higher increase in prices. More than half of the Kosovar consumer's basket consists of the two categories most affected by the crisis - food (41%) and transport (18%), therefore the weight that these categories have in the overall consumption basket has influenced the inflation rate in Kosovo to be higher compared to countries that have a lower share of these products. In this way, the inflationary effects due to the price increase manage to be higher by 8.5 percentage points in 2022 in the moderate scenario and 13.3 percentage points in the severe scenario compared to the base scenario. In 2023, inflationary pressures

are lower than in the base scenario, mainly due to the higher base in 2022. Further, the increase in prices is expected to affect the weakening of the general demand in the country and consequently the weakening of the economic activity.

Table 3. Alternative macroeconomic scenarios (annual percentage changes)

Description	2021	2022	2023
Baseline scenario			
Inflation	3.35	10.40	5.40
GDP	10.53	2.45	3.19
Adverse scenario			
Inflation	3.35	14.24	2.82
GDP	10.52	-4.70	5.60
Severe scenario			
Inflation	3.35	20.00	4.04
GDP	10.53	-11.60	3.40

Source: CBK.

The overall impact on real GDP growth is significantly negative in both scenarios, with a larger effect in the severe scenario (table 3). Under the moderate scenario, where external demand is weaker while risks to production and commodity prices are high, the decline in real GDP would be around 6.3 percent in 2022, or 9.3 percentage points lower compared to the base scenario. In 2023, GDP growth under this scenario would be around 6.5 percent or 2.5 percentage points higher than in the base scenario. In the severe scenario, in addition to the assumptions in the moderate scenario, higher prices lead to a significantly higher decline in real GDP in 2022 (-11.0 percent) while in 2023, GDP would return to an increase of 5.5 percent.

However, these scenarios do not take into account other important factors that can have a significant impact on economic activity and the level of inflation. In particular, these scenarios are prepared under the same fiscal assumptions. In addition to the commodities included in the scenarios, the prices of other commodities and some metal prices may also be affected by the conflict given the role of Russia and Ukraine in global supplies of these commodities.

The fiscal sector during 2021 was characterized by an increase in budget revenues by 27.1 percent and an increase in budget expenditures by 2.3 percent. As a result of the very high increase in budget revenues, the budget deficit was very low, declining to 0.9 percent of GDP from 7.2 percent in 2020. The public debt was also characterized by an increase of 13.1 percent, which reached the value of about EUR 1.7 billion. **As a percentage of GDP, public debt reached 23.3 percent from 22.4 percent in 2020.** The increase in public debt is attributed to the increase in domestic debt of 15.0 percent (which amounted to EUR 1.1 billion), and increase in public external debt by 9.6 percent, reaching EUR 576.4 million. The increase in public debt is attributed to the increase in budget needs to cope with the increased expenditures caused by the Covid-19 pandemic.

The recovery of economic activity during 2021 has affected the increase of the current account deficit of the balance of payments by 42.5 percent, reaching the value of EUR 673.0 million. In relation to GDP, the current account deficit has reached 8.6 percent (7.0 percent in 2020). The increase in the current account deficit was as a result of a high increase in the deficit of goods, while the balance of services and that of primary and secondary revenues have improved.

The increase in the import of goods, as a result of the increase in general demand in the country, has affected the increase in the goods deficit of 38.3 percent (9.4 percent decrease in 2020), while the recorded value of the deficit was about EUR 3.9 billion. The value of the import of goods was EUR 4.7 billion, which corresponds to an annual increase of 41.1 percent (5.7 percent decrease in 2020). All import categories have been characterized by growth, while the highest growth has been noted in the import of mineral products (mainly petroleum products), base metals, means of transport, various machines as well as food items. All these categories were characterized by significant price increases in international

markets. The export of goods increased by 57.8 percent, reaching the value of EUR 749.7 million. The growth of exports of goods was more pronounced in base metals, plastics and rubber - as categories that dominate the structure of exports, followed by mineral products, food items, beverages and tobacco, etc.

In terms of the balance of payments, trade in services was the component that increased the most as a direct result of the restrictive measures taken to manage the health crisis. The services component had a balance of EUR 1.1 billion (in 2020 and 2019, the balance of services was EUR 391.6, respectively 926.0 million). The value of exported services was EUR 2.0 billion or 96.4 percent higher compared to 2020 (16.7 percent higher compared to 2019), while the value of imported services was EUR 870.7 million or 44.3 percent higher compared to 2020 (16.2 percent higher compared to 2019). The export of services has a share of 25.0 percent in the GDP of the country and consists mainly of the expenses of the diaspora during their stay in Kosovo. The increase in diaspora visits to Kosovo and the easing of restrictive measures has affected the export of travel services to reach the value of EUR 1.5 billion, an annual increase of 137.3 percent (12.8 percent increase compared to 2019). The export of transport services, the export of computer services and the export of construction services were also characterized by high growth. Similar dynamics characterized the import of services, where the highest growth was recorded by travel services, transport services, insurance services and computer services.

In order to minimize the consequences of the pandemic crisis in the economy, the countries where the Kosovar diaspora is concentrated undertook monetary, financial and fiscal policies, which resulted in maintaining the well-being and general performance of these economies. The impact that the financial facilities had in the EU countries was translated not only into a significant number of arrivals of the Kosovar diaspora in 2021, but also into an increase in the income sent from

these countries. **Remittances reached the value of about EUR 1.15 billion in 2021 and recorded an annual increase of 17.7 percent (35.4 percent increase compared to 2019) reaching 14.8 percent of GDP.** Remittance inflows were characterized by a high increase throughout the year, with the exception of last quarter thus recording a slowdown in growth. Given the greater flow of the diaspora that visited Kosovo, remittances coming through the "informal channel" have recorded the highest growth of 86.3 percent. Remittances through banks increased by 26.5 percent, while remittances through money transfer operators decreased by 1.2 percent.

FDI in Kosovo reached the value of EUR 415.3 million in 2021, which corresponds to an annual growth of 20.1 percent (63.1 percent higher compared to 2019). The increaser of FDI was mainly recorded in the real estate sector as the sector with the highest share in the total structure of FDI, then in the information and communication sector, construction, etc., while FDI in the energy sector, financial activities, etc., decreased. FDI in the real estate sector have increased the share to 92.6 percent of total FDI in 2021, from 58.2 percent in 2020. On the other hand, the participation of financial activities in total FDI has decreased to 6.0 percent from 24.6 percent in 2020. The decline of investments in this sector is mainly related to the dividend distribution.

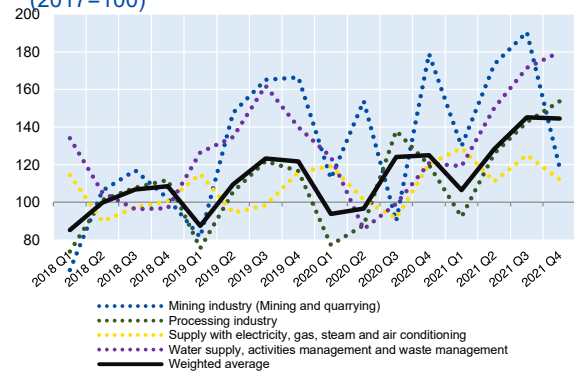
3.2. Financial position of enterprises

Economic and financial indicators of enterprises suggest a significant increase in the volume of industrial production and turnover in retail trade during 2021, after the decline that characterized them in 2020.

The weighted industrial production volume index, which represents the performance of enterprises in four sectors of industry, has marked an increase of 19.3 percent in 2021. The highest increase was recorded in water supply (44.5 percent), followed by processing industry (21.7 percent), extractive industry

(14.3 percent) and electricity supply sector (10.4 percent) (chart 10).

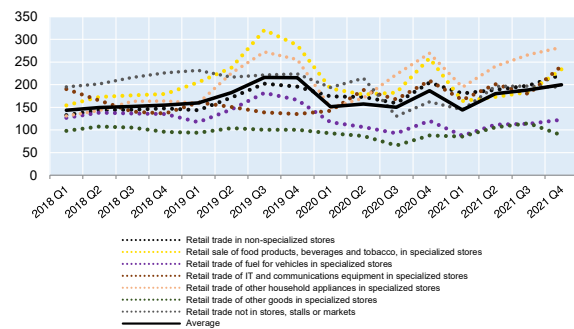
Chart 10. Industrial producer volume index (2017=100)



Source: KAS.

Even the turnover index in retail trade has recorded a double-digit growth of 10.4 percent. Almost all sectors recorded high growth, with the exception of retail trade of food products and fuel for vehicles which recorded a decrease of 7.0 and 0.4 percent respectively (chart 11).

Chart 11. Retail turnover index (2015=100)

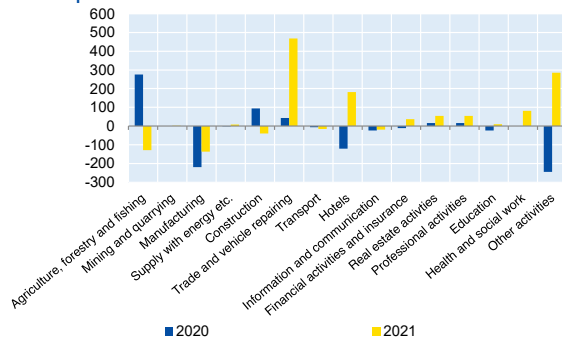


Source: KAS.

As a result of the improvement of economic activity, entrepreneurial initiative has increased. In 2021, 10,649 enterprises were registered or 8.6 percent more compared to 2020, while 1,608 enterprises were closed or 21.3 percent more compared to 2020. The sectors that recorded the highest growth in the number of registered enterprises were mainly the sectors that were most affected by the easing of restrictive government measures, measures that enabled free movement. The number of enterprises registered in the trade sector increased by 19.4 percent, hospitality by 17.9 percent, professional activities by 5.9 percent, etc., while there were also sectors in which the number of registered enterprises decreased (chart 12).

Enterprise debt to domestic and foreign financial institutions has increased at an accelerated pace. Total enterprise debt recorded an annual increase of 19.6 percent in 2021 (chart 13) and reached 43.3 percent of GDP.

Chart 12. Annual change in the number of new enterprises



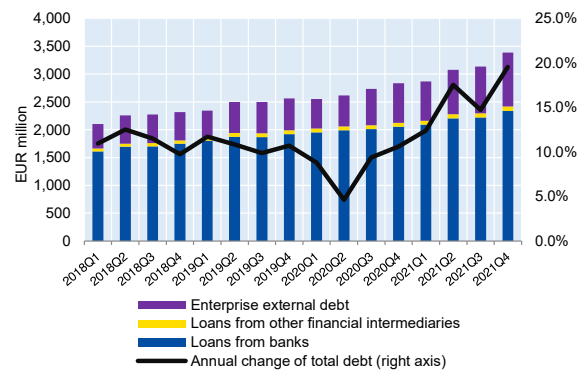
Source: KAS.

Domestic debt, i.e. debt of enterprises to lending institutions in the country has increased by 13.8 percent (6.8 percent increase in 2020), as a result of the increase in bank loans by 13.6 percent, but also the increase of 17.8 percent of loans issued by other financial intermediaries, which remain insignificant (3.4 percent) in the total debt of enterprises to the financial sector. The external debt of enterprises has increased even higher (36.9 percent), mainly due to the increase in commercial loans, and has reached 28.6 percent of the total debt from 25.0 percent in 2020.

The increase in lending to enterprises by the banking sector has contributed to the increase in the degree of financial intermediation. The ratio of lending to enterprises by lending institutions in the country to GDP, reached 30.9 percent in 2021 (28.2 percent in 2019 as a pre-pandemic year). This increase in the ratio of lending to GDP has caused the credit to GDP gap, to be positive.¹⁰

Net debt position of enterprises to the banking sector has marked an increase of 10.3 percent (4.2 percent increase in 2020). The deposits of the enterprises recorded a growth rate of 19.3 percent, while the growth rate of lending to the enterprise sector was 13.8 percent. So, despite

Chart 13. Enterprises debt



Source: CBK.

the higher growth of deposits, the much higher volume of loans to enterprises has affected the increase in the debt position of enterprises to the banking sector. 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 currency position remains low as the share of foreign currency deposits to total deposits was only 2.9 percent while foreign currency loans to enterprises were non-existent during 2021.

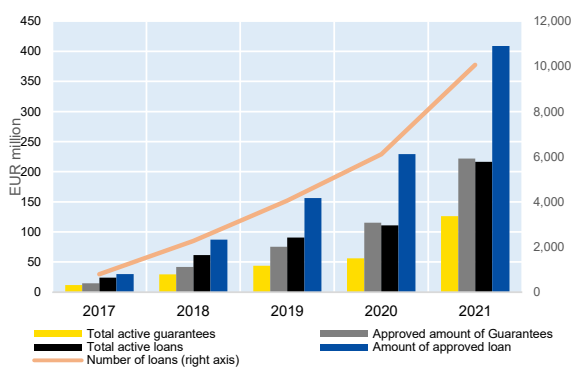
New loans to enterprises increased by 10.4 percent in 2021 (4.4 percent increase in 2020). According to the purpose, new non-investment loans increased by 41.9 percent and increased participation in the structure from 33.2 percent to 42.6 percent of total new loans to enterprises. New investment loans decreased by 6.6 percent and reduced participation in the structure from 64.6 percent to 54.7 percent of total new loans to enterprises. In terms of maturity, loans with a maturity of more than 5 years comprise about 24.2 percent of new loans, a category that recorded a decrease of 2.1 percent. Loans over 2 years to 5 years, as the main category, increased participation from 44.7 percent to 48.5 percent in the overall structure of new loans to enterprises.

Borrowing of small and medium-sized enterprises has also been supported by the Kosovo Credit Guarantee Fund (KCGF), which has shown a continuous growth trend. In December 2021, the number

¹⁰ Credit gap calculated with the Hodrick-Prescott filter.

of loans guaranteed by KCGF was 10,064, while the approved amount of guarantees reached 221.8 million euros (chart 14). The structure of guaranteed loans is a representation of the general structure of loans in the banking sector, where loans for the wholesale and retail trade sector dominate, followed by the service sector and the production sector. The sector of agriculture, forestry and fisheries had a representation of 8 percent in the total portfolio of guaranteed loans.

Chart 14. Loans approved and guaranteed by KCGF



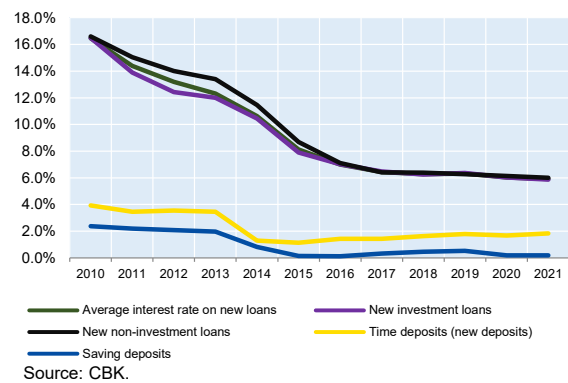
Source: KCGF.

The changed dynamics during these years of the pandemic have strengthened the role of the KCGF in supporting economic recovery by facilitating access to finance, where in 2020, the KCGF in collaboration with the Government of Kosovo and international donors launched the Economic Recovery Package, which ended on 31 December 2021. This package constituted a new guarantee line to support access to finance for micro, small and medium enterprises through guaranteeing loans.

This package has enabled the KCGF to increase the coverage with credit guarantees from 50 percent to 80 percent, offering more security to banks in this way to increase lending and reduce the lack of liquidity in the market. The Economic Recovery Package mainly supported lending in the production, agribusiness, services, trade sectors, with a special focus on women in business, new businesses and investments in energy efficiency. Also, during 2021, several financial agreements were signed to support the private sector. With the German Development Bank

(KfW) an agreement worth 6.0 million euros has been signed to support the private sector especially in energy efficiency, resource efficiency and investments in renewable energy. Also, guarantee agreements have been signed with three microfinance institutions for the guarantee of agricultural loans, which will be a great impetus in increasing lending to smallholders and farmers and thus increasing financial inclusion in Kosovo.

Chart 15. Interest rates for enterprises



Source: CBK.

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

The average interest rate for new loans in the banking sector to enterprises was 5.9 percent in 2021, which represents a slight decrease compared to the rate of 6.0 percent in 2020, mainly as a result of increased competitive pressures in the market. On the other hand, the average interest rate on time deposits increased from 1.7 percent in 2020 to 1.8 percent in 2021 (chart 15).

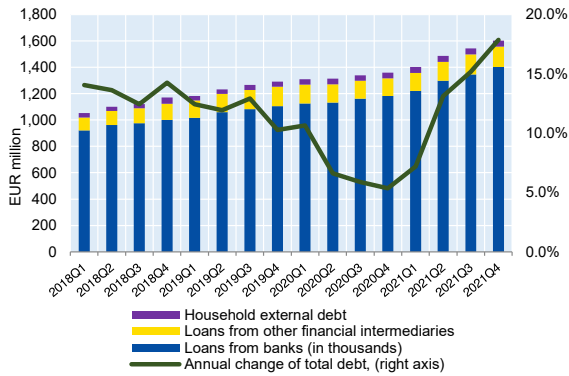
3.3. Financial position of households

Household debt, as well as enterprises debt, has grown at an accelerated rate. In total, household debt increased by 17.9 percent in 2021 and reached 20.5 percent of GDP. Internal debt to the banking sector increased by 18.5 percent, while debt to microfinance institutions increased by 15.8 percent. On the other hand, the external debt of households, which has a low share in the total debt of households (2.8 percent), has recorded an increase of 5.7 percent (chart 16).

New loans issued by the banking sector for households recorded high growth. The

total increase in new debt to banks was higher by 45.0 percent compared to 2020. According to the purpose, new mortgage loans increased by 56.5 percent, consumer loans (68.3 percent of total new loans to households) increased by 40.3 percent and investment loans by 24.4 percent.

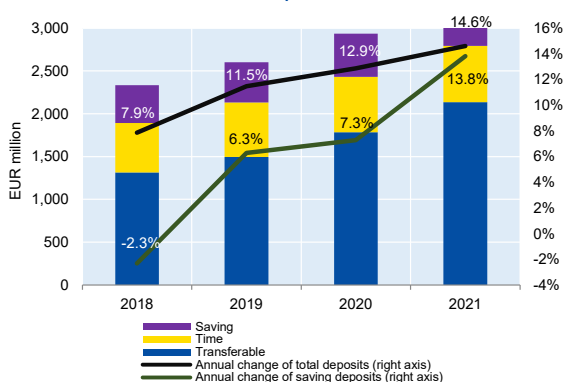
Chart 16. Households debt



Source: CBK.

The net credit position of households to the banking sector increased as a result of the acceleration of deposit growth.

Chart 17. Household deposits

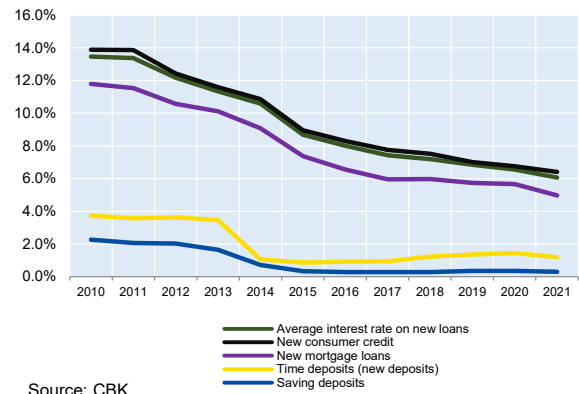


Source: CBK

Household deposits reached the value of 3.4 billion euros¹¹, which represents an annual increase of 14.6 percent (chart 17). Also, loans continued to grow by 18.5 percent and reached the value of 1.4 billion euros. As a result, the credit position that households traditionally have to the banking sector increased by 12.0 percent. As for the net foreign currency position, the households sector has recorded an

increase in its credit position by 13.7 percent, as a result of the increase in foreign currency deposits of 13.3 percent, while foreign currency lending that has a participation of only 0.2 percent of total loans to households marked a decrease of 7.7 percent.

Chart 18. Interest rates for households



Source: CBK.

Household savings in the form of transferable deposits, term deposits and savings deposits increased. The increase in household deposits can be attributed, among other things, to the increase in income in the economy (increase in remittances, withdrawal of 10 percent of pension savings in the KPST at the end of 2020, etc.). On the other hand, during the year 2021, the interest rate on deposits has marked a slight decrease and this may have negatively affected savings and time-depositing (chart 18).

Total household deposits increased by 14.6 percent (12.9 percent increase in 2020). Time deposits recorded an increase of only 1.1 percent, where the average interest rate on time deposits was 1.19 percent or 0.24 percentage points lower compared to 2020. Savings deposits recorded an increase of 13.8 percent, while the interest rate on time deposits saving was 0.29 percent (0.35 percent in 2020). The cost of new household debt decreased slightly, influenced by competitive pressures. The average interest rate on new consumer loans of 6.7 percent in 2020 decreased to 6.4 percent in 2021. Meanwhile, the interest rate on investment loans increased to 9.8 percent from 9.7 percent in 2020.

¹¹ Including deposits in foreign currency, converted to equivalent values in euros.

Table 3. Banks debt and households performance

Description	2018	2019	2020	2021
Household debt to banks (EUR million)	1,001.1	1,104.7	1,182.2	1,401.2
Of which in foreign currency	2.6	2.6	2.3	2.2
Household deposits at banks (EUR million)	2,334.2	2,601.9	2,937.1	3,366.1
Of which in foreign currency	140.4	138.5	155.4	176.1
Net position to banks (credit position), EUR million	1,333.1	1,497.3	1,754.9	1,964.9
Average value of loans per employees	2,900.8	3,041.6	3,406.3	4,037.3
Economic dependence rate	268.0%	253.0%	275.0%	264.0%

Source: CBK.

Household income sources showed an upward trend, where remittances increased by 17.7 percent while employees'¹² compensation registered a slight increase of 0.2 percent. Until March 2021, the net monthly salary, according to the Labor Force Survey¹³, was in the range of 400 to 500 euros. As for the labor market, the labor force participation rate was 39.5 percent until March 2021 or 0.7 percentage points higher compared to the same period of 2020.

The employment rate has increased to 29.3 percent, which is 0.2 percentage points higher compared to the same period of 2020. Even the indicator of economic dependence, which represents the ratio between the general inactive population (over 15 years old) and employment, until March 2021 has decreased to 264 percent, from 275 percent in 2020. On the other hand, the unemployment rate has increased (25.8 percent) compared to the same period of 2020.

¹² Income from employees' compensation - income of seasonal workers abroad as well as Kosovar workers abroad for a period of less than one year.

¹³ Kosovo Statistics Agency, <https://ask.rks-gov.net/media/6354/afp-tm1-2021.pdf>

Box 3. Household indebtedness in Kosovo¹⁴

The household indebtedness represents a direct risk to the sustainability of household debt and the stability of the financial system as a whole, and as such is increasingly attracting the attention of policy makers. Therefore, in order to ensure a favorable environment for the growth and development of the financial system, as well as to

ensure financial stability, the Central Bank of Kosovo (CBK) in March 2022, has published the second study in a row on the assessment of the indebtedness of borrowers and respective households, which will be an important tool for informing policy-making and decision-making. Through this study, it was attempted to address the following issues:

Socio-demographic and socio-economic characteristics of borrowers with active loans in banking and microfinance institutions;

The most frequent models of borrowing (type and purpose of loans, approved value of the loan, duration, use of collateral, co-borrowing, multiple borrowing in several institutions);

Repayment performance characteristics and potential influencing factors;

The level of indebtedness of individual borrowers and households;

The impact of the outbreak of the COVID-19 pandemic crisis on the income and level of indebtedness of the borrower and his household.

The study is based on a sample that was selected from the population of individual clients from all banking and microfinance institutions in Kosovo, who had at least one active credit contract in CRK at the end of March 2021. Respecting the confidentiality level of 99% and with margin of error, the sample included 1,991 individual customers with 10,738 credit contracts (of which 5,014 active credit contracts).

The main source of data is CRK, a platform on which all lending financial institutions report on a regular basis. However, the obtaining of information on the financial situation of the households of the respective borrowers, such as income and expenses, was realized through a request from credit institutions. At the same time, additional socio-demographic data of the borrowers as well as data on loans were also provided, in order to complement the two

databases (CRK, FI) as well as to compare/evaluate the quality of the information.

The indebtedness of households has no definition and standard evaluation method. Noting the lack of consensus on the 'best' indicator, different indicators were used to assess specific aspects of the indebtedness, in order to reach a more realistic picture of the problem. The indicators, which respect most of the principles elaborated in various studies, reflect four aspects of indebtedness such as: high share of debt in relation to income, delays in payment, frequent use of loans and the subjective aspect of considering debt as a heavy burden. Therefore, in this study, the assessment of indebtedness was made through some of these objective and subjective indicators, as well as the relationship between them was tested and analyzed (table 1).

¹⁴ The box is a comprehensive part of the study carried out by CBK "Household Indebtedness in Kosovo", March 2022, <https://bqk-kos.org/publikimet/ngarkesa-me-borxh-e-klienteve-bankare-ne-kosove/>

Table 1. Objective and subjective indicators of indebtedness

Category	Indicator	Assessment/Indicator	Results
Cost of debt servicing: Debt to income ratio	Households that spend over 50% of their gross monthly income to pay their debt (secured and unsecured debt)	a) <i>Indebtedness Index (amount of monthly installments of active borrowings =>50% of gross monthly income of borrowers); (sample 1,805)</i> b) <i>Indebtedness index (amount of monthly installments of active borrowings =>50% of household gross monthly income); (sample1,751)</i>	27.4% of borrowers use over 50% of their income to pay their installments 11.7% of borrowers use over 50% of their income to pay their installments
	Households spending over 50% of their gross monthly income to pay their debt (secured and unsecured debt)	<i>Households survey (sample of 1068 households)</i>	a) 60.3% of households do not have active loans at all, while only 1.9% use more than 50% of their income on loan repayment, while 4.7% have not responded. b) Within households that had active loans, 4.8% of them use more than 50% of their household income on installments, while 11.7% did not respond.
Arrears	Households are in arrears for more than 2 months in paying credit contracts	<i>Borrowers are in arrears for more than 60 days (sample 1,984)</i>	8.5% of borrowers are in arrears for more than two months on paying credit installments. Most of them (74.4%) are in arrears for over 2 months in only one credit contract
	Households are in arrears for more than 2 months on payment of regular monthly obligations for utility expenses (water, electricity, waste, property tax),	<i>Households survey (sample of 1.068 households)</i>	9% of households are often in arrears for longer than 2 months on the payment of these obligations; while 45.7%, stated that they are sometimes in arrears
Number of credit contracts	Households=>4 active credit contracts	<i>Borrowers=>4 active credit contracts (sample 1,984)</i>	17.7% of borrowers have 4 or more than 4 active credit contracts

Source: CBK.

The main indicator of the indebtedness of borrowers and households (the results of which are elaborated below) is considered the index that is based only on loan installments, eliminating the installments of other credit products such as credit cards and overdrafts, due to the difficulties in quantifying monthly installment of these products. Credit cards and overdrafts, although they can be a constant source of debt for borrowers, with a significant effect on increasing their over-indebtedness, may also reflect temporary debt situations (one-time use of the product). In the absence of information on credit installments, the assessment of indebtedness when the payments of these credit products are included is made under the assumption that the total debt outstanding on the credit card and overdraft is a monthly installment. Because of this conservative assumption, the rate of over-indebted borrowers turns out to be much higher, and is considered overestimated (chart 1).

Source: CBK.

The results of the study suggest that 27.4 percent of borrowers¹⁵ are over-indebted with loan debt.¹⁶

While, when taken based on the incomes of the entire family unit, the participation of

cases of over-indebtedness drops to 11.7 percent.¹⁷

In the first stage of over-indebtedness - at risk of over-indebtedness because the monthly installment of the loan constitutes 50% to 75% of monthly income - **are 21.8 percent of borrowers.** Whereas, when the incomes of the entire family unit are taken into account, 8.2

¹⁵ The main indebtedness index for the individual borrower was calculated for 90.7 percent of the customers of the selected sample, respectively for 1,805 observations.

¹⁶ Over-indebtedness includes cases where the level of monthly debt for loans alone (the sum of monthly loan installments, not

including other credit products such as overdrafts and credit cards) exceeds 50 percent of monthly income.

¹⁷ The main indebtedness index for households was calculated for 87.9 percent of the sample of borrowers, namely 1,751 observations.

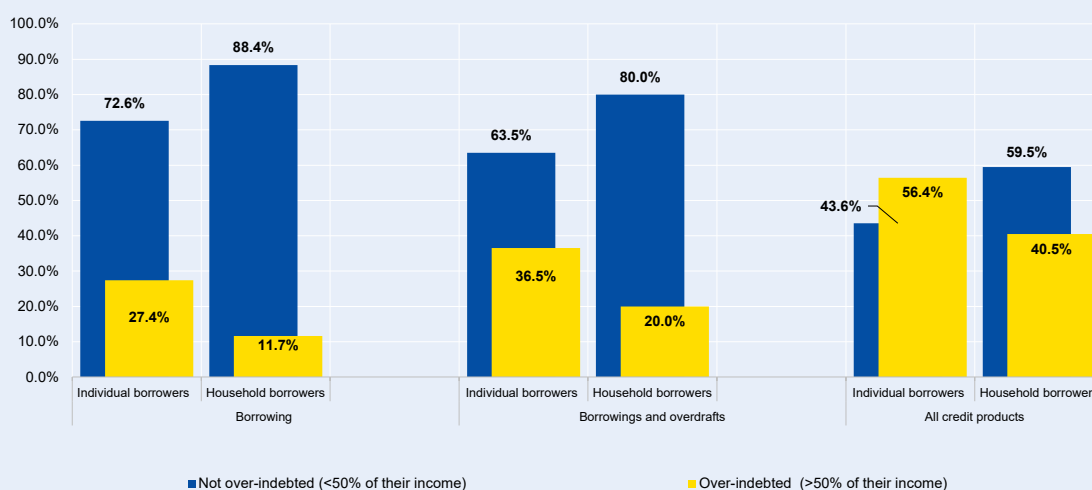
percent of households are at risk of being over-indebted. **In the critical phase** - with a ratio of debt to income in the range of 75 to 100% - there result **3.8 percent of borrowers** and 2.0 percent of households. Cases where the borrower's

installment expenses completely exceed the gross monthly income, passing into a **non-solvent state**, are presented in **1.8 percent of the sample of borrowers** and 1.4 percent of households (chart 2a and 2b).

Over-indebtedness based only on the borrower's income may reflect an overestimation of the state of the indebtedness, due to co-borrowing and the fact that households pool income to cover expenses. On the other hand, in the assessment of indebtedness with household income, due to the lack of information on the possible loan debt of other family members, we may have an underestimated overview of the indebtedness level. Therefore, the results of the over-indebtedness should not be interpreted as an absolute assessment of the actual situation, but as an indication of the approximate level of households over-indebtedness with loans in the financial sector in Kosovo, which is considered to be in the range between 27.4 percent and 11.7 percent of sample of borrowers, respectively in the range of results from both indicators - based on the income of the borrower and that on the income of the family unit.

Source CBK.

Chart 1. The level of burden on borrowers and their households



Source: CBK.

The indebtedness of borrowers and households is higher in the period **after the emergence of the COVID-19 pandemic**, on average by 2 percentage points for each of the indebtedness categories. However, these results do not fully

reflect the impact of the pandemic and should generally be taken with caution due to the inconsistency of the time period that the data reflect.¹⁸ Also, post-pandemic data are not complete¹⁹ and in many cases have been collected in the form of a survey, which creates room for

¹⁸ The timing of recording income before the pandemic is not consistent across financial institutions. While some of them have reported the data in the last month before the outbreak of the pandemic, others have reported the incomes of the borrowers on the date of granting/approval of the loan.

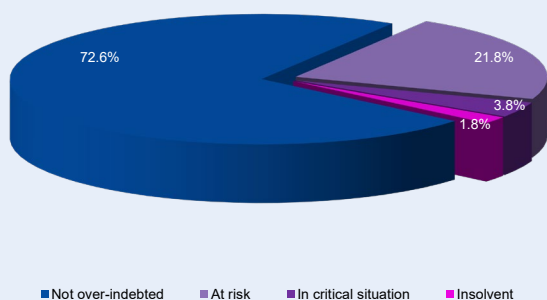
¹⁹ Changes in credit installments, namely restructuring, are not complete. Restructured installments as a result of Covid-19 have been accepted by

Financial Institutions for active loans of their customers (customers selected as a sample for the relevant institution). However, for the calculation of the total debt of the customer, namely households, all installments of all active credit products that have appeared in the CRK have been received (collected). Therefore, other restructurings that borrowers may have had in other financial institutions may not have been reflected in the CRK.

subjectivity. Among the **socio-demographic characteristics** that had significant (statistically significant) differences in the trends for over-indebtedness or late payment of loans were profession, age group, number of employees in the household and income level.

Within the framework of borrowing models, the number of credit contracts and lending institutions, collateralization, credit restructuring, credit history, as well as roles as co-borrower and guarantor were found statistically significant (table 1).

