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

Financial Stability Report

Number 20

BANKA QENDRORE E REPUBLIKËS SË KOSOVËS

CENTRALNA BANKA REPUBLIKE KOSOVA

CENTRAL BANK OF THE REPUBLIC OF KOSOVO

Financial Stability Report

Number 20

January-December 2023

PUBLISHER

© Central Bank of the Republic of Kosovo

Department of Financial Stability and Economic Analysis

33 Garibaldi, Prishtina 10000

Phone: +383 38 222 055

Fax: +383 38 243 763

Website

www.bqk-kos.org

Email address

economic.analysis@bqk-kos.org

EDITOR IN CHIEF

Zana GJOCAJ

EDITORS

Krenare MALOKU BAKIJA

Bejtush KIÇMARI

AUTHORS

Arta NUSHI

Taulant SYLA

Tringa NIKA

Blerta HYSENI

Albion MAZREKU

Shqipe ÇERKINI GRAINCA

TECHNICAL EDITOR

Butrint BOJAJ

ABBREVIATIONS:

ATM	ATM (*Automated Teller Machines*)
CAR	Capital Adequacy Ratio
CBK	Central Bank of the Republic of Kosovo
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
FDI	Foreign Direct Investments
GDP	Gross Domestic Product
IMF	International Monetary Fund
KAS	Kosovo Agency of Statistics
KCGF	Kosovo Credit Guarantee Fund
KPST	Kosovo Pension Savings Trust
MFI	Micro-Financial Institutions
MFLT	Ministry of Finance, Labour and Transfers
MTA	Money Transfer Agencies
NFA	Net Foreign Assets
NIM	Net Interest Margin
NPL	Non-performing loans
ODC	Other Depository Corporations
POS	Point of Sale
pp	Percentage Points
ROAA	Average Return on Assets
ROAE	Return on Average Equity
RWA	Risk Weighted Assets
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 (2024), Financial Stability Report No.20, Prishtina.
Any necessary corrections will be made in the electronic version.

CONTENTS:

LIST OF CHARTS AND FIGURES

LIST OF TABLES

1. Governor's Foreword

The Central Bank of the Republic of Kosovo (CBK) presents to the public the 20th issue of the Financial Stability Report (FSR). Through a risk-based analysis perspective, FSR aims to inform the public on the state of the financial system, increase transparency and foster professional debate on developments and challenges in the financial system and its infrastructure.

The dynamics in global economic activity indicate a slower growth in economic activity and a decrease in global inflation, under the conditions of a significant increase in interest rates. The drop in inflationary pressures was accompanied by the beginning of monetary policy easing, while balancing this easing in the context of economic support without returning inflationary pressures was considered a challenge. The Eurozone economy was characterized by a more pronounced economic slowdown and, despite the fall in the inflation rate, a high rate of core inflation throughout 2023. Despite the stability of the financial system, the increase in interest rates and the reduction of liquidity by the ECB increased the cost of financing. for banks and credit risk. While forecasts suggest a gradual improvement in the eurozone economy in the coming years, risks to these expectations continue to be on the upside, including geopolitical tensions and the potential impact on supply chains and prices, shifting inflation expectations, climatic conditions, etc.

Similar to global dynamics, the Western Balkans faced a slowdown in economic activity and tightening of monetary policies. The gradual decrease in interest rates is expected to positively affect economic growth in the future, although subject to the influence of external pressures such as the recovery of external demand and internal dynamics.

The economy of Kosovo in 2023 marked a stable growth and a decrease in the rate of inflation. Throughout 2024, the domestic environment and macroeconomic dynamics have improved, while CBK forecasts suggest an acceleration of the real growth of the economy, mainly supported by the increase in real disposable income, stabilization of prices and easing of monetary policy in the global markets, a factor that is expected to translate into an increase in the reliability of consumers and investors. The significant slowdown of inflation, the increase in the level of financial intermediation and the improvement of the fiscal position indicate positive developments in the internal environment, supported by the stabilization of international prices, which are expected to reflect real economic growth towards the potential level and positively affect the the financial stability of Kosovo, as an open economy.

In support of economic activity, the banking sector maintained the level of a double-digit increase in lending throughout the year, mainly supported by demand, while the materialization of risks remained low with unchanged low indicators of non-performing loans. The increase in net interest income contributed to the increase in profit, which, due to competition and pressure on the cost side, marked a slower annual growth. The capital reserve increased with CBK's capitalization approach, contributing positively to the sustainability of the sector. Meanwhile, the slowdown in profit growth and pressures on financing costs are expected to continue in 2024, maintaining a moderate risk for financing and profitability.

The good financial performance of the sector and the capitalization approach of CBK enabled the capital adequacy ratio to increase, despite the double-digit growth of lending from the growth of risk-weighted assets. Also, the increase in private sector deposits maintained liquidity indicators above regulatory requirements.

The financial system in Kosovo has adapted a prudent and proactive approach to operation in relation to the circumstances, as well as has created satisfactory reserves of capital and liquidity to cope with the increased risks of its operation in the upcoming period.

Ahmet ISMAILI

Governor

Chairman of the Executive Board

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

The financial system of Kosovo continued to expand, maintaining a good liquidity, financing and capital position, despite operating in an environment with higher risks and uncertainties. The global economy and that of the Eurozone have shown relatively high resilience in the face of numerous challenges and shocks in recent years. Despite the fact that economic growth was slower as a result of monetary tightening policies in the fight against inflation, it remained satisfactory given the many risks and uncertainties that have surrounded it. Moreover, the effects of the economic slowdown and indirect credit risks from rising inflation were not transmitted to the financial sector.

However, global and macroeconomic developments have created pressures and challenges for the financial system of Kosovo, which were successfully faced. Uncertainties in the eurozone and geopolitical tensions did not increase the exposure to risks in the banking sector, while the increase in interest rates had a partial impact. This affected the increase in borrowing and deposit costs. Competition for deposits and pressure on the profit margin, due to the increase in interest rates, increased the financing and profitability risks for the banking sector. As a result, banks have faced a more challenging financial environment, changing their investment and funding structure to remain competitive and better manage the risks associated with interest rate fluctuations..

Risks to financial stability are expected to remain similar in 2024, with improving trends. The softening of inflationary pressures and the curbing of the increase in interest rates are expected to have a positive effect on the risks from the external sector. Likewise, the pressures on the liquidity and financing position are expected to remain high due to the increased need for sources of financing credit activity and the high competition for deposit withdrawals in the domestic market, with the possibility of expanding sources of funds abroad as well.

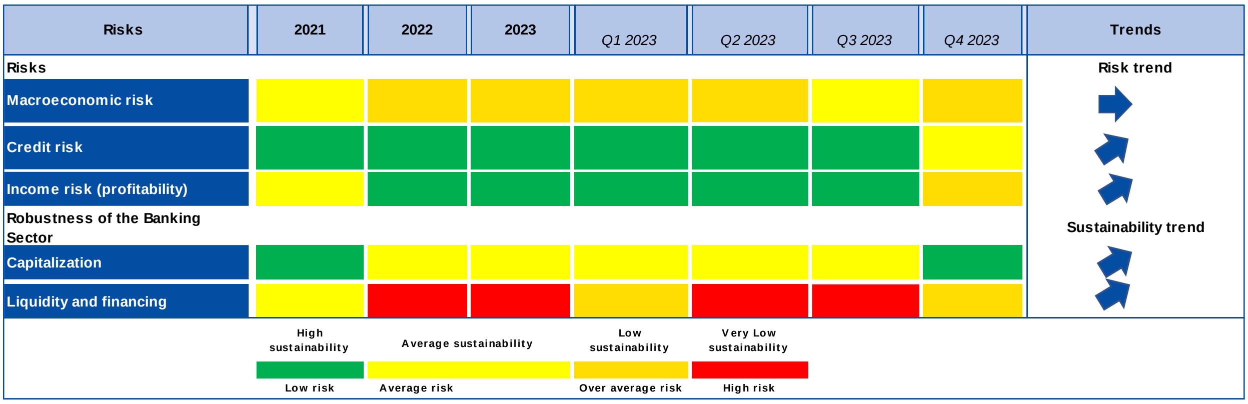
Global economic activity slowed slightly to 3.3 percent, and the same pace is projected to continue over the next two years. Global inflation continued to decline, but remained high due to tight labor markets and pressures from wage growth. To curb inflation, central banks, including the Federal Reserve and the ECB, raised interest rates sharply. However, with inflation falling, some central banks have already begun to ease monetary policies. The challenge remains balancing this easing to avoid a premature easing that could restore inflationary pressures, while simultaneously maintaining economic stability.

In this context, the Eurozone economy recorded a more pronounced slowdown, with modest growth of 0.4 percent. Inflation eased to 5.4 percent in 2023, from 8.4 percent a year earlier, mainly due to lower energy prices and stabilization of basic commodity prices. However, core inflation picked up and remained high at 5.0 percent in 2023. Despite the stability of the financial system, rising interest rates and reduced liquidity by the ECB increased the cost of funding for banks and credit risk, tightening lending conditions. The ECB predicts a gradual improvement in the economy in the coming years, supported by wage growth, exports and monetary policy easing, but that risks to these projections continue to be tilted to the upside, including geopolitical tensions and the potential impact on supply chains and prices, shifting expectations for inflation, climatic conditions, etc.

The Western Balkans facced similar dynamics, in which case the developments in the EU economy as well as the tightening of the monetary policies of the banks in the region to curb inflation, affected the slowdown of economic growth. Inflation in the region decreased to 7.7 percent, but remained higher in some countries, and was characterized by high core inflation pressures. The gradual decline in interest rates is expected to positively affect economic growth going forward, but remains subject to external pressures, including the slowdown in economic activity in the Eurozone and geopolitical tensions, as well as internal challenges such as dealing with inflation and potential migration based on the labor market.

The economy of Kosovo in 2023 recorded a stable growth, with a real GDP growth rate of 4.1 percent, showing a slight decrease compared to 4.3 percent in 2022. The decrease in the export of goods and the increase in the import of goods and services affected the slowdown of economic activity. However, consumption, together with investments and export of services, contributed positively to economic dynamics. Inflation in Kosovo decreased to 4.9 percent from 11.6 percent in the previous year, mainly due to the slowdown in the growth of food prices, the decline in energy prices in international markets, and the slowdown in the prices of services.