Chart 2a. Distribution of borrowers by main over-indebtedness index (borrowing product)



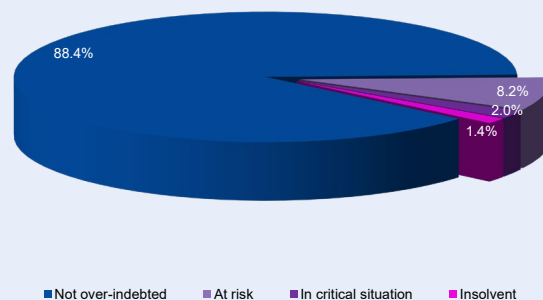
Source: CBK.

The probability of over-indebtedness is the highest among borrowers with active loans in the banking and microfinance sectors at the same time. While comparing separately by sector, the trends for over-indebtedness were higher for borrowers with active loans in the banking sector (25.7 percent of borrowers and 9.7 percent of respective households, compared to 15.6 percent of borrowers and 6.2 percent of households of borrowers with loans only in the microfinance sector). The highest level of indebtedness of borrowers is associated with multiple borrowing - with the possession of many active credit contracts in different institutions.

Multiple borrowers in different institutions had almost twice as many cases of over-indebtedness (table 1). Likewise, **the highest trends in loan payment delays were among multiple borrowers - more than one active credit contract and from different institutions.** About 30.0 percent of multiple borrowers, with credit products at different institutions, are in arrears, compared to only 2.0 percent of multiple borrowers but at the same institution. **Consequently, problems in payment performance also turned out to be related to the highest level of indebtedness. Borrowers**

in arrears had almost twice as many cases of over-indebtedness.

Chart 2b. Distribution of Households by main over-indebtedness index (borrowing product)



Source: CBK.

The assessment of household over-indebtedness, according to a survey commissioned by CBK, carried out on another sample of households, is lower. The results of the household survey suggest that 60.3 percent of households do not have active credit at all. Within the households that had active loans, only 4.8 percent of them use more than 50 percent of the family income in the payment of credit installments.

According to the survey, **the outbreak of the COVID-19 pandemic** has had a different effect on household incomes. A third of the households, namely 35.6 percent, declared that the family's income did not change, 31.1 percent declared that their family's income decreased, while the rest of 27.8 percent said that there was a temporary decrease in their income, which have returned to the previous state and 5.5 percent stated that family incomes have increased. Finally, different indicators have evaluated different aspects of over-indebtedness, which together provide important information on the level of indebtedness of households in Kosovo.

Table 2. Levels of indebtedness of households according to socio-demographic and socio-economic characteristics

Socio-demographic and socio-economic characteristics of individual borrower	Not over-indebted (installment < 50% of HH income)	Not over-indebted (installment > 50% of HH income)		
		At risk (debt/income = 50%-75%)	in critical situation (debt/income = 75%-100%)	Insolvent (debt/income = over 100%)
Gender of the respective borrower***				
Man	87.3%	8.8%	2.2%	1.7%
Woman	91.1%	6.7%	1.4%	0.8%
Marital status of the respective borrower				
Not married	92.3%	6.4%	0.6%	0.6%
Married	87.2%	8.6%	2.6%	1.6%
Divorced	81.8%	18.2%	0.0%	0.0%
Type of residency***				
Urban	89.4%	7.9%	1.5%	1.2%
Rural	87.3%	8.4%	2.7%	1.5%
Region of the respective borrower				
Prishtina	89.5%	8.6%	1.0%	0.8%
Mitrovica	80.6%	13.1%	3.1%	3.1%
Prizren	90.9%	6.4%	1.7%	1.0%
Ferizaj	92.5%	4.5%	0.8%	2.3%
Gjilan	90.2%	5.3%	1.5%	3.0%
Gjakovë	84.6%	9.2%	5.1%	1.0%
Peja	88.0%	8.6%	2.4%	1.0%
Profession of the respective borrower				
Armed forces	80.0%	20.0%	0.0%	0.0%
Managers	85.0%	13.3%	1.7%	0.0%
Professionals	88.0%	8.9%	2.4%	0.6%
Technicians and professional co-workers	92.5%	6.0%	0.5%	1.0%
Office employees and assistants	78.6%	17.9%	3.6%	0.0%
Service and sales employees	89.5%	8.4%	1.6%	0.5%
Skilled workers of agriculture, forestry and fishing	83.0%	5.4%	3.6%	8.0%
Craft workers and similar professions	90.8%	7.1%	1.4%	0.7%
Operators and installers in factories and machines	82.1%	14.3%	0.0%	3.6%
Elementary professions	89.8%	6.0%	2.3%	1.9%
Pensioners	71.9%	18.8%	3.1%	6.3%
Housewives	83.3%	8.3%	8.3%	0.0%
Other, including social welfare	90.0%	6.0%	4.0%	0.0%
Student	100.0%	0.0%	0.0%	0.0%
Age of the respective borrower				
< 30 years of age	95.1%	3.9%	0.7%	0.4%
30 - 40 years of age	88.8%	7.7%	2.6%	1.0%
40 - 50 years of age	85.3%	10.2%	2.8%	1.7%
50- 60 years of age	88.3%	8.4%	1.6%	1.6%
> 60 years of age	83.7%	12.6%	1.3%	2.5%
Work experience of the respective borrower***				
0-5 work experience	91.4%	5.9%	1.3%	1.3%
6-10 years	87.9%	9.4%	2.0%	0.7%
Over 10 years	86.1%	9.9%	2.7%	1.3%
Number of household employees				
1 (only the borrower)	81.9%	13.2%	2.6%	2.3%
2 employees	90.8%	6.2%	2.3%	0.8%
3-5 employees	95.0%	3.8%	0.3%	0.9%
Over 5 employees	94.4%	2.8%	0.0%	2.8%
Level of household income				
Up to 170 EUR	20.0%	20.0%	0.0%	60.0%
170 -249 EUR	50.0%	21.4%	10.7%	17.9%
250 -449 EUR	81.6%	13.4%	3.0%	2.0%
450 -749 EUR	83.5%	12.3%	3.5%	0.8%
750 -999 EUR	92.2%	6.0%	1.3%	0.6%
1000 -2000 EUR	95.1%	3.3%	0.6%	1.0%
Over 2000 EUR	92.1%	6.1%	0.6%	1.2%
Type of lender institution				
Bank	90.3%	8.0%	1.1%	0.6%
Microfinance	93.8%	4.0%	1.3%	0.8%
Bank and microfinance at the same time	81.4%	11.4%	3.9%	3.2%
Number of contracts of the respective borrower				
Many contracts - one lender institution	92.5%	6.5%	0.6%	0.4%
Many contracts - some issuing credit institution	77.8%	13.8%	5.1%	3.4%

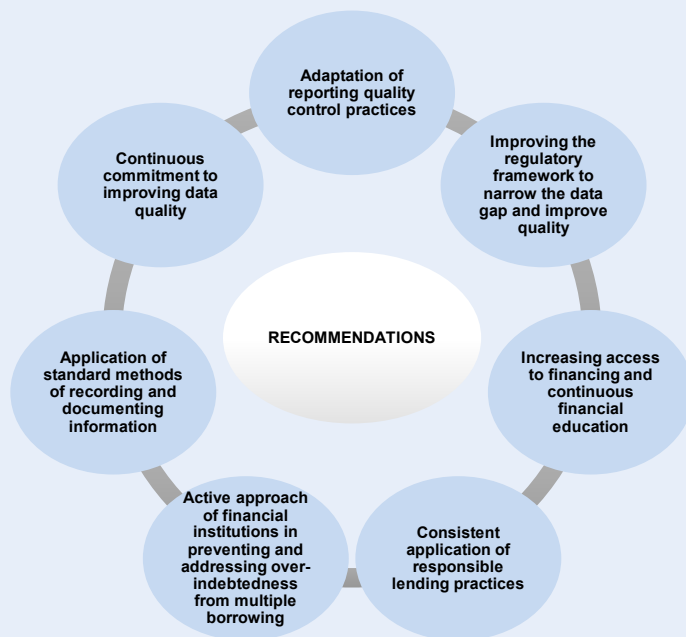
***In these socio-demographic characteristics there were no significant differences - statistically important - in tendency of over-indebted

The results suggest that over-indebtedness is associated with multiple borrowing and poorer repayment performance. However, it should be noted that the cause-and-effect relationship between these factors is not defined, and it can develop in different directions: the possession of more credit contracts definitely affects the increase in the monthly payment debt and has an impact on the increase in the level of indebtedness of borrowers; however, there is the possibility that borrowers may take on additional debt to service existing debt in cases of repayment inability and thus affect over-indebtedness.

Household over-indebtedness being a complex concept and the presence of many influencing factors on indebtedness and the interrelationship between them has made the process of assessing the indebtedness quite challenging. Such nature and the evaluation process faced with data limitations means that the results of the study are subject to some limitations in terms of the quality of the available data and the assumptions made due to the deficiencies encountered. **In terms of data availability**, cases have been identified such as: lack of information on co-borrowings that may have influenced the overestimation of the borrower's indebtedness and the possible inconsistency of the time of reporting/updating data for the borrower that may affect the underestimation or over-estimation of the current indebtedness.

In terms of quality, in the absence of mandatory mechanisms for reporting data on households, the results on households should be taken with caution (lack of information on the possible debt of other members of the family unit that may reflect underestimation of the over-indebtedness, as well as cases, although rare, when the monthly expenses reported for the entire household unit have exceeded the monthly income of the household that express doubts about the quality of the information provided).

The numerous limitations in data for the household unit, and the complex and very important nature of the problem of over-indebtedness, emphasize the need for the interaction of institutions, namely the commitment of all relevant parties in the collection and provision of quality data. **Recommendations** regarding possible measures that can be taken by stakeholders emerge naturally from the findings of the study, as well as from the consultation of materials and relevant parties:

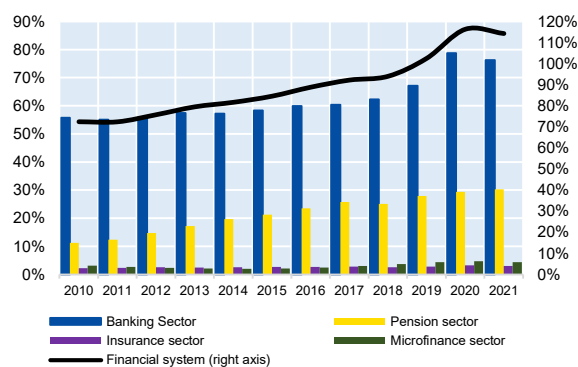


4. Developments in the financial system

In line with the developments in economic activity, the financial system marked a significant increase in activity during 2021, where all the constituent sectors contributed to the increase.

In December 2021, the value of financial system assets reached 8.93 billion euros, corresponding to an annual growth of 12.7 percent (growth of 9.1 and 14.9 percent in 2020 and 2019, respectively). The rate of financial intermediation (the ratio of assets to GDP) decreased by 2 percentage points, to 114.2 percent, mainly influenced by the higher growth of GDP expected for this year as a result of the strong recovery of the economy (chart 19).

Chart 19. The weight of financial system sectors to GDP

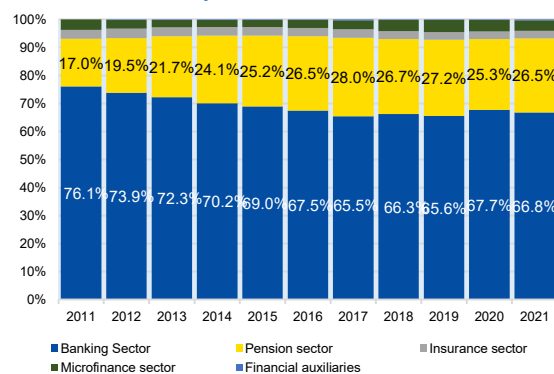


Source: CBK.

The increase in the assets of the banking sector is mainly attributed to the increase in credit activity and the increase in investments in securities, while the increase in the assets of the microfinance sector is mainly attributed to the recovery of lending activity and the acceleration of the growth of leasing. The increase in lending from the banking sector reflects the reactivation of the economy in the country, reflecting the regained trust and the realization of investments held in abeyance since 2020. The growth of pension sector assets accelerated during 2021 compared to the previous year, influenced by the positive return from investments as well as from the increase in contributions collected during this period. Insurance sector assets also saw

accelerated growth. The highest growth was in the category of deposits held in commercial banks (mainly in the form of term deposits), followed by investment in securities of the Government of Kosovo.

Chart 20. The share of respective sectors to total financial system assets



Source: CBK.

As for the number of financial institutions, until December 2021 only the number of microfinance institutions and non-banking financial institutions increased, from 29 last year to 30 this year. Meanwhile, the number of insurers was reduced to 12 due to the revocation of the license of one of the insurers (table 4). Financial auxiliaries have the largest number of financial institutions, although their share in the total assets of the financial system continues to remain at 0.3 percent (chart 20).

Foreign capital dominates most of the sectors of the financial system, especially the sectors dealing with lending activity (chart 21). The banking sector is dominated by EU-origin capital, which constitutes 52.5 percent of the total assets of the sector. Local banks increased their share in total banking market assets to 14.5 percent (13.5 percent in December 2020). Banks with the origin from Turkey marked an increase in market share, with a share of 16.6 percent in 2021 (16.1 percent in 2020).

The increase in the competition of services provided by banks was reflected in the

decrease of banking concentration²⁰ to 52.5 percent from 55.5 percent in the previous year.

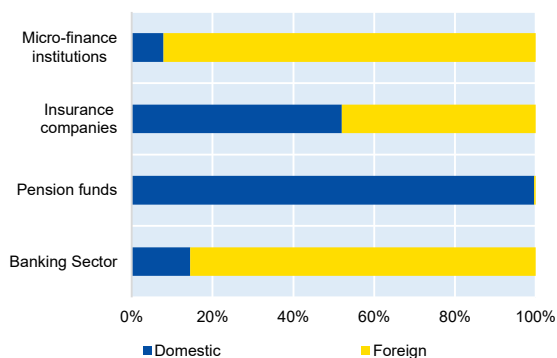
Table 4. Number of financial institutions

Description	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Commercial banks	8	8	9	9	10	10	10	10	10	10	11	11
Insurance companies	12	13	13	13	14	15	15	15	14	13	13	12
Pension funds	2	2	2	2	2	2	2	2	2	2	2	2
Financial auxiliaries	28	34	38	39	42	44	40	43	50	50	57	53
Microfinance institutions and non-bank financial institutions	17	20	17	17	18	18	22	25	29	29	29	30

CBK: CBK.

The insurance sector continues to have a lower level of concentration as a result of the more balanced distribution of assets in the market. However, over the last three years, a trend of increased concentration of insurance sector assets can be seen, due to the revocation of the license of two insurers (one in 2019 and one in 2021).

Chart 21. Ownership of financial system constituent sectors, December 2021



Source: CBK.

Insurance companies with local capital constitute 50.2 percent of the total assets of the sector, from 50.9 percent in the previous year. Whereas, companies with foreign capital with a participation of 49.8 percent have their country of origin in Austria, Slovenia and Albania (chart 21).

The financial system in Kosovo has a simple balance sheet structure, in relation to the traditional model of activities, with low linkage of activities between the sectors of the system. With regards to the interconnections in the financial system in general, the biggest interconnection continues to be between

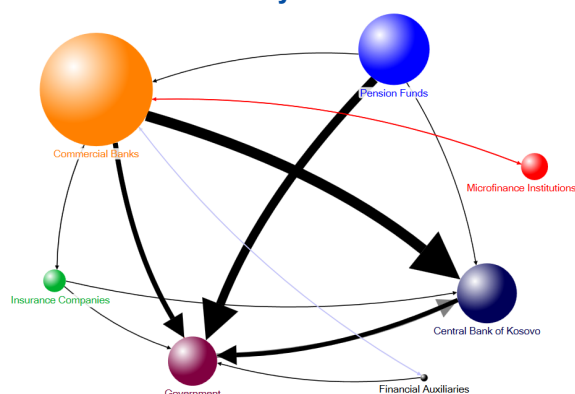
commercial banks and the CBK; however, during 2021, there was only an increase in exposure to the Central Government, precisely investment in Government securities from the banking, pension and insurance sectors. In the framework of interbank connections, the interconnection between the banking sector and the parent banks continued to be at a higher level, as a proactive line for increasing the absorption capacity for possible losses, as well as for financing.

The dynamics in the interconnections between the stakeholders of the sector in 2021 have changed compared to the previous year. The main link with the highest growth was in the form of securities of the Government of Kosovo, while in previous years dominated the links in the form of deposits in CBK and commercial banks. However, the level of these connections continues to be low, thus minimizing the possibilities of transferring problems and risks from one institution to another.

The most prominent connection is between commercial banks and the CBK, which is represented in the form of deposits for the mandatory reserve and the surplus of this reserve that the banks keep at the CBK. Insurance companies and pension funds also hold claims, in the form of deposits (current accounts) against the CBK. However, the weight of this relationship decreased in 2021, where together with commercial banks they constituted 46.5 percent of the total deposits of the CBK against 51 percent in the previous year.

²⁰ Expressed as a ratio of the assets of the three largest banks to the total assets of the sector

Figure 1. Institutional connections of Kosovo's Financial System



Source: CBK.

Note: the size of each node (circle) reflects the total assets of each institution, excluding the Central Government, where the total liabilities in the form of securities to these institutions are taken as a basis. The direction of the arrows means the claims to the institution to which the arrow is directed, while the thickness of the hyphen and the arrow reflects the level or size of the connection. Status is as of December 2021.

This reduction was influenced by the withdrawal of pension fund deposits from the CBK and their allocation to the securities of the Government of Kosovo, which increased the connection of this sector with the Central Government (figure 1). Deposits that non-banking financial institutions hold in commercial banks represent high inter-institutional exposure (excluding exposure to the government) for some of these institutions. Insurance companies hold about 46 percent of their assets as deposits in commercial banks. Microfinance institutions, in December 2021, halved the share of balance sheets with commercial banks in their total assets to 5.4 percent from 10.7 percent in the previous year, influenced by the increase in lending. Also, pension funds significantly reduced balance sheet participation with commercial banks to 1.9 percent from 6.5 percent in December 2020. The deposits of these institutions constitute 4.1 percent of the total deposits of the banking sector, the value that decreased from 6.1 percent in the previous year after the withdrawal of pension fund deposits from the banking sector. Consequently, the liquidity of the banking sector represents an important factor in the stable functioning of other financial sectors, since in the context of interconnections, deposits constitute one of the main channels for the possible transmission of

inter-institutional problems. Whereas, the claims of commercial banks to other non-banking financial institutions, which are represented in the form of loans, have a low participation of only 0.3 percent of the total loans of the banking sector.

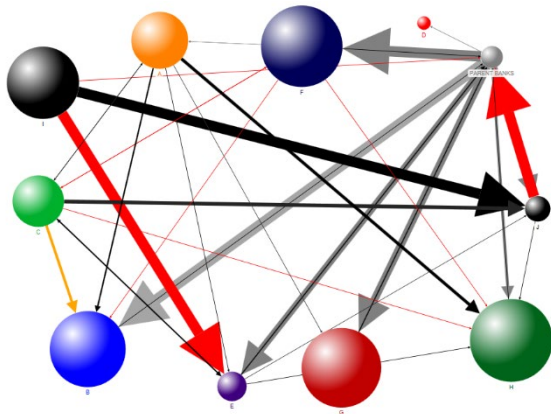
An important part of the interconnection picture is the exposure of the financial system to the Central Government, expressed in the form of securities, since it has been considered that the importance of such exposures is increasing in conditions where the opportunities for investment by institutions are limited precisely to government securities and deposit-loans.

The pension sector is one of the main investors in government securities, followed by CBK (through the secondary market) and commercial banks. Other financial institutions also have claims against the Government in the form of government securities, while the government has claims (exposure) only against the CBK and commercial banks through the deposits it holds in these institutions.

Inter-bank connections are still more concentrated than inter-institutional ones, where some banks that are relatively smaller have significant exposures to larger banks, as well as at a lower level between them within the financial system in the country (figure 2). Large banks have their main exposures in foreign markets, to parent banks or even banks and other financial institutions.

The highlighted links between the three banks in the country presented in the chart above are mainly represented in the form of funding sources such as deposits. The most pronounced connection is between bank I, bank E and bank J, due to the financial claims in the form of time deposits that bank I has towards these banks, which at the same time constitutes a source of financing for the latter.

Figure 2. Banking interconnections of Kosovo's banking sector



Source: CBK.

Note: The size of each node (circle) reflects the total assets of each institution, excluding the parent banks, where the total claims that the parent banks have in the form of credit lines or interdependent debt to the respective banks in the country are taken as a basis. The direction of the arrows means the claims to the banking institution to which the arrow is directed, while the thickness of the hyphen and the arrow reflects the level or size of the connection. Status is as of December 2021.

At the same time, Bank C has significant connections with Bank J, in the form of claims as well as in the form of deposits. As a protective measure against the possible effects of the pandemic, the interconnection of some of the banks of the sector with the parent banks was multiplied in 2020 and 2021, due to the requirements for increasing the absorption capacity in case of deterioration of the credit portfolio. The connections with the respective parent banks are the most expressed at banks B, F, E and J, mainly obligations in the form of short-term loans, deposits and, to a lesser extent, loans. Whereas, Bank J also has significant connections with the parent bank in the form of claims against it, namely deposits in the parent bank and other branches of the group.

4.1. Banking activity

The banking sector during 2021 was characterized by a marked increase in activity, mainly supported by the significant increase in financing of the sector. Banking activity was mainly concentrated in lending and investing in securities. The assets of the banking sector increased by 11.1 percent from the previous year, and reached the value of 5.96 billion

euros. Credit activity marked accelerated growth, as a result of the strong recovery of economic activity in the country during 2021.

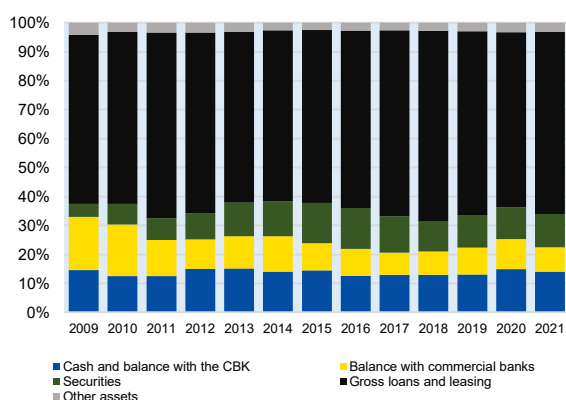
In the circumstances of the high growth of deposits collected during the year, as well as the increase in the demand for loans as a result of the recovery of the economic activity in the country and the improvement of the market perspective, the banks have concentrated the means on the expansion of the credit activity as well as investment in the securities. At the same time, these were the only items that were characterized by an accelerated rate of growth. There was also an annual increase in the category of cash and balance with CBK (annual increase of 5.2 percent), but at a lower level compared to the previous year, implying the orientation of funds in instruments with higher financial returns as a result of the better market perspective. Meanwhile, the only item with a decrease was the balance with commercial banks which decreased by 11.8 percent (increase by 27.6 percent in the previous year), where mainly the deposits held in commercial banks abroad decreased. These dynamics suggest that the banks, instead of keeping the funds in the form of reserves, have invested them, reflecting the improvement of the perspective of economic activity in the country during 2021. While, for the following year, the expectations are the changing of the orientation of assets from lending to holding reserves as a protective measure against the deterioration of the perspective in the local and global market, as a result of high inflation.

The sector has not undergone structural changes in terms of assets over the years, with the exception of the subcategory of securities, which marked growth from 2012 as a result of the start of the internal securities market and the active participation of banks in this market (chart 22).

The stock of securities marked an accelerated annual growth of 17.1 percent. Investments of the banking sector in securities of the government of Kosovo increased by 22.6 percent compared to the previous year, while investments in securities of foreign governments increased by 18.0 percent.

The activity of the banking sector continues to be financed mainly by the deposits of households and non-financial corporations, which this year marked double-digit annual growth as a result of the reserves held since the previous year, the high level of remittances, as well as the high arrival of the diaspora, which means the entry of remittances also through informal channels.

Chart 22. Share to assets structure



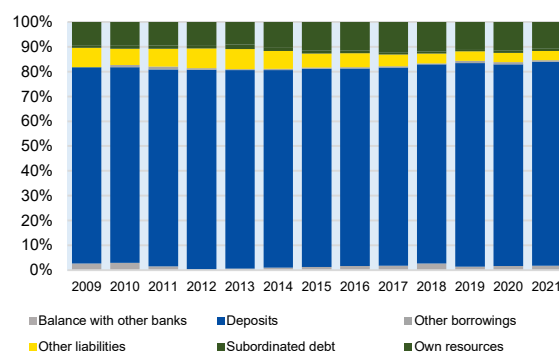
Source: CBK.

Total deposits of the sector marked an annual increase of 12.4 percent (increase of 11.6 and 16.2 percent in 2020 and 2019, respectively) and reached the level of 4.90 billion euros, mainly influenced by the significant increase in transferable deposits of households and enterprises (public and private), as well as at a lower level household savings deposits. In 2021, deposits represented 82.3 percent of the financing sources of the banking sector (chart 23).

Household deposits, which make up 68.7 percent of the total stock of deposits, marked an increase of 14.6 percent. The significant increase in deposits during 2021 reflected the uncertainties carried over from 2020 as well as the increasing waves of infections during 2021, which influenced the postponement of expenses and investments by households. Moreover, in the dynamics of household deposits, remittances also play an important role, the level of which marked a double-digit increase during this year. Furthermore, there was a significant marked increase in the level of visits from the diaspora to the country, which means the entry of remittances from

informal channels as well. At the same time, the revenues from the easing schemes applied by the Government contributed to the growth of deposits.

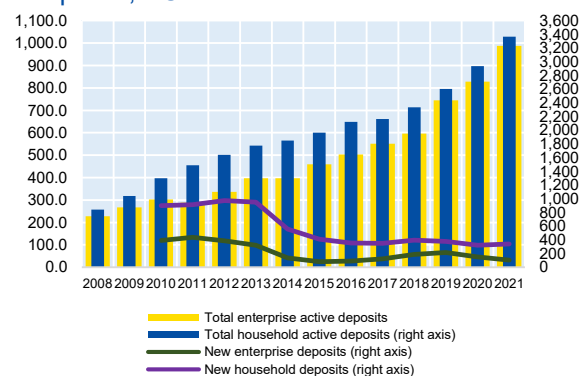
Chart 23. Share to liabilities structure and own resources



Source: CBK.

The year 2021 was characterized by an increase in deposits also from non-financial and public corporations, while the deposits of financial corporations recorded a decrease, mainly influenced by the decrease in deposits of pension funds (chart 24).

Chart 24. Stock of total deposits and new deposits, EUR million

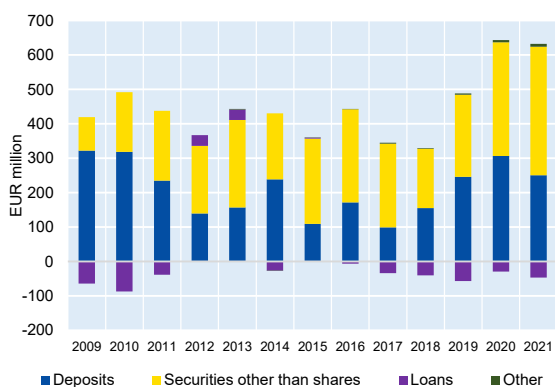


Source: CBK.

Within the financial system, insurance companies increased the level of deposits held in local banks, as a result of the higher profitability of the sector during 2021, but at the same time insurers also increased investments in securities. Whereas, pension funds reduced term deposits in the banking sector, which also have the highest share of pension fund deposits held in the banking sector. Also, due to the improved perspective in the country's economy, the microfinance sector has reallocated their funds from reserves held

in commercial banks in the form of deposits to credit and leasing activities. Deposits received from non-financial corporations had an accelerated growth rate compared to the previous year. Within the deposits of this segment, transferable deposits had the highest growth. This dynamic may have been influenced by the recovery of the economic activity of this sector with the improvement of the situation with the pandemic during 2021, influencing the increase in the turnover of enterprises, which consequently may have been reflected in the accelerated growth of their deposits in the banking sector. However, according to the Bank Lending Survey, company deposits during the first quarter of 2022 already decreased, and in one of the systemic banks there was a significant decrease in them. The decrease in deposits from enterprises reflects the higher investment of funds in working capital as well as the early purchase of stock to avoid the increase in costs as a result of the increase in prices in foreign and local markets. While, during the second quarter, the banks were optimistic about the increase in deposits from enterprises, although at a low level, which may have been influenced by the seasonality that characterizes this quarter in terms of the increased economic activity of enterprises.

Chart 25. Net position to non-residents



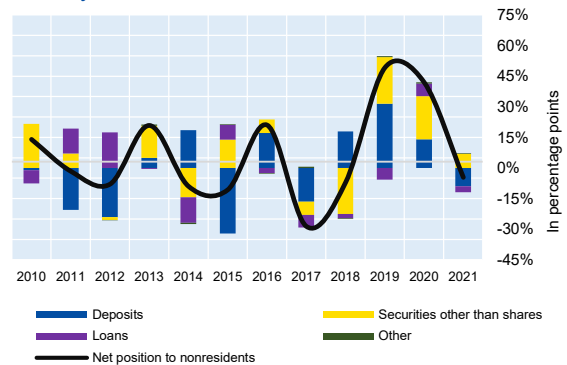
Source: CBK.

The exposure of the banking sector to the external sector continues to be low, and marked a decrease compared to the significant increase of the previous year. The net credit position to the external sector decreased by 4.6 percent, reducing the value to 585.1 million euros (charts 25 and 26). This

decrease in the net credit position was mainly the result of the decrease in investments in the external sector, in the form of deposits and loans.

Claims against non-residents account for 14.4 percent of the total assets of the banking sector, where 89.0 percent of them are deposits and investments in securities.

Chart 26. Items contribution in annual change activity with non-residents



Source: CBK.

The banking sector's liabilities to non-residents constitute 4.5 percent of the total banking sector's liabilities, in the form of credit lines and foreign sector deposits held in the country. Loans received from the external sector and deposits of the external sector held in the country, together constitute 98.4 percent of the total liabilities to non-residents.

The banking sector continues to have low exposure to the external sector. The low level of assets in foreign currency further reduces the effects of the transfer of problems from the external sector as well as avoids possible losses against the euro currency.

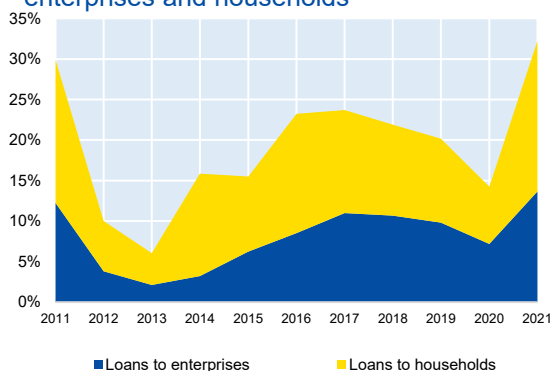
4.1.1 Credit developments

The credit activity of the banking sector accelerated growth as a result of the high growth in the demand for financing, driven by the rapid recovery of economic activity from the pandemic crisis. However, as a result of global developments in the increase in the prices of energy and basic products, the expectations are that the demand will decrease, namely to be halved in 2022, while the credit supply will remain

similar, without significant positive changes.

The dynamics of lending activity, during most of 2021, for non-financial corporations and households, according to the bank lending survey, was mainly determined by movements in credit demand. At the same time, the credit supply had a positive effect, but at a lower level. The significant increase in credit demand from enterprises was driven by the demand for financing inventories and working capital and fixed investments, while for households the demand for credit was influenced by the demand for financing consumption expenses. According to the bank lending survey, the aforementioned factors contributed to the accelerated growth of lending compared to the previous year. However, bank sentiment shows a halved credit demand in the second quarter onwards, as well as a similar outlook and uncertainty for the dynamics during the remainder of 2022 as well. Also, in the answers of the banks, to some extent, hesitation is observed on the side of the credit offer, especially for large enterprises. Banks during the next period, even if they will not tighten the credit standards, have declared that they will increase vigilance in the internal procedures for analyzing lending demands.

Chart 27. Annual growth of loans to enterprises and households



Source: CBK.

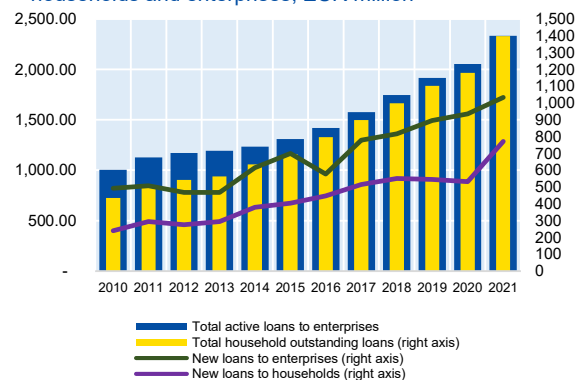
The stock of active loans in the country's banks reached 3.75 billion euros, which represents twice the annual growth compared to the previous year, of 15.5 percent, supported by loans to enterprises and households (chart 27).

The stock of loans to enterprises increased by 13.6 percent and reached the value of 2.33

billion euros. Meanwhile, new loans during 2021 were 1.03 billion euros (chart 28), of which 564.7 million euros were for investment purposes, while loans for non-investment purposes were 440.2 million euros.

Almost all economic sectors were characterized by an increase in lending, except for the agricultural sector, which was characterized by a decrease. The sectors that were credited the most were manufacturing, trade and financial services.

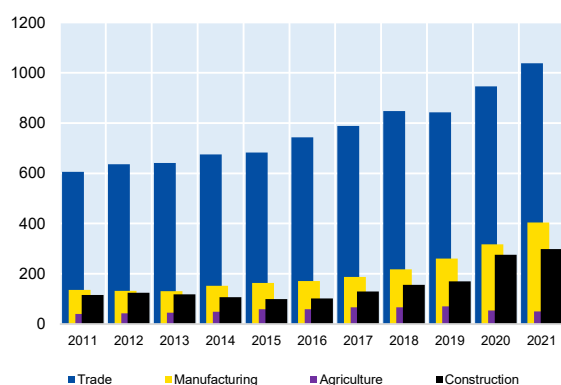
Chart 28. Stock of total loans and new loans to households and enterprises, EUR million



Source: CBK.

Loans for the production and financial services sectors increased by 27.5 percent and 29.9 percent, reaching the value of 404.8 and 148.2 million euros, respectively.

Chart 29. Stock of loans, by economic sectors

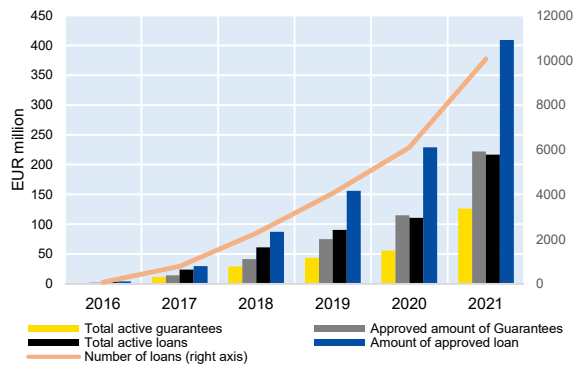


Source: CBK.

Loans to the trade sector, which dominates the structure of total loans, marked an annual increase of 9.6 percent and reached the value of 1,036.9 million euros (chart 29). Whereas, the agriculture sector, which has a small share

in the total stock of enterprise loans, was characterized by a decrease of 6.8 percent.

Chart 30. Loans approved and guaranteed by KCGF



Source: KCGF.

An important supporter of lending to small and medium-sized enterprises continues to be the Kosovo Credit Guarantee Fund, the use of which marked an accelerated growth trend in 2021. The cumulative number of bank loans for SMEs, guaranteed by KCGF, reached 10,064 at the end of 2021 (6,103 at the end of 2020). The total amount of loans guaranteed until December 2021 was 408.7 million euros, against the guaranteed value of 229.0 million euros in the previous year (chart 30). Among other things, the accelerated growth of guarantees was supported by the signing of the financial agreement for the increase of the guarantee capital with the German Development Bank in the amount of 6 million euros. Also, at the beginning of 2021, the implementation of the guarantee measures started within the Economic Recovery Package, which includes the increase of the credit coverage for SMEs from the KCGF up to 80 percent, the change that affects the expansion of the profiles that can benefit from guarantees.

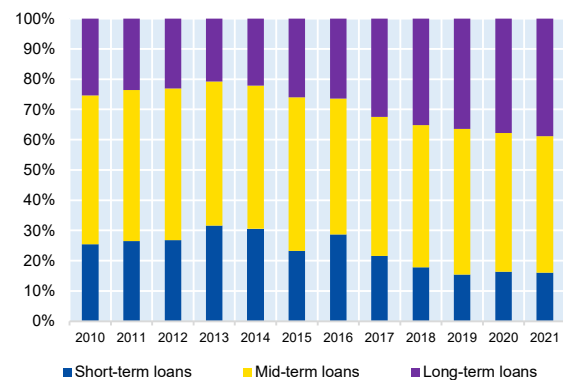
Mainly, the structure of guaranteed loans is a representation of the general structure of loans of the banking sector. Compared to the previous year, all economic sectors increased their share in the total portfolio of guaranteed loans, except the services sector, which decreased its share.

The trend of the growth of lending to households also marked an accelerated growth, influenced by the improved

perspective of the local market as a result of the improvement of the situation with the pandemic.

In December 2021, the annual growth of the stock of household loans was 18.6 percent compared to the 7.1 percent growth a year ago and the 10.4 percent growth in 2019. The value of the loan for this sector reached 1.40 billion euros. The acceleration of the growth of household lending is largely attributed to the dynamics of new loans in this sector, which during this period marked an annual increase of 45.0 percent (decrease of 2.4 percent in December 2020) (chart 28).

Chart 31. Loans to enterprises, share by maturity



Source: CBK.

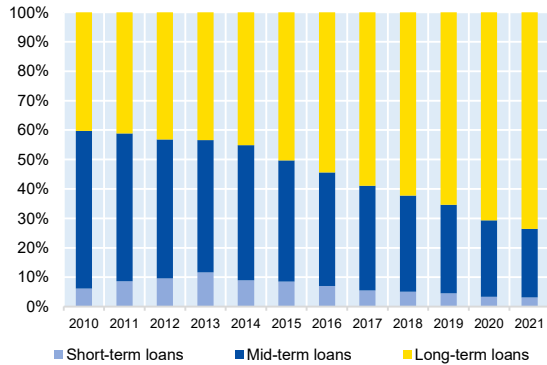
Within the framework of new household loans, both categories had significant growth, both for mortgage loans and for consumer loans with annual growth of 56.6 percent and 40.3 percent, respectively.

This increase in new loans for households was influenced by the improvement of the situation with the pandemic, consequently the release of restrictive measures, which was characterized by an increase in investments and consumption postponed by households until the pandemic situation improved, as well as the aid received from the relief packages of the Government.

Loans with medium term maturity dominate the structure of total loans with a share of 51,7

percent,²¹ marking the highest annual growth of 20.4 percent. Their value reached 1.94 billion euros.

Chart 32. Loans to households, share by maturity



Source: CBK.

Loans with medium term maturity had an increase of 10.2 percent with a value of 1.38 billion euros.

Box 4. Bank Lending Survey²²

The latest results of the Bank Lending Survey²³ reflect developments in bank lending activity during the period January - March 2022 (referred to as Q1 2022), as well as expectations for lending activity for the period April - June 2022 (referred to as Q2 2022).

The dynamics of lending to **enterprises** during Q1 2022, according to the bank lending survey, turns out to have had a positive impact, at a higher level, by the demand for credit, while the credit supply also has a positive impact, albeit at a lower level.

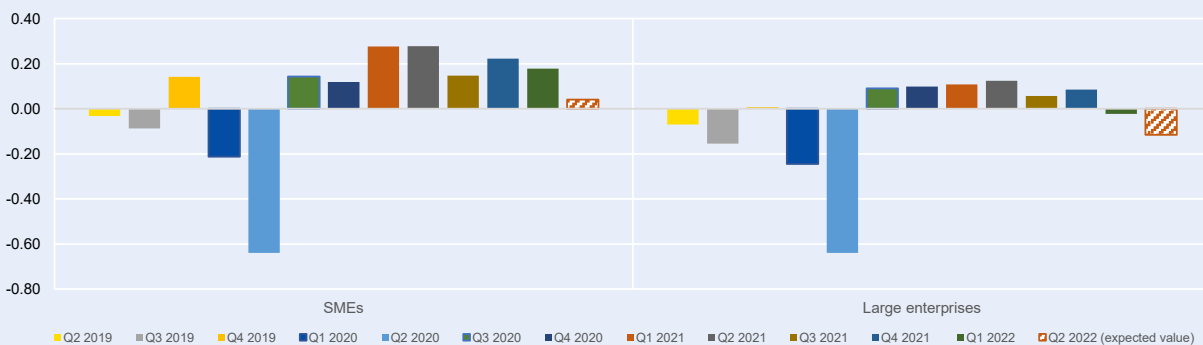
In terms of credit supply, banks have reported to have eased to some extent the standards applied

Medium-term maturity loans are mainly dominated by loans issued to non-financial corporations (chart 31), while long-term lending is mainly characteristic of the credit portfolio of the household segment (chart 32)). According to the Bank Lending Survey carried out for the fourth quarter of 2021, long-term loans to households were positively influenced mainly by the credit demand side, while the credit supply favored more loans with short-term maturities.

during the process of assessing the enterprises' applications for loans. This easing reflects the changes in credit standards for the SMEs category.

For the second quarter of 2022, banks are expected to tighten credit standards for large enterprises, while for SMEs they are expected to remain unchanged based on the uncertainties that are following the year 2022 as a result of rising prices and the impact of the Russia-Ukraine war in supply chains (chart 1).

Chart 1. Bank's credit standards applied when assessing enterprise loans applications



Source: CBK.

²¹ Short term includes maturity up to 1 year, medium term includes maturity from 1 to 5 years, and long term includes maturity over 5 years.

²² Bank Lending Survey is conducted by the Central Bank of the Republic of Kosovo with 10 banks operating in Kosovo and representing 99.9 percent of the total sector lending. The survey is conducted on a quarterly basis.

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

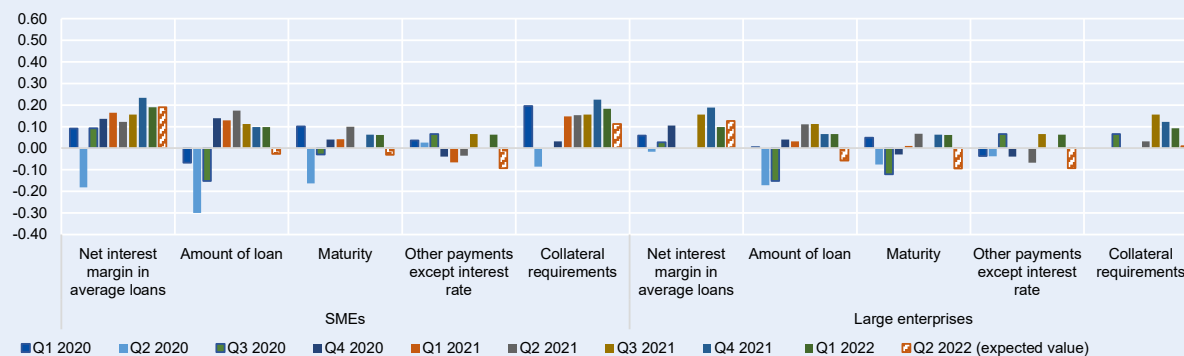
The main factor that influenced the easing of credit standards, according to the banks, was the increase in competitive pressures among banks. While, at a lower level, the favorable perspective of the banking market in the country and the support of enterprises in lending by KCGF also positively influenced the easing.

In the context of the credit offer, banks reported that the terms and conditions applied by banks when granting loans to enterprises were slightly eased. Increased competition pressures, as well as favorable access to financing in the local market, influenced the easing of credit conditions. Specifically, eased terms and conditions were applied mainly to SMEs, mainly through the reduction of the interest rate and the reduction of collateral requirements (chart 2).

The banks stated that relying on the favorable approach to financing from the parent banks, on the increase in competition pressures as well as on the

support from the KCGF for SMEs, the banks for Q2 2022 expect ease to a certain extent of the conditions and rules. In this context, the banks stated that they are expected to mainly offer simplified conditions and rules for both categories of enterprises, and especially for SMEs. Terms and conditions are expected to ease through more favorable interest rates and lower collateral requirements. During the reporting period, the demand of enterprises for bank loans turns out to have increased to a certain extent. The increase in demand for enterprises is mainly attributed to the demand from SMEs, while for large enterprises there was a lower level of demand for loans (chart 3). Furthermore, the quality of applications received improved, especially for SMEs. The ratio of non-performing loans of enterprises improved during Q1 2022 according to the statements of banks in the survey.

Chart 2. Terms and conditions applied for loans to enterprises



Source: CBK.

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

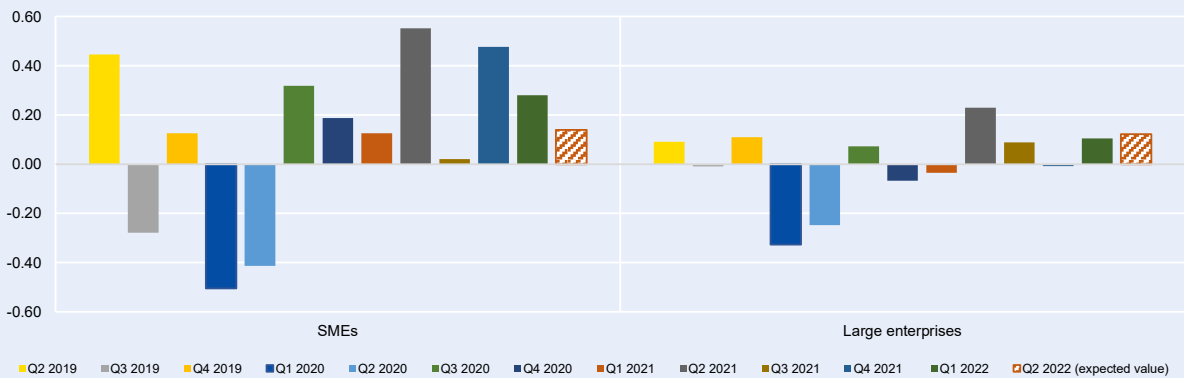
Uncertainties in the outlook in the country and abroad are dictating the banks' expectations regarding changes in the demand for loans. Consequently, during the second quarter of 2022, banks expect a halved increase in the demand for loans, from both categories of enterprises, compared to the current quarter.

Regarding the quality of the corporate loan portfolio, banks expect that during the second quarter the ratio of non-performing loans to total loans will increase, but at a low level. Regarding the term of

the loans, the results of the survey show that there was a greater increase in demand during this period for short-term loans. Demand for long-term loans also increased, but to a lesser extent. At the same time, the credit offer divided according to the maturity of loans favors loans with short-term maturity, next to those with long-term maturity. In the next quarter, banks expect marginal easing of credit standards mainly for short-term loans. Similarly, in terms of demand, banks expect a marginal increase in demand mainly for short-term loans (chart 7).

The dynamics of lending activity to **households** during the reporting period, according to the survey, were positively affected to a greater extent by the demand for credit than by the credit supply.

Chart 3. Household demand for loans



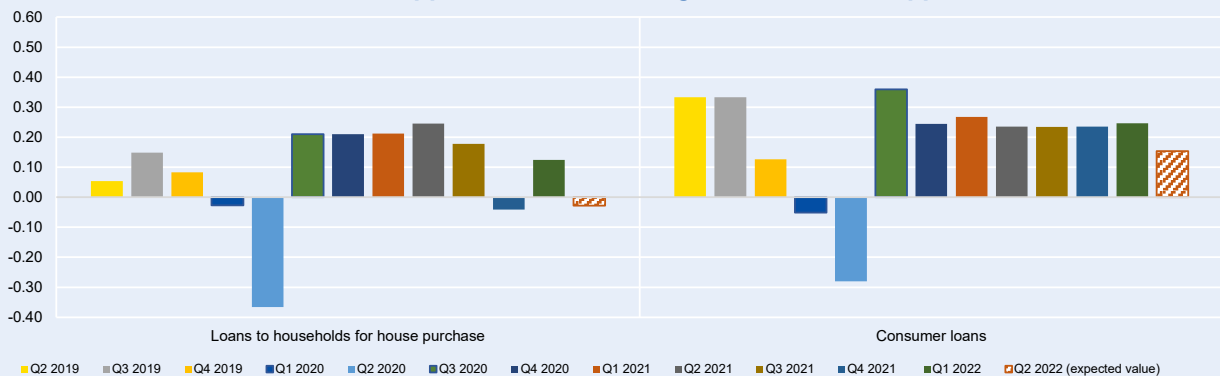
Source: CBK.

The credit standards applied during the review of loan applications from households were eased for both types of loans, and especially for consumer loans (chart 4). According to the bank lending survey, the factors that contributed positively to the credit standards applied during this quarter were the increase in competition pressures, the favorable

liquidity position of the sector, as well as the improvement of the outlook of the banking market in the country.

Banks' expectations for Q2 2022 give indications for the easing of credit standards, but at a significantly lower level than Q1 2022. Easing is expected to be applied to consumer loans.

Chart 4. Bank's credit standards applied when assessing household loan applications



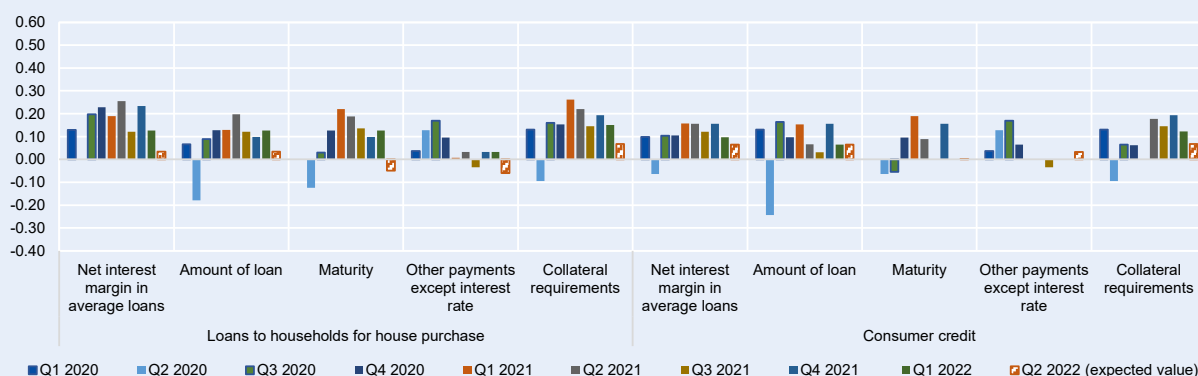
Source: CBK.

Terms and conditions for new loans to households were generally eased to some extent in the first quarter of 2022. Easing of terms and conditions was higher for home loans than for consumer loans. Mainly, the terms and conditions were eased through lowering the interest rate, lowering the collateral requirements and to a lesser extent increasing the amount approved and extending the maturity period. At the same time, the decrease in demand for collateral had the highest positive index for new consumer loans during this quarter (chart 5). The increase in competition pressures, the improvement of prospects in the banking market, as well as the favorable approach to financing turn out to have been a key factor in the easing of lending

conditions and rules for households during the first quarter of 2022.

In the next quarter, insignificant changes to the terms and conditions for loans to households are expected. Marginal easing is expected to be applied to consumer loans, focused on increasing the size of loans, reducing interest rates and reducing collateral requirements. Banks reported increased demand for household loans. Both categories of household loans had an approximate increase in demand (chart 6). The increase in demand from households is mainly attributed to the satisfactory perspective of the real estate market and the increase in the financing of other consumption expenditures.

Chart 5. Terms and conditions applied for loans to households



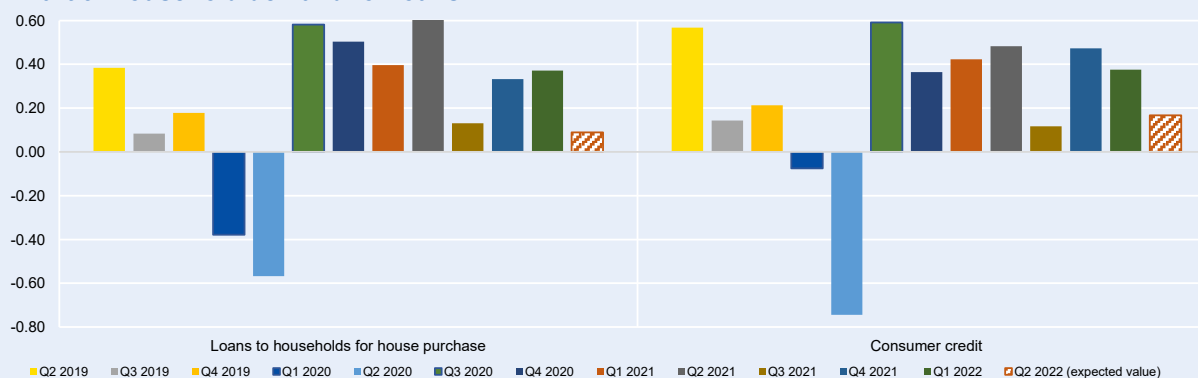
Source: CBK.

Also, the quality of received applications had a marginal increase for both categories of loans to households. According to the survey, the ratio of non-performing loans to total loans for households decreased, which for the next quarter is expected to change direction with a positive marginal index.

In the second quarter of 2022, banks expect credit demand to increase to some extent for consumer

loans, while demand for home loans is expected to remain largely unchanged. The results of the survey suggest that banks attributed these expectations to the satisfactory outlook of the real estate market, even though it was characterized by a marginally positive index.

Chart 6. Household demand for loans

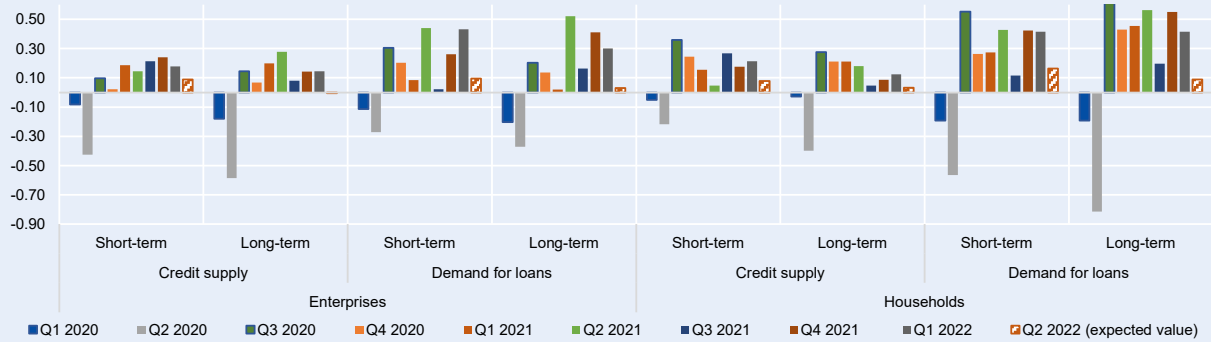


Source: CBK.

Regarding the time periods, the results of the survey show that households during Q1 2022 had a similar increase in demand for both time periods. Also, the credit supply dividend according to credit maturity turns out to have been eased at greater extent for short-term loans. Banks expect that in the next quarter, the credit supply easing will be oriented at a higher level towards short-term loans than long-term loans. Also, the demand for loans is expected to be dominated by loans with short-term maturity (chart 7). The aggregate index for **access to financing** by banks was unchanged during the first quarter of 2022. However, six of the banks participating in the survey declared an increase to

some extent in access to financing, while three other banks declared a decrease (one declared a significant decrease), where two of them have systemic importance and a large weight in the banking sector, resulting in the index close to zero. Considering the traditional model of the banking sector in Kosovo, financing continued to be dominated by household deposits. The results of the survey show that bank financing during this quarter was positively influenced by household deposits, while financing from enterprise deposits marked a significant decrease.

Chart 7. Change of credit standards and demand for loans, by maturity



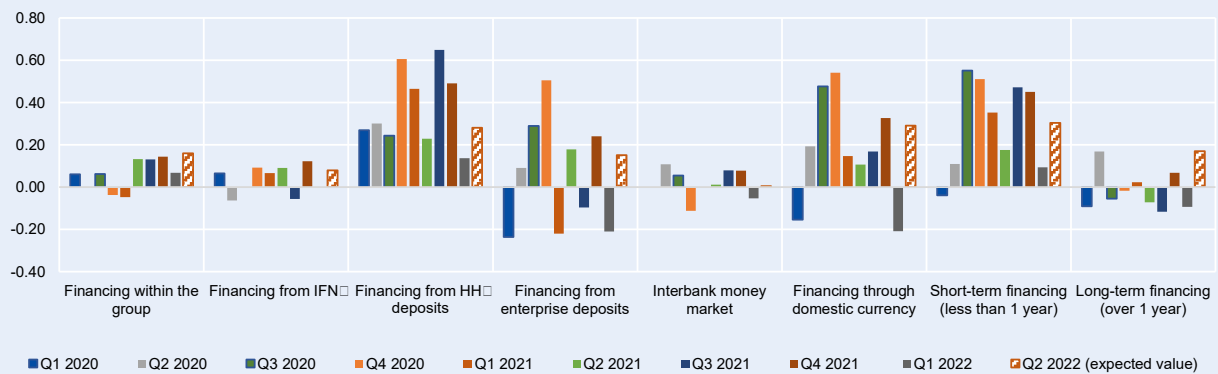
Source: CBK.

While, other funding sources did not have significant changes. According to maturity, banks declared a marginal increase in short-term deposits, while there were no significant changes for long-term deposits in this quarter.

For the next quarter Q2 2022, banks expect increased access to financing. Financing through household deposits is expected to have a higher increase than through company deposits. Unlike this quarter, in the next quarter three banks, two of

them with systemic importance, expect support in financing banking activity from the parent banks. At the same time, one of the banks also of systemic importance stated that it expects support in financing from international financial institutions, which consequently resulted in a low positive index. In the next quarter, surveys signal expectations for the continuation of the dominance of short-term financing (chart 8).

Chart 8. Change of the banking sector financing



Source: CBK.

5. Risks of the banking sector

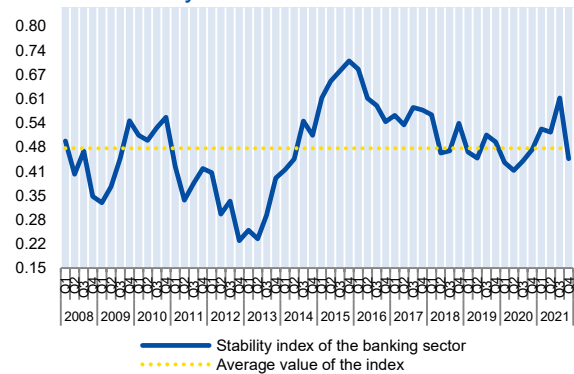
During 2020, the banking sector experienced new dynamics created after the pandemic year, characterized by increased activity, in the process and in support of economic recovery. The measures taken by the CBK such as restructuring, which helped to maintain the good credit performance of customers, the positive sentiment and perception of the market and the risks related to it, the increase in the activity of enterprises and the increase in remittances and the arrival of the diaspora, resulted in an increase of credit activity from banks and increased liquidity from received deposits. Therefore, as a result, the banking sector was exposed to an increase in some risks that are related to inconsistencies due to increases in some balance positions. More specifically, faster credit growth has increased risk-weighted assets, dividend distribution has reduced retained earnings, increased short-term deposits have increased short-term liabilities and maturity mismatches between assets and liabilities. However, all indicators of the financial health of the banking sector remained in favorable positions to support the sector in the event of risks materializing.

The stability index of the banking sector, elaborated below, evaluates the internal conditions of the banking sector, which reflect its stability in the last period in relation to the historical situation over the years.

The index is built on the basic financial indicators of the stability of the banking sector, taking values in the range of 0 to 1, where higher values represent downward risk and vice versa. The index is calculated on a

quarterly basis, through which it is assessed whether there is an increase or decrease in risk sensitivity.²⁴

Chart 33. Aggregated index of the banking sector stability



Source: CBK.

According to the general aggregated index of the stability of the sector, on average, an annual increase in sensitivity to risks was noted (chart 33). The general increase in sensitivity to risks was influenced by indicators with increased risk such as solvency and liquidity. Whereas, a decrease in sensitivity was noted in the indicators of profitability, credit and market risk.

The increased sensitivity to solvency risk is attributed to the lower level of the capital adequacy indicator, due to the increase in assets with higher credit risk, while the capital was also slightly lower than the previous year due to the distribution of the dividend, the distribution of which was suspended, as a temporary protective measure recommended by the CBK, until October 2021.²⁵ (chart 34). **The increased sensitivity to liquidity risk** is attributed to the lower level of liquidity indicators, such as the ratio of liquid assets to short-term liabilities. The increase in deposits, mainly in short maturities, has influenced that

²⁴ For more information about the methodology of building the stability index of the banking sector, refer to the Financial Stability Report No. 9.

²⁵ On 16 March 2020, the CBK made a decision on the temporary suspension of the applicability of certain provisions of some regulations on the supervision of lending institutions, as support for the challenges created

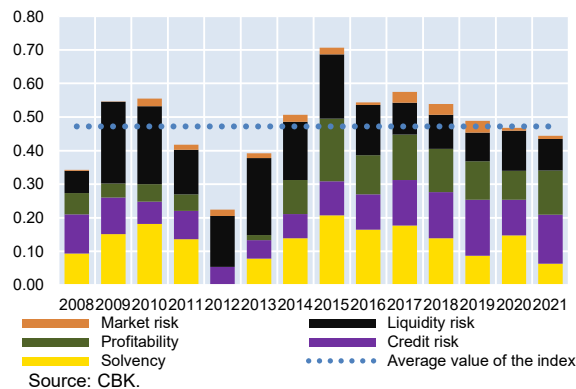
by the Covid-19 pandemic in the Kosovo economy and the financial system. In addition to these regulatory measures, CBK took the temporary measure of banning the distribution of the dividend, in order to preserve the realized profit to cover the requirements for additional provisions and possible credit losses.

short-term liabilities have increased faster against the increase in liquid assets.

However, the decrease in sensitivity to credit risk was the result of the annual decrease in the ratio of non-performing loans, an effect of the reduction in the value of the stock of non-performing loans, but also of the significant increase in lending. The decrease of the sensitivity to profitability risk is attributed to the higher profit realized from interest and non-interest income (fees and commissions), as well as to the reduction of expenses for provisions for possible loan losses.

The indicator that assesses the sensitivity of the market to risk, measured through the open position in foreign currency against the Tier 1 capital, has also recorded a decrease. However, this indicator has a very low weight in the general index of financial stability (chart 34).

Chart 34. Stability index of the banking sector, by risk criteria



The aggregated overall index suggests increased sensitivity to risk, compared to the historical average of the index (2008–2020), but also to the average of the last four years. Despite the positive developments during the year, although facing the consequences of the pandemic, the third and fourth quarters increased sensitivity due to the increase in inflation. However, the state of the health indicators of the banking sector at the end of the year remains satisfactory as it suggests the capacity to cope with the risks that the sector may potentially face in the following year.

5.1. Credit risk

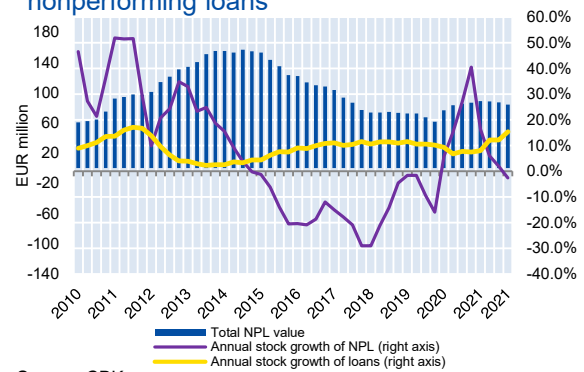
With the gradual easing of restrictive measures to control the COVID-19 pandemic, the first half of 2021 brought economic recovery and positive market sentiment. In terms of credit risk, in the conditions where certain sectors were exposed to the restrictive measures continued throughout the first quarter of the year, the greatest uncertainty came from restructured loans whose repayment period was approaching. The stock of non-performing loans during this first quarter had increased by 2.8 percent, but this trend changed to the downward direction from the second quarter, and that in both segments (households and almost in all economic sectors). Furthermore, the perception of reduced credit risk on the part of banks is based on the reclassification of credit exposures during this period, in the category of loans with lower risk, respectively the reduction of the category of loans with longer delays towards the increase of the participation of the category of loans without delays (the first pillar of credit classifications). However, the non-performing loans of the restructured loans, which at the end of the year accounted for almost half of the non-performing loans, are accompanied by uncertainties. While the value of loans still under restructuring at the end of 2021 constituted 19.3 percent of total loans, problem loans of this category had a participation of 44.3 percent in total non-performing loans. Furthermore, the optimism of the first half of the year was hit by rising inflation and increasing geopolitical tensions, a situation that was immediately followed by increased concerns about business activity in the sectors most sensitive to such circumstances (such as the trade, construction and agriculture sector) and by the weakening of the consumer's purchasing power and the deterioration

of the standard of living, which directly affect credit performance.

Finally, assessed by the trend of the key quality indicators of the credit portfolio, the credit risk is lower than in previous periods, but in the context of these unfavorable dynamics elaborated above, the credit risk has increased and remains the most eminent risk of banking sector and financial stability. Throughout 2021, the NPL rate returned to pre-pandemic downward trends, although almost all restructured loans, including those in the final phase of restructuring in February 2021, ended their term of deferment of repayments. The rapid economic recovery, supported by aid and unprecedented visits of the diaspora in Kosovo, has influenced that the negative effects of the pandemic do not materialize in the increase of non-performing loans. On the contrary, the NPL rate decreased to 2.3 percent at the end of the year, from 2.7 percent a year ago, as a result of the accelerated growth of lending and the continuation of the easing measures by the CBK, namely the restructuring of loans.²⁶ The decrease in the NPL rate also reflects the one-off effect of repayments. The debt payments of some large borrowers in some banks and the closing of some contracts reduced the value of NPLs by 2.6 percent, to 84.1 million euros (from 86.4 million euros in 2020 (chart 35)). The value of NPLs started the downward trend from the second half of 2021, which also coincides with the reduction of new non-performing loans in these months, more specifically, significant decreases were recorded in June, August and September. Most banks had a decrease in new non-performing loans on a monthly basis and compared to the previous year, the cumulative number of new non-performing loans was 73.0 percent lower than in the previous year (477.3 thousand euros from 1.8 million euros in the year 2020). The exception is the performance of December, which recorded a higher level of new non-performing loans and that in most banks.