Table 1. Key risks and sustainability of the banking sector



Source: CBK.

*Construction methodology of the table of risk and sustainability of the banking sector is partially based on the methodology of the Financial Stability Map of Kosovo (according to which the value of the main relevat indicators is scored in relation to its historic statement) and analysts' jugdment.

The arrow direction suggests the risk/sustainability trend in the recent period (last quarter), and the development expectations on the following one-year period.

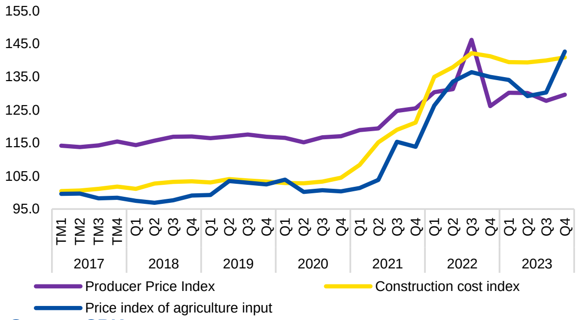
When the arrow of the risk indicators is in an upward direction, we are dealing with increased risks and vice versa

When the sustainability indicator arrow is pointing up, we are dealing with strengthening of sustainability and vice versa

Consumption was supported by rising wages and financing sources, slowing price growth and improving consumer confidence. Investments also made a positive contribution in contrast to the decline in the previous year, mainly due to the increase in public investments in infrastructure. The sectors with the highest contribution to economic growth were the processing industry, construction, financial and insurance activities, as well as transport and storage. Meanwhile, the electricity supply sector, agriculture, and education recorded a decline in this period. The slowdown in inflation in Kosovo occurred mainly due to the slowdown in food price growth and the drop in energy prices in international markets. Core inflation eased to 4.4 percent, supported by a slowdown in transport and hospitality services prices. CBK predicts inflation to slow to 1.6 percent in 2024, although risks from geopolitical tensions and changes in oil markets remain present.

As for the year 2024, an improvement of the macroeconomic conditions in the internal environment has been observed, where the preliminary estimates of KAS suggest an economic growth of 4.9 percent in the first half of the year. CBK projections suggest a 4.3 percent increase in economic activity in 2024, supported by increased household income, foreign demand and price stabilization, which will increase consumer and investor confidence. Domestic demand is expected to have the main positive contribution, while net exports are expected to contribute negatively to growth. Rising real disposable income and public investment, along with easing monetary policy in global markets, will support consumption and investment. However, uncertainties about the projections remain high due to the weak growth of the world economy and geopolitical tensions, which may negatively affect investments and trade in the country.

Chart 1. Construction, producer and agriculture input price indices



Source: CBK.

The significant slowdown of inflation and the improvement of the fiscal position indicate positive developments in the internal environment, which, supported by the stabilization of international prices, are expected to reflect in a real economic growth towards the potential level and positively affect the financial stability of Kosovo, as an open economy.

The fiscal position was further consolidated and the balance of payments improved during the year. The budget balance, due to the increase in budget revenues, went to a positive balance of 0.2 percent from the negative territory last year, and the public debt decreased to 17.5 percent. The balance of payments also saw significant improvements, with the current account deficit reducing and the capital account balance increasing. Positive developments were mainly marked by the increase in the export of services, especially in the travel and technology sector, while remittances and foreign direct investments increased, reinforcing their important role for the economy of Kosovo. However, the decrease in the export of goods, influenced by the decrease in external demand and price dynamics, as well as the increase in the import of goods, also influenced by the dynamics of global prices, reflect the high dependence of the economy on global developments as well as problems of the narrow range of export goods. During 2023, the investments of Kosovars abroad increased, especially in the real estate sector, and this phenomenon may lead to a decrease in private investments within the country, weakening the potential for domestic growth. Meanwhile, visa liberalization is expected to increase remittances through informal/non-official channels, but may also affect the decline in the balance of services due to increased import of travel services abroad.

The private sector recorded an increase in turnover in the trade and industry sector, mainly as a reflection of the increase in prices and the expansion of production activities. Likewise, the number of new enterprises increased, mainly concentrated in the trade, professional activities and information sectors, while closed enterprises decreased, especially in construction and hospitality. Financing of enterprise activity through debt from local and foreign financial institutions continued to grow, although at a lower rate compared to last year. Total corporate debt increased by 9.7 percent, to 45.1 percent of GDP, with a slower growth trend compared to last year. Domestic debt has increased by 10.7 percent, with a slower rate of growth of debt to the banking sector, while the growth of debt in the microfinance sector accelerated and resulted in 4.5 percent of the total debt of enterprises to the financial sector. The external debt of enterprises, mainly in the form of commercial loans, has increased by 7.1 percent, reaching 28.6 percent of the total debt. The ratio of lending to enterprises from local lending institutions to GDP reached 32.2 percent, leading to a positive credit gap to GDP. Despite the higher growth of enterprise deposits in relation to lending, the net debtor position of enterprises to the banking sector recorded an annual increase of 9.4 percent, as a result of the effect of the larger volume of loans. New corporate loans in the banking sector showed a slowdown in annual growth, influenced by the drop in demand but also the increase in interest rates in the last two years. For 2024, it is expected that the risk for the enterprise sector will remain at similar levels, with a slight downward trend, as a result of expectations for increased economic activity. However, labor market challenges remain and may be further impacted in part by visa liberalization, adding to the need for innovative strategies to increase productivity.

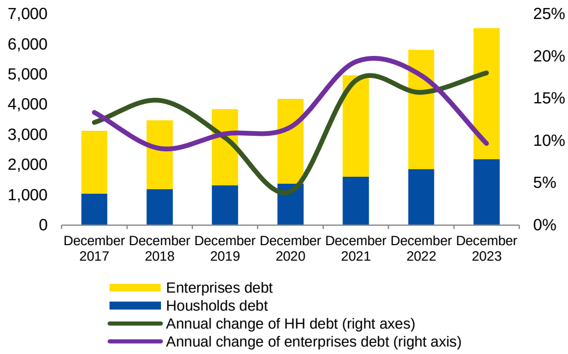
The household debt recorded a higher annual growth compared to the debt of enterprises, of 18.0 percent and reached 22.7 percent of GDP, still at a lower level of intermediation compared to the region. Growth was mainly influenced by internal debt to banks, because the increase in internal debt from microfinance as well as external debt, despite the high growth, have a low share. New loans issued by the banking sector to households recorded accelerated annual growth, mainly as a result of the high growth of personal non-investment (non-mortgage) loans for 23.2 percent, while new mortgage loans (according to the regulatory definition) recorded a decrease by 11.3 percent. The net credit position of households to the banking sector recorded an annual increase of 6.8 percent, influenced by the higher level of deposits in relation to loans. Lending activity, despite the slight increase in the interest rate, grew faster than deposits, which also recorded accelerated annual growth. The latter increased as a result of the favorable interest rate offered by the banks as well as the increase in household income from the increase in wages, remittances and the increase in the employment rate. Also, the indicator of economic dependence, which represents the ratio between the general inactive population (over 15 years old) and employment, showed improvement, suggesting an increase in disposable income. The results of the assessment of the indebtedness of individual borrowers suggest a slight decrease in the level of share of borrowers whose monthly installments exceed 50 percent of monthly income to 25.9 percent from 26.1 percent. But, despite this, the share of borrowers in the critical phase - the monthly installment exceeds 75 percent of the monthly income - and those who have the monthly installment higher than the income level, has shown a slight upward trend, with a focus on borrowers with lower income. As a mechanism for transferring interest rate risk to borrowers, banks have continued to increase the share of variable rate loans that reached 33.9 percent of the loan portfolio, which in the current circumstances of expectations for monetary policy easing, may result decreasing the cost of debt servicing for this part of borrowers. In general, the repayment performance of households has remained satisfactory with a low impact from the increase in the cost of living, while inflationary pressures are expected to decline and the potential risk from migration did not materialize.

The exposure of the banking sector to the external sector recorded high annual growth for the second year in a row, mainly due to the increase in investments in securities, which offered higher returns, although their share remains relatively low. Claims against non-residents in December 2023 constituted 16.8 percent of the total assets of the banking sector. The liabilities of the banking sector to non-residents also remain low, at only 4.2 percent of liabilities. Whereas, the limited presence of assets and liabilities in foreign currency reduces the risk of transferring problems from abroad and avoids possible losses from unfavorable exchange rate fluctuations against the euro.

The credit activity of the banking sector maintained a double-digit growth level, although it marked a slowdown in growth. Credit dynamics in the fourth quarter of 2023, as during the rest of the year, were mainly influenced by credit demand, while credit supply had minor changes. The slowdown in the growth rate reflects the slower trend in credit growth to non-financial corporations, as well as the prepayment of a portion of loans by some large creditors, while households accelerated growth.

The slower growth of lending to non-financial corporations characterized the economic sectors with a high weight of the banking credit portfolio such as production, trade and construction, which is in line with the slower turnover of enterprises of these economic activities. Lending to micro, small and medium enterprises continued to be supported by the Kosovo Credit Guarantee Fund, which in 2023 added two new windows to support women in business and exporting enterprises. Household loans accelerated the pace of growth, as a result of the high growth of new consumer loans for financing consumption needs. New mortgage loans continued the decline that began in 2022, and this development had the effect of restraining the upward trend of the share of long-term loans (over 5 years) in the total structure of loans by maturity.