²⁶ By postponing the term of payment of installments, as well as restructuring loans by changing one or more terms of the contract.

Chart 35. Annual growth of loans stock and nonperforming loans



Source: CBK.

The NPL rate of restructured loans was higher compared to loans that have not been restructured. At the end of 2021, almost half of the sector's non-performing loans were from loans that were restructured in any of the restructuring phases due to the COVID-19 pandemic. Although restructured loans carry higher risk in terms of their performance, current sector levels remain low and payment performance was better than initial expectations. However, the performance of non-performing loans of restructured loans should be treated more carefully and with close supervision, due to the high participation in total non-performing loans (almost half of the stock of non-performing loans is represented by loans that were restructured throughout this period).

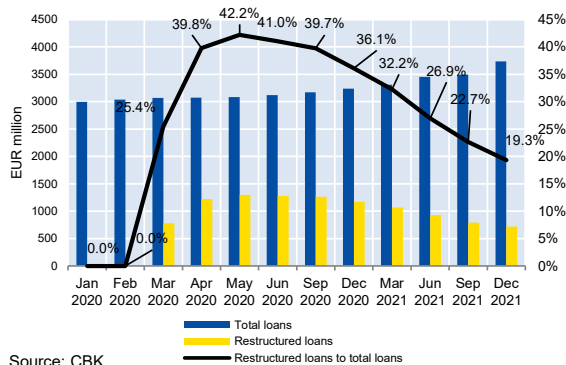
In the first stage of restructuring, which included the moratorium on loan payments for the period March - June 2020, the participation of restructured loans was 40.9 percent²⁷, due to the difficult economic condition of borrowers caused by the total shutdown of the economy, while the remaining stock in December 2021 was 12.9 percent.

In the second phase of restructurings, which started from June 2020, the participation of restructured loans (from the first and second phase) was 18.7 percent according to the balance in December 2021, of which 5.8 percent

²⁷ The chart reports the outstanding balance of loans that were restructured in the corresponding phase.

of the total loans were restructurings of only the second phase.

Chart 36. Restructured loans, by categories



Source: CBK.

While with the latest restructuring guidelines in February 2021, only 0.3 percent of total loans have been restructured, and the stock of all loans still under restructuring decreased to 19.3 percent at the end of the year (chart 36) from 36.1 percent in December 2020. In December 2021, non-performing loans of restructured loans alone accounted for 5.2% of total restructured loans. Translated to the level of the stock of total loans, the share of non-performing loans of restructured loans turns out to be 1.0 percent, while 44.3 percent to total non-performing loans.

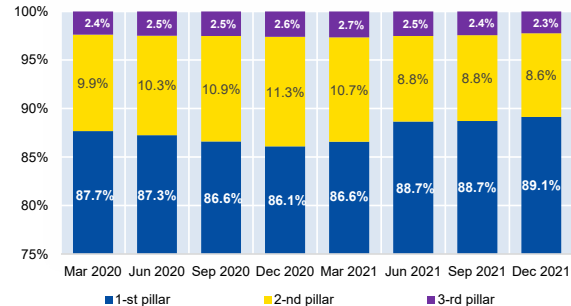
The general improvement of credit quality in 2021 is also reflected in the migration of loans from the category with the lowest classification quality to the one with the highest quality, namely from pillar 2 to pillar 1 of the credit classification.

The participation of loans in the second pillar of credit classification decreased to 8.6 percent in December 2021 from 11.3 percent in December 2020, while loans in the first pillar increased the participation to 89.1 percent from 88.7 percent (chart 37).

In December 2021, credit exposures without delays (delays less than 30 days) have increased participation to 97.2 percent from 96.9 percent in December 2020. Loans 30 to 90 days past due have not changed participation, and remain at 0.5 percent of the total loans (chart 37). Meanwhile, non-performing loans (with low probability of payment, as well as

those with delays over 90 days) have reduced participation to 2.3 percent from 2.7 percent in December 2020 (chart 37).

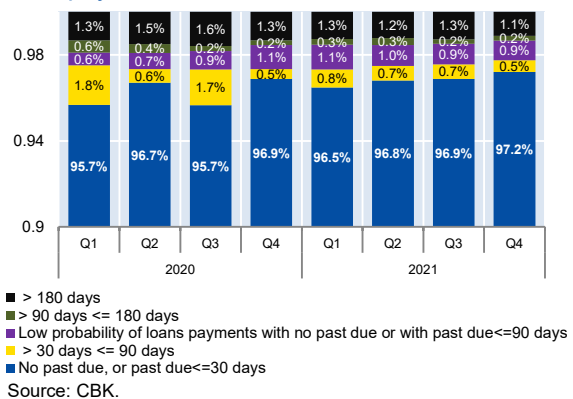
Chart 37. Loans by new credit classification in three pillars



Source: CBK.

Households recorded a decrease in the ratio of non-performing loans, to 1.2 percent from 1.3 percent in the previous year, as a result of the more pronounced increase in lending. The double-digit growth of lending to the household segment in recent years (excluding 2020), is expected to eventually be reflected in increased problems in loan repayment, considering that the sources of income in the economy have not increased.

Chart 38. Structure of loans classified by past due payments, new method

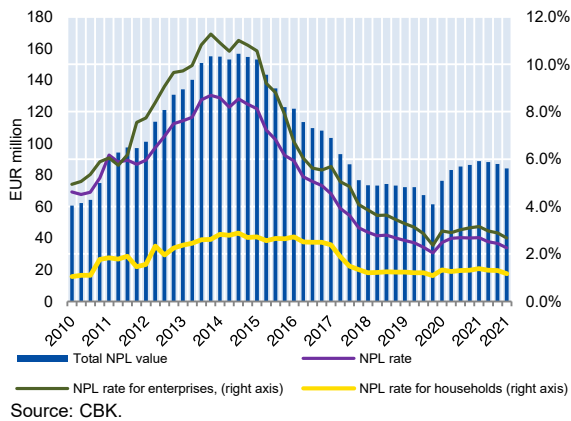


Source: CBK.

Although the value of non-performing loans in 2021 has increased by 5.2 percent, the marked increase in lending by 18.4 percent was the category that influenced the decrease in the NPL rate by 0.1 percentage points (chart 39). From the first phase of restructuring, 12.6 percent of household loans are still restructured according to the situation at the end of 2021. From the second phase of restructuring (the June 2020 guidelines), 1.1 percent of these loans remain restructured,

while the last phase in February 2021 enabled the restructuring of 0.05 percent of loans, according to the situation in December 2021. At the end of the year, loans still under restructuring compared to total loans for households were at the level of 18.1 percent (5.0 percent to total loans).

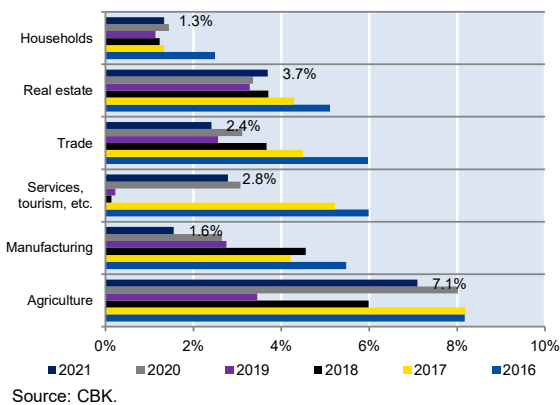
Chart 39. Nonperforming loans



The enterprise segment has recorded an improvement in credit quality, where the NPL rate decreased to 2.7 percent from 3.1 percent a year ago. The value of nonperforming loans in this sector decreased by 1.5 percent, while loans increased by 14.2 percent (chart 39).

Developments in the quality of the loan portfolio of economic sectors were positive, influenced by the relaxation of restrictive measures for the prevention of Covid and the almost complete reopening of economies. The trade sector, which represents the most credited sector, recorded a decrease in the NPL rate by 0.7 percentage points.

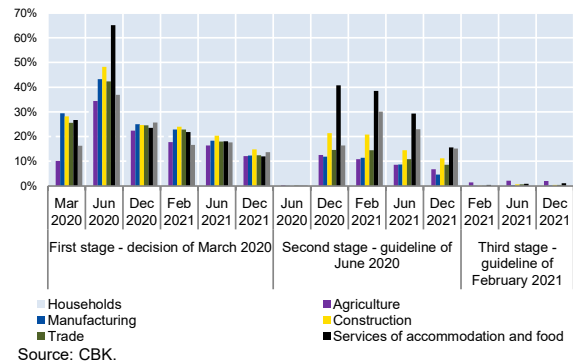
Chart 40. NPL to loans stock ratio, by sectors



The agriculture sector, which is characterized by the highest rate of NPLs, recorded a decrease of 0.9 percentage points, going down to 7.1 percent. The highest decline was recorded by production sector, of 1.1 percentage points, falling to the level of the NPL ratio of 1.6 percent. Only the real estate sector recorded an increase in the NPL rate, from 3.4 percent to 3.7 percent (chart 40).

Chart 41 shows the loan restructuring by economic sectors. The average of restructured loans to the enterprise segment in the first phase of restructuring (June 2020) was 45.0 percent of total loans to enterprises, while in the third phase of this year, only 0.7 percent of loans were restructured for the enterprise sector. In December 2021, the share of active loans that have been restructured resulted in 19.8 percent of loans to enterprises. 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, 15.6 percent in the second phase, according to the outstanding balance at the end of 2021, while 1.1 percent were restructured in the third phase.

Chart 41. Share of restructured loans to total loans of the respective sectors



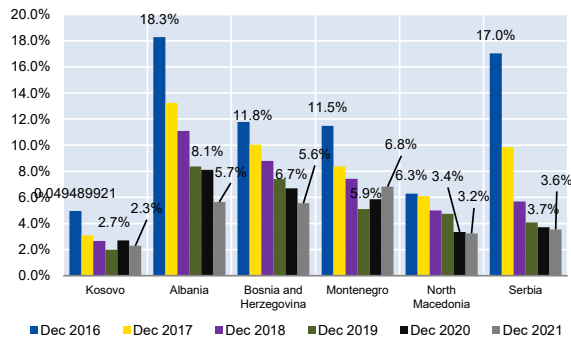
While the agricultural sector in the first and second stages of restructuring was the fifth and sixth sector in a row in terms of the level of restructuring, in the third stage this sector represents the second highest level of restructuring (after the trade sector) in relation with total restructuring according to

economic sectors. At the end of 2021, the restructured loans of the trade sector constituted the largest group of restructurings, respectively 9.6 percent of active loans to enterprises.

The quality of the credit portfolio is expected to be negatively affected by the chain effects due to the new order created with the start of the war in Ukraine and the economic sanctions imposed on Russia, which, together with the economic consequences of the pandemic, have translated into high inflationary pressures with consequences on the standard of living and the performance of businesses. The interruptions of activities during 2020 and the restrictions continued during 2021 have damaged the financial position of enterprises and households, which even without having yet recovered well from the pandemic crisis, at the end of the year they faced the geopolitical crisis and its accompanying consequences. Therefore, this situation can be reflected in the decline in the quality of the credit portfolio with a more pronounced effect on the economic sectors and households most sensitive to these developments.

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 42).

Chart 42. NPL to total loans ratio, in the region countries

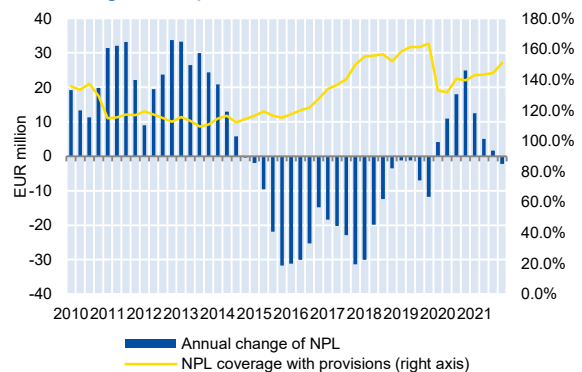


Source: IMF and respective Central Banks.

However, the macroeconomic dynamics that are characterizing both the economy of Kosovo and the region are expected to be reflected in the repayment capacity of borrowers. The magnitude of the loans quality deterioration will largely depend on the policies that the countries will follow (fiscal and monetary/financial measures) and the transmission channel, to ensure the reduction of inflationary pressures and the avoidance of a big shock on GDP.

The provision coverage ratio of the sector has increased to 151.0 percent from 139.5 percent in December 2020. The increase in the provisioning rate resulted from the higher level of the stock of allocated provisions (5.5 percent annual increase) and simultaneously the decrease in the value of NPLs (annual decrease of 2.6 percent) (chart 43).

Chart 43. Annual change of NPL stock and coverage with provisions



Source: CBK.

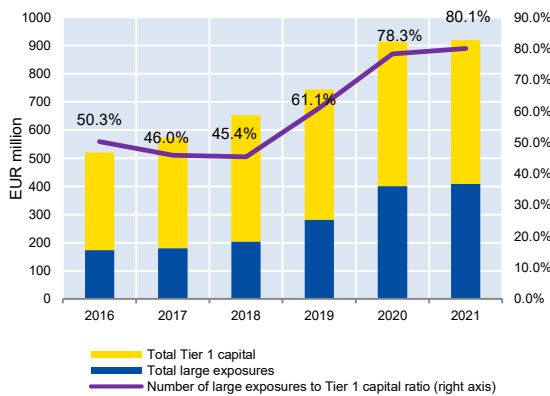
The higher value of provisions this year was expected due to the increased credit risk as a result of the crisis, a risk that is thought to be present in the following year as well, as a result of uncertainties and quite challenging dynamics in the market.

Although the banking sector has allocated a higher level of provisions this year, the rate of provisions spent (provision expenses to loans) for the sector, was lower in December 2021 (-0.4 percent) compared to the previous year (-1.2 percent), as a result of improved credit performance.

5.1.1 Large credit exposures

The credit exposure rate recorded an increase to 80.1 percent, compared to 78.3 percent in the previous year, although it continues to be well below the maximum regulatory level.²⁸ The annual increase in the value of large exposures by 1.9 percent, along with the lower growth of 0.3 percent in the level of Tier 1 capital (only for the banks under analysis, excluding bank branches²⁹) resulted in an increase in the rate of credit exposure (chart 44).

Chart 44. Concentration of credit risk



Source: CBK.

The concentration of credit risk, expressed as the ratio between the values of large exposures to the number of these exposures, has decreased. The average value of large exposures³⁰ increased to EUR 10.0 million from EUR 9.3 million as a result of the effect of a higher increase in the amount of large exposures alongside a decrease in the number of large exposures.

The ratio of the three largest exposures to total large credit exposures has increased to 50.8 percent from 40.5 percent. The rate of large credit exposures in 2021 has increased as a result of the increase in large exposures from mainly three banks of general systemic importance.

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 ongoing effects from the crisis caused by Covid-19 and the new dynamics created by the war in Ukraine reiterate the need for a more proactive and dynamic approach to monitoring and dealing with large exposures.

5.2. Sustainability of profit and interest rate risk

Kosovo's banking sector this year recorded the highest increase in profit since 2015. The profitability position was favoured by all categories of profit realization. The reduction of expenses for provisions and the higher realized revenues influenced the profit of the banking sector to be higher compared to the previous year by 47.1 percent. Revenues were characterized by faster annual growth than expenses, in which case non-interest revenues (fees and commissions) were the revenue category that contributed the most to profit realization.

The value of net profit reached 117.5 million euros, from 79.9 million in the previous year (chart 45). The reduction of the perceived risk from the pandemic influenced the release of a part of the provisions allocated in the previous year. The reduction of expenses for provisions, together with the faster growth of revenues in relation to expenses was reflected in the annual increase of profit of 47.1 percent (chart 46).

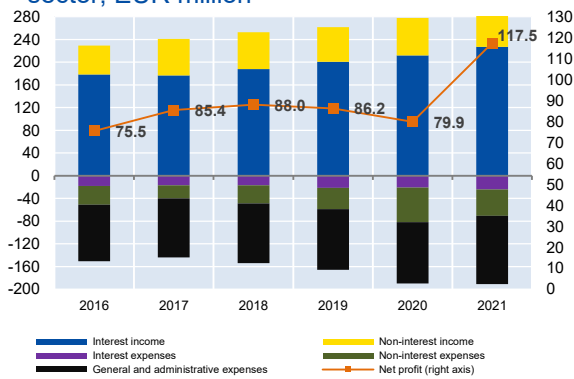
²⁸ Ratio of total large credit exposures to Tier I capital. Large credit exposures, as defined by the CBK Regulation on Large Exposures, are considered any exposure to a single person or related group of persons whose value exceeds 10% of the Tier I capital of the bank. While all large credit exposures together cannot exceed more than 300% of Tier I capital. Bank branch exposures are excluded here

²⁹ Large exposures reported by bank branches are not included in the analysis, 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.

³⁰ Ratio of total exposure to the number of exposures.

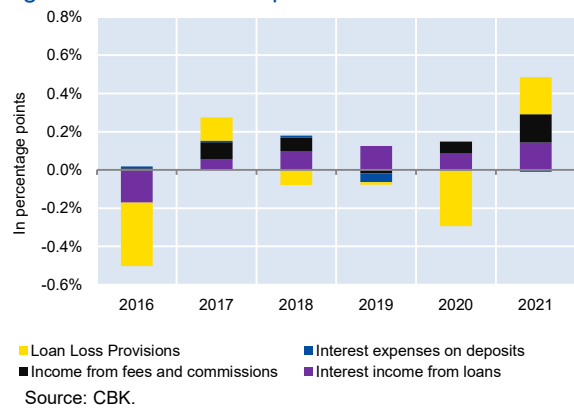
Chart 45. Profit structure of the banking sector, EUR million



Source: CBK.

The provisioning ratio, expressed as the ratio of provisioning expenses to net loans, decreased to 0.4 percent in 2021 from 1.2 percent last year.

Chart 46. Main contributors to the growth/decline of the profit



Source: CBK.

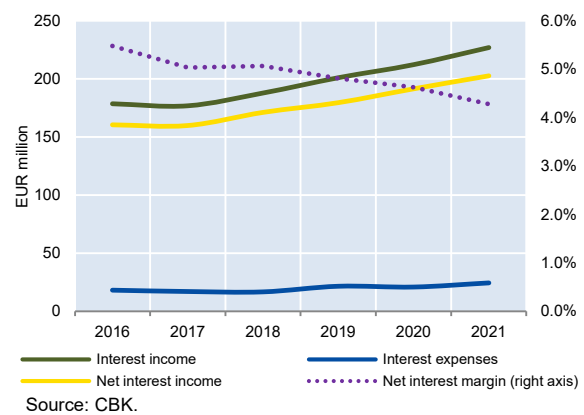
However, the level of the stock of allocated provisions has increased throughout the year, which mainly reflects the banks' conservative approach against the potential materialization of increased credit risk, driven first by the pandemic crisis and more recently by the increase in geopolitical tensions.

Revenue for the banking sector increased by 15.4 percent as a result of higher growth in non-interest revenue (fees and commissions) and to some extent in income from credit activity. Net non-interest revenue was the contributor that influenced the increase in profit in relation to the contribution of net interest revenue. Net revenue from the interest increased by 5.9 percent or 11.2 million euros, as a result of revenue from increased credit activity. While the net non-

interest revenue has increased by 35.3 million euros, as a result of the increase in revenue from fees and commissions and the decrease in provision expenses.

However, the net interest margin declined slightly to 4.3 percent from 4.6 percent in the previous year, which can be attributed to the quantitative effect due to higher growth in the stock of interest-bearing assets (14.3 percent annual growth) than of the price - revenue from interest in these assets (5.9 percent annual growth) (chart 47).

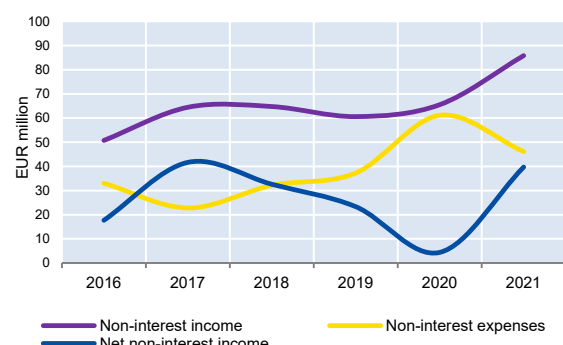
Chart 47. Interest income and expenses



Source: CBK.

Total interest revenue increased by 14.7 million euros, or 6.9 percent. While only revenue from loan interest increased by 16.8 million euros (or 8.5 percent).

Chart 48. Non-interest income and expenses



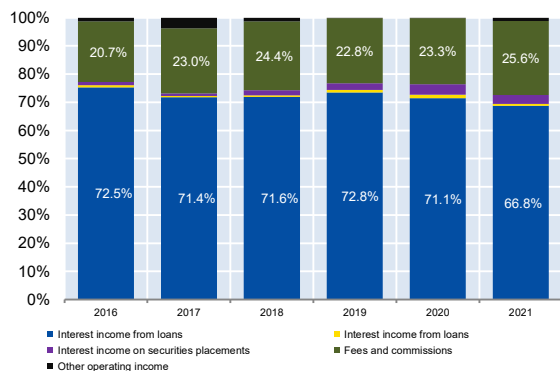
Source: CBK.

Non-interest revenue (fees and commissions as well as other operating income) increased by 31.0 percent, or by 20.3 million euros (charts 48 and 49).

Interest expenses on deposits recorded an increase of 5.7 percent, but the impact of the

increase was not transmitted to profit due to the higher positive effects of other categories (chart 46).

Chart 49. Income structure of the banking sector



Source: CBK.

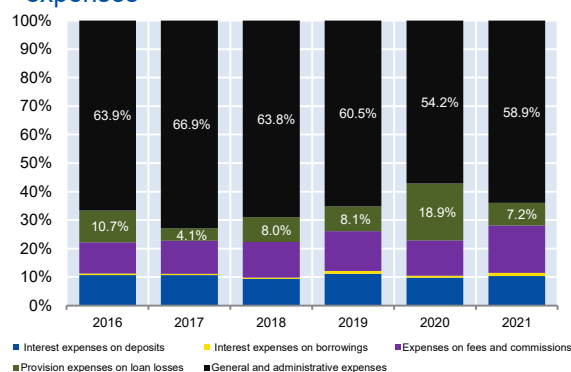
Non-interest expenses decreased by 24.5 percent to 46.1 million euros, mainly as a result of expenses for provisions which were significantly reduced by 22.8 million euros. Expenses for fees and commissions increased by 7.8 million euros, while general and administrative expenses increased by 12.5 million euros (11.6 percent) influenced by personnel expenses and general expenses (chart 50).

In the following months, the profit of the banking sector is characterized by growing uncertainties and pressures caused by the war crisis in Ukraine, and consequently high inflation. The weakening of the repayment ability of customers as well as the increase in the need to allocate provisions to cover possible losses can affect both the decrease in the sector's revenues and the increase in expenses.

The deadline of instalment repayment deferrals of no more than 9 months, enabled by the last restructuring decision in February 2021, has ended at the end of 2021.³¹ The effects of increased credit risk have not been observed during 2021, but negative dynamics starting from the end of the year may worsen the credit performance of customers in the following period.

The potential 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 noncollection of the principal as well as the deduction of the accrued interest, due to the expected increase of NPLs. Provisioning requests are also expected to increase in line with 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.

Chart 50. Structure of the banking sector expenses



Source: CBK.

While the intensification of the banks efforts to digitize services, as well as the increase in demand or the use of these services by customers, will be beneficial in terms of increasing the efficiency of cost management and decreasing operating expenses.

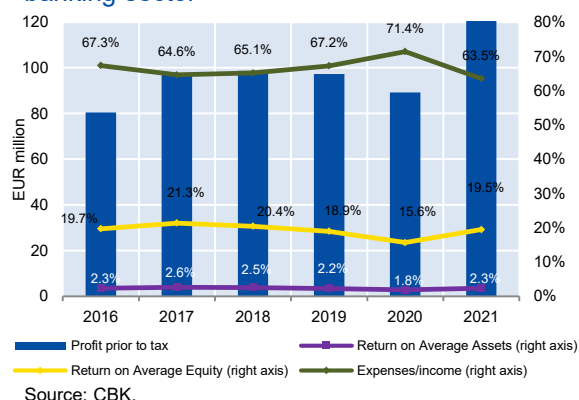
Profitability indicators increased as a result of profit growth, and continue to remain at the highest level in the region. The average return on assets and capital of the banking sector of Kosovo increased to 2.3, respectively 19.5 percent, from 1.8, respectively 15.6 percent a year ago (chart 51).

These levels are well above the average of the region's banks, which recorded an average return on assets of 1.3 percent and a return on equity of 9.9 percent. The countries of the region also recorded an increase in profitability indicators during this year, but lower than the banking sector in Kosovo, which is why the

³¹ [Guideline on Loan Restructuring.pdf \(bqk-kos.org\)](#)

difference between the average of Kosovo and these countries has increased.³²

Chart 51. Profitability indicators of the banking sector



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 interest-bearing assets and liabilities.

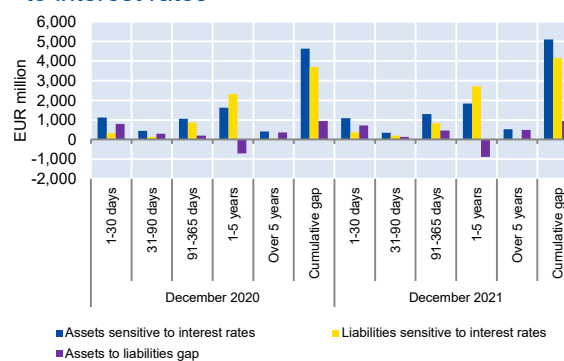
The cumulative gap between assets and liabilities sensitive to interest rates in 2021 was positive of 951.28 million euros, slightly higher than the previous year. Liabilities sensitive to interest rates recorded higher annual growth, and that in the maturity terms 'up to 90 days' and '1-5 years', while the growth of assets was slower, and mainly in the maturity term 'over 5 years'. The higher level of short-term liabilities and the increase in mismatches in maturities between assets and liabilities are related to the higher level of deposits from the inflow of the diaspora, the growth of remittances through formal and non-formal channels and the higher saving tendencies against spending in the circumstances of uncertainty that have characterized the last two years.

³² 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.

The balance of the banking sector in Kosovo is mainly characterized by fixed interest rates (76.1 percent of loans are at fixed rates), therefore the sector is affected by interest rate movements mainly at maturity of these positions. In the short term, the possible increase in the cost of financing may increase the pressure on the sector's expenses, since the main category of assets, loans, are contracted with fixed interest rates and have longer maturities. If we analyse only loans and deposits, which make up the largest part of the banks' balance sheet, the cumulative gap between them is negative as a result of the higher level of deposits compared to loans, especially for the group with maturity "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 52).

Chart 52. Assets and liabilities gap sensitive to interest rates



The expansion of mismatches in these categories of maturities between assets and liabilities may increase the risk exposure to interest rate fluctuations respectively 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.

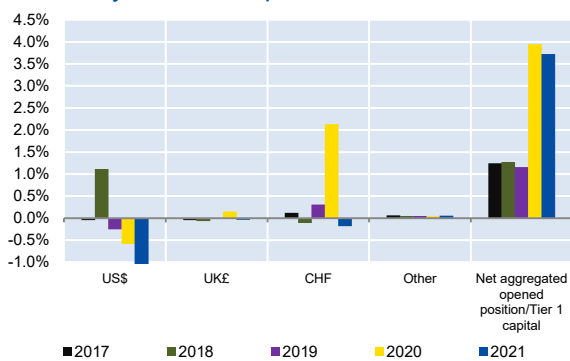
Data for Bosnia and Herzegovina reflect the situation in September 2021 due to the lack of more recent data.

5.3. Risk from the position in foreign currencies

Banking sector exposure to the risk of changes in foreign exchange rates has decreased compared to the previous year. The aggregate net open position for all foreign currencies decreased to EUR 20.3 million equivalent from EUR 21.6 million, which consists of a ratio of 3.7 percent of Tier 1 capital compared to 3.9 percent in 2020 (Chart 53). The decline in foreign currency positions resulted mainly from reduced exposures to the British currency and the Swiss franc.

By specific currencies, the net position to Tier 1 capital for the Swiss franc results in negative territory, from the positive position of the previous year as a result of the high increase in liabilities and the decrease in assets in this currency. This means that the banking sector is more exposed to the risk of possible depreciation of the EUR against these currencies. Likewise, the net position for the British pound moved from positive to negative territory, but as a result of the higher increase in liabilities alongside the increase in assets in this currency. For the US dollar, the negative net open position widened further, which means that banks have further increased liabilities in this currency.

Chart 53. Opened positions in foreign currency to Tier 1 capital



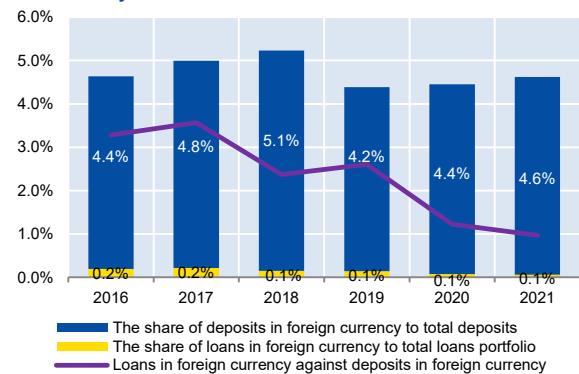
Source: CBK.

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 open 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 constitute only 0.1 percent of total loans, and recorded a decrease of EUR 0.2 million in the foreign currency credit portfolio compared to the previous year.

Chart 54. Loans and deposits in foreign currency



Source: CBK.

Foreign currency deposits also have a low share, 4.6 percent, while they increased by EUR 32.6 million from the previous year (Chart 54).

5.4. Capital

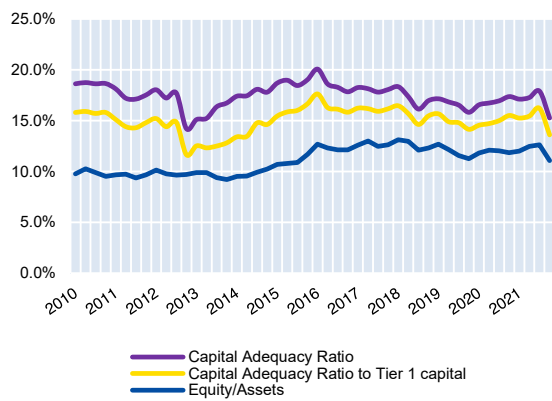
The banking sector continues to have a capital ratio above the required regulatory levels.³³ However, high lending activity throughout 2021 has increased risk-weighted assets on banks' balance sheets, resulting in the Capital Adequacy Ratio (CAR) being lower by 2.1 percentage points, at 15.3 percent, from 17.4 percent in the past year.

³³ The Capital Adequacy Ratio should always be above 12 percent of risk-weighted assets. Tier 1 basic capital must at all times be at least 4.9 percent

of RWAs, while the Tier 1 regulatory capital must remain at least 9 percent in relation to the RWAs.

The capital ratio varies among banks, in which case mainly the systemically important banks have a higher capitalization rate. At the sector level, the variance between the CAR of individual banks against the average of the banking sector has declined (approximation of the CAR to the average of the sector). The capitalization position of the sector is reflected to be at an adequate level also by the indicator of the capital adequacy ratio of Tier 1 to risk-weighted assets, which stood at 13.6 percent, although lower than last year, for the same reason, i.e., the increase in risk-weighted assets that mainly consist of long-term loans (Chart 55).

Chart 55. Banking sector capitalization



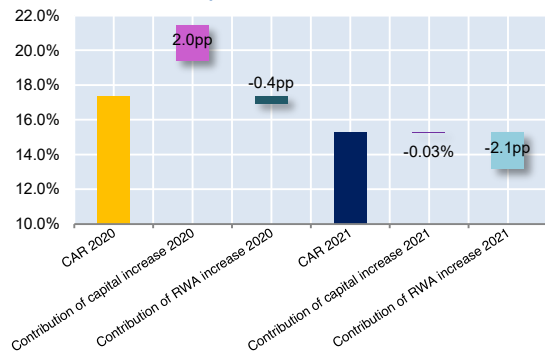
Source: CBK.

Compared to the previous year, the annual growth rate of RWAs was almost five times higher (13.6 percent growth from 2.8 percent a year ago and from 11.7 percent growth in the pre-pandemic year), as a result of acceleration of lending activity in the circumstances of economic revival after the pandemic period and increased optimization and mitigation of the perception of risks by banks. The regulatory capital recorded an annual decline of 0.1 percent, influenced by the lower profit retained from previous years, due to the dividend distribution at the end of the year.

Therefore, the higher effect of the growth of risk-weighted assets gave a higher declining contribution of 2.1 percentage points to the capital adequacy indicator. Likewise, the slight reduction of regulatory capital contributed to the decline of CAR by 0.03 percentage points (Chart 56).

The banking sector has a strong regulatory capital base, 89.1 percent of which is Tier 1 capital. Retained profit has a high share in Tier 1 capital (35.9 percent), which suggests that banks are oriented to capital creation mainly within their own activity (profit capitalization).

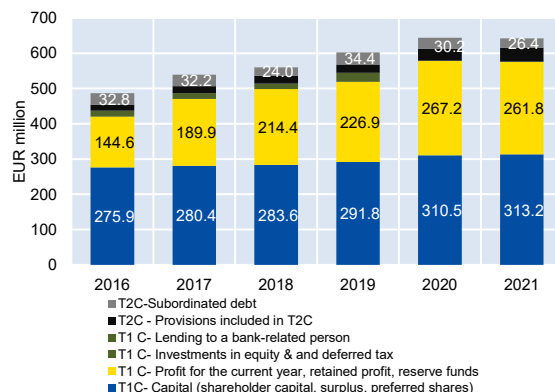
Chart 56. Contribution of Regulatory Capital and RWA to capitalization ratio



Source: CBK.

In the context of total regulatory capital, the share capital, the value of goodwill and the retained provisions recorded an increase. Interdependent debt and retained profit from previous years were characterized by a decrease (Chart 57). The retained profit was reduced due to the distribution of the dividend in the last quarter of the year, which was suspended until now as a temporary measure undertaken by CBK during the pandemic, in order to preserve the profit made to cover the requests for additional provisions and as a support measure for strengthening the capital position and lending activity.

Chart 57. Structure of regulatory capital



Source: CBK.

The financial leverage indicator (the ratio of Tier 1 capital to exposures after regulatory

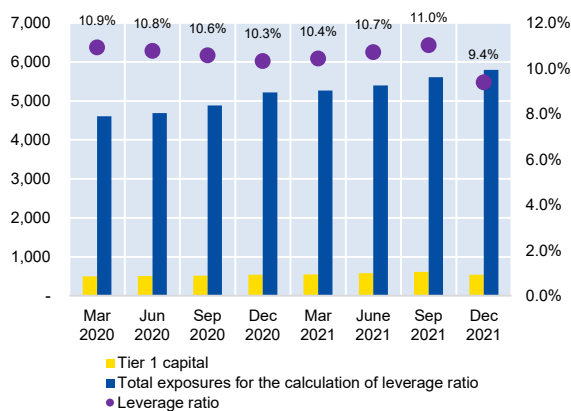
corrections) in December 2021 stood at 9.4 percent (Chart 58). This ratio stands above the minimum suggested by the Basel III framework for financial leverage of a minimum of 3.0 percent³⁴, and suggests a good capital position.

In the context of risk-weighted assets, credit risk-weighted assets recorded a higher growth rate of 14.3 percent from 2.8 percent a year ago, resulting from increased lending activity.

While assets weighted for operational risk recorded an increase of 5.2 percent from 3.6 percent. The share of risk-weighted assets remains similar, with 93.2 percent of RWAs weighted for credit risk, 6.8 percent for operational risk and a very low share, 0.0002 percent, for market risk (Chart 59).³⁵

Credit risk weighted assets (Chart 60) recorded a value of EUR 3.7 billion (3.3 billion in 2020). In the context of these assets, retail loans dominate with 43.9 percent, followed by exposures to corporations with 19.9 percent.

Chart 58. Leverage ratio



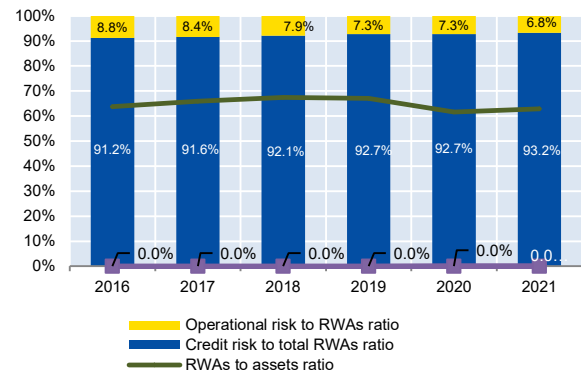
Source: CBK.

Mortgage loans supported by commercial and residential real estate have a share of 14.5 and 8.2 percent, respectively. Exposure to other banks, governments and central banks was relatively low at 3.7 percent and 2.0 percent, respectively.

Other remaining exposures constitute 7.8 percent of exposures, which include local

authorities, the public sector, development banks, international organizations (Chart 60).

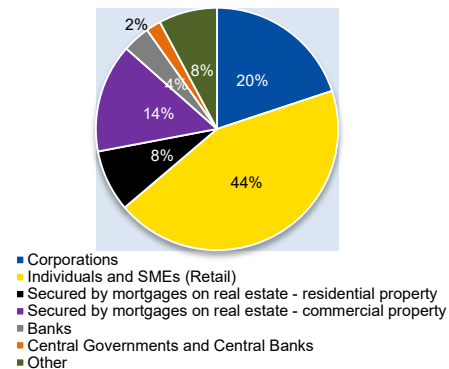
Chart 59. RWAs to total assets ratio



Source: CBK.

According to risk weight, the category weighted by 100 percent, which also constitutes the category with the most pronounced weight in total risk-weighted assets (72.4 percent), and which includes retail exposures (retail/individuals), loans to corporations and mortgage loans supported by commercial property (Charts 61 and 62), marked the most pronounced increase this period (for EUR 401.7 million).

Chart 60. Risk-Weighted assets, share



Source: CBK.

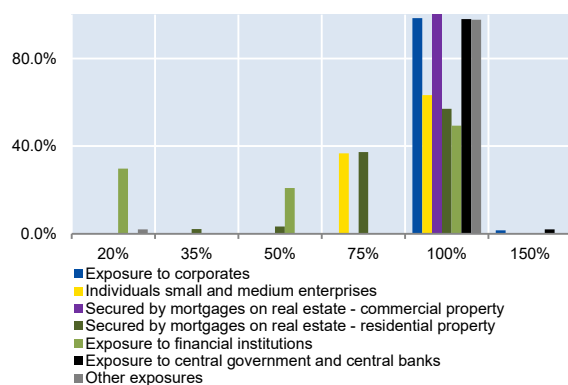
Likewise, assets with a risk weight of 75 percent (which includes retail loans and mortgage loans supported by residential real estate) recorded an increase of 9.4 percent (or EUR 61.5 million).

³⁴ According to Basel III, the leverage rate is calculated as the ratio between Tier 1 capital and exposures following regulatory changes. This rate must be equal to or above 3 percent. The CBK, as of 2020, commenced calculating this rate, according to the Basel III standard.

³⁵ Market risk-weighted assets were reported for the first time starting from 2020, according to the new reporting format required by the CBK.

While only the category of assets with a risk weight of 20%, which includes lending to financial institutions, governments and the central bank, recorded a decrease of 9.7 percent.

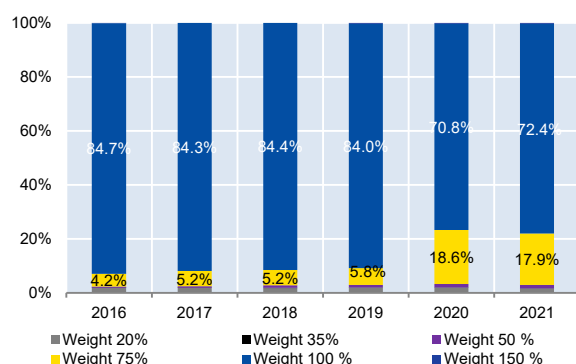
Chart 61. Assets classification, by risk weight



Source: CBK.

This development suggests higher credit growth in the retail segment - for individuals, corporations and mortgage lending based on residential real estate (Charts 61 and 62).

Chart 62. RWA structure for credit risk, by risk weight



Source: CBK.

5.5. Financing and liquidity risk

The liquidity position of the banking sector has been further strengthened, mainly supported by the marked increase in private sector deposits. The pandemic crisis initially increased the uncertainty of actors in the financial system for possible pressure on liquidity management. However, the increase in preferences for savings versus spending, but also the reduced opportunities and uncertainties to spend in times of crisis,

influenced the financing balance of banks to be in favour of the liquidity position, a position that was also inherited in 2021. Prospects for 2022 and beyond give indications of new increased challenges in the context of financing costs. Initially, the growth of deposits is not expected to have the same growth trend as in 2021 and this will boost the competition of banks in withdrawing/retaining deposits, influencing the increase in financing costs. Further, the costs of maintaining liquidity will be challenged by the increase in interest rates at the global level which are transmitted directly through financing from parent banks. The monetary policies of some central banks have already responded to the increase in inflation by increasing the basic interest rates. The ECB has been reluctant to intervene and change monetary policy in the first half of 2022, mainly due to the expected impact of the increase in the cost of financing in some of the EU economies (potential recession) and the further weakening of the EUR. However, the persistent increase in inflation at levels not seen in the last decade has influenced the ECB to signal the potential decision to increase interest rates at the meeting of the Council in July 2022. Changes in interest rates at the ECB will indirectly affect the costs of maintaining liquidity and financing costs in the country. Moreover, despite the high rate of liquidity at the sector level, most banks have recorded a decrease in their liquidity ratio from last year, while some banks recorded a more pronounced decrease.

The good liquidity position of the sector during 2021 was further supported by the continuous growth of deposits, and in particular household deposits, mainly supported by remittances through formal but also informal channels (the high flow of the diaspora with the opening of opportunities for travelling). However, the growth in inflation has increased the uncertainties, the pressure to maintain the level of deposits in the banking sector and the

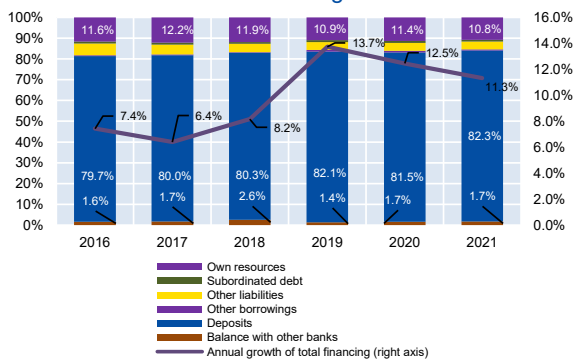
challenges for the design of appropriate economic (fiscal and financial) policies. Although more limited in the spectrum of mechanisms for direct injection of liquidity into the market (in the absence of monetary policy, CBK has at its disposal the instrument of the Emergency Liquidity Fund for direct injection of funds into the banking sector), CBK can fulfil the possible needs for liquidity also through other mechanisms such as liquidity reserve management, interbank liquidity agreements, as well as financing from parent banks.

Under the influence of the state of uncertainty, as well as low interest rates, the share of transferable deposits has expanded, which, in combination with the growth of long-term lending, contributed to the emphasis of maturities mismatches between these items. However, the main liquidity indicators give positive signals for the current state of banking liquidity, where the high level of banks' liquidity reserves that are held in the CBK, but also of total liquid assets, makes the sector more resistant to possible negative effects that could result when the maturity mismatches between investments and financing are pronounced.

5.5.1 Bank financing

The financing structure of the banking sector is dominated by financing from the non-banking sector, mainly private sector deposits, which continued to grow.

Chart 63. Structure of financing

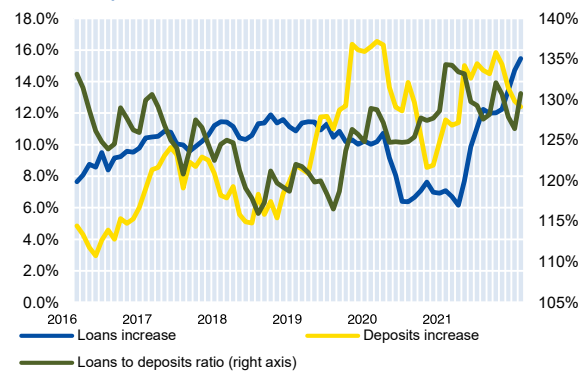


Source: CBK.

Interbank financing is at a very low level and banks are also very little exposed to financing in the external sector (Chart 63).

This year, deposits exceeded loans by 130.8 percent, an indicator that decreased by 3.6 percentage points from the previous year, under the influence of higher lending growth (Chart 64).

Chart 64. Increase of banking sector loans and deposits



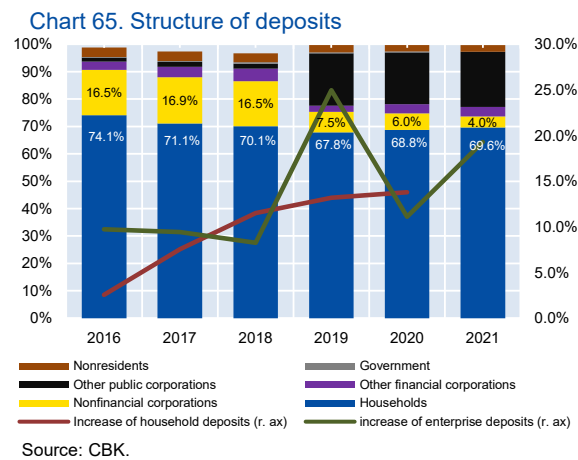
Source: CBK.

The increase in deposits, mainly of households, in these circumstances of uncertainty and inflationary pressures, reflects the preferences for saving or keeping transferable deposits for consumption purposes to the detriment of investments.

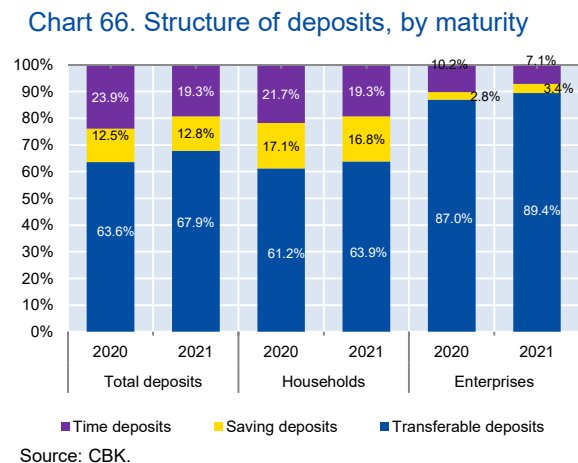
Household deposits continued the accelerated growth trend at 13.8 percent (13.2 percent in 2020), while their stock reached EUR 3.4 billion (Chart 65). Most of them were transferable deposits, which, with their annual growth of 18.9 percent, contributed to the increase of total household deposits (Chart 66).

Enterprise deposits recorded a more accelerated trend of annual growth of 19.3 percent (11.1 percent annual growth in 2020), which can be related to the increase in their business activity upon lifting of restrictive measures against COVID-19 and the full opening of economies. The increase in deposits may also be an effect of the financial support provided within the aid packages by the government - measures to support businesses affected by the pandemic crisis. The increase was particularly pronounced towards the end of the year, more specifically, December 2021 constitutes the highest level of deposits.

The stock of enterprise deposits reached EUR 987.1 million, with 20.0 percent share in total deposits.



The growth of enterprise deposits was mainly influenced by the increase of transferable deposits with 22.7 percent, and, given that they also constitute the category with the highest share, they have contributed to emphasizing the general growth of enterprise deposits. High uncertainties about the progress of business activity due to the pandemic situation and inflation, but also the nature of the functioning of the business sector, in general, require more reliance on transferable deposits to cover their liquidity needs and daily activity, compared to holding assets in the form of time deposits.



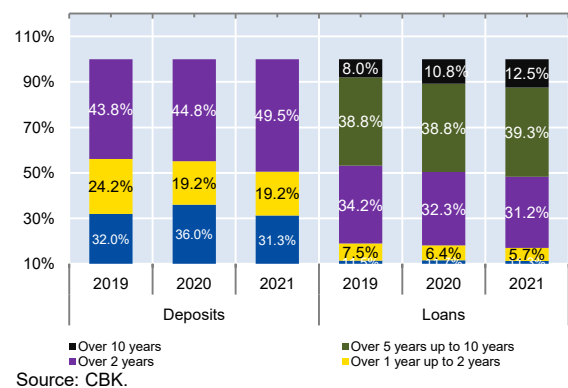
The structure of total deposits by maturity is dominated by transferable deposits with a share of 67.9 percent, which recorded an increase this year as well, at an annual rate of 19.1 percent (Chart 66).

Transferable deposits are mainly owned by households with 64.0 percent (while 26.5 percent belong to enterprises). While transferable deposits and savings deposits recorded annual increases of 19.1 percent and 14.4 percent, respectively, time deposits were characterized by an annual decrease of 10.1 percent.

The maturities of deposits and loans emphasize the structural mismatches between them, which are more pronounced with periods of 'up to 1 year' and 'over 1 year to 2 years'. Time deposits with maturity of 'over 2 years' dominated the structure of time deposits and increased their relative share to 49.5 percent of total time deposits (from 44.8), while loans with maturity period of 'over 5 to 10 years' are the ones that have the highest share of 39.3 percent in total loans (Chart 67).

The high share of transferable deposits and the domination of deposits with short-term maturity, on the one hand, and the increase of long-term lending, on the other hand, increase the needs for more prudent supervision of the stable financing of banks, especially in this period of high growth of inflation. Financing costs may grow with possible increases in key interest rates as a measure to control inflation.

Chart 67. Maturity structure of deposits and loans

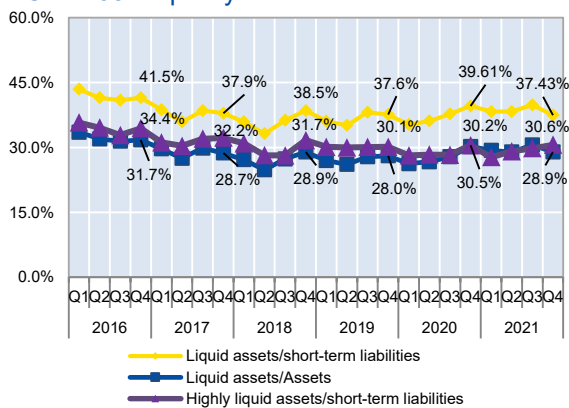


As long as foreign financing is at a low level, the increase in the cost of living in the country due to the increase in inflation (if incomes remain unchanged or have marginal changes) will increase the living expenses which will consequently reduce deposits, thus directly causing challenges for financing.

5.5.2 Liquidity risk

The banking sector continues to maintain a satisfactory liquidity position, demonstrating its capacity to support lending activity, as well as its high capacity to face potential risks. In 2021, the liquid assets to short-term liabilities ratio decreased to 37.4 percent compared to 39.6 percent in 2020. This result was driven by the higher increase of short-term liabilities versus the increase of liquid assets by 12.8 percent and 6.6 percent, respectively. However, the narrow liquidity ratio, which includes only highly liquid assets (cash and cash equivalents, current accounts and placements), compared to short-term liabilities, increased slightly to 30.6 percent from 30.5 percent in the previous year, due to the higher increase of highly liquid assets of 13.2 percent.

Chart 68. Liquidity indicators



Source: CBK.

The liquid assets to total assets ratio decreased to 28.9 percent (30.2 percent in 2020), as assets grew faster than liquid assets (Chart 68). However, the higher rate of the basic liquidity ratio (the liquid assets to short-term liabilities ratio) versus the regulatory minimum³⁶ indicates the sector's potential for financing the expansion of lending activity.

The increase in liquid assets during the period resulted mainly from the increase in deposits with short-term maturity up to 30 days placed in the country's banks. The increase consists of

a value of EUR 73.5 million. The increase of EUR 23.2 million of the dominant category, which is the liquidity reserve with the central bank (with a share of 35.0 percent), also had an important contribution to the growth of liquid assets, then of cash for EUR 20.7 million or 9.0 percent annual growth, as well as the increase in government bonds of the Republic of Kosovo of EUR 19.5 million, or an annual increase of 10.0 percent.

Meanwhile, the current account category that banks hold in banks and other financial institutions decreased by 21.2 percent, or EUR 51.7 million. Deposits and placements in other banks abroad also decreased by EUR 5.9 million (4.9 percent annual decrease), as well as bonds of foreign governments by 0.3 percent (EUR 412 thousand).

The liquidity reserves of commercial banks continue to be at high levels, exceeding the required reserve held at the CBK by 68.3 percent. From August 2016, the CBK has applied a negative interest rate on the surplus of the required reserve that commercial banks in the country hold at the central bank, in line with the ECB's decision to apply negative rates to deposits.

The application of the negative rate affected the reserve balance immediately in the following month (in September 2016 the balance decreased by 29.9 percent), but the long-term effects of the measures through the application of the negative rate on the level of the reserve balance have not been observed, potentially due to limited opportunities for the allocation and investment of assets (Chart 69).³⁷ However, the level of the surplus of bank reserves during 2021 by 68.3 percent has decreased compared to 2020 (which was at the level of 82.3 percent) as a result of the much higher annual growth of lending activity, despite the continuous growth of deposits.

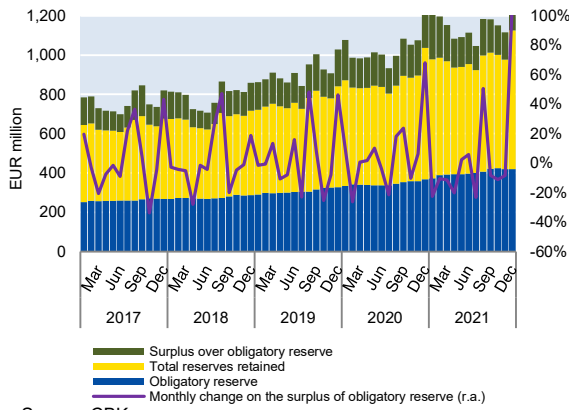
The environment of low interest rates in recent years has stimulated households to shift their deposits in favour of short-

³⁶ The ratio of liquid assets to short-term liabilities is defined in the Regulation on Liquidity Risk Management at 25 percent (Article 17. Liquidity rate)

³⁷ 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.

term maturity, which, in addition to the growing trend of long-term lending, has resulted in highlighting maturity mismatches between assets and liabilities.

Chart 69. Liquidity reserves

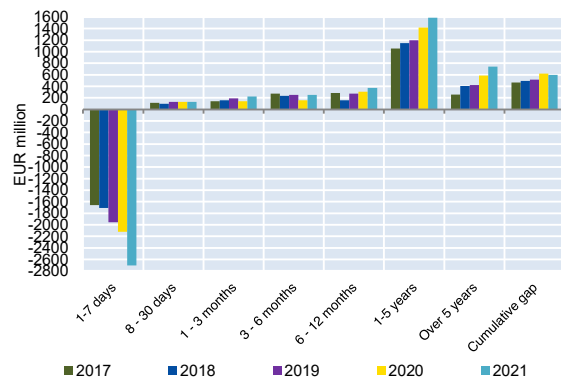


Source: CBK.

Maturity mismatches between investments and financing are increasing in conditions where transferable deposits have increased and loan maturities have been extended, a move that increases exposure to liquidity risk.

The cumulative liquidity gap in 2021 narrowed to EUR 598.8 million from EUR 619.0 million in the previous year. This result was mainly influenced by the more pronounced expansion of the negative gap between assets and liabilities with maturities of “1 to 7 days”, due to the higher growth of liabilities with this maturity. About 77.2 percent of the liabilities are categorized in the term of “1-7 days” in relation to the assets of this term, which constitute only 22.1 percent of the total assets. Other categories of maturities also recorded growth and create a positive liquidity gap. The next highest expansion was in the positive gap between assets and liabilities with maturities of “1 to 5 years”, due to the higher growth of assets with this maturity. About 37.2 percent of the assets are categorized in the term of “1-5 years” compared to the liabilities of this term, which constitute only 10.8 percent of the total liabilities.

Chart 70. Liquidity gap*



Source: CBK.

Consequently, the mismatches in the maturity terms of the balance sheet items are the most pronounced in the categories of maturity of '1-7 days' and '1-5 years' (Chart 70). This situation presents a challenge for the management of banks' liquidity with the continuation of the rapid growth of long-term lending.

5.6. Shock absorption capacity - Stress-test analysis³⁸

The stability of the banking sector against the consequences of the COVID-19 pandemic crisis and other unfavourable dynamics such as the increase in inflation has been tested and evaluated through the calibration of scenarios based on possible forecasts of events for the next one-year period. However, the developments and therefore the assumptions are accompanied by great uncertainty, because the measures taken by the local authorities to mitigate the pandemic crisis have isolated the direct effects of the pandemic on the balance sheets of the banking sector. Likewise, the new situations created by the increase in inflation and the imposition of economic sanctions against Russia due to the war started in Ukraine are accompanied by uncertainty about the duration and the chain effects that will follow, which subjectivize the economic performance of all actors in the market. The development of credit risk scenarios will include macroeconomic shocks to the credit

³⁸ 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.

portfolio and capital position. In this exercise, three scenarios have been considered at the sector level, based on the assumptions of shocks to the economic activity in the credit portfolio and capital, assumptions that are built on the predicted levels of inflation growth³⁹, being the driving factor in the creation of new dynamics in the market.

Unprecedented stimulating measures taken by local authorities to help economies recover from the pandemic have encouraged the price increase in many economies. Consequently, the pronounced reinforcement of general demand with the reopening of economies was not accompanied by an increase in supply as a result of massive interruptions in the production chains of goods, thus causing inflationary pressures. Global mismatches between demand and supply for energy, food products and other products worsened with the start of the war in Ukraine, which is weighing on the world economic order. The war and the imposition of economic and financial sanctions against Russia will have negative implications in slowing down world economic activity and further increasing prices. The increased prices of energy and raw materials, in addition to causing obstacles in production, have simultaneously reduced the purchasing power of the consumer and its credibility in the market, due to the uncertainties created about the future. Therefore, the direct implications of inflation on the purchasing power of the consumer and the standard of living are of particular importance for the chain effect they will have on the credit performance of borrowers (reduction of solvency) and on the liquidity of banks (reduction of deposits due to the increase of expenses from the effect of inflation).

This analysis also includes the assumption of changes in interest rates. The Bank of England (BoE) and the US Federal Reserve (FED) have responded to inflation by taking monetary policy measures through raising basic interest rates. Practices also prove that in times of

crisis, new loans would be considered higher risk, therefore an increase in the interest rate can be expected. However, movements in interest rates in the country are subject to banks' sentiment towards risks and credit performance of customers, but also developments and changes in interest rates in the eurozone. Consequently, in the compiled scenarios, it is assumed that interest rates will grow due to increased risks in the market as a result of uncertainties about the future of the conflict and inflationary pressures.

According to the results from the credit portfolio shock test, the capital position of the banking sector, in general, could withstand shocks in two of the three designed scenarios (Chart 71, Table 7). At the level of banks, in the most severe scenario, many of them would face the need for additional capital to cope with shocks to their credit portfolio.⁴⁰

The results from the shock test on the liquidity position suggest that the banking sector has the financial capacity to withstand the supposed withdrawal of a significant number of deposits. In all the assumed scenarios, the liquidity position of the majority of banks is stable, except for the assumption of withdrawals of 38.6 percent of deposits at the end of the fifth day in a row, where four banks would be presented with a lack of liquid funds (Table 9).

5.6.1 Assessment of resilience to shocks in the credit portfolio and capital position

The stress-test analysis for credit risk assesses the sustainability of the banking sector, for a period of one year based on this year's situation, against possible shocks in the credit portfolio, as well as in the capital position, from unfavourable developments. The analysis was carried out through the application of three scenarios: the basic, moderate and severe scenario which as a starting point have the assumptions of the decrease in economic activity due to the increase in inflation (Tables 5 and 6). In the first two scenarios, credit

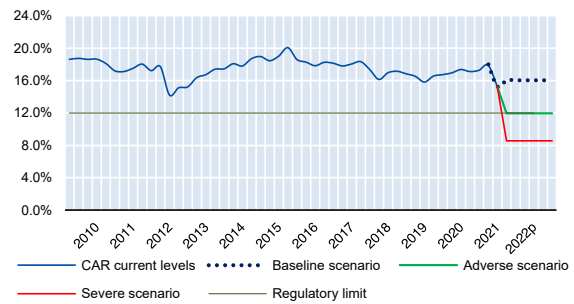
³⁹ The rate of inflation growth is predicted with the ARIMA statistical model.

⁴⁰ 10 out of 11 banks operating in the Kosovo market are included in the analysis. Credins Bank is not included, considering it is at the beginning of its activity.

growth is assumed to be 10.1 per cent, lower than this year's growth, and 7.0 per cent in the severe scenario, due to uncertainties about the progress of inflation and economic activity (Table 5).

The basic scenario relies on expected macroeconomic developments. In this scenario, economic activity in the country is forecasted to have a positive growth of 2.5 per cent. Economic growth is assumed to be accompanied by slower credit growth⁴¹ (tables 5 and 7). It is also assumed that higher incomes will be realized because the income from interest on loans can increase from the increase in lending. These assumptions are reflected in the calculation of the profit for the 2022, so that the net profit after tax realized during the year 2021 was taken as the basis, to which the deduction of the revenues that would have been realized if the NPL had not been increased. In this case, the profit will be lower than in the current year by 1.7 per cent due to the increase in NPLs in addition to the increase in lending.⁴² The results based on these assumptions suggest that the ratio of non-performing loans will increase by 0.91 percentage points, but the sector turns out to be resistant to the growth of NPLs, in which case the capitalization rate will improve to 16.0 per cent from the current level 15.1 per cent.⁴³ The increase in the capitalization rate results because the revenues anticipated to be realized in the following year are greater than the requirements for the expected additional provisions, as well as due to the inclusion of the profit realized in the current year in the calculation of capital level, under the assumption that no dividend will be distributed (Chart 71, Chart 72, Table 7). Two banks, which are bank branches and therefore are not subject to the minimum capital requirement of 12 per cent, would experience deterioration of the capital position.

Chart 71. Capital Adequacy Ratio, by scenarios



Source: CBK.

In the other two scenarios, it is assumed that there will be stagflation, a decline in economic activity accompanied by a higher level of inflation. The intensification of the war in Ukraine and the imposition of economic and financial sanctions against Russia, the duration of which remains uncertain but whose consequences will be evident, will further exacerbate supply-side constraints that will potentially further put pressure on prices. Inflation in the country is expected to be significantly higher compared to the base scenario since the Kosovar consumer basket has a high participation of the most affected categories (food and transport) from the newly created crisis and which are marking the highest growth high prices. The increase in prices will directly affect the standard of living and the solvency of the consumer.

The moderate scenario assumes that economic activity will suffer a decrease of 4.7 per cent in 2022. Consequently, based on the coefficient of elasticity of NPLs to economic growth, the rate of non-performing loans will increase by 6.7 percentage points, in 8.9 per cent (Table 6). These assumptions are reflected in the profit calculation for a period of one year, so that the net profit after tax generated for 2021 is taken as the basis, reduced for the revenues that will not be generated due to the increase in the NPL rate.⁴⁴ Profit for 2022 will

⁴¹ According to banks' forecasts for 2022, the annual growth of banking sector lending will average 10.1 per cent (provided by the Department of Banking Supervision)

⁴² The impact of these developments on the quality of the credit portfolio is calculated through the coefficient of resilience of non-performing loans to the production gap of 0.8pp. IMF research paper, unpublished, 'CESE Bank Loss Projection and Stress Testing Exercise', July 2009.

⁴³ The provisioning ratio according to the credit pillars for each bank, in order to calculate the additional provisions necessary with the increase of NPLs, has been determined to be the same as the provisioning ratio of each correspondent bank, which is realized in 2021.

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

suffer a shock, reduced by 12.7 per cent, as a result of the loan defaults increase rate. The losses of the sector would reach the value of EUR 196.0 million (Chart 72). These losses will be charged directly to capital, but the high level of current provisions held to cover loan defaults makes the sector more resilient to the shocks assumed in this scenario, with the capital adequacy ratio declining to 12.0 per cent. However, six banks would be undercapitalized, including two banks of general systemic importance for which the capital adequacy ratio would drop to 10.8 per cent and 9.9 per cent, respectively. The additional funds needed to raise the capital to the minimum required level will reach the value of EUR 54.4 million (Table 7).

In the adverse scenario, more extreme negative developments of the current dynamics and higher sensitivity of the economic activity in the country to these developments, although with a lower probability of occurrence, are estimated. Inflation is assumed to rise to 20.0 per cent while the economic downturn will to be 11.6 per cent. This situation can be characterized by increased uncertainty in the generation of incomes and further weakening of the borrowers' solvency. Whereas lending is assumed to increase by 7.0 per cent, at the same rate as in the pandemic year when most activities were limited or even prohibited. The banking sector would cope with an increase in the ratio of non-performing loans by 12.2 percentage points, increasing to 14.4 per cent. In the analysis, the possibility of realizing collateral or increasing capital from other sources is not considered, since the efficiency and possibility of realizing these actions is very uncertain in times of crisis. Profits will suffer a shock from the increase in the failure rate of existing loans, decreasing by 22.5 per cent.

The sector losses would reach the value of EUR 336.7 million (Chart 72) and the level of capitalization after the shock will go down to 8.6 per cent, below the regulatory minimum (Table 6). The number of banks with problems in the capital position would increase to eight, of which four are systemically important

banks, whose CAR would decrease to 10.6 per cent, 8.8 per cent, 8.1 per cent and 6.5 per cent. The additional funds needed to raise the capital to the required minimum level would reach the value of EUR 160.1 million (Chart 72, Table 7).