Chart 2. Debt of enterprises and households, EUR million



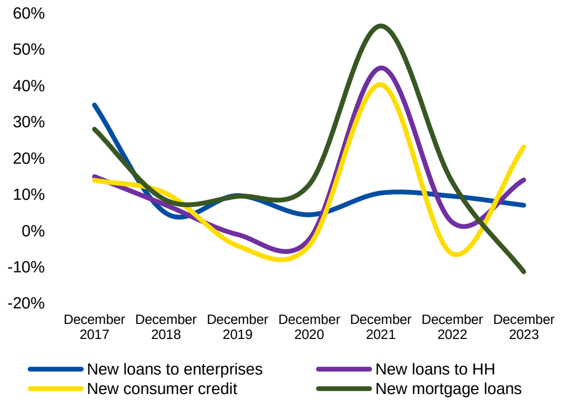
Source: CBK

Despite concerns about the credit risk caused by macroeconomic changes, its materialization was low and the deterioration of the credit portfolio was observed only in the last quarter of the year, which resulted in a more pronounced increase in the value of non-performing loans, although the indicator of non-performing loans remained the same (2%). The good financial performance and the ability of enterprises to repay debts was mainly supported by the increased economic activity and the transfer of costs to final consumers, while consumers were supported by the increase in wages, stimulus packages, remittances and economic activity in some sectors. Meanwhile, even though non-performing loans increased slightly, their ratio to total loans remained the same as in the previous year, at 2.0 percent, due to the expansion of lending. Households recorded a slight annual increase in the ratio of non-performing loans, from 1.2 percent to 1.4 percent, while the enterprise segment recorded a slight decrease in this ratio from 2.5 percent to 2.4. Banks reacted by increasing reserves, classifying the most affected sectors and tightening lending criteria. Some sectors sensitive to the energy crisis and inflation were categorized in the second pillar (according to IFRS 9 classification), including individual customers with lower incomes. In 2024, with the improvement of market conditions, some of these loans were reclassified to the first pillar due to the non-materialization of credit risk. However, banks remain attentive, monitoring the potential risk from migration after visa liberalization for Kosovo in the Schengen area, although according to current data, this risk did not materialize. Imbalances in the labor market and their potential impact on the performance of enterprises, especially SMEs, together with the increase in personal-consumer loans, emphasize the need for continued prudent approach to potential credit risk. The concentration of credit risk, expressed as the ratio between the value of large exposures to the number of these exposures, has shown a slight increase but remains below the maximum regulatory level of credit exposures.

The increase in net interest income contributed to the increase in profit, which, due to competition and pressure on the cost side, marked a slower annual growth. The capital reserve increased with CBK's capitalization approach, contributing positively to the sustainability of the sector. However, the slowdown in earnings growth and pressures on financing costs are expected to continue in 2024, maintaining a moderate risk to financing and profitability.

The structure of investments and financing has undergone significant changes, driven by the increase in interest rates and competition for deposits, which was reflected in the decrease in the profit of the banking sector from the previous year.Thus, this decrease in profit was mainly influenced by two factors: the increase in interest rates and changes in the structure of investments and financing. The increase in interest rates partially affected the demand for credit, slowing lending compared to the previous year. In addition, some banks faced high competition for deposits, which affected their credit supply. Meanwhile, some larger banks benefited from attractive rates of return on investments in foreign markets, shifting positions from lending to investments in international securities.

Chart 3. Annual change of new loans

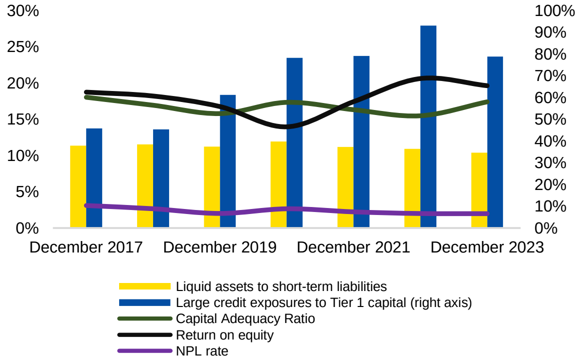


Source: CBK.

This resulted in higher profits for some banks, while others faced higher funding costs. Income from interest on loans and securities contributed to the increase in profit, while administrative expenses and interest on deposits slowed down this growth. The average return on assets remained at the same level as a year ago at 2.5 percent, while the average return on equity decreased by 1 percentage point to 22.0 percent.

Exposure to the risk of changes in interest rates has increased, assessed by the increase in the gap between assets and liabilities sensitive to interest rates. This cumulative gap widened as a result of the increase in the maturity of loans as well as investments in long-term securities, while deposits are still mainly of short-term maturity. However, this is a moderate risk that enables support for the economy, within the risk appetite. As a mechanism for protection against exposure to this risk, the sector continued to increase the share of loans with variable rates, shifting part of the risk to borrowers, which on the other hand represents increased credit risk. The expected decrease in interest rates may negatively affect the income from variable loans and the reinvestment possibilities of these funds. Therefore, in the future, the profit of the banking sector is characterized by increased uncertainties in terms of the sector's opportunities to realize income at the current levels, because the growing competition is expected to increase the pressure on financing costs, despite the general decrease in interest rates.

Chart 4. Selected indicators of financial soundness



Source: CBK.

The good financial performance of the sector and the capitalization approach of CBK, enabled the capital adequacy ratio to increase, despite the double-digit growth of lending from the growth of risk-weighted assets. Systemically important banks continue to have a higher capitalization rate. However, the variance between the CAR of individual banks and the average of the banking sector has decreased, indicating an approximation of the CAR to the average of the sector. CAR increased to 17.4 percent, from 15.5 percent a year ago. The share of Tier 1 capital is high at 89.3 percent, which indicates high quality of regulatory capital. The ratio of Tier 1 capital adequacy to risk-weighted assets, as well as financial leverage, increased to 15.6 percent and 9.8 percent, respectively, and are above regulatory requirements. However, despite capital levels above the minimum regulatory requirements, the continuous increase in the complexity of the sector and the external risks that the sector may face increases the need to strengthen mechanisms to increase resilience. Due to the significant growth of assets and lending during the last years, in the absence of appropriate data for certain segments it is difficult to measure the risks in certain segments at the sector level. At the same time, macroeconomic and geopolitical risks have created an environment of uncertainty, making it even more necessary to increase resilience to potential shocks. Global trends suggest that, due to challenges in predicting risks, it is important for banks to use the current period of high profitability to increase regulatory capital levels, which, in the case of Kosovo, are lower compared to the region and the European Union.

The banking sector of Kosovo continues to remain stable in terms of liquidity, with the main indicators remaining above regulatory requirements, mainly due to the increase in private sector deposits. However, the increase in interest rates during the year has created competition and pressures for banks in maintaining their liquidity position and managing financing costs. Deposit growth was higher in early 2023, but this growth slowed towards the end of the year, driven by larger deposit withdrawals by corporations and individuals, which may be related to increased funding needs in the cycle of business and expectations for stabilization of interest rates. The ratio of liquid assets to short-term liabilities has decreased in some banks due to the higher increase in liabilities, while some other banks have maintained or improved this ratio. On the other hand, the liquidity coverage indicator (LCR), which began to be reported from the beginning of the year, remains at a high level, although with significant differences between banks. Imbalances in liquidity surpluses between banks and the slowdown in deposit growth have highlighted funding risk. The high share of transferable deposits, together with the increased demand for sustainable financing, further emphasizes the importance of banks' prudent practices regarding their funding sources and related costs, in the face of expanded credit and financial activity.

Other sectors within the financial system were characterized by growth and positive financial performance, benefiting from increased global interest rates. The pension sector, the second largest in the financial system, recorded an accelerated growth of assets after a pronounced slowdown a year ago. This increase is attributed to the positive return on investments in the amount of 88.5 million euros. The number of contributors and the value of paid contributions has accelerated the growth trend, also contributing to the expansion of assets. Unlike last year, investments abroad have seen an increase in share, influenced by the greater opportunities for return.

As a result of the higher returns, the share price of the two pension funds rose.

The insurance sector continued the double-digit expansion of assets, supported by the increase in premiums written from policies sold, but its weight within the financial system remains low with only 2.7 percent of total assets. The level of intermediation and density of the sector remain similar to previous years, with a marginal increase in gross written premiums in relation to GDP, standing at 1.51 percent, and a density of 92.3 euros per capita. As a result of increased revenues from premiums sold and reduced reinsurance payments, the sector closed the year with a much higher profit than the previous year, further contributing to the reduction of losses carried over from previous years. The level of liquidity in the sector has suffered a slight decrease as a result of the higher growth of technical reserves. The progress of treatment, reservation and payment of claims remains in the high focus of CBK.

The microfinance sector recorded significant growth, mainly thanks to the expansion of lending and leasing, despite the high costs of financing from abroad, which were not passed on to borrowers and slowed down the sector's profit growth. Next year is expected to bring more favorable conditions in terms of interest rates in the global financial markets, which may be reflected in the reduction of financing costs.

The assets of the sector increased by 34.8 percent (also due to the re-categorization of two financial institutions from the license change), while the stock of loans increased by 25.9 percent, with a noticeable increase in both segments, households and non-financial corporations, supported by increased credit demand. Leases also increased by 30.8 percent, with the majority of leases for non-financial corporations. Interest rates for microfinance sector loans were partially influenced by global dynamics, stopping the gradual downward trend of recent years and marking a slight increase. The increase in interest rates in the global markets from which the sector is financed to the greatest extent influenced a significant increase in interest expenses, while the high interest rates on the assets side (loans and leases) limited the opportunities for increasing income from interest of the same magnitude. Expenditures also increased due to lack of interest, influenced by pressures to increase wages and the increase in the number of workers, and together with the increase in expenses for provisions, they affected the increase in the ratio of expenses to revenues as well as the decrease in profitability indicators for the sector. However, the sector remains well provisioned and has maintained a low level of non-performing loans despite high credit growth and recent challenges such as the high cost of living and slower economic activity.

Kosovo's inter-bank payments system has continued to operate with high stability and efficiency, contributing to financial efficiency and stability. In addition to the gradual increase in the use of the payment system, regulatory and operational actions have been taken to expand the inclusion base, increase digitalization, and advance the system towards applicable international standards and practices. Transactions in the system have increased both in volume and value, with a more pronounced increase in the use of digital payments and a decrease in the use of cash. The use of online banking accounts and services through electronic devices, such as POS and ATMs, has increased with an accelerating trend, improving access and services for customers. At the same time, the increase in the use of digitized services and automated processes has also been reflected in the increased sensitivity to operational and cyber risk, increasing the capital for coverage against this risk as well as other efforts to protect and address it.