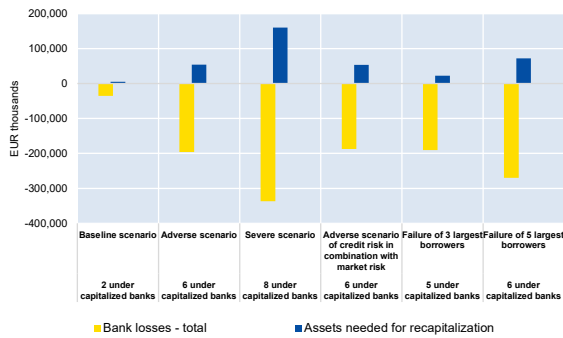
5.6.1.1 Credit risk scenario combined with market risk

The moderate credit risk scenario, which forecasts an economic decline of 4.7 per cent is associated with the market risk scenario, namely with the assumption of a 2.0 percentage point increase in interest rates in the banking sector's balance sheet positions (Table 5). Practices prove that in times of crisis, the initial reaction of creditors would be to increase interest rates due to increased risk. While as a response, the demand for lending would decrease due to the uncertainty for investment, which consequently in a later stage would create pressures to reduce interest rates in order to stimulate economic activity. However, the assumption of an increase in interest rates in this scenario is based on the current situation of increased inflation and the fact that some monetary authorities (the US Federal Reserve and the Bank of England) have already raised the basic interest rates to control inflation and forecast further increase throughout 2022. Also, the monetary authority of the Eurozone has given signals that the possibility of increasing the basic interest rates is not excluded, and this will indirectly affect the interest rates in the country. The analysis is based on 1-year static balance sheet; therefore, it is considered that the same instruments that mature within one year will be reinvested and refinanced with assumed interest rates in this scenario.

The share of non-performing loans to total loans remains the same as in moderate credit risk, at 8.9 per cent. While the sector losses with application of the assumption on the increase of interest rates would be reduced to the value of EUR 187.1 million from EUR 196.0 million from the moderate scenario (Chart 72). The assumption of an increase of interest rates has had positive effects on net interest income, resulting from the fact that the sector has a

positive balance sheet gap with sensitivity to interest rates and under the assumption that the same positions will be reinvested, then as a result of the revenues of the sector will be higher even with other negative effects that this assumption may have (such as increased costs for borrowers).

Chart 72. Stress test results for credit risk-losses and recapitalization



Source: CBK.

The level of capitalization after the shock results in 12.2 per cent for 2022, which is above the regulatory requirements (Table 7). At the level of individual banks, six banks would cope with capitalization problems, of which two banks of general systemic importance, whose CAR would drop to 10.5 percent and 10.1 percent, respectively. The additional funds needed to raise the capital to the required minimum level would be a total of EUR 53.8 million (Chart 72 and Table 7).

5.6.1.2 Scenario of the risk from failure of large credit exposures

In this scenario, the stability of the banks against the possible failure of the three and five largest borrowers has been evaluated. The assumption of the failure of **the three largest borrowers** would affect the capitalization level of the sector to fall to 12.1 per cent and the losses to reach EUR 190.3 million (Chart 72 and Table 7).⁴⁵ Five banks would cope with

the high losses, among them two bank branches that are not subject to capital regulation and two banks of general systemic importance, whose CAR would drop to 10.5 and 10.9 per cent, respectively.

The failure of **the five largest borrowers** would further worsen the situation in these five banks, as well as another bank that would also result under-capitalized. The losses would reach EUR 270.0 million and the CAR of the sector would decrease to 10.1 per cent. Under-capitalized banks would need an additional EUR 72.4 million to increase capital to the minimum regulatory level (Chart 72 and Table 7). **The results of this scenario suggest that the sector is sensitive to large exposures, whose performance should be closely monitored under the current crisis conditions. It is also emphasized that the increase in the concentration of credit exposures in conditions of further deepening of the economic crisis represents a marked increase in the sensitivity of credit risk.**

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

The banking sector is able to handle the NPLs to total loans ratio up to 8.87 per cent without need for additional capital injection to maintain the sector's CAR at the required regulatory level. Also, the NPLs affordability levels of each bank before capital problems appear are high for some banks. The exception is one systemically important bank, which could only afford an increase in the NPL rate up to 6.1 per cent. The highest level of coping with the increase in the NPL rate is 15.9 per cent of the total loan portfolio, before the bank is presented need for additional capital.

⁴⁵ The large exposures reported by bank branches are included in the analysis, although operate in the capacity of branches of foreign banks, these institutions are not subject to the regulation for limiting the ratio of

exposures to the first class capital of the bank, but to the capital of the first class of parent banks, despite this, cannot exceed the amount of EUR 25 million

Table 5. Assumptions for credit risk scenarios

Indicators	Baseline scenario	Adverse scenario	Severe scenario
	Assumptions		
GDP (real growth rate, %)	2.5	-4.7	-11.6
Gross loan (credit growth rate, %)	10.1	10.1	7.0
Interest rates increase on balance positions (for percentage points)	n/a	2.0 pp	n/a
profit (profit growth rate, %)	-1.7	-12.7	-22.5

Source: CBK.

Table 6. Coefficient of NPL rate resilience

Description	Resilience	NPL rate reactions		
		Baseline scenario	Adverse scenario	Severe scenario
Expansion of output gap	0.80 pp	0.91 pp	6.67 pp	12.19 pp

Source: CBK.

Table 7. Results of stress test scenarios for credit risk

Description	Number of banks with CAR<12%	Capitalization rate			NPL rate			Additional assets needed for recapitalization (EUR thousands)
		higher level	lower level	sector level	higher level	lower level	sector level	
Current levels (prior to shocks)		52.5	10.1	15.1	3.1	0.0	2.2	
Scenarios results								
Baseline scenario: NPL growth rate for 0.91pp, credit growth for 10.1%, profit decline for 1.7%	2	52.9	9.0	16.0	4.0	0.9	3.2	4,820
Adverse scenario: NPL growth rate for 6.67pp, credit growth for 10.1%, profit decline for 12.7%	6	52.2	5.2	12.0	9.8	6.7	8.9	54,359
Severe scenario: NPL growth rate for 12.19pp, credit growth for 7.0%, profit decline for 22.5%	8	51.7	1.8	8.6	15.3	12.2	14.4	160,122
Adverse scenario of credit risk in combination with market risk	6	52.7	4.9	12.2	9.8	6.7	8.9	53,769
Failure of three largest borrowers	5	18.6	10.5	12.1	36.8	2.2	8.7	22,666
Failure of five largest borrowers	6	16.4	8.3	10.1	51.4	2.2	11.6	72,428

Source: CBK.

5.6.2 Assessment of resilience to shocks in the liquidity position

The resilience test of the liquidity position of the banking sector aims to assess the financial ability of banks to cope with the lack of liquidity caused by extreme situations.

The test is based on two hypothetical scenarios that assess the sufficiency of banks' liquid assets to cope with withdrawals of a value of deposits within 5 days, as well as coping with the risk of failure of concentrated deposits. The scenarios are quite conservative due to the fact

that the possibility of banks meeting part of the liquidity needs through external sources of financing has not been taken into account.

Scenario 1: Withdrawal of deposits on a daily basis

In this scenario, the withdrawal of deposits divided by structure and subjects, at different levels of withdrawals on a daily basis (Table 8), for five consecutive days, is taken into consideration. After each day, 5 per cent of the

deposits are allocated from the remaining deposits for the purposes of the bank's operation in the following days. This implies that, under the assumed scenarios, the reserve requirement of 10 per cent would be halved. The scenario is also built on the assumption that during this period the possibility of

converting liquid assets into cash would be 80 per cent of liquid assets, while non-liquid assets would be only 1 per cent of these assets within the day.

Table 8. Assumptions for liquidity risk scenarios

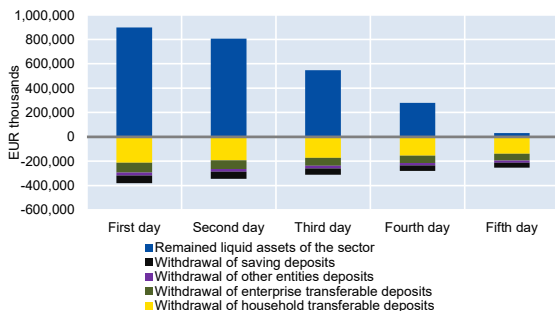
Withdrawals of deposits	Assumptions for time withdrawals	Level of deposits withdrawal
Households- Transferable Deposits	Every day, for 5 consecutive days	10.0%
Enterprises - Transferable deposits	Every day, for 5 consecutive days	9.0%
Other entities - Transferable deposits	Every day, for 5 consecutive 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.

While the banking sector in Kosovo has no history of previous financial crises and the practice of the pandemic did not provide high levels of deposit withdrawals, then more extreme levels have been assumed to assess the banking sector capacity to cope with the losses if such a situation would 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 withdrawal situations in the past.

would need liquidity. On the fifth day, liquidity problems would appear in four banks, including three banks of general systemic importance. The value of liquid assets in the absence would reach EUR 79.2 million (Chart 73, Table 9). The general withdrawal rate of deposits in the banking sector on the fifth day would reach 38.6 per cent of total deposits (Table 9).

Chart 73. ST results for liquidity risk - scenario 1



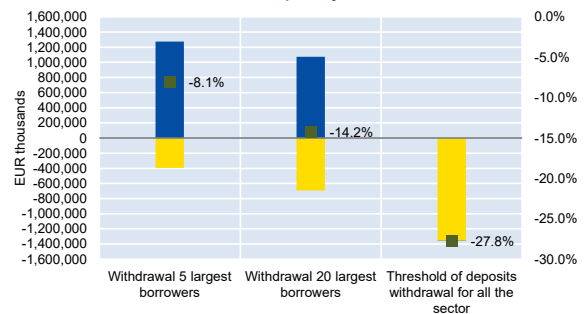
Source: CBK.

The scenarios results suggest that the most of banks would be able to afford to withdraw deposits according to the defined levels, on a daily basis until the fourth day, when a bank

Scenario 2: Withdrawal of deposits from larger depositors

The banks' liquidity position turns out to be able to withstand deposit withdrawals from the **five largest depositors**.

Chart 74. ST results for liquidity risk - Scenario 2



Source: CBK.

While under the assumption that **the twenty largest depositors** of each bank will withdraw their deposits within the day, then the liquidity situation would weaken in three banks. The lack of funds for these three banks would reach EUR 31.8 million (Chart 74, Table 9). **The results of this scenario generally suggest that the banking sector of Kosovo does not have a significant concentration of the source of financing, namely deposits.**

5.6.2.1 Coping level of deposit withdrawal before the liquidity position reaches critical levels

Liquidity problems for the entire banking sector would arise in case of withdrawal of 27.8 per cent of deposits within a day, which means that the banking sector may be able to cope with the withdrawal of close to one third (1/3) of the total deposits without needing additional liquid assets (Chart 74 and Table 9). Whereas at the bank level, the bank with the lowest withdrawal threshold stands at 22.0 per cent, while the bank with the highest at 68.0 per cent and 32.0 per cent (as a result of the high level of liquid assets they possess).

Table 9. Results of stress test scenarios 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	4	-38.6%	(79,215)	124.4%
Scenario 2.1: Withdrawal of deposits from 5 largest borrowers	0	-8.1%		83.1%
Scenario 2.2: Withdrawal of deposits from 20 largest borrowers	3	-14.2%	(31,756)	89.1%
Threshold - Withdrawal of deposits to the critical level of liquidity		-27.8%	(84,014)	105.8%

Source: CBK.

Box 5. Climate change and its importance to financial stability

The topic of climate change and the accompanying impacts on social welfare and financial stability will be included for the first time in the Financial Stability Report. However, before elaborating on the impacts that climate change has on the financial system, the basic concepts of climate change, as well as global and local initiatives in this regard, will be elaborated.

Introduction

Intensification of human activity affected the increase in economic activity, which consequently intensified production at the global level. The increase of intensity in production and the nature degradation influenced the increase of greenhouse gases, such as carbon dioxide, nitrogen oxide and methane, which are accumulated in the atmosphere preventing the release of heat out of

the planet, the phenomenon also known as the greenhouse effect (according to the estimates of NASA⁴⁶, the level of carbon dioxide increased by 50 per cent compared to the pre-industrial period (1750). As a result, the increase in the level of these gases causes an increase in temperature and fluctuations in climate balances, which bring about the frequency of natural disasters, such as floods, droughts and fires. Consequently, the impact of climate change poses an increasing risk to social well-being, economic development and financial stability in the future. According to UNEP FI⁴⁷ estimates, the continuation of current levels of climate change carries an annual cost of between 5 and 20 per cent of global GDP. In Kosovo, greenhouse gas emissions during 2019 were around 9.6 million tons⁴⁸, whereas in 2020, this figure dropped into 7.9 million tons⁴⁹ due to the decline in general economic activity as a result of the COVID-19 pandemic. This trend also characterized the performance of the emission in

⁴⁶ NASA Global Climate Change, <https://climate.nasa.gov/vital-signs/carbon-dioxide/>

⁴⁷ UN Environment Programme Finance Initiative, <https://www.unepfi.org/climate-change/climate-change/>

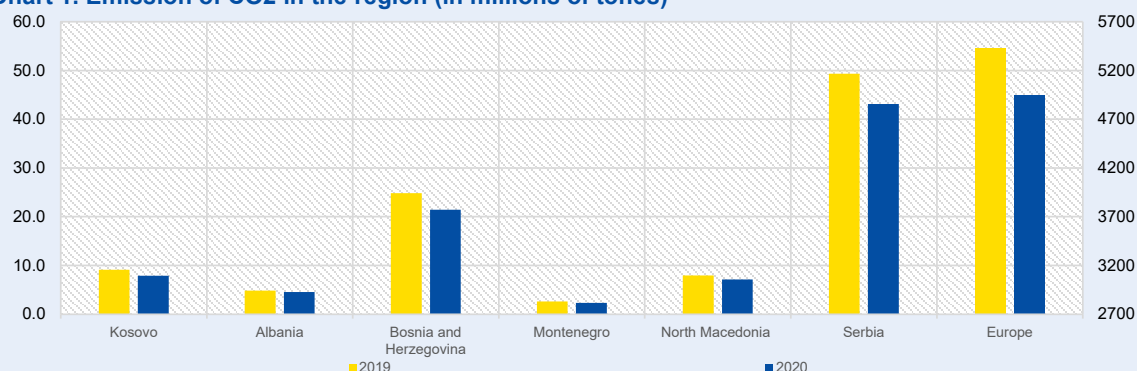
⁴⁸ KEPA, Emission of Greenhouse Gases in Kosovo 2014-2019, 2021

⁴⁹ Global Carbon Project. (2021). Supplemental data of Global Carbon Project 2021 (1.0) [Data set]. Global Carbon Project. <https://doi.org/10.18160/gcp-2021>

the region and at the global level. In comparison with the region, Kosovo is ranked the third country with the highest emission (Chart 1).

However, at the global level, the emission of greenhouse gases in Kosovo is marginal.

Chart 1. Emission of CO₂ in the region (in millions of tones)



Source: Global Carbon Budget - Global Carbon Project.

As according to the Kosovo Agency for Environmental Protection (KEPA), about 99 per cent of the greenhouse gases emitted in Kosovo consist of carbon dioxide (CO₂), in the following we will take CO₂ as the basis of the analysis. The energy sector constitutes the sector with the highest CO₂ emission at about 86 per cent, followed by the sector of agriculture, forestry and land use with 8 per cent, whereas 5 per cent of the emission of greenhouse gases in Kosovo is the waste sector (Chart 2). According to KEPA, the total CO₂ emissions in Kosovo are highly dependent on the amount of electricity produced from coal, which is the main source of CO₂ emissions in our country.

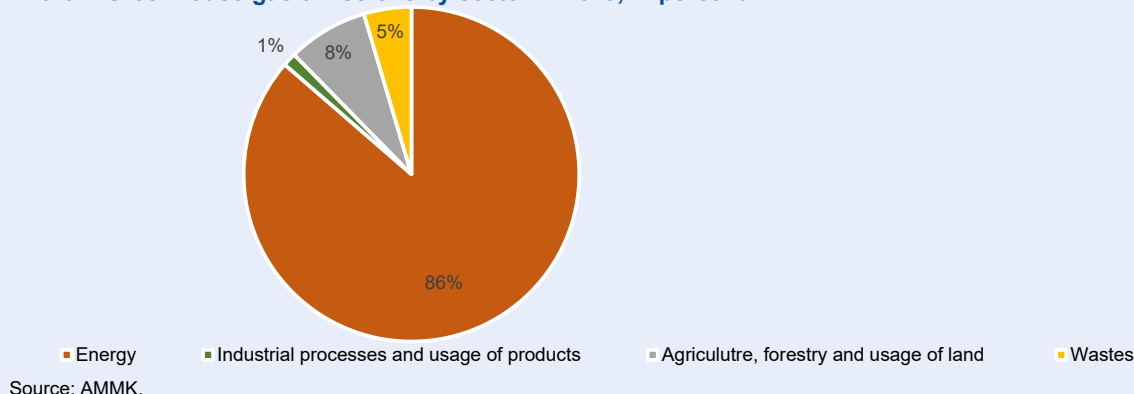
The identification of the effects of climate change led to awareness raising about the risks they carry, and as a response, initiatives to reduce them also began. Although various initiatives started decades ago, at the end of 2015, 196 countries adopted the Paris Agreement that entered into force in November 2016. The aim of this agreement is to restrain global warming or the emission of greenhouse gases and build resilience to face the effects of rising temperatures. The Paris Agreement represents an important step towards the fight against climate change, as it legally obliges the participating states to report on medium-term (5-year) objectives in the fight against global warming, objectives that must be advanced (be progressive) over the next periods. Progress towards the objectives within the framework of the Paris Agreement requires economic and social transformation. Also, considering the high financial cost of this process, the agreement also

specifies financial support and capacity building for developing countries.

Regarding initiatives for the management of climate change in the country, the Government of Kosovo approved the Climate Change Strategy 2019-2028 and the Action Plan for Climate Change 2019-2021. This strategy defines policies for reducing greenhouse gas emissions and adapting to climate change, policies that would provide sustainable economic development through reforming the economic model. According to this strategy, the areas affected and which at the same time increase the risk from climate change, among others, are industries that use outdated technologies (example: thermal power plants), uncontrolled construction and urbanization, socio-economic instability as a result of the high degree of poverty in the country, as well as unsustainable agricultural practices⁵⁰. Also, the Government of Kosovo signed in October 2020 the Sofia Declaration, which, in line with the Green Agenda for the Western Balkans, provides promotion to increase energy efficiency for the private sector and households, the support of renewable energy projects, as well as the adaptation of an action plan for the gradual adjustment of electricity tariffs. This declaration also foresees the adaptation of a long-term strategy for energy and climate, which, among other things, focuses on the reduction of CO₂ emissions and plans for the gradual removal of subsidies on coal and fuel.

⁵⁰ Climate Change Strategy 2019-2028 and action plan for climate change 2019-2021, Government of Kosovo, 2018

Chart 2. Greenhouse gas emissions by sector in 2019, in percent



Furthermore, in January 2022, the Government approved the establishment of the National Council for Climate Change, which will be responsible for monitoring the implementation of the adopted strategies and plans for the management of climate change. The local activities that will be undertaken must be in line with commitments within global and regional initiatives, such as the United Nations Framework Convention on Climate Change, the Paris Agreement, as well as the Green Agenda for the Western Balkans.⁵¹ In June 2022, the Government of Kosovo drafted the National Energy Strategy 2022-2031. Pending the review and approval by the Assembly, this strategy will focus, among other things, on investments in renewable energy sources, decarbonisation of energy, as well as security in electricity supply.

Impact on the financial system

To analyse the impact of climate change risks, the effects of two types of risks arising from these changes must be taken into account, which are physical and transition risks. Specifically, the physical risk comes from unforeseen climatic events, such as fires, floods, storms, as well as predictable and gradual events, such as global warming or rising water levels. This risk, among other things, can directly affect productivity, damage assets or indirectly disrupt supply chains. Whereas, the transition risk mainly results from the necessary changes in economic activities and reflects all costs of making the relevant changes, to move to an economy with low CO₂ emissions. The transition risk may be triggered, among other things, by changes in fiscal policies or environmental and climate change policies, technology advancement, as well as changes in consumer preferences or sentiment. A large part of

the sectors most be affected by climate change, such as agriculture, energy, transport, construction and manufacturing carry both types of risks.⁵² Climate changes have an impact on the activities of companies and as a result, affect the real sector being reflected in increased risk in the financial system as well. In terms of the banking sector, climate change risks contribute in increasing of existing risks, such as credit risk, operational risk, market risk and liquidity risk.

Clarification: To further elaborate and understand the nature of the impact of climate change risks, credit and operational risk are taken as examples. Credit risk comes from external factors, such as the performance of repayment of obligations by customers. Specifically, in terms of physical risk, the banking sector can be affected by the fall in the value of collateral due to physical damage, or in terms of transition risk, it can be affected by the increase in expenses to cover the advancement of technology (for lower CO₂ emission), which is consequently reflected in the financial performance of the customer. On the other hand, operational risk is mainly based on internal factors such as the bank's policies and strategy. From the perspective of physical risk, it can be affected by physical damage to bank branches as a result of natural disasters, while in terms of transition, it can be affected by reputational risk as a result of financing projects with negative consequences on the environment.

The financing structure of the economic sectors, which reflects the exposure of the banking sector to sectors with high CO₂ emissions, as well as sectors with a certain geographical position, determines the impact assessment of this risk on the banking sector. Regarding lending structure in Kosovo, the trade sector has a high weight of 43.4

⁵¹ Document on Decision, 2022, <https://kryeministri.rks-gov.net/ep-content/uploads/2022/01/Vendimet-e-mbledhjes-se-54-te-Queverise-se-Kosoves-1.pdf>

⁵² ECB, 'Guide on climate-related and environmental risks', November 2020 (<https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.202011finalguideonclimate-relatedandenvironmentalrisks-58213f6564.en.pdf>)

by climate change. This type of financing in Kosovo is supported by various development programs for the promotion of green investments in the country. Funds from the relevant programs enable lending with more favourable conditions to clients who invest in green projects, whether households that will invest in the construction or renovation of houses with high energy efficiency technology or companies that invest in technology and processes for reducing CO₂ emissions their economic activities. Within the initiatives for the Western Balkans, it is worth highlighting the EBRD program, Green Economy Financing Facility, a program with a capital of EUR 85 million that supports households to invest in green technologies that increase energy efficiency through financing from financial institutions participating in the program and operating in the country.⁵⁴ This program includes 5 financial institutions. In addition, the investment fund initiated by the European Investment Bank (EIB) and the German Development Bank (KfW), Green for Growth Fund (GGF), KfW aims to alleviate climate change and sustainable economic growth through investment in measures that reduce consumption and the use of resources, as well as the CO₂ emission.⁵⁵ The fund operates through targeted financing for enterprises and households through financial institutions and through direct investment in projects and companies. This fund consists of four financial institutions in the country, with an investment portfolio of EUR 14.2 million.⁵⁶

Furthermore, the Kosovo Credit Guarantee Fund (KCGF) within the regulatory policies for the provision of guarantees also includes the Environmental and Social Management Policy and Framework based on which the decision to issue the guarantee is made. Through these policies, KCGF aims to identify and address climate risks related to the activities for which it provides guarantees. Moreover, KCGF does not offer credit guarantees for activities with high CO₂ emissions, which are listed in this policy.⁵⁷ In addition to green financing, financial institutions must ensure that within the institution they implement and monitor policies on environmental protection, whereby they indirectly contribute to decarbonisation. This means, among other things, efficiency in the use of energy, digitization of the institution's operational processes and digitization of the customers' services provision.

Adequacy of the regulatory framework

The main responsibility to develop, implement and monitor adequate policies to reduce the effects of climate change falls on governments. However, the materialization of risks from (physical and transitional) climate change has a significant effect on macroeconomic developments and on the increase of financial risks. In this case, maintaining financial stability falls under the mandate of the central bank. Consequently, the supervision of the effects of climate change on the financial system must be part of the regulations and operations of central banks or relevant supervisory institutions. Although initiatives to reduce and manage climate change began decades ago, initiatives to incorporate climate change risks into the regulatory framework have only begun in recent years, given the challenge of quantifying and assessing the effects of climate change on the financial system. Precisely, the Basel Committee on Banking Supervision and the European Banking Authority at the end of 2021, within the framework of the 'Guidelines for addressing the risks from climate change'⁵⁸, have started with the assessment of whether the current Basel regulatory framework sufficiently covers the specific features of the risks of climate changes and issuing proposals to address potential shortages. Also, with the initiative of the European Commission, the relevant institutions in the supervision of systemic risk will evaluate and potentially modify the adequacy of policies and macro prudential measures to address these risks.⁵⁹ The current regulatory framework addresses the management of lending, liquidity, solvency and operational risks. As it was emphasized above, the risks from climate change contribute to these risks of the banking sector, in this respect it is expected that the possible effects from the aforementioned risks will be covered by this regulatory framework. However, the current framework for supervision of financial institutions mainly relies on historical data to assess the relationship between risk factors and exposures, including periods of economic downturns and crises. Consequently, the focus on future periods and the uncertainties and unknowns associated with the effects of climate change pose a significant challenge for the accurate assessment of relevant risks. Precisely, the difficulties in assessing the impact of climate change based on the current regulation lie in the inclusion of risks from climate change in the determination of the risk weights of assets, in the requirements for additional capital, the inclusion of exposure to climate

⁵⁴ For more information, see <https://ebrdgeff.com/kosovo/the-programme/the-facility/>

⁵⁵ For more information see <https://www.ggf.lu/about-green-for-growth-fund>

⁵⁶ H2 2021 Country Fact Sheet Kosovo, GGF https://www.ggf.lu/fileadmin/user_upload/Publications/Country_Fact_Sheets/GGF_Kosovo_Fact_Sheet_H2_2021.pdf

⁵⁷ Environmental and Social Management Policy, KCGF, <https://fondikgk.org/wp-content/uploads/2021/07/Politika-e-Menaxhimit-Medisor-dhe-Social.pdf>

⁵⁸ FSB Roadmap for Addressing Climate-Related Financial Risks, 2021, Financial Stability Board, full document can be found at <https://www.fsb.org/ep-content/uploads/P070721-2.pdf>

⁵⁹ ECB 2021, https://www.ecb.europa.eu/pub/financial-stability/macprudential-bulletin/html/ecb.mpbu202110_1-5323a5baa8.en.html

change within the limits and adjustments for large exposures, lack of coverage of climate change risk in indicators and liquidity requirements.⁶⁰

Furthermore, the lack of quality data on the financial system's exposure to climate change risks, both at high frequency and at a granular level, presents an additional challenge.

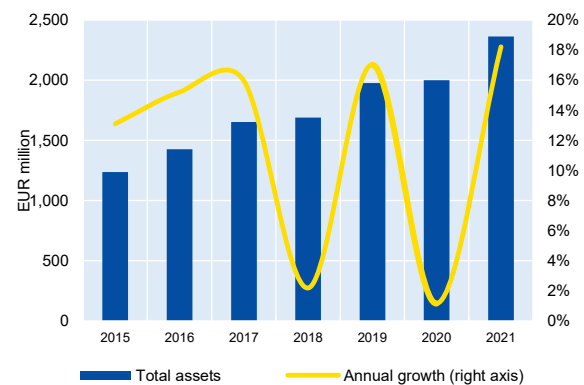
This lack means difficulties both in assessing the risks from climate change, as well as in justifying the adequate assessment of the basis for the necessary regulatory changes in this view. While the rules for the supervision of financial institutions will help address the risks from climate change at the micro level, macro prudential policies will address the same at the system level. Regarding the adequacy of macro prudential policies, it is estimated that the flexible nature of the available measures can serve efficiently and in the shortest time frame in limiting sensitive exposures to the effects of climate change, as well as simultaneously promote the financing of 'green' investments. However, the high complexity, long time frames, partial irreversibility of climate risks mean a high level of uncertainty about their timing and impact, which presents difficulties in forecasting the relevant risks and consequently underestimating their impact on financial stability.⁶¹ In addition, the legal and operational aspects are factors that contribute to the challenges of reviewing and implementing changes in policies and the relevant regulatory framework.

6. Non-banking financial institutions

6.1 Pension sector

The pension sector in 2021 marked accelerated growth in activity, which is mainly attributed to the increase in vaccination rates and economic recovery at the global level. The return on investment at the end of the year exceeded pre-pandemic levels and reached a record value.

Chart 75. Assets of the pension sector



Source: CBK.

The value of assets reached EUR 2.36 billion at the end of 2021, which corresponds to an annual growth of 18.2 percent (Chart 75).⁶² This growth is attributed to the high return on investments, as well as the increase in collections from contributors. The higher level of return on investment came as a result of the global economic recovery after the economic recession caused by COVID-19 in the previous year.

New collections marked an annual increase of 9.8 percent (4.2 percent in 2020), the value of which reached EUR 213.5 million at the end of the year. The accelerated growth of collections from contributors was attributed to the opening of the economy during this year compared to last year, where there was closure

⁶⁰ ECB 2021, https://www.ecb.europa.eu/pub/financial-stability/macprudential-bulletin/html/ecb.mpbu202110_1~5323a5baa8.en.html

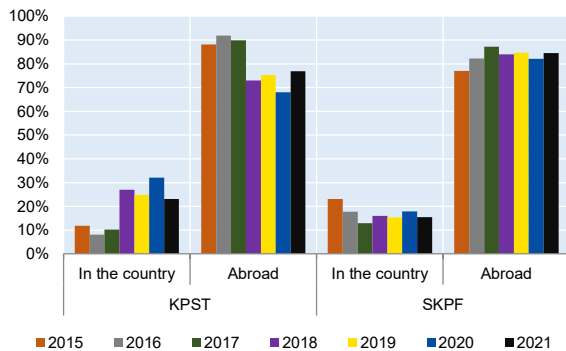
⁶¹ A theoretical case for incorporating climate risk into the prudential framework, ECB 2021.

⁶² Kosovo Pension Savings Trust (KPST) in December 2021 had a share in the total assets of the sector of 99.6 percent, while the rest are assets managed by the Slovenian-Kosovar Pension Fund (SKPF).

of the economy (operation of only essential sectors) and restrictions with the external sector.

The value of the assets of KPST, which manages 99.6 percent of the total assets of the pension sector, reached EUR 2.35 billion, representing an annual increase of 18.2 percent. **The structure of KPST's assets continues to be dominated by investments in the foreign market, which have marked an increase in the share compared to the previous year, as a result of positive prospects compared to the uncertainty for investment a year ago.** Investment portfolio in foreign markets increased to EUR 1.81 billion, representing an annual increase of 33.7 percent (annual decrease of 8.6 percent in 2020).

Chart 76. Structure of pension sector investments

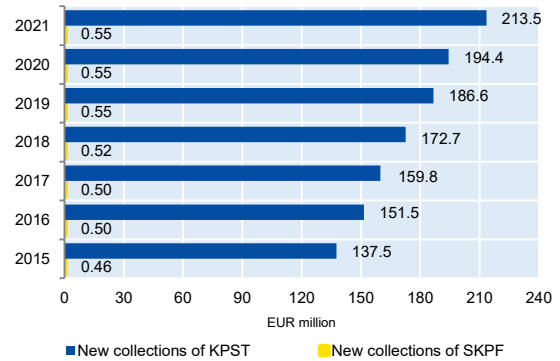


Source: CBK.

As a result, the share of investments abroad in December 2021 reached 76.9 percent of the total assets of KPST (68.0 percent in 2020). The value of investments within the country decreased to EUR 544.6 million, representing an annual decrease of 14.6 percent (Chart 76).

Within the framework of investments within the country, the securities of the Government of Kosovo continue to be the category with the largest share, followed by that of certificates of deposit and cash held in the country. The share of securities increased to 90.3 percent (70.7 percent in 2020), while certificates of deposit decreased to 8.2 percent (20.3 percent in 2020). The share of the cash held in the CBK in all assets held within the country decreased to 1.5 percent from 8.9 percent participation in 2020.

Chart 77. Contributions collected by pension funds



Source: CBK.

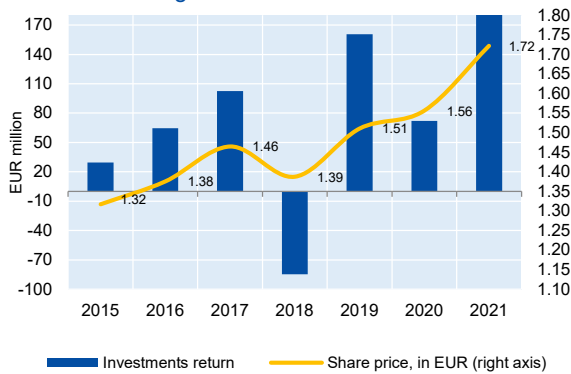
Compared to the previous period, investments in the domestic securities market showed a slower growth (for 9.0 percent from 50.8 percent in the previous year), which reflects the decrease in the request of the Government of Kosovo to finance its activities through debt issuance, as well as competition from the banking and insurance sectors. Meanwhile, placements in certificates of deposit decreased by 65.4 percent, which reflects the reallocation of part of the funds in the external sector.

At the end of 2021, the value of total assets of SKPF reached EUR 9.5 million, marking an annual increase of 11.1 percent. However, the new collections marked the value of EUR 546.4 thousand, which corresponds to an annual decrease of 1.4 percent (Chart 77). **The majority of SKPF assets continue to be invested abroad, respectively 79.3 percent of total assets.** The structure of investments abroad consists mainly of investments in the form of shares (87.2 percent), securities (7.8 percent), and cash (5.1 percent). On the other hand, investments in Kosovo decreased by 3.0 percentage points, with a share of 20.7 percent of the total assets of SKPF. Investments in the domestic market were distributed in securities of the Government of Kosovo (64.7 percent), deposits in commercial banks (3.6 percent), cash in the SKPF treasury (1.6 percent), and others (30.1 percent).