Macroprudential supervision has marked significant progress in terms of improving assessment models and developing the framework for financial stability tests (macroprudential stress test), although the availability of qualitative and sectoral data for the adequate assessment of systemic risk remains a constant challenge. Despite the quality capital and high levels of profit of the banking sector, the need for the application of specific macroprudential policy instruments is assessed, in order to further increase the sector's resilience to potential risks, in situations suitable for their construction. The growing complexity of the banking sector and exposure to cyclical and structural risks highlights the need for a more proactive approach to maintaining sustainability. While Kosovo's banking sector exceeds minimum capital requirements, trends from dividend withdrawals and capital reduction above regulatory requirements and potential pressures on profitability due to internal competition and falling global interest rates underline the importance of maintaining coping capacities with the potential shocks, in the circumstances of the rapid growth of credit and the lack of information for timely assessment of the accumulation of risks. Therefore, in order to strengthen the financial system, the framework of the positive-neutral countercyclical buffer (CCyB) has been adopted in line with the recent practices of European countries, which allows maintaining a certain level of capital even when the risks are not pronounced or when sufficient information for systemic risk assessment is lacking. Also, to address the structural component of the systemic risk, the application of the capital buffer for systemically important banks is being considered. Consequently, they are expected to help strengthen the stability of the sector, manage cyclical and structural risks, ensuring that banks maintain sufficient capital during periods of rapid credit growth and can withstand possible negative impacts in certain periods, in accordance with their critical role in the financial system, respectively their systemic weight.

Box 1. Financial Stability Map[1]

The financial stability map[2] presents developments in the main indicators of risks to financial stability (Chart 1). In 2023, risks to financial stability remained low and at a level similar to the previous year. While the risks stemming from the high rate of inflation decreased as a result of the easing of inflationary pressures, the risks from the increase in the cost of financing and the slowdown of economic activity increased - these developments are expected as a result of the tight monetary policy measures.

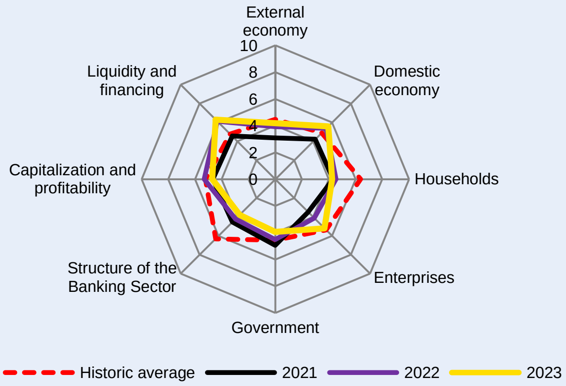
The indicators of the internal and external economy, as well as that of the activity of enterprises, were characterized by an annual increase in risk, while other indicators such as the activity of households and that of the Government recorded a decrease. Within the indicators of the stability of the sector, a decrease in risk - respectively an increase in stability was marked by the indicator of Capitalization and Profitability as well as that of the Structure of the banking sector, while the indicator of Liquidity and Financing was characterized by a slight increase in risk. Although the enterprise activity indicator marked the highest increase in the risk score, it is below the historical average level. While the other two indicators that marked a slight increase in the risk score, that of the domestic economy and Liquidity and Financing, remained above the historical average (Chart 2).[3]

The dynamics of the external economy indicator for 2023 was determined by the sub-indicator of interest rates, which marked a pronounced increase as a result of the tightening monetary policy at the global level. Also, the sub-indicator of the rate of economic growth of Kosovo's main trading partners was characterized by an increase in risk, as a result of the slowdown in economic growth in these countries. The other sub-indicators recorded a decrease in risk, mitigating the increasing effect of risk in the average rate of the indicator. Oil prices were at their lowest level since 2022; The sentiment of the enterprises showed an improvement, as well as the Unemployment Indicator showed a decrease, since the negative dynamics in the real sector and the tight monetary policy were not reflected during the year in the labor market in European countries with the highest concentration of the Kosovar diaspora.

Further in 2024, the expectations are that the risks from the external sector will remain at a similar level, with the possibility of improvement as a result of the easing of inflationary pressures, and the stagnation of interest rate growth.

The risk from the domestic economy also increased, reflecting the impact of the slowdown in economic growth in the country as well as the devaluation of the euro in relation to the currencies of trading partners. External debt in relation to GDP also increased, but at a low level. Meanwhile, the sub-indicator of the consumer price index recorded a decrease in the risk rating, as a result of the slowdown in the inflation trend. The current account deficit in relation to GDP marked an improvement, and together with inflation, mitigated the effect of the increase in the risk rating from other sub-indicators. For the following year, the risk from the domestic economy is expected to soften, as a result of expectations for greater economic activity and falling inflation.

Chart 1. Financial stability map



Source: CBK.

Enterprise sector marked an increase in the overall score compared to a year ago, as a result of the progress in the turnover indices in the main sectors with the greatest weight in the country's economy.

[1] The calculation of the indicators is based on the GDP value until March 2021, and does not include the last revision of the GDP in April 2021.

[2] The Financial Stability Map (HSF) graphically presents the movement of the degree of risk in the main categories of risk to financial stability in the banking sector of Kosovo, as well as enables comparison with the historical average grade of risk 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 constant revisions in indicators and their calculation method, is presented in CBK Study Material No. 6.

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

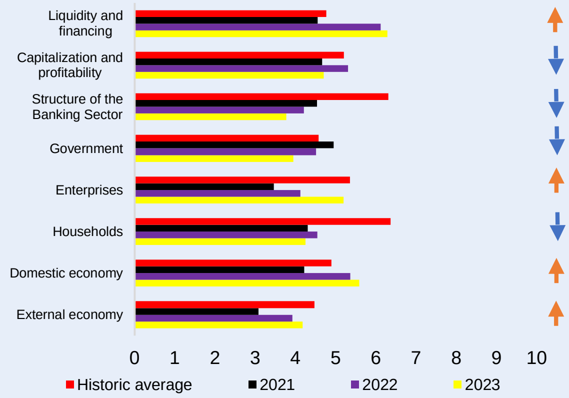
Accordingly, the industrial turnover index, the services sector turnover index, as well as the added value in GDP from the trade sector, despite the positive annual growth, recorded a lower rate of annual growth compared to the previous year. The sub-indicator of the credit gap remained at a similar level as a result of the slowdown in the credit trend alongside the slowdown in the growth of economic activity. The sub-indicator of the performance of enterprises had a positive contribution as a result of the positive balance of registration of new enterprises. Also, the indicator of the quality of the credit portfolio had a slight positive contribution, influenced by the higher growth of loans in relation to the value of non-performing loans of enterprises. For 2024, the enterprise indicator is expected to have a similar level of risk with a downward trend as a result of expectations for accelerated economic activity.

The risk from **households** marked a slight decrease, mainly influenced by the increase in financing sources, namely the accelerated annual growth of immigrants' remittances as well as the decrease in the unemployment rate. While, the other sub-indicators were characterized by an increase in the risk grade, mitigating the positive effect of the above sub-indicators. The credit gap to GDP widened, influenced by the accelerated growth of loans to households relative to GDP. Also, the rate of non-performing loans showed a slight increase as a result of the higher increase in the value of non-performing loans in relation to the increase in lending. Information on the sub-indicator of the affordability of expenses, which is a very important sub-indicator for risk assessment, was also lacking for 2023. The progress of the high growth of lending to households, if accompanied by a potential increase in the NPLs of this segment may affect the increase in the risk rating of this indicator in the following year. However, indications for this are not observed from the evaluation so far.

The risk from the **government sector** decreased, as a result of the decrease in the risk grade in four of the total five component sub-indicators. The tightening of the monetary policy has influenced the more pronounced increase in the interest rate on the German government's treasury bonds, compared to those of the Kosovo government, which experienced a lower rate increase, thus being reflected in the narrowing of the difference, respectively decrease in the sovereign risk premium. The next sub-indicator with the highest decrease in the risk score was that of tax revenues, which recorded a higher increase in relation to GDP. The decrease of the public debt in relation to the GDP contributed to the decrease in the risk score as well, while the sub-indicator of the budget balance in relation to the GDP had a low contribution due to the similar level of the fiscal deficit. The only sub-indicator with an increase in the risk rating was that of the cost of public debt, as a result of the increase in interest rates. As for the year 2024, the negative effect from the financing cost sub-indicator can be mitigated due to the inhibition of the further tightening of the monetary policy at the global level, with a positive effect on the risk dimension from the government sector.

Within the internal indicators of the stability of the sector, the indicator of capitalization and profitability was characterized by strengthening, namely a general decrease in risk, as a result of positive development in almost all sub-indicators. The main positive contribution was marked by the decrease of large exposures in relation to the Tier 1 capital. Furthermore, the increase in the ratio of net interest income to the assets of the sector, as well as the decrease in the ratio of non-performing loans, gave a positive contribution. Also, the capital reserve, namely the difference between the capitalization rate and the minimum required by regulation, marked an increase compared to the previous year, and together with the increase in the ratio of equity to assets of the sector contributed positively to the decrease in the risk rating.

Chart 2. Financial stability map



Source: CBK.

The only sub-indicator with a negative contribution to the risk score was that of the sector's profit to assets, which recorded a decline as a result of the sector's slowing profit growth, which is expected to be subject to the highest pressure even in 2024 due to competition and increased cost of financing.

Liquidity and funding indicator of the sector marked a slight increase in risk, with variable developments in the component sub-indicators. The slowdown in the upward trend of household deposits had the main contribution to the increase in the risk rating. The dynamics of higher credit growth alongside the slowdown in deposit growth also affected the drop in the liquidity ratio and the increase in the loan/deposit ratio, reflecting a higher risk rating from these sub-indicators. Whereas, the sub-indicator of the cumulative liquidity gap for the 3-month period and that of the share of non-residents' liabilities marked a decrease in the risk rating. In 2023, the cumulative liquidity gap for this maturity widened at a slower rate relative to total assets, as a result of the increase in deposit maturities and the relative reduction of shorter-term ones, driven by higher interest rate offers. As a result of the increased risk in the Liquidity and Funding indicator, the deviation above the historical average level that this indicator had over the years marked an increase. In the future, it is expected that the pressures on the liquidity and financing position will increase, as a result of the increased need for financing the lending activity in circumstances of increased competition and a slowdown in the growth of deposits.