6.1.1 Pension Sector Financial Performance

The pension sector closed the year 2021 with extremely good financial performance, accomplishing a positive return on investments in record value since the beginning of the operation.

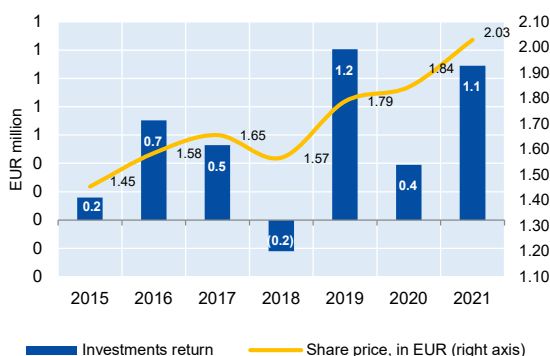
Chart 78. Financial performance of Kosovo Pension Saving Trust



Source: CBK.

Increasing of vaccination rates and economic recovery at the global level had an impact on the improvement of the performance of global markets, which impacted the increase in return from investments for the pension sector of Kosovo. The gross return from investments reached the record value since the beginning of operation of EUR 228.4 million, and significant increase in unit price compared to last year.

Chart 79. Financial performance of Slovenian-Kosovo Pension Fund



Source: CBK.

KPST accomplished a gross return on investments in the amount of EUR 227.3 million, with a unit price of EUR 1.72 from EUR 1.56 on the last day of December 2020 (Chart 78). During 2021, SKPF accomplished a gross return on investments in the amount of EUR 1.1 million, while the unit price increased

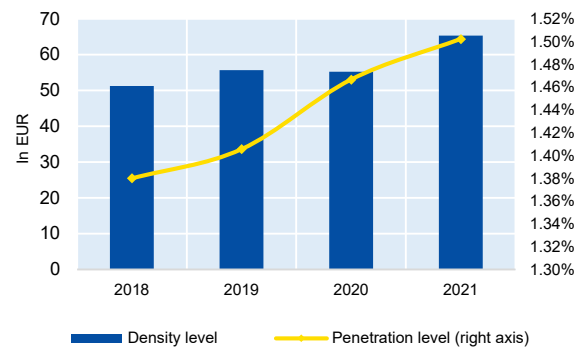
to EUR 202.86 from EUR 184.38 at the end of December 2020 (Chart 79).

6.2 Insurance sector

6.2.1 Activity of the insurance sector

The insurance sector in 2021 was characterized by the expansion of activity, which was reflected in the high level of written premiums. Also, the sector generated a high level of profits compared to the historical average, despite the increase in the level of claims paid.

Chart 80. Development indicators of the insurance sector



Source: CBK.

The insurance sector is the fourth largest sector within the financial system with a share of 2.7 percent in the total assets of the financial system.

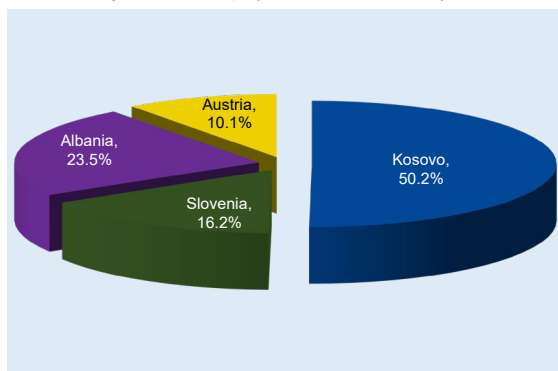
The level of intermediation and density of the insurance sector remains similar to previous years, with marginal annual growth (Chart 80). Expressed through gross written premiums in relation to GDP, the intermediation of the sector continues to remain at a relatively low level compared to the average of the countries of the European Union, to 1.50 percent (1.47 percent in 2020). Similarly, low remains the level of density, measured through premiums written per

capita, which in 2021 reached the value of EUR 65.3 (EUR 55.2 in 2020).⁶³

The structure of the insurance sector continues to be dominated by the services of 'non-life' insurers, representing 91.3 percent of the assets of the insurance market, while the remaining part consists of the assets of 'life' insurers.

Half of the insurance market is represented by local insurers (50.2 percent), while the other part by the insurers of foreign origin. Within the companies with foreign capital, insurers from Albania have the highest share in assets, followed by insurers from Slovenia and insurers from Austria (Chart 81).

Chart 81. Structure of assets of insurance sector, by ownership (December 2021)



Source: CBK.

The insurance market in Kosovo is characterized by a lower degree of concentration compared to other sectors of the financial system. However, in the last three years we have a slight increase in concentration as a result of the liquidation of two insurance companies (one in 2019 and another in 2021). Herfindahl index⁶⁴ for gross written premiums (GWP) has risen to 981 points from 925 points in 2020). The same index calculated based on insurance market assets shows lower values, but also increasing, namely 913 points for 2021 from 845 points in 2020.

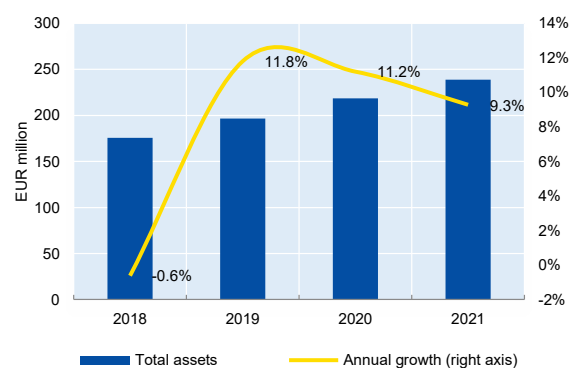
⁶³ According to statistics published in the Insurance Europe database, the level of density during the period 2009-2018 in 32 European countries was EUR 1,904 (written premiums per capita), while the level of penetration (intermediation) in the market during this period remained at 7.25 percent. <https://www.insuranceeurope.eu/insurancedata>

⁶⁴ The Herfindahl index is calculated with the following formula: $H = \sum_{i=1}^n s_i^2$, where S is the company's share in the total means

Meanwhile, index CR5⁶⁵ for 2021, calculated in relation to GWP for the insurance sector results in 56.6 percent (55.1 percent in 2020), while calculated in relation to assets, it results in 53.3 percent (50.2 percent in 2020). The concentration is higher in the "life" insurance sector, as a result of the smaller number of insurers in this segment of the insurance market.

The assets of the insurance sector reached the value of EUR 238.8 million and recorded an annual increase of 9.3 percent (Chart 82). "Non-life" insurance recorded annual growth of 9.2 percent and represented 91.3 percent of the total assets of the sector at the end of 2021. Meanwhile, "life" insurances, which comprise the rest of the assets, recorded an annual increase of 10.3 percent.

Chart 82. Assets of insurance sector



Source: CBK.

Within assets, the most significant increase was recorded in the category of deposits held in commercial banks, which are mainly in the form of time deposits. The second category with the highest growth was that of investments in Kosovo Government securities. Meanwhile, loan position and receivables, and the position of money and deposits in the CBK, were the only categories that recorded a decrease compared to the previous year.

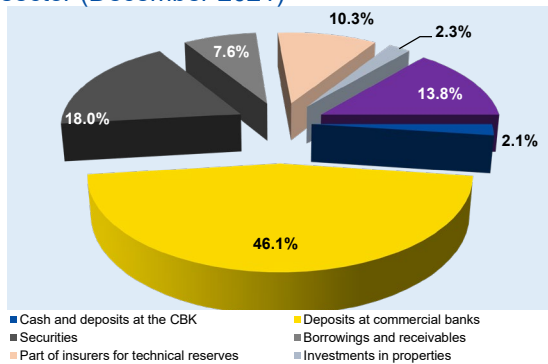
(gross written premiums - GWP) of the insurance market, n is the total number of institutions in the respective sector. If the index lies between the intervals of 1,000 - 1,800 units, the level of concentration in the insurance sector is considered acceptable.

⁶⁵ The CR5 index combines the market share of the 5 companies with the highest asset values in relation to the total assets of the sector and GWP to the total GWP of the sector.

The structure of insurers' investments is concentrated only in investments within the country. Investments in Kosovo Government securities increased the weight of insurance industry investments to 18.0 percent in 2021, from 16.4 percent in the same period last year (Chart 83).

As for the liabilities of the sector, technical and mathematical provisions make up the largest part with a total of 64.1 percent, followed by equity with 26.6 percent and the rest from other liabilities (Chart 84). The value of the total capital of insurers during this period marked a significant increase of 12.4 percent. The capital increase is mainly attributed to the profit generated during 2021, since the paid-up share capital remained unchanged in 2020. The value of losses accumulated over the years by the sector was reduced by EUR 2.6 million, to EUR 42.4 million at the end of 2021.

Chart 83. Assets structure of insurance sector (December 2021)



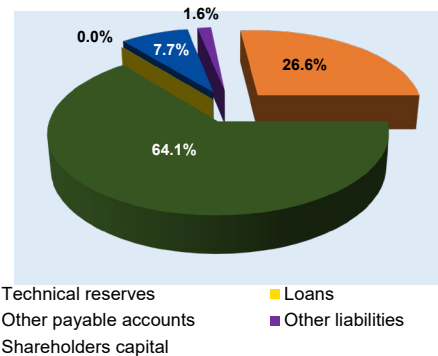
Source: CBK.

The value of premiums written by insurers in 2021 reached 117.4 million, an annual increase of 18.2 percent (0.1 percent in 2020). The significant increase in written premiums in 2021 compared to the situation a year ago is as a result of the economic contraction during 2020 and which had also affected the insurance sector. During the past year (2020), the level of written premiums remained almost unchanged from 2019. Therefore, the significant annual increase in premiums in 2021 has compensated for the stagnation in written premiums

throughout 2020 as a result of the COVID-19 pandemic, which had its peak in 2020.

The structure of written premiums is dominated by “non-life” insurance premiums, which represent 95.9 percent of the total written premiums. The value of premiums written by “non-life” insurance in 2021 reached EUR 112.6 million, which represents an annual increase of 17.6 percent (Chart 85). The number of policies sold also increased, to 1.15 million compared to 824.1 thousand a year ago.⁶⁶

Chart 84. Liabilities and equity of insurance sector (December 2021)

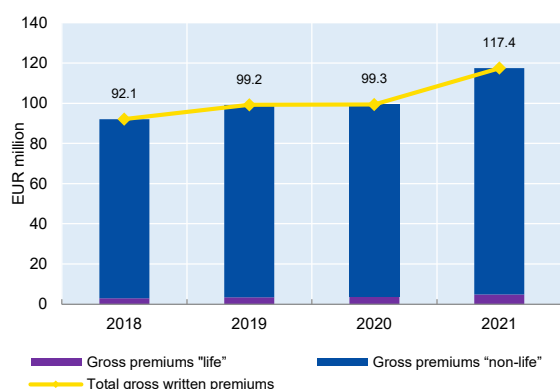


Source: CBK.

Increase in the level of written premiums and policies sold compared to last year reflects increased economic activity and the easing of restrictive measures to prevent COVID-19. “Non-life” insurance continues to be dominated by compulsory insurance with a share of 62.4 percent in total “non-life” gross written premiums, while the rest include voluntary insurance. The value of premiums written by “life” insurance reached EUR 4.9 million, which represents a higher value for 35.7 percent compared to 2020. In 2021, compulsory insurance products recorded annual growth of 17.7 percent, and further increased their share in total “non-life” premiums. The increase in compulsory insurance share was mainly influenced by “MTPL” products. Voluntary insurance registered an annual increase of 17.3 percent, with more pronounced growth in products, such as “Accident and Health” and “Casco” insurance (Table 10).

⁶⁶ Only non-life insurance is included.

Chart 85. Gross collected premiums



Source: CBK.

Claims paid by the insurance sector, which include the damages of insurers and the Kosovo Insurance Bureau (KIB), had an increase of 24.4 percent, reaching the value of EUR 61.0 million at the end of 2021 (EUR 49.1 million in 2020). Of the total amount of claims

paid, EUR 50.8 million (EUR 43.2 million in 2020) were claims paid by insurers, while EUR 10.2 million (EUR 5.8 million in 2020) damages paid by KIB. Claims paid by reinsurers account for 14.4 percent in the total amount of damages paid by insurers⁶⁷ (11.4 percent in the previous year). Increasing the level of claims paid by insurance companies and KIB among other things, it is the result of less strict measures against the spread of the pandemic applied in Kosovo during 2021 compared to the stricter measures during the previous year that were reflected in the reduced level of movement, and consequently of the claims incurred and paid.

Table 10. Gross written premiums by business classes (EUR million)

Activity	2020	2021	Change	Share: 2020	Share: 2021
Total non-life	95.7	112.6	17.6%	96.4%	95.9%
<i>Obligatory insurance</i>					
MTPL	53.8	60.3	12.0%	54.2%	51.3%
TPL+	1.8	2.8	56.7%	1.8%	2.3%
Border insurance	4.2	7.3	74.7%	4.2%	6.2%
<i>Voluntary insurances</i>					
Accident and health	16.4	21.0	27.9%	16.5%	17.9%
Casco	5.5	7.2	31.1%	5.5%	6.1%
Loans and guarantees	4.4	4.6	4.0%	4.5%	3.9%
Fire and other damages in property	6.1	5.1	-16.9%	6.1%	4.3%
Overall liabilities	3.6	4.5	22.5%	3.7%	3.8%
Total life	3.6	4.9	35.7%	3.6%	4.1%
Total market	99.3	117.4	18.2%	100.0%	100.0%

Source: CBK.

The value of claims paid by “non-life” insurance increased to EUR 59.9 million in 2021 (EUR 48.1 million in 2020). However, the value of claims paid by “life” insurance increased to EUR 1.1 million from EUR 0.9 million in 2020, representing an annual increase of 20.4 percent. Increase in the level

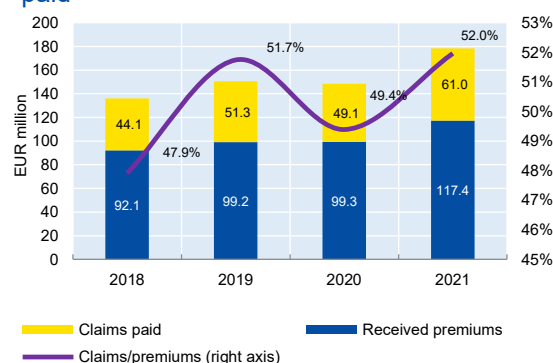
of claims paid in 2021 within the “non-life” insurance was affected by both voluntary and mandatory insurance claims payments (Table 11). The value of claims paid by voluntary insurance increased by EUR 3.4 million compared to the previous year, to EUR 20.1 million.

⁶⁷ KIB is not included.

Table 11. Claims paid, by business classes (EUR millions)

Activity	2020	2021	Change	Share: 2020	Share: 2021
Total non-life	48.1	59.9	24.5%	98.1%	98.2%
<i>Obligatory insurance</i>					
MTPL	25.4	29.4	15.7%	51.8%	48.2%
TPL+	0.2	0.2	40.3%	0.3%	0.4%
Border insurance, FG MoU	5.8	10.2	74.5%	11.9%	16.7%
<i>Voluntary insurances</i>					
Accident and health	9.8	10.6	8.8%	20.0%	17.5%
Casco	3.4	4.6	34.8%	6.9%	7.5%
Loans and guarantees	2.5	1.0	-60.7%	5.1%	1.6%
Property insurance	1.0	3.4	248.3%	2.0%	5.6%
Insurance of goods in transit	0.0	0.0	-100.0%	0.1%	0.0%
Overall liabilities	0.0	0.5	13130.2%	0.0%	0.8%
Total life	0.9	1.1	20.4%	1.9%	1.8%
Total market	49.1	61.0	24.4%	100.0%	100.0%

Source: CBK.

Chart 86. Received premiums and claims paid

Source: CBK.

This increase was mainly influenced by the “Property Insurance”, “Accident and Health” and “Casco” products. Whereas, claims paid by compulsory insurances, which also have the largest share in the total portfolio of paid claims, recorded the fastest annual growth, of 26.8 percent, reaching the value of EUR 39.8 million. The categories “MTPL” and “Border insurance, FG, MoU” had the main contribution to the increase in the level of compulsory insurance claims.

As a result of the higher increase in claims paid in relation to premiums collected, the claims/premium ratio increased by 2.6 percentage points, to 52.0 percent (Chart 86).

6.2.2 Financial performance of the insurance sector

The insurance sector closed this year with a positive financial result of EUR 6.9 million, unlike the previous year where it recorded a net profit of EUR 2.3 million (Table 12). Non-life insurers recorded profits in the amount of EUR 6.4 million, compared to the value of EUR 2.0 million in 2020. Meanwhile, “life” insurers made a net profit in the amount of EUR 492.4 thousand compared to EUR 273.3 thousand in 2020. The highest level of profit generated in 2021 compared to the previous year is mainly a consequence of the higher level of income from written premiums (for 18.2 percent). The level of claims occurred this year increased by 27.8 percent, while the sector's net operating expenses during this period marked an annual decrease of 3.7 percent compared to 2020.

The combined sector ratio also reflects the improved financial position. In December 2021, this ratio stood at 94.1 percent (99.7 percent in the previous year), reflecting the claims to net earned premiums ratio of 58.9 percent and the expenses to net earned premiums ratio of 35.2 percent, not including income from investment interests.

The insurers’ sector increased the level of liquidity compared to the situation at the end of last year. The cash and cash equivalents to

reserves ratio stood at the level of 103.2 percent (101.3 percent in 2020), as a result of higher annual growth in cash and cash equivalents of 10.2 percent, compared to the lower growth of 8.2 percent in the technical reserves of the insurance sector. Meanwhile, the cash and cash equivalents to total liabilities ratio remained at a level similar to the previous year, of 87.3 percent.

Regarding capitalization, the non-life insurance sector, at the end of 2021, except for the two insurers has achieved full compliance with the legal requirements in relation to the guarantee fund, solvency and eligible assets to cover technical provisions, marking a significant improvement compared to previous periods. This improvement from the same

period of the previous year comes as a result of not being included in the calculation of the insurer “New Kosova” since on 24 September 2021, the Executive Board of CBK has taken the Decision to revoke the insurer's license and open liquidation procedures. Consequently, the capital in relation to the guarantee fund for non-life insurers results in 135 percent above the accepted rate of 100%, while for insurers the ratio is 153.5 percent. The coverage of technical provisions with eligible assets reached 109.3 percent for non-life insurers and 115.9 percent for life insurers. However, two insurers continue to be below the minimum legal requirements for capital and eligible assets to cover technical provisions.

Table 12. Financial result (EUR millions)

Description	2018	2019	2020	2021
Non-life insurance	1.0	-5.1	2.0	6.4
Life insurance	0.6	0.5	0.3	0.5
Total market	1.6	-4.7	2.3	6.9

Source: CBK (2021)

6.3. Microfinance sector and financial auxiliaries

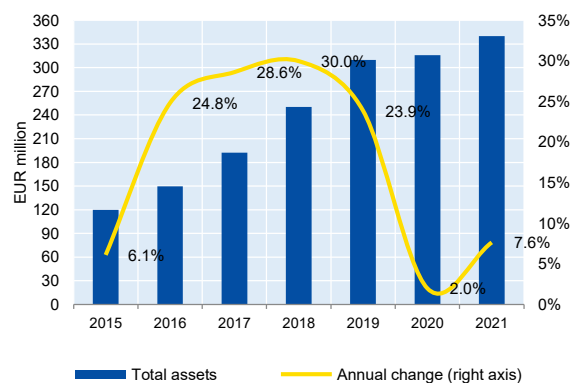
6.3.1 Activity of the microfinance sector

The microfinance sector recorded an acceleration in the growth of activity, as a result of the recovery of the lending activity and the acceleration of the leasing growth. The accelerated growth of the sector's activity during 2021 reflects the recovery of demand in the country, as a result of the easing the economic / social restrictions to combat the COVID-19 pandemic.

Assets of the sector reached the value of 340.0 million, which corresponds to an annual increase of 7.6 percent; recovering to some extent the slowdown in growth of the previous year compared to the growth trend in recent years (Chart 87). 30 microfinance institutions⁶⁸

operate in the local market, of which 13 have foreign ownership and represent 92.1 percent of the total assets of the sector.

Chart 87. Assets of the microfinance sector



Source: CBK.

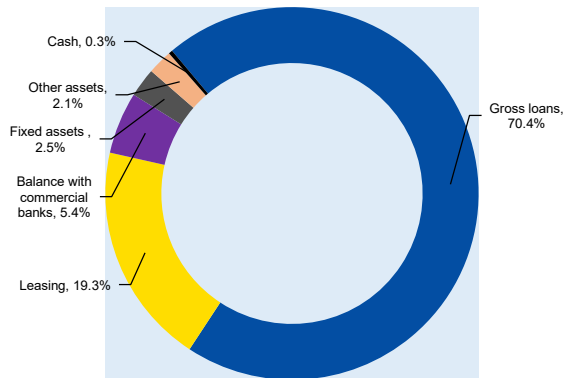
Herfindahl-Hirschman index for assets resulted in 1,518 points in 2021, which represents a light increase in concentration from the same period of the previous year

⁶⁸ This also includes ten non-banking financial institutions that perform lending, leasing and factoring activities. Also, if the data is compared with previous years, you can notice that there is a highlighted difference in the

number of MFIs reported this period compared to previous periods due to methodological differences. The number of MFIs also includes NBFIs with money transfer/payment/exchange activity, which have influenced a significant increase in the number of financial institutions in this sector.

(1,487 points). While, the share of the assets of the three largest institutions in the total assets of the sector increased to 56.5 percent, from 56.1 percent in 2020, an increase that can be attributed to a certain extent to the revocation of the registration of two microfinance institutions in 2019.

Chart 88. Structure of assets of microfinance sector (December 2021)

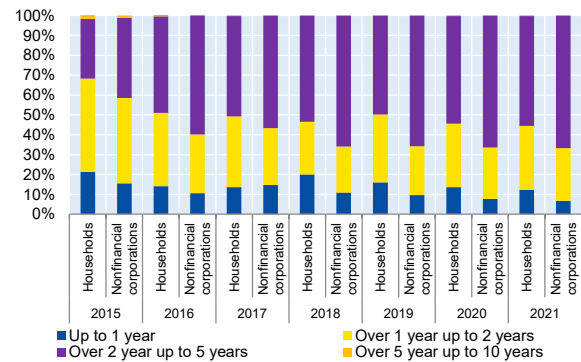


Source: CBK.

Loans constitute 70.4 percent of the total assets of the sector. The second most important category in terms of weight continues to be leasing, with a share of 19.3 percent (Chart 88). The balance sheet category with commercial banks has reduced its share in the total assets of the sector by 5.5 percentage points compared to last year, to 5.4 percent at the end of December 2021. This came as a result of the recovery of lending activity and the accelerated growth of leasing compared to last year, so there was a reallocation of funds towards investments with a higher return.

The activity of the microfinance sector is mainly financed by loans, which constitute 62.1 percent of total liabilities and capital, while only financing from the external sector constitutes 60.1 percent of total liabilities and capital. After the annual decrease of 0.4 percent in 2020, financing from the external sector recovered and recorded an annual increase of 3.6 percent in 2021. The externally borrowed funds were used to increase the credit and leasing activity of the sector, which increased in addition to the rapid recovery of demand and the economy in the circumstances of the improvement of the pandemic situation.

Chart 89. Loans to economic sectors, by maturity



Source: CBK.

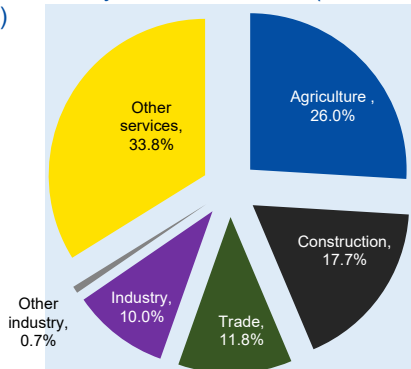
Total loans issued by the microfinance sector reached the value of EUR 239.2 million, which represents an annual increase of 17.1 percent (annual decrease of 7.1 percent in 2020). Lending to both households and non-financial corporations marked a significant increase in 2021 compared to the contraction during the previous year (which was as a result of the COVID-19 pandemic, as well as the revocation of the license of two MFIs/NBFIs). Lending to households recorded an increase of 16.7 percent (decrease by 9.4 percent in 2020), reaching a value of EUR 156.5 million. Meanwhile, loans to non-financial corporations recorded an annual increase of 17.8 percent (decrease of 2.4 percent in 2020), reaching the value of EUR 82.7 million. According to the maturity period, loans of households and non-financial corporations with a maturity period of “more than 2 to 5 years” dominate the structure of these loans, followed by those with a maturity of “more than 1 to 2 years” (Chart 89).

The structure of lending to non-financial corporations according by economic activities remained similar to previous periods. Lending to the agricultural sector continues to have a greater share in the loans issued by the microfinance sector, followed by loans destined for the construction, trade and industry sectors (Chart 90).

Lending activity, according to economic sectors, reflects the general trend of lending to non-financial corporations, where we have growth recovery in all sectors without exception compared to the previous year

(Chart 91). Lending to the agriculture sector, trade and other services marked a more significant increase, recovering the contraction that had occurred in the previous year.

Chart 90. Structure of loans to nonfinancial corporations, by economic sectors (December 2021)



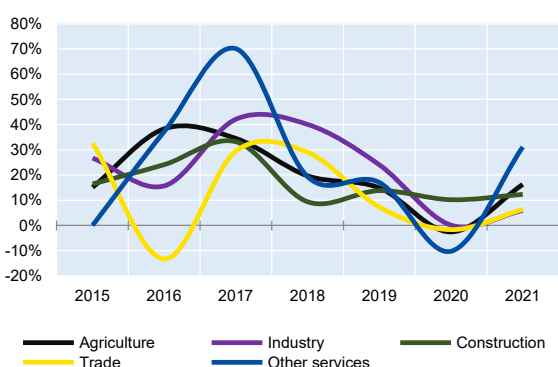
Source: CBK.

Leasing continued the steady trend of expansion in recent years, despite facing the crisis and the COVID-19 pandemic (Chart 92).

In the growth of leasing, the main contribution was made by leasing for non-financial corporations, while the contribution of leasing for households was more limited.

Leasing to non-financial corporations have a share of 59.1 percent in total leasing. This category of leasing recorded an annual increase of 23.2 percent and reached the value of EUR 38.7 million.

Chart 91. Microfinance sector growth rate of loans to nonfinancial corporations, by economic sectors

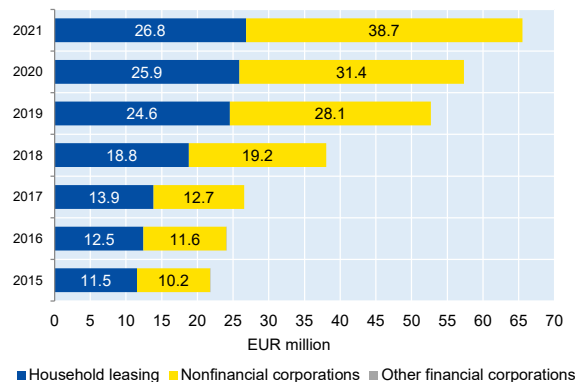


Source: CBK.

According to the maturity of leasing for non-financial corporations, the majority is dominated by medium-term leasing 'more than 2 to 5 years' with a share of 80.9 percent, followed by leasing with a maturity term of

'more than 5 to 10 years' with a share of 14.6 percent.

Chart 92. Microfinance sector leasing

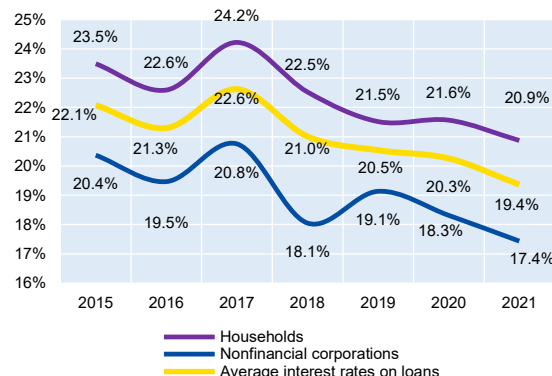


Source: CBK.

While, leasing to households marked a slower growth of 3.6 percent, reaching EUR 26.8 million at the end of 2021. Within leasing for households, 'mortgage leasing', which represents the dominant category, marked an annual increase of 1.0 percent in 2021 (6.3 percent annual growth last year). This category of leasing had the main contribution to the slowdown of leasing to households, since they represent about 71.5 percent of leasing to households.

Leasing to households continue to be dominated by long-term leasing 'over 10 years' which have a share of 53.9 percent, followed by leasing with a maturity period of 'more than 5 to 10 years' with a share of 29.7 percent.

Chart 93. Average interest rate on microfinance sector loans



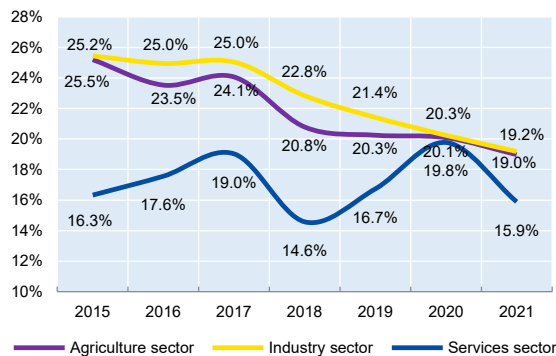
Source: CBK.

The average interest rate for loans issued by the microfinance sector continued the gradual downward trend of recent years, dropping to 19.4 percent from 20.3 percent in December 2020 (Chart 93).

Both the non-financial corporate sector and the household economy sector were characterized by a decrease in the average interest rate on loans.

The average interest rate on loans to households decreased to 20.9 percent at the end of December 2021. While, the average interest rate on loans to non-financial corporations decreased to 17.4 percent (Chart 93). In terms of loans to non-financial corporations, the average interest rate decreased for all the main economic sectors - more pronounced for the service sector (Chart 94).

Chart 94. Average interest rate on loans, by economic sectors



Source: CBK.

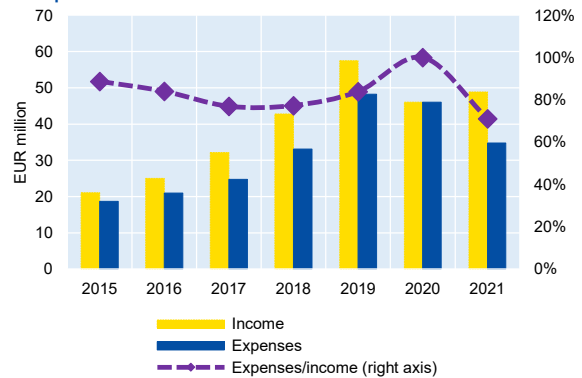
6.3.2 Microfinance sector performance

The microfinance sector generated the highest annual profit since the beginning of their operation, in the amount of EUR 14.1 million in 2021. The accelerated decrease in expenses, as well as the increase in incomes of the sector has impacted on the significant increase in the generated profit in this period (Chart 95).

The incomes of the microfinance sector reached EUR 48.9 million, an annual increase of 6.2 percent compared to last year. Within the income, interest income, representing the dominant category of the revenue (88.9 percent), recorded an annual increase of 2.8 percent (decrease of 20.1 percent in 2020), as a result of the recovery of the lending activity. However, the main contribution to the increase in total incomes was the non-interest income category (11.1 percent of total incomes). This

category recorded an increase of 45.2 percent (decrease of 19.3 percent in 2020), mainly as a result of the increase in other operating incomes.

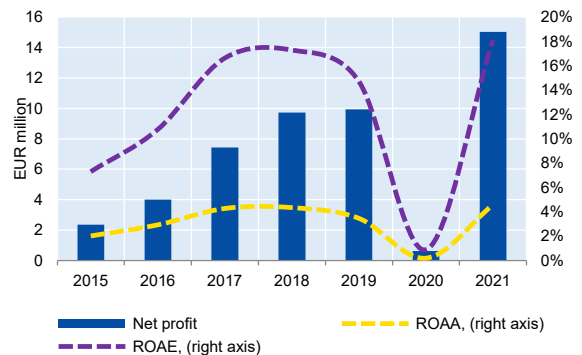
Chart 95. Microfinance sector income and expenses



Source: CBK.

Sector expenditures decreased to EUR 34.0 million, representing an annual decrease of 25.2 percent. The decrease in expenses came as a result of the reduction of non-interest expenses (decrease by 37.1 percent in 2021), namely provisions for possible loan losses, similar to the banking sector. Even the category of interest expenses recorded an annual decrease (of 8.5 percent), but that was significantly lower compared to 2020 (a decrease of 19.1 percent), since during 2020 there was a decrease in loans to finance the activities of the sector (lending and leasing).