The structure of the banking sector marked the most pronounced drop in risk, as a continuation of the gradual downward trend that characterizes this indicator over the years. All component sub-indicators recorded a decrease in the risk grade, but the highest contribution was made by the increase in the diversification of funding sources. The next sub-indicator with the highest contribution was that of the negative deviation of the capitalization rate to the average capitalization rate, which was characterized by an improvement, namely narrowing of the negative deviation to the average. The sub-indicator of the diversification of the banks' loan portfolio to that of the market also marked an improvement as a result of the increase in the diversification of lending and the reduction of concentration. While positive but smaller changes were marked by the general sub-indicator of competition, namely the assets of the three largest banks to the assets of the sector, and that of the diversification of the portfolio of business loans, which had almost the same level as the previous year.

3. The external environment and developments in the domestic economy

The global economy showed resilience in 2023, with an increase in economic activity and a slowdown in inflation supported by the tightening of monetary policy. Also, the financial system was stable, as the challenges in the banking system did not intensify as some concerns existed. However, the tightening of financing conditions, geopolitical tensions and the slowdown in global trade in goods, among others, influenced the slowdown in global economic activity. According to International Monetary Fund (IMF) estimates, global economic activity slowed to 3.3 percent in 2023 from 3.5 percent in the previous year, and this pace is projected to continue in the following two years. Of course, the outlook is subject to constant revision based on economic developments. Economic dynamics varied across economies, with accelerated growth in developed economies such as China, the US, and Japan, and notable slowdowns in the EU and Great Britain. Economic growth was supported by activity in services, namely travel and tourism, while demand for goods remained subdued.

Global inflation continued to follow a downward trend throughout 2023, resulting in an average annual rate of 6.7 percent. The slowdown in inflation was made possible by the tight monetary policy that affected economic activity and by the drop in the prices of basic goods in the international markets. Despite concerns about the return of inflationary pressures from the conflict in the Middle East and obstacles to the transportation of goods through the Red Sea, the impact was limited on supply chains and prices. On the other hand, tight labor markets, reinforced by migration to developed economies, as well as rising wages exerted inflationary pressures that slowed down the rate of inflation decline. According to IMF projections, global inflation is expected to fall to 5.8 percent in 2024 and 4.3 percent in 2025. However, inflation performance is conditioned by factors affecting the supply side, such as geopolitical tensions, trade barriers, climatic conditions, etc. and recently mainly from the dynamics in the service sector and the labor market. US labor market data raised concerns about the outlook for the economy as the unemployment rate rose. Concerns have also been raised for the Eurozone, based on the fact that the number of workers may turn out to be artificially high in anticipation of increased demand, which may turn out to be more muted. If these dynamics continue, the rate of inflation decline would accelerate, potentially influencing the pace of monetary policy easing. Therefore, the challenge for Central Banks remains the duration of monetary policy tightening as necessary to avoid an early easening that could restore inflationary pressures, but also a delay that could bring significant consequences to economic activity and a lower inflation rate than the targeted one.

Throughout 2023, the Federal Reserve raised interest rates by 100 basis points, resulting in a cumulative increase of 525 basis points from March 2022. Meanwhile, ECB interest rates increased by a total of 450 basis points from July 2022, with increase of 200 basis points only in 2023. Slowing down of inflation, but also of economic activity in an effort to curb inflation, influenced the growth of market expectations for monetary policy easing. The Federal Reserve cut interest rates by 50 basis points in September 2024, while the European Central Bank (ECB) cut the key interest rate by 50 basis points as of September, as well as reducing the difference between the key rate and the refinancing operations rate from 50 to 15 basis points.

The raised interest rates in 2023 at the global level were reflected in the slowdown in credit growth as a result of the drop in credit demand and the tightening of financing conditions by banks. Throughout the year, pressures were evident in certain segments, especially in banks exposed to the commercial real estate sector as a result of the drop in prices in this sector. On the other hand, as a result of the increase in optimism in the financial markets for easing the monetary policy, there was a reduction in the risk premium and a decrease in the spreads of corporate and government securities, as well as an increase in the value of assets in major exchanges. The latter has increased risks to global financial stability in the event of a potential correction in asset prices.

The economy of the Eurozone and the Western Balkans

Economic activity in the Eurozone was relatively weak in 2023, with growth of just 0.4 percent according to Eurostat. Faced with a background characterized by high financing costs, high inflation rates and other uncertainties, domestic demand was relatively weak, also reflected in the decrease in the import of goods. Meanwhile, the drop in external demand for goods negatively affected the export of goods and the accumulation of stocks, which marked a decrease in 2023. The European Central Bank (ECB) predicts a gradual improvement of the Eurozone economy in the following years. Economic activity is expected to grow by 0.8 percent in 2024 and 1.3 percent in 2025. This forecast is based, among other things, on expectations of easing financing conditions, increased disposable income from rising wages, increased exports with improved global trade.

Inflation in the Eurozone slowed to 5.4 percent in 2023, from 8.4 percent the previous year. The drop in inflation was the result of the drop in energy prices and the stabilization of prices of other basic goods in international markets, the anchoring of inflation expectations, as well as the transmission of monetary policy tightening in economic activity. On the other hand, inflationary pressures continued to be felt in the services sector, driven in part by the tight labor market and wage growth, which were also reflected in the acceleration of core inflation to 4.9 percent in 2023 from 4.0 percent in the previous year.

According to Eurostat, headline inflation slowed to 2.6 percent in July 2024, and core inflation to 2.9 percent. ECB projections see inflation averaging 2.5 percent annually in 2024 and easing to 2.2 percent in 2025. Key risks to these projections continue to lean to the upside, including geopolitical tensions and the potential impact on supply chains and in prices, shifting inflation expectations, rising wages or earnings beyond expectations, climatic conditions, etc.

The increase in interest rates and the reduction of liquidity by the ECB resulted in an increase in the cost of financing for banks in the Eurozone and an increase in credit risk. These factors influenced banks to continue tightening credit conditions for all segments of the economy in 2023. The tightening of credit conditions was more pronounced for enterprises, especially those in the commercial real estate market. For households, there was a tightening of standards for consumer loans, while for mortgage loans there was a noticeable slowdown in the tightening of lending conditions as a result of increased competition for lending to this segment. Moreover, lending was also negatively affected by the drop in demand from enterprises as a result of the weakening of fixed investments and the increase in the cost of financing. Likewise, the demand of households for loans has decreased as a result of the increase in interest rates, the decrease in consumer confidence and uncertainties in the real estate market.

The economy in the countries of the Western Balkans recorded growth that slowed down to an average of 3.0 percent in 2023 (4.1 percent in 2022), influenced by the slowdown in economic activity in the EU countries and the monetary policies applied by the central banks of the region to curb inflation. In Albania and Montenegro, economic growth was supported by the expansion of the services sector, especially due to the increase in income from tourism. While in other countries of the region, economic growth was mainly supported by consumption. The highest economic growth was recorded in Montenegro (6.0 percent), supported by the good performance of tourism, while the lowest growth was recorded in North Macedonia (1.0 percent), mainly influenced by the slowdown in investments.

IMF projections for 2024 suggest an average growth of 3.2 percent for the countries of the Western Balkans. Economic growth may be affected by external pressures, including the slowdown in economic activity in the eurozone and geopolitical tensions, as well as internal challenges such as dealing with inflation and the labor market.

The rate of inflation marked a decrease in single-digit values in all countries of the Western Balkans (with the exception of Serbia). Inflation in the region slowed to 7.7 percent (from 11.6 percent in 2022), supported by commodity price dynamics in international markets, especially energy and food, which have a high share in the consumption basket. The tightening of monetary policies by the central banks of the countries of the region, together with the gradual improvement of supply chains also contributed to the stabilization of inflation in the region.

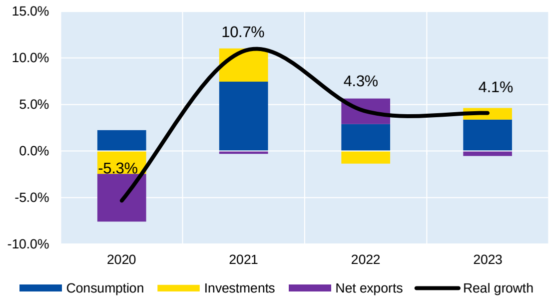
Lending activity in 2023 has grown at a slower level compared to the previous year, with Kosovo recording the highest growth at 13.0 percent, followed by Montenegro at 7.7 percent and Bosnia and Herzegovina at 5.5 percent. Credit quality in the region has remained stable, considering that non-performing loans declined in almost all countries in the region, except for Serbia which reported marginal growth. The most pronounced decline was in Montenegro and Bosnia and Herzegovina, while Kosovo was the only country that had a similar level of non-performing loans compared to the previous year.

The central banks in the countries of the region have taken decisions on the basic interest rates depending on the progress of the economic developments in the respective countries. The Supervisory Council of the Bank of Albania in July 2024 reduced the base interest rate by 0.25 percentage points, from 3.25 percent to 3.0 percent, based on the good performance of the economy and the slowdown in inflation. While in August 2024, it decided to keep the basic interest rate unchanged, at the level of 3.0 percent. In North Macedonia, the base interest rate was reduced by 0.25 percentage points as of September 2024 from 6.30 percent to 6.05 percent. While in Serbia, the basic interest rate was reduced three times as of September 2024, from 6.5 percent to 5.7 percent, in an effort to stimulate economic growth. The gradual decline in interest rates is expected to have a positive impact on economic growth in the coming months, increasing the demand for borrowing and investments.

3.1 Domestic economy

The economic activity in Kosovo, similar to the dynamics in the region, was characterized by stable growth in 2023. The real GDP growth rate was 4.1 percent, according to KAS estimates, against 4.3 percent in 2022 (Chart 5) .

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



Source: KAS and CBK calculations

The decrease in the export of goods, as well as the increase in the import of goods and services, caused the growth of economic activity to be slightly slower compared to the previous year. However, economic growth was supported by consumption, investment and export of services.