Chart 96. Profitability indicators of microfinance sector



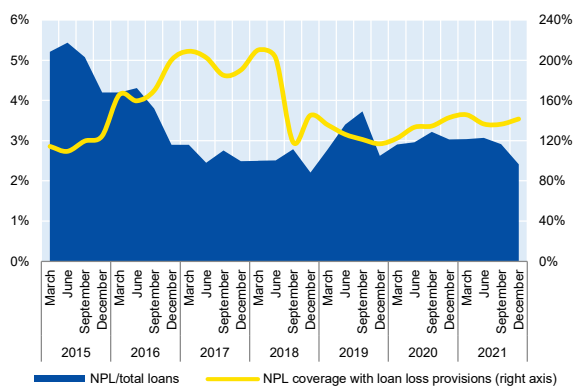
Source: CBK.

Expenses to incomes ratio of the microfinance sector improved significantly, decreasing by 28.9 percentage points, as a result of the increase in incomes in the situation of

significant decrease in expenses. In 2021, this indicator stood at 71.1 percent (Chart 95).

The financial results during 2021 were also reflected in other profitability indicators of the sector, which marked a significant improvement compared to the previous period. The Return on Average Assets (ROAA) remained at the level of 4.6 percent (0.2 percent in 2020), while the Return on Average Equity (ROAE) at 18.1 percent (0.9 percent in 2020) (Chart 96).

Chart 97. Indicators of loans portfolio quality



Source: CBK.

The microfinance sector continues to have a relatively low level of non-performing loans and good coverage with provisions (Chart 97). The level of non-performing loans to total loans remains low and has further decreased by 0.6 percentage points, to 2.4 percent. The coverage level of non-performing loans with provisions in December 2021 stood at 141.6 percent (143.0 percent in 2020).

The financial auxiliaries sector comprises the largest number of financial institutions in the country, although it manages only 0.3 percent of total assets. This sector consists of exchange bureaus and money transfer agencies (MTAs). The value of assets of financial auxiliaries in 2021 reached EUR 23.8 million, which represents an annual increase of 16.5 percent

The income of financial auxiliaries recorded an annual increase of 1.9 percent and reached the value of EUR 10.2 million at the end of December 2021. The structure of the income of financial auxiliaries is dominated by income from transfers (share of 66.7 percent), which were characterized by an annual decrease of 10.7 percent.

However, the category of other revenues marked an annual increase of 42.5 percent in 2021, and represented about 33.3 percent of the total incomes of financial auxiliaries. Expenses marked an annual increase of 21.7 percent, reaching the value of EUR 7.0 million, which is mainly the result of the increase in general operating expenses. The net profit generated by these financial institutions in 2021 decreased to EUR 3.2 million, which represents an annual decrease of 24.4 percent. The significant increase in the activity of the sector and profits generated in the past year was the result of sending remittances through these financial institutions, as the physical arrival was impossible (closure of land and air borders in certain periods) due to the measures that were in force to fight the COVID-19 pandemic. However, during 2021, the lifting of the measures restricting the movement as a result of the increase in vaccination affected the increase in diaspora tourism and consequently the decrease in the share of remittances sent through financial auxiliaries.

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 2021, with the improvement of the pandemic situation, and consequently the recovery of the economy in the country, the transactions carried out through the CBK payment system, both in number and in value, marked a significant increase.

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.

The strong economic recovery in the country during 2021 was also reflected in the significant increase in transactions carried out through the payment system, both in terms of their number and value. The increase in the number and value of transactions during 2021 had an accelerated pace even compared to the period before the pandemic (year 2019). The number of transactions processed by SPN in 2021 reached 14.6 million (13.0 million in 2020 and 12.4 million in 2019), representing an annual increase of 12.9 percent (4.7 and 8.1 percent in 2020 and 2019, respectively). Also, in the same period, the value of the total transactions generated increased to EUR 17.1 billion (EUR 14.0 billion in 2020 and EUR 14.1 billion in 2019), which represents an annual increase of 22.5 percent (annual decrease of 1.0 percent in 2020 and annual growth of 9.1 percent in 2019). Regular mass payments and mass priority payments dominated the structure of the number of interbank transactions carried out (Table 13). Regular mass payments represent about 5.9 million completed transactions, while regular mass payments represent about 5.3 million completed transactions. As for the value of transactions, priority payments are the category with the highest share in the transactions carried out, a category that reached the value of EUR 7.25 billion, followed by the bank-to-bank category, which reached the value of EUR 3.26 billion by the end of 2021. Number of total valid bank accounts⁶⁹ in 2021 reached 2.38 million, representing an annual increase of 4.0 percent.

⁶⁹ The total number of bank accounts includes: the number of current accounts and other accounts in the bank.

Table 13. Share of payment instruments to total IPS transactions, as a percentage

Description	Number of total transactions		Value of total transactions	
	2020	2021	2020	2021
Regular	12.5%	14.3%	10.8%	11.5%
Prioritized	3.4%	4.0%	38.4%	42.3%
Regular - massive (payments from taxes, taxes, customs, etc)	32.4%	36.3%	5.3%	5.5%
Priority - massive (wages and pensions from the government)	46.8%	40.2%	11.7%	8.7%
Giro payments	4.6%	4.9%	7.8%	8.3%
Securities	0.0%	0.0%	5.8%	4.5%
Direct debiting	0.0%	0.0%	0.0%	0.0%
Bank-Bank	0.0%	0.0%	20.0%	19.0%
Returned	0.2%	0.2%	0.1%	0.1%

Source: CBK.

The fast and secure trend of virtual infrastructure development has continued, also driven by the circumstances created by the pandemic situation. Banks have increased the overall efforts for digitization and automation of services, in order to provide opportunities for the realization of services while maintaining the health of customers. Most banks have increased the limit of contactless payments that can be made through bank cards. E-banking bank accounts, through which

banking services are performed 'online', have continued to grow. By the end of 2021, the total number of E-banking accounts reached 537.7 thousand⁷⁰ (Table 14), which represents an annual increase of 30.7 percent. The structure of E-banking accounts continues to be dominated by individual accounts with a share of 88.1 percent of the total E-banking accounts, followed by business accounts with a participation of 11.9 percent.

Table 14. Banking sector network

Description	2017	2018	2019	2020	2021
Number of bank branches	45	46	47	50	43
Number of bank sub-branches	183	166	159	149	145
ATM number	512	491	497	513	516
POS number	11,501	13,183	13,769	13,421	13,836
Number of E-banking accounts	301,841	250,733	337,693	411,346	537,733

Source: CBK.

The total number of cards (debit and credit cards) offering services for cash withdrawals and various payments increased by 5.9 percent. The number of cards with debit function recorded an annual increase of 6.6 percent and reached nearly 1.3 million, while the number of cards with credit function recorded an increase of 0.8 percent and reached 176.5 thousand.

Visa cards had the highest share among cards according to operators (53.9 percent), followed by Master Cards (42.2 percent), while local cards had a share of 3.9 percent. The banking infrastructure in the country has expanded in the context of the network of the number of automated teller machines (ATM) and the number of POS devices (Point-of-Sale) compared to the previous period (Table 14).

⁷⁰ With the entry into force of the "Regulation for the reporting of statistics of payment instruments" from 2018, the methodology of reporting the number of accounts accessible from the Internet has also changed. This

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

Table 15. Share of transactions value processed with cards by terminals to total card transactions value, as a percentage

Description	2017	2018	2019	2020	2021
ATM withdrawals in cash	61.9%	58.9%	59.5%	62.7%	58.8%
ATM deposits	29.3%	30.9%	29.9%	27.3%	30.8%
Credit transfers through ATMs	0.0%	0.1%	0.1%	0.0%	0.0%
POS cash withdrawals	0.2%	0.2%	0.2%	0.1%	0.2%
Card payments through POS	8.5%	9.8%	10.3%	9.8%	10.2%

Source: CBK.

The number of deposits in the banking sector through ATMs during this period amounted to 2.3 million transactions worth EUR 1.77 billion. As a result, 30.8 percent of the total value of card transactions through terminals belonged to ATMs with deposit function (Table 15).

In the same period, the number of payments through card sales points at POS terminals reached 18.4 million in the amount of EUR 590.6 million. The value of payments through POS to total card transactions in 2021 had a share of 10.2 percent.

8. Macroprudence framework

The primary aim of the macroprudential policy is to identify, monitor and assess the systemic risk of financial stability, and to take measures aimed at preventing or reducing systemic risks and strengthening the stability of the financial system against these risks. The intermediate objectives are aimed at mitigating systemic risks that may be caused by developments in certain economic indicators.

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 accordance with the macroprudential mandate, the Macroprudential Advisory Committee (MAC) has held regular quarterly meetings where it has reported on market dynamics and risks for financial stability. On a regular basis, among other things, the results of two instruments calibrated for the purposes of macroprudential oversight that apply Capital based Buffers are presented in ACM. In order to address the dynamics within the cyclical dimension of

The outlook for financial stability in the eurozone has worsened with rising inflation, especially since the start of the war in Ukraine. This has encouraged the eurozone countries to be more active in the application of relevant macroprudential measures or the activation of new measures regarding increased risks. The increased risks in many dimensions and especially the increased risk over the years from the real estate market in the eurozone, has impacted many countries to start tightening the macroprudential policy through increase in requests for countercyclical capital

systemic risk, quarterly results of the Countercyclical Capital Buffer, which is mainly based on the parameter of the Credit/GDP, gap have been presented in ACM). Also, in order to address the structural and cross-sectoral dimension of risk, ACM has also analysed the quarterly results of Capital Buffer based on the assessment of systemically important banks.

While the relevant regulatory changes that will specifically address the CBK's macroprudential mandate are in process⁷¹, changes that, among other things, will define the methodology of these instruments and potentially redefine the levels of capital buffers, the calibrated instruments have served to monitor the dynamics of these risks and the indications they have given have been presented at the highest executive levels.

The other relevant indicators presented in Table 15 and elaborated within the chapter of banking sector risks in this report, in addition to the credit gap, are further supplemented with qualitative information and the judgment of relevant experts, to finally shape the judgment on the weight of specific developments in overall systemic risk.

buffers, activation of new capital buffers based on sectoral systemic risk (CRD V⁷²), as well as the implementation of other macroprudential measures, such as restrictions on household lending.⁷³

In 2021, the general dynamics in selected indicators of macroprudence were characterized by stability, resulting in high parameters above the regulatory requirements. Economic activity in the country was characterized by high economic growth, after the economic contraction that marked the pandemic year.

⁷¹ The new draft law on banks is in the process of review and approval, and this will assign the CBK as the only authority responsible for macroprudential supervision and exercise of the mandate for macroprudence, while simultaneously enabling regulatory instruments to be issued regarding systemic risk assessments.

⁷² The 5th Capital Requirements Directive (CRD V), a directive brought under the discretion of the local authorities of the euro zone, has enabled

the application of capital buffers according to the specific risks for the respective countries, the so-called the buffer for systemic sectoral risk.

⁷³ Instruments applied since the end of 2021, by eurozone countries <https://www.ecb.europa.eu/pub/financial-stability/macroprudential-measures/html/index.en.html>.

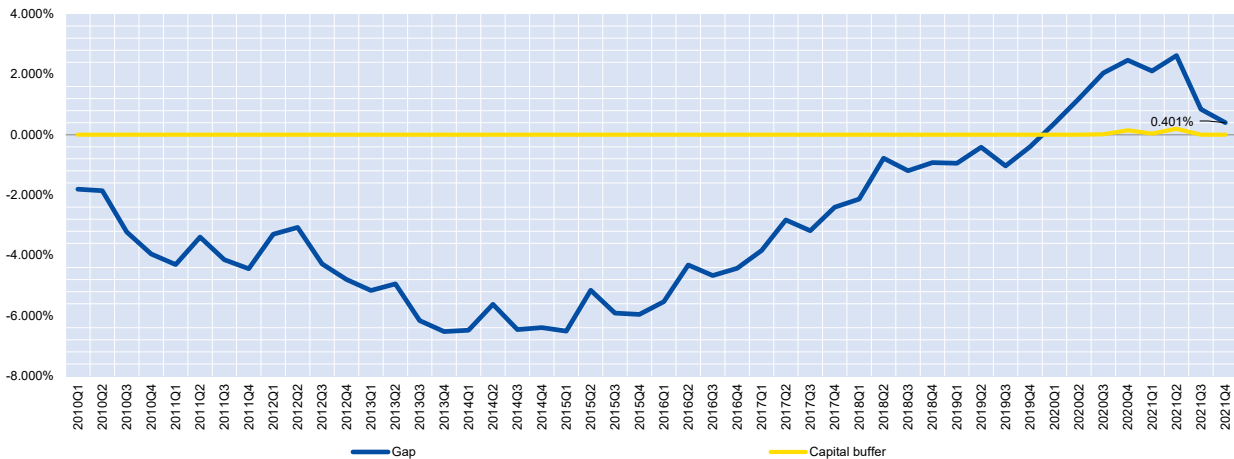
https://www.ecb.europa.eu/pub/financial-stability/fsr/shared/pdf/measures/Overvie_e_measures_notified_to_ECB_A_pril_2022.xlsx?129e7e6b656f325c6455ba0b4f28a06a

Table 16. Objectives, systemic risk assessment indicators and macroprudential policy instruments

	OBJECTIVES	RISK INDICATORS DEFINED BY OBJECTIVES	SUPPORTING INSTRUMENTS
1	Reducing and preventing an excessive increase of lending and leverage	-Macroeconomic environment (GDP, inflation) -Lending by segments and economic sectors -Capitalization -Loans/GDP gap	Capital based measure 1. <u>Countercyclical capital buffer (CCyB)</u> 2. Sectoral capital buffers 3. Buffers on leverage ratio Borrower based measures: 1. Loan-to-value ratio LTV 2. Debt-to-income DTI & Debt-service-to income DSTI
2	Mitigate and prevent high inconsistencies of maturity term and liquidity in the market	-Liquidity indicators (liquid assets to short-term liabilities) -Loans to deposits ratio -Liquidity reserves -Liquidity gap	Liquidity based measures: 1. Liquidity-coverage-ratio LCR 2. Net-stable -funding-ratio NSFR 3. Restrictions on funding resources, loans-to-deposits ratio 4. Large depository exposure limits
3	Direct and indirect limits of concentrations to credit exposures	-Credit risk concentration (large credit exposures); large credit exposures to Tier 1 capital ratio	Other macroprudential measures 1. Large credit exposure restrictions
4	Limitation on systemic impact from incorrect initiative in order to reduce moral hazard	-Financial performance of banks -Interest rates on loans and deposits -Assets concentration -Banks with systemic importance	Capital based measure 1. SIFI capital surcharges OSII

Source: European Systemic Risk Board

Chart 98. Countercyclical capital buffer



Source: CBK.

However, the end of the restructuring phase, cyclical movements and the change in the dynamics of general risks (the continuous increase in the level of prices in the country and the economic slowdown in 2022) give signals for the potential accumulation of systemic risk in the following months. While

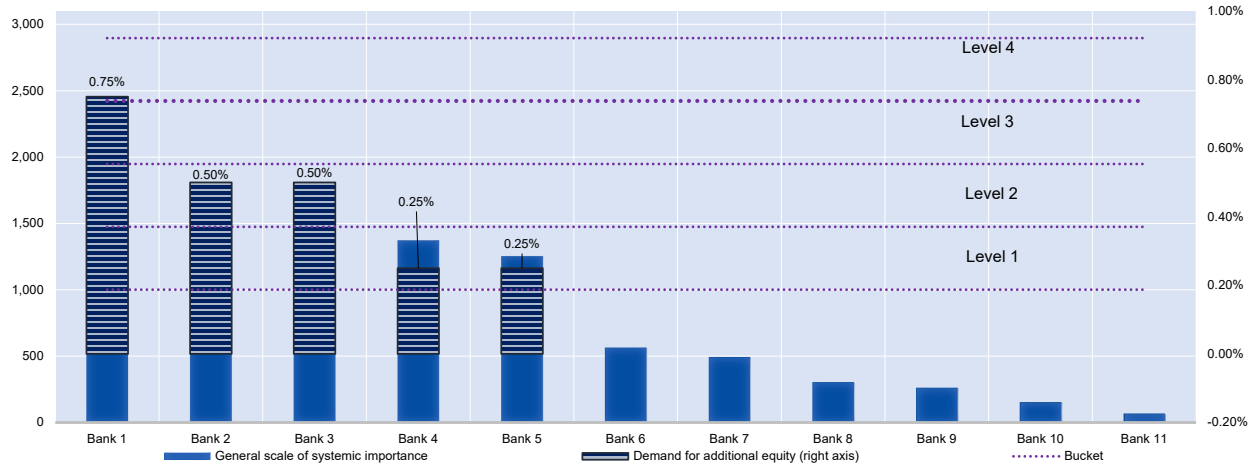
financial institutions are expected to continue to support the economic recovery and have a countercyclical effect in this phase, credit policies should be tailored towards economically stable borrowers. The credit to GDP gap has decreased in 2021, to 0.40 percent from 2.47 percent, as a result of the economic recovery from the pandemic year that was

accompanied by economic contraction and slowed lending activity (Chart 98).

In 2021, the banking sector turns out to have five banks of systemic importance, similar to the previous year. The capital buffer to systemically important banks is calibrated and

presented in Chart 99, based on the Basel III framework and the methodology recommended by the European Banking Authority (EBA). However, these two methods and relevant macroprudential instruments⁷⁴, in the absence of a legal basis, are currently used only as an indication of the level of risks.

Chart 99. Systemic importance scale and allocation of capital buffer 1



⁷⁴ Methodology of both methods is found in previous versions of the RSF.

9. Statistical Appendix

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

Chart 1. External economy

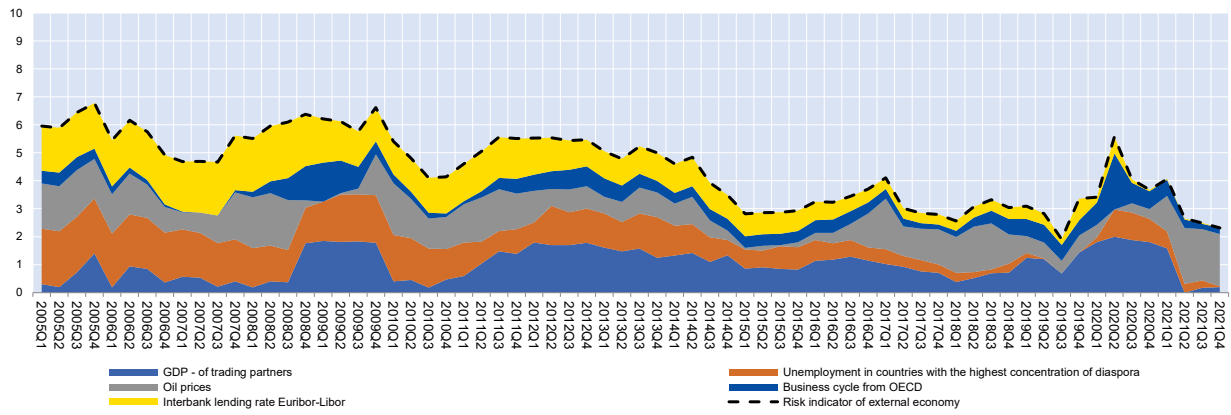


Chart 2. Domestic economy

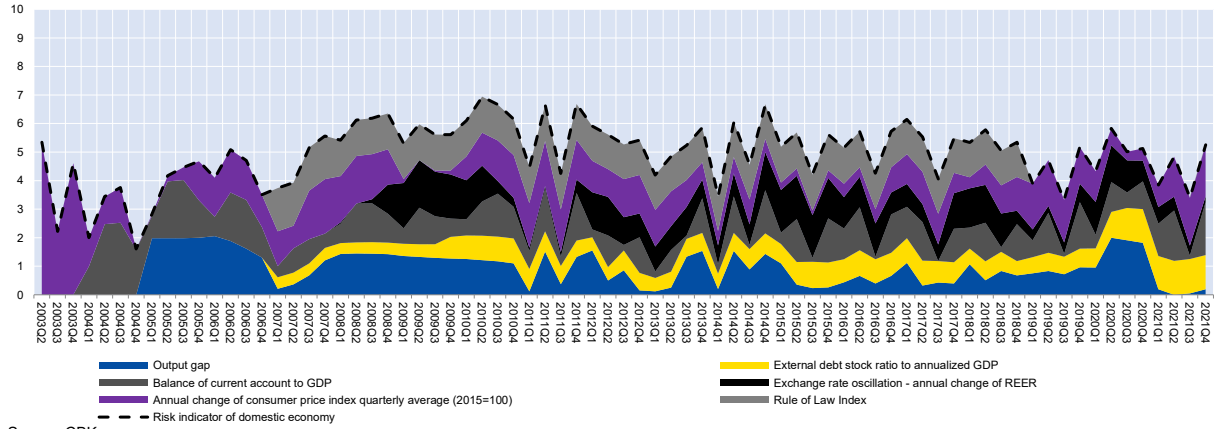


Chart 3. Households

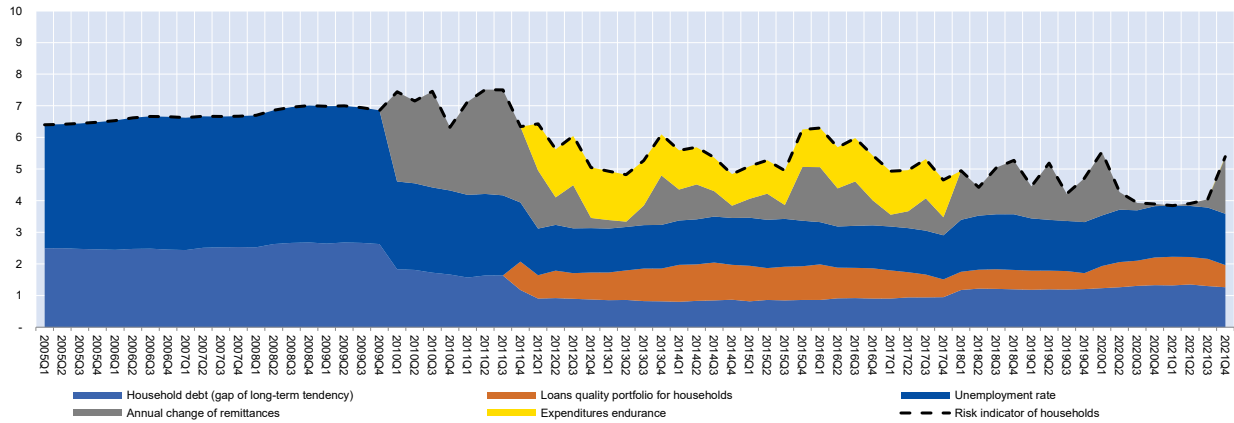
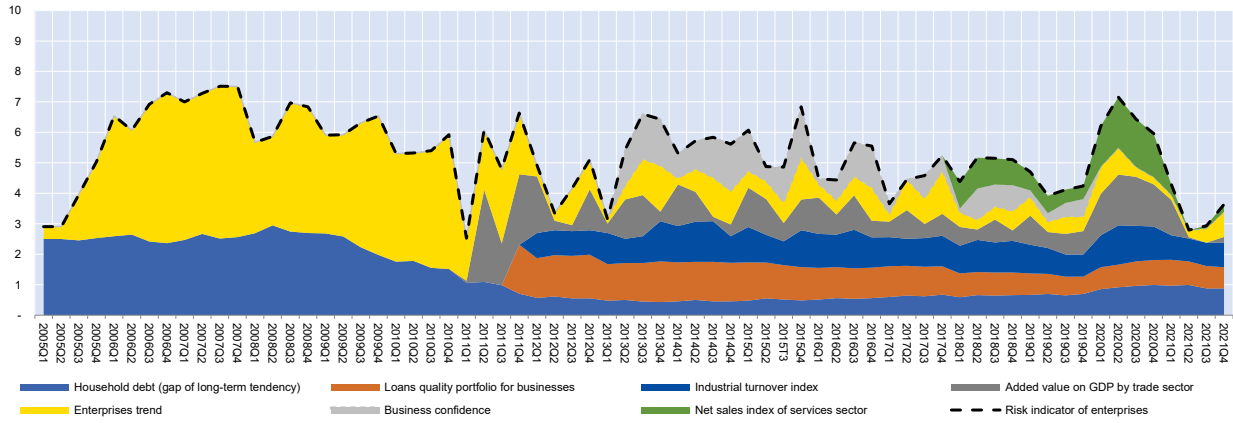
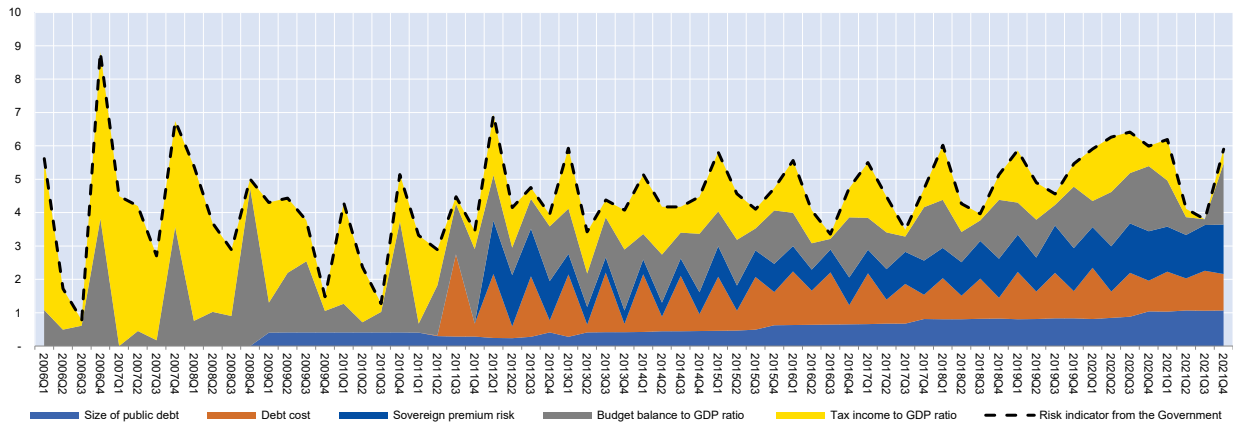


Chart 4. Enterprises



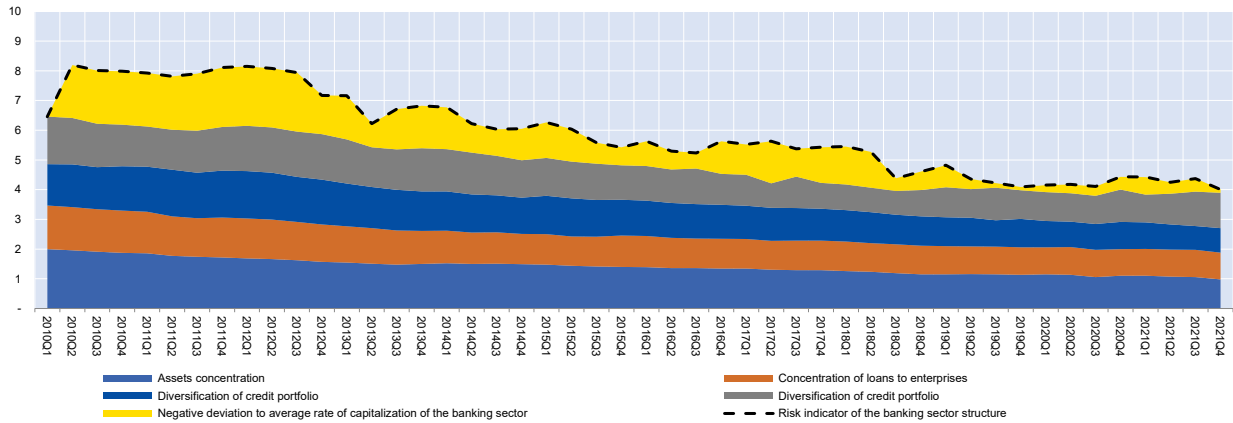
Source: CBK.

Chart 5. Government



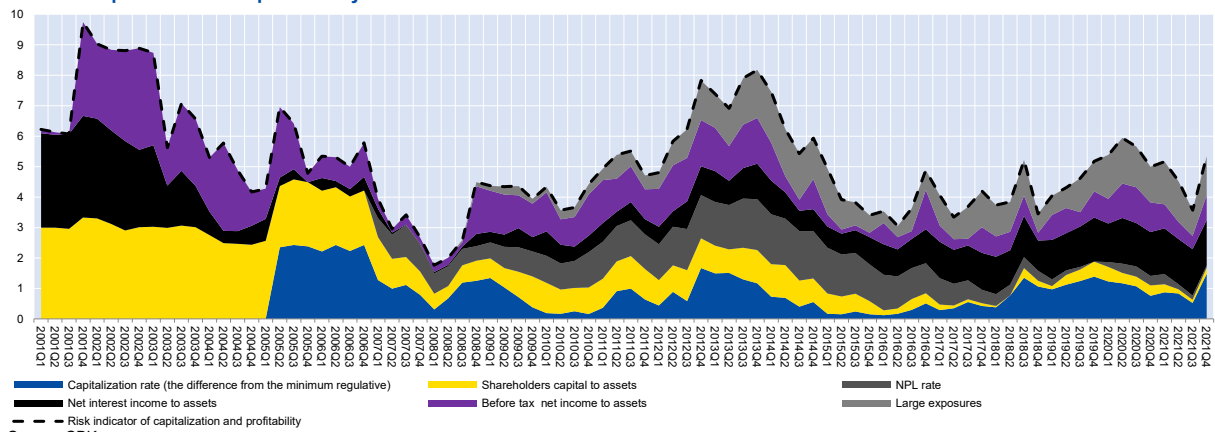
Source: CBK.

Chart 6. Structure of the Banking Sector



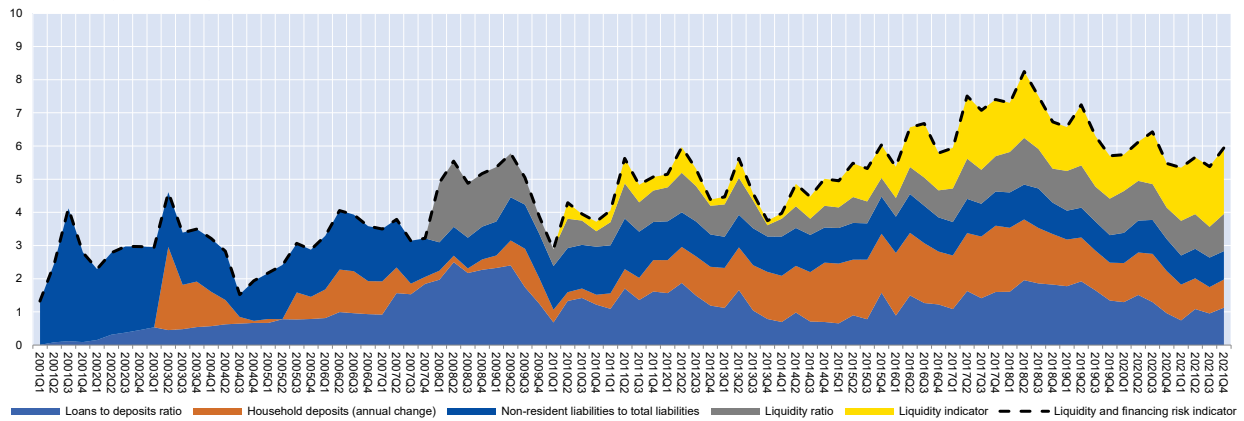
Source: CBK.

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 2018	December 2019	December 2020	December 2021
Capital Adequacy	Regulatory capital to risk-weighted assets	17.0	15.9	16.5	15.3
	Regulatory Tier I capital to risk-weighted assets	15.5	14.2	14.7	13.6
	Nonperforming loans net of provisions to capital	1.5	1.5	4.5	3.6
Assets quality	Nonperforming loans to total gross loans	2.5	1.9	2.5	2.1
Sectoral distribution of loans to total loans	Other financial corporations	0.2	0.2	0.2	0.3
	Public nonfinancial corporations	0.00	0.00	0.00	0.00
	Other nonfinancial corporations	63.4	63.3	63.3	62.3
	Households	36.3	36.4	36.4	37.4
	NPISH	0.01	0.03	0.03	0.02
	Nonresidents	0.0	0.0	0.1	0.0
	Total	100.0	100.0	100.0	100.0
Earnings and profitability	Return on assets (ROA)*	2.3	2.1	1.7	2.2
	Return on equity (ROE)*	18.3	17.2	14.0	17.6
	Interest margin to gross income	78.4	80.6	79.2	76.0
	Noninterest expenses to gross income	48.2	48.1	46.1	45.3
Liquidity	Liquid assets (core) to total assets	29.0	28.8	30.1	28.9
	Liquid assets (broad) to total assets	23.8	23.3	23.2	23.7
	Liquid assets (core) to short-term liabilities	32.2	31.2	31.1	30.6
	Liquid assets (broad) to short-term liabilities	38.5	37.6	39.8	37.4
Sensitivity to market risk	Net open position in foreign exchange to capital	3.8	4.7	3.5	3.2
	Encouraged set				
	Capital to assets	12.2	11.2	11.7	11.1
	Large exposures to capital	65.9	81.8	89.5	100.3
	Personnel expenses to noninterest expenses	44.0	43.5	43.3	42.8
	Spread between reference lending and deposits rates	4.5	4.8	4.7	4.5
	Customer deposits to total (noninterbank) loans	122.8	129.2	133.9	130.9
	Foreign-currency-denominated liabilities to total liabilities	5.0	4.4	4.2	4.3



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

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

Web:www.bqk-kos.org