The dynamics that characterized the external sector of the economy, especially the trade balance of goods and services, contributed a negative impact of 0.5 percentage points to

GDP growth. The export of goods and services contributed by 2.8 percentage points, while the import of goods and services contributed negatively by 3.3 percentage points to the real GDP growth. The increase in the trade deficit in real terms was the result of the increase in the import of goods by 1.3 percent and services by 20.2 percent, as well as the decrease in the export of goods by 7.2 percent. While, among other things, the increase in diaspora visits to Kosovo resulted in a real increase in the export of services by 12.7 percent.

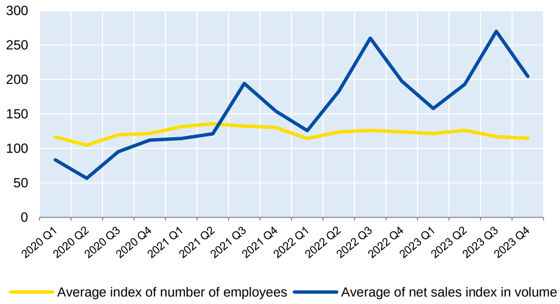
In 2023, consumption as the main component of domestic demand contributed 3.4 percentage points to real GDP growth, compared to 2.9 percentage points in 2022. The increase in consumption is explained by the increase in wages and financing sources, the slowdown in growth of prices and improving consumer confidence. Investments also contributed positively to real GDP growth by 1.2 percentage points in 2023, compared to -1.4 percentage points in 2022, mainly due to increased public investment in infrastructure.

In the first quarter of 2023, economic growth was mainly generated by increased investment and improved net exports, mainly as a result of increased export of services and decreased import of goods. Consumption recorded slower growth due to the high level of inflation in the first quarter. From the second quarter onwards, domestic demand starts to recover as a result of price stabilization. Meanwhile, the weakened external demand and the drop in international prices negatively affected the export of goods and positively affected the import of goods, causing the economic growth to be slightly slower compared to the previous year.

The sectors with the highest share in added value with the highest contribution to economic growth were manufacturing industry, trade, financial and insurance activities, extractive industry, as well as transport and storage. Meanwhile, the electricity supply sector, agriculture and education recorded a decline in this period.

The increase in economic activity, especially in the services sector, is also reflected in the statistics of services, where an increase in the turnover volume index was observed. The sectors that recorded the highest increase in sales volume were architectural and engineering activities (23.6 percent), hotels (12.1 percent), followed by travel agencies (8.5 percent), restaurants (8.0 percent), trade (5.7 percent), and information and communication (1.8 percent). On average, the turnover volume index in the service sector increased by 7.8 percent in 2023, while the average number of employees increased by 2.6 percent (Chart 6).

Chart 6. Index of sales and employees in services sector (2015=100)



Source: KAS.

As for the year 2024, an improvement of the macroeconomic conditions in the internal environment has been observed, where the preliminary estimates of KAS suggest economic growth of 4.9 percent in the first half of the year. In addition, a significant slowdown of inflation and improvement of the fiscal position was noted. These positive developments in the internal environment, supported by the stabilization of international prices, are expected to support economic growth and positively affect the financial stability of Kosovo.

CBK projections suggest that economic activity will increase by 4.3 percent in 2024. This growth is expected to be supported by the increase in household income, foreign demand and price stabilization, which are expected to influence the increase in consumer and investor confidence. Domestic demand is expected to contribute 6.8

percentage points to GDP growth, while net exports are expected to contribute negatively by 2.6 percentage points.

The increase in real disposable income, as a result of increased remittances, workers' compensation, consumer credit and price stabilization, is expected to support consumption, which is expected to contribute 5.3 percentage points to GDP growth. Investments are expected to contribute 1.5 percentage points to GDP growth, with a significant impact from public investments, positive price dynamics and the easing of monetary policy in global markets.

The export of goods and services is expected to positively affect GDP growth by 4.4 percentage points, supported by the increase in the export of services, especially the expenses of the diaspora in Kosovo. Meanwhile, the import of goods and services is expected to contribute negatively by 7.0 percentage points, influenced more by the import of services.

However, uncertainties about macroeconomic projections remain relatively high due to geopolitical tensions and the weak growth of the world economy, especially the Eurozone, which may negatively affect investments and trade with other countries. Price fluctuations in international markets, caused by these tensions, increase uncertainty about inflation and interest rates, affecting the confidence of consumers and investors, which can lead to a slowdown in economic activity. Such a situation when there could be an economic slowdown in the Eurozone with consequences on income from the diaspora, together with geopolitical tensions and impacts on trade and investments, constitute important challenges for the economy of Kosovo.

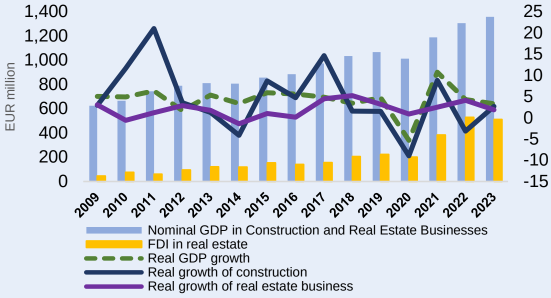
Box 2. Overview of Immovable Property and Construction Activities Sectors

The sectors of immovable property activities and construction have attracted increased attention in recent years, due to fluctuations in immovable property prices globally. The interconnection of these sectors with the financial system makes them fundamentally important for macro-financial stability. Moreover, the procyclical nature of these sectors can amplify fluctuations in the economic and financial cycle. In this context, a possible correction of immovable property prices may affect the banking sector due to exposure to these sectors, affecting the performance of credit portfolios and the value of collateral, despite the prudent policies banks have and high collateral requirements. Therefore, it is necessary to continue monitoring these sectors to avoid risks and strengthen financial stability to successfully withstand potential shocks.

The construction and immovable property sectors make up about 15 percent of the gross domestic product (GDP) and about 44 percent of the total investments in Kosovo, according to KAS data for the last ten years. In nominal terms, the gross value added in these sectors reached 1.4 billion euros in 2023. Moreover, the construction and immovable property sectors are among the sectors with the largest number of employees in the country, with about 12 percent of total employees in 2023. These sectors are also related to the external sector, with 511.2 million euros of foreign direct investment (FDI) in immovable property in in 2023, which finance part of the economic activity in construction and immovable property business.

Economic activity in the construction and immovable property sectors has recorded growth for the 10th time in recent years, with an average real growth rate of 2.2 percent, except for the years 2014, 2020 and 2022 (Graph 1).

Chart 1. Construction sectors and real estate businesses, economic growth and GDP



Source: CBK.

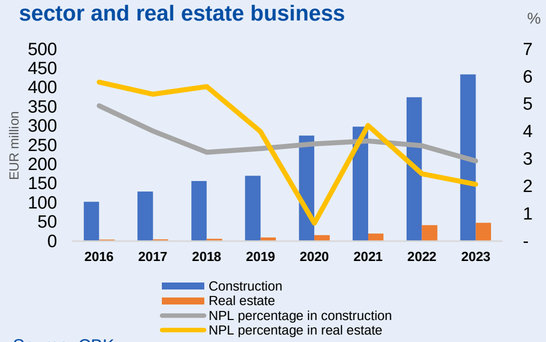
This growth was mainly supported by steady demand for immovable property. One of the most important factors that contributed to this growth are the socio-demographic changes in the country. According to preliminary data from the Population Census, in 2024 there was an increase in the number of households and a decrease in the average number of persons per household, resulting in 4.5 in 2024, compared to 6 in 2011 (ASK, 2024). Moreover, as a result of the limited opportunities for investments by family economies, the purchase of immovable property is seen as one of the most suitable forms of investment. Demand for immovable property is also supported by FDIs, mainly from the diaspora, which recorded an average growth of 41.8 percent during the period 2021-2023.

The dynamics in these sectors are also reflected in the immovable property supply indicators. According to data from the Municipality of Pristina, the area approved for construction reached its peak in 2021, significantly influenced by the reopening of the economy after the pandemic and the continuation of interrupted projects. However, the increase recorded in the construction cost index (IKN) from 12.1 percent in 2021 to 20.1 percent in 2022 affected the decline in construction activity of 3.1 percent in 2022. On the other hand, the immovable property sector recorded an increase of accelerated by 4.1 percent in this period, supported by the growth of FDI in immovable property of 37.9 percent.

However, in 2023, while the economic activity in construction recovered, marking an increase of 2.7 percent, the immovable property business slowed down significantly, mainly influenced by the fall of FDI in immovable property of 3.4 percent.

Bank loans have played an important role in supporting the demand for financing in the construction sector and for the purchase of immovable property throughout the years. In 2023, as a result of construction projects and infrastructure investments, loans to the construction sector increased by 15.9 percent, while loans to the immovable property business sector increased by 13.5 percent, even as interest rates increased. This growth in the immovable property sector reflects the high demand for investments in this area. At the same time, the improvement of the quality of loans and better risk management have contributed to the reduction of non-performing loans (NPLs) in the construction sector, which has reached 2.9 of the total loans for this sector, while in the immovable property sector the level of NPLs was 2.1 percent (Chart 2).

Chart 2. Loans and NPL in the construction sector and real estate business



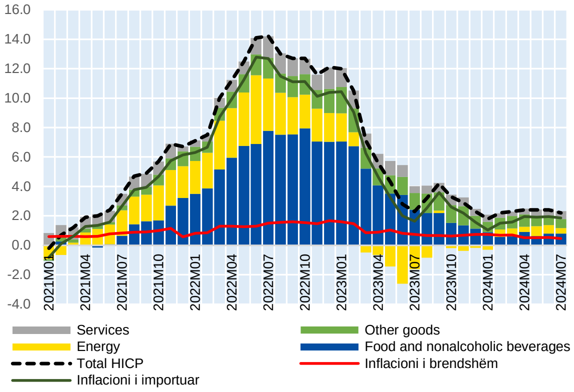
Source: CBK.

Despite the low level of NPLs, their coverage with provisions has improved in both sectors. The construction sector has reached a coverage of 152.8 percent, while in the immovable property business sector the coverage was 87.0 percent. Collateral has also increased, with an increase of 21.0 percent for the construction sector and 17.7 percent for the immovable property sector. The coverage of loans in the construction sector with collateral was 102.6 percent in 2023, which means that the collateral covers more than the loans offered to this sector, while in the immovable property business sector, the collateral was 90.3 percent, ensuring a good coverage for the loans offered. On the other hand, the stock of household loans, which includes mortgage loans, reached 1.91 billion euros at the end of 2023, marking an annual increase of 17.3 percent. Meanwhile, the NPL rate of this segment remained low at 1.4 percent.

The increase in loans and the improvement of the quality of loans in the construction and immovable property sectors are positive indicators for financial stability. However, it is important to continue monitoring non-performing loans, their coverage, as well as the performance of these sectors to manage risk and maintain financial stability. Instruments used by banks to minimize shocks from revaluation of immovable property prices as collateral may include measures based on borrowers and/or banks' capital. In order to avoid risks from new loans, when necessary, banks can set limits on the value of the loan for the purchase of immovable property depending on the value of the collateral (loan-to-value ratio), based on the debt-to-income ratio for the borrower, and also according to the characteristics of the borrowers in an effort to reduce the social cost and ensure the prevention of high lending in the future. However, there are no indications that this could happen. On the other hand, banks have the opportunity to minimize the risk of losses even in existing loans by dedicating additional capital over the required capital when there are well-founded concerns about the accumulation of risks in these sectors with potential consequences on repayment capacity.

Inflation in Kosovo slowed throughout 2023, with the average annual rate being 4.9 percent, against 11.6 percent in the previous year (Graph 7). This slowdown is mainly attributed to the slowdown in food prices, thanks to improved global supply chains and falling energy prices in international markets. As for services, the prices of transport and hotel services slowed down as a result of the weakening of domestic demand due to the decline in the purchasing power of consumers. Meanwhile, inflationary pressures continued to be present in the prices of other goods, including clothing, tobacco and alcohol.

Chart 7. Inflation by contribution of respective subgroups



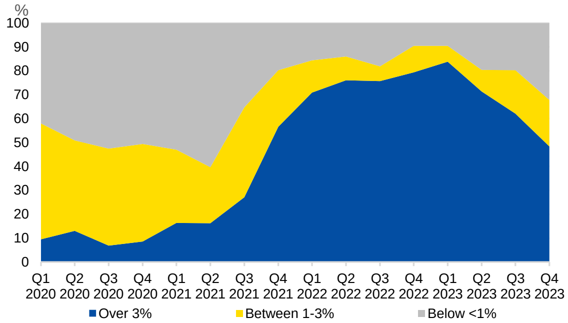
Source: ASK (2024) and CBK calculations.

The stabilization of the prices of basic goods in the international markets contributed to the decline of imported inflation, which had a contribution of 4.1 percentage points to the general inflation. Meanwhile, the decrease in domestic inflation to 0.8 percentage points was mainly the result of the slowdown in the prices of hotel services and electricity as a result of a number of factors, including the base effect, the performance of oil prices in international markets, the milder climatic conditions, as well as energy efficiency measures.

The slowdown in general inflation was also evident in the narrowing of the base of items in the consumption basket with annual price increases above 3.0 percent, which resulted in an average annual weight of 66.4 percent of the consumption basket in 2023, from 75.5 percent in the previous year (Chart 8).

The easing of inflationary pressures during 2023 was also evident in the basic inflation, which resulted in an average annual rate of 4.4 percent, against 4.9 percent in the previous year. The decline in core inflation was mainly supported by the slowdown in the prices of transport and hotel services. However, the pace of decline in core inflation remained slower than that of headline inflation.

Chart 8. Products weight in consumption basket by price increasing rate



Source: AS (2024) and CBK calculations.

According to CBK forecasts, the average rate of inflation in 2024 is expected to slow down to 1.6 percent. Factors that are expected to contribute to this slowdown include the stabilization of basic commodity prices in international markets, the downward trend of inflation in the eurozone, the impact of the tightening of financing conditions on economic activity, and others. Inflation projections are accompanied by potential risks to the upside, including the possibility of new disruptions in supply chains in the event of escalating geopolitical tensions, particularly in the Middle East, reductions in oil production from exporting countries, displacement of consumer expectations for inflation, dynamics in the labour market in the country, and others.

The fiscal sector during 2023 was characterized by an increase in budget revenues by 14.4 percent and an increase in budget expenditures by 13.1 percent. The increase in budget revenues was the result of increased economic activity, efforts to formalize the economy and the high rate of inflation. As a result of this higher increase in budget revenues and overall fiscal performance, a positive primary budget balance of 0.2 percent of GDP was recorded, compared to a negative primary budget balance of -0.2 percent of GDP in the previous year.

Public debt as a percentage of GDP fell to 17.5 percent, from 20.0 percent in 2022. This decrease came as a result of the improvement of the government's budget balance and the increase of the nominal GDP, thus reducing the ratio of debt to GDP. The nominal value of the public debt reached 1.66 billion euros, which is 5.1 percent lower compared to 2022. The decrease in the public debt is attributed to the decrease of the internal public debt by 12.8 percent, reaching 970.2 million euros. On the other hand, the external public debt increased by 8.1 percent, reaching 692.9 million euros or 41.7 percent of the total public debt.

In general, the fiscal performance during 2023 indicates a careful management of public finances, with a focus on increasing revenues and controlling expenditures, which has helped to reduce public debt and improve the country's fiscal stability. This was also widely evidenced in the Sovereign Credit Rating that the Republic of Kosovo received.

In 2023, the balance of payments marked an improvement in the deficit in the current and financial account, while it marked an increase in the positive balance of the capital account. The current account deficit decreased by 20.5 percent, reaching 729.4 million euros, or 7.5 percent of GDP (10.3 percent of GDP in 2022). This improvement was influenced by the 18.7 percent increase in the positive balance of services, as well as by the increase in primary and secondary income by 72.2 and 8.5 percent, respectively, compared to the previous year. Whereas, the increase in the trade deficit of goods of 7.3 percent had a negative impact.

The export of goods reached the value of 863.1 million euros, or 8.9 percent of GDP, marking an annual decrease of 6.2 percent. This decrease was mainly influenced by the decrease in the export of mineral products of 52.5 percent (54.5 million euros less compared to the previous year), as a result of the weakening of external demand and price dynamics in international markets. Also, other manufactured items recorded an annual decrease of 24.9 percent. The main partners for the export of goods were the countries of the Western Balkans, with 39.8 percent, and the countries of the EU, with 32.3 percent of the total export. Due to Kosovo's dependence on a limited number of exported products, the export of goods is more exposed to external shocks such as the slowdown in global economic activity and geopolitical tensions. Export diversification can improve the economy's resilience and resilience to these dynamics.

The import of goods in 2023 reached the value of 5.9 billion euros, or 61.1 percent of GDP, marking an annual increase of 4.9 percent. The increase in import is attributed to price dynamics in international markets and increased demand within the country, where the quantity and weight of imported goods increased by 11.6 and 8.3 percent, respectively. Merchandise imports were dominated by mineral products, foodstuffs and machinery including household appliances. Intermediate goods had the highest share in total imported goods with 46.4 percent, followed by consumer goods with 32.5 percent and capital goods with 10.3 percent. EU countries accounted for 43.0 percent of total imported goods, 15.7 percent the countries of the region and 14.8 percent Turkey.

Services continued to contribute positively to the current account, reaching a value of 1.6 billion euros (16.8 percent of GDP). The export of services increased by 18.4 percent, reaching the value of 3.0 billion euros, with the main contribution from travel services and computer services, including telecommunications. The export of travel services (with an annual increase of 17.7 percent) increased due to the increase in the number of travellers, while computer services recorded an increase of 36.1 percent, supported by the increase in external demand. On the other hand, the import of services recorded an annual increase of 18.2 percent and reached the value of 1.3 billion euros, mainly from travel services, which recorded an annual increase of 39.2 percent and accounted for about 46.8 percent of the total import of services.

The balance of primary income reached the value of 198.9 million euros, with an annual increase of 72.2 percent. The dynamics of primary income was mainly influenced by workers' compensation, the balance of which reached the value of 338.1 million euros, with an annual increase of 18.0 percent. On the other hand, investment income recorded a negative balance of 140.0 million euros, mainly due to the reinvested profit from foreign direct investments.

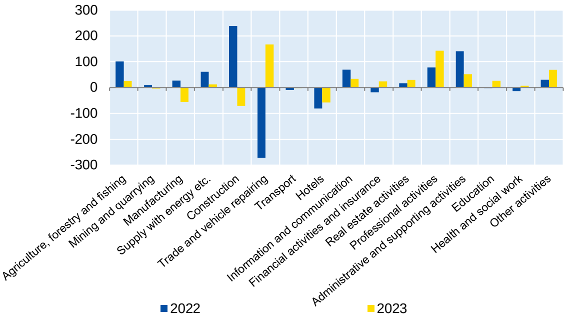
The value of remittances received in 2023 reached 1.3 billion euros (13.8 percent of GDP), marking an annual increase of 9.2 percent. The main countries from which remittances came remained unchanged, Germany with 38.2 percent, Switzerland with 18.8 percent and the USA with 7.3 percent of total remittances. Remittances through formal channels (banks and other institutions) increased by 6.6 percent, while informal channels increased by 16.9 percent. The increase in visits by Kosovars in the diaspora after the liberalization of visas may have influenced the even higher growth of remittances through informal channels.

Foreign direct investments recorded an annual increase of 14.8 percent and reached the value of 840.1 million euros (8.7 percent of GDP). The immovable property sector continues to have the highest participation with 61.2 percent of total FDI, followed by the financial sector including insurance with 21.3 percent and electricity supply with 6.2 percent. On the other hand, the direct investments of residents from Kosovo in other countries recorded an increase of 8.5 percent, reaching the value of 190.0 million euros (175.2 million euros in 2022). About 82.0 percent are investments in the immovable property sector and mainly destined to the countries of the region. However, in recent years, there has been an increase in direct investments originating from Kosovo in EU countries, especially in Germany, which reached the value of 17.8 million euros, with 9.1 percent annual growth. The continuous growth of direct investments abroad (on average 36.9 percent growth for the period 2019-2023) could affect the decline of private investments in the country, mainly in the immovable property sector.

3.2. Financial position of enterprises

Economic and financial indicators of enterprises present a positive overview of economic growth for 2023, reflecting the improvement of the financial position of the business sector. The increase in turnover in the trade sector of 10.6 percent, although slower compared to the growth of 21.4 percent in 2022, indicates an increase in consumption, as an important indicator of economic growth. Likewise, the added value in this sector marked an increase of 6.9 percent, consolidating the position of the trade sector in the general economy. In the processing industry sector, the turnover marked an increase of 8.7 percent, while the added value in this sector also marked an increase of 7.0 percent, suggesting an improvement in production capacities and an increase in the demand for processed products.

Chart 09. Annual change in the number of new enterprises

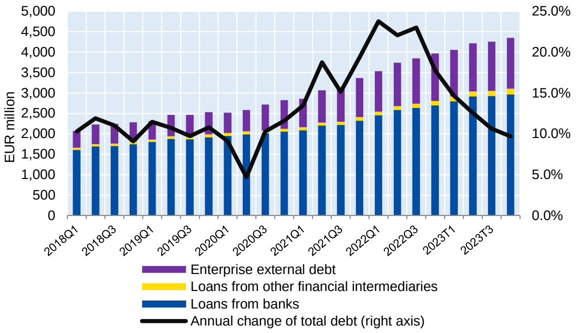


Source: KAS.

The entrepreneurial initiative has also recorded an increase of 3.6 percent, with 11,422 new enterprises registered, indicating a positive climate for the creation of businesses. This increase is a sign of confidence in the economic outlook, while the closure of 1,617 enterprises, which is 9.4 percent less compared to the previous year, suggests a stabilization of economic activity (Graph 9).

The debt of enterprises to local and foreign financial institutions has continued to grow, but at a lower rate compared to the previous year. In 2023, corporate debt recorded an annual increase of 9.8 percent (Graph 10), reaching 44.9 percent of GDP.

Chart 10. Enterprises debt



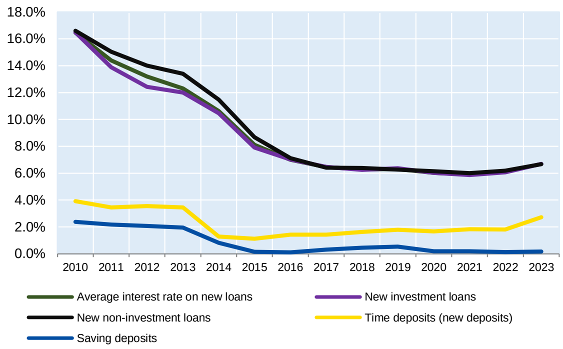
Source: CBK.

The internal debt of enterprises to financial institutions has increased by 10.7 percent, reflecting an increase of 9.8 percent in bank loans and an increase of 34.9 percent in loans issued by other financial intermediaries, which have a smaller weight (4.5 percent) in the total the debt of enterprises to the financial sector. Mainly as a result of the increase in commercial loans, the external debt of enterprises increased by 7.1 percent and reached 28.6 percent of the total debt. The increase in lending to enterprises from the banking sector has contributed to the increase in the degree of financial intermediation, with the ratio of loans to GDP reaching 32.1 percent, from 31.5 percent in 2022. This increase has resulted in a positive credit gap to GDP.[4]

The net debtor position of enterprises to the banking sector recorded an increase of 9.4 percent in 2023, compared to the increase of 14.9 percent in 2022. Enterprise deposits increased by 12.6 percent, while lending to the enterprise sector increased by 10.7 percent. Despite the higher growth of deposits, the much larger volume of loans to enterprises has influenced the growth of their debtor position towards the banking sector. In foreign currency, the enterprise sector has a net credit position to the banking sector due to the higher level of deposits in foreign currency compared to loans. However, the position in foreign currency remains low, as the participation of deposits in foreign currency to total deposits was 3.0 percent, while loans in foreign currency constitute only 0.4 percent of total loans.

The cost of borrowing for enterprises has seen a slight increase, reaching an average of 6.7 percent, mainly as a result of the tightening of the ECB's monetary policy. This increase in interest rates can have a negative impact on companies' investment decisions, making it more expensive to borrow for new projects. Also, the average interest rate on time deposits and savings has increased (Chart 11).

Chart 11. Interest rates for enterprises

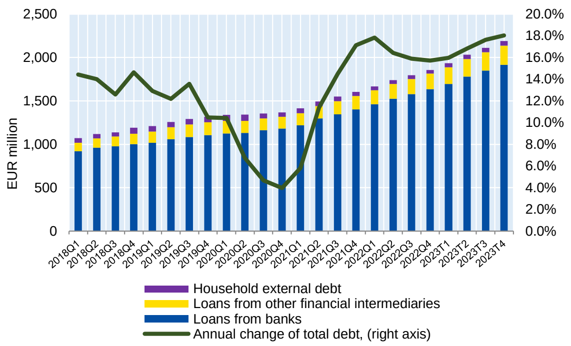


Source: CBK.

3.3. Financial position of households

Household debt has grown faster than corporate debt, reaching 22.6 percent of GDP in 2023, an increase of nearly 18.0 percent. Internal debt to the banking sector and microfinance institutions recorded an increase of 17.2 and 21.3 percent respectively, while external debt, which constitutes 2.4 percent of total, marked an increase of 37.0 percent (Graph 12).

Chart 12. Households debt

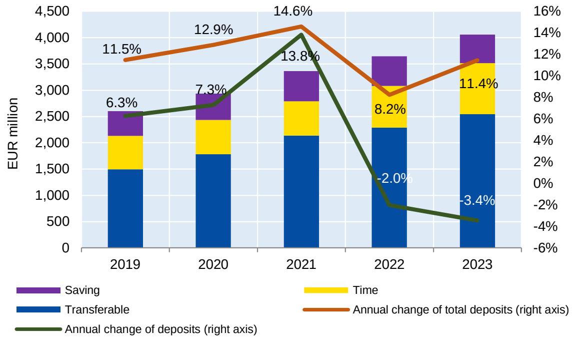


Source: CBK.

[4] The credit gap calculated with the Hodrick-Prescott filter.

New loans for households, especially consumer/personal or individual ones, recorded an accelerated growth of 23.2 percent and constitute 67.5 percent of new loans for this sector. Meanwhile, mortgage and investment loans decreased by 11.3 and 60.6 percent respectively (Chart 13). However, the data show an increase in a category of investment loans (non-consumer) with a range of over 20,000 euros (around 75% of them) but which are not classified as mortgages in terms of the regulatory definition. This, however, has had a positive effect on filling the gap in the rate of financial intermediation among individuals.

Chart 13. Household deposits

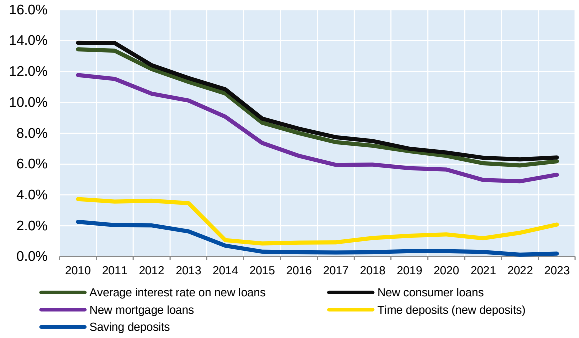


Source: CBK.

The credit position of households improved due to the increase in deposits, which reached the value of 4.1 billion euros, with an annual increase of 11.4 percent (Graph 13).

The increase in interest rates on time deposits has stimulated the growth of time deposits by 22.4 percent, while those of savings recorded a decrease of 3.4 percent. The cost of new debt for households showed a slight increase, which was influenced by the increase in interest rates in international markets. The average interest rate for new consumer loans reached 6.4 percent, while that for mortgage loans reached 5.3 percent (Chart 14).

Chart 14. Interest rates for households



Source: CBK.

Sources of household income showed an upward trend, with wages increasing, remittances increasing by 9.2 percent while workers' compensation[5] which marked an annual increase of 13.7 percent. In the labour market, the labour force participation rate reached 40.7 percent, which is 2.1 percentage points higher compared to 2022.

The employment rate has increased to 36.3 percent, which is 2.5 percentage points higher compared to 2022. The economic dependence indicator, which represents the ratio between the total inactive population (over 15 years old) and employment, has decreased to 211 percent from 230 percent as it was in 2022. On the other hand, the unemployment rate decreased to 10.9 percent, which is 1.7 percentage points higher low compared to 2022.

Table 2. Debt to banks and household performance

Description	2020	2021	2022	2023
Household debt to banks (EUR million)	1,182.2	1,401.2	1,634.1	1,915.2
Of which in foreign currency (EUR million)	2.3	2.2	17	13
Household deposits at banks (EUR million)	2,937.1	3,366.1	3,643.5	4,060.5
Of which in foreign currency (EUR million)	155.4	176.1	115.1	155.7
Net position to banks (credit position), EUR million	1,754.9	1,964.9	2,009.4	2,145.3
Average value of loans per employees	3,406.3	3,655.7	4,046.6	4,432.9
Economic dependence rate	275.0%	248.0%	230.0%	211.0%

Source: CBK.

[5] Income from workers' compensation - income of seasonal workers abroad as well as Kosovar workers outside the border for a period of less than one year.

Box 3. Debt burden of Individual borrowers in Kosovo

The debt burden for borrowers in Kosovo has been estimated based on the total population of individual clients from all banking and microfinance institutions in the country, namely borrowers with active loans reported in the Kosovo Credit Registry (KCR) until the end of December 2023. The total population includes 346,490 individual clients with a total of 603,141 active loans[6].

The load estimation methodology is the same as the methodology used in the previous studies.[7]

Several different indicators have been used that assess specific aspects of the debt burden. These indicators, which respect most of the principles mentioned in various studies of the problem of debt burden: the participation of debt in relation to income, delays in payment as well as the frequent use of loans and the subjective perception of debt as a burden of heavy. through (table 1).

Table 1. The results of objective indicators of debt burden

Category	Indicator	Assessment/Indicator	Results
Cost of debt servicing: Debt to income ratio	Borrowers spending over 50% of their gross monthly income to pay secured and unsecured debt	*Indebtedness Index (amount of monthly installments of all credit products=>50% of monthly income of borrowers); (calculated for 270,597 borrowers)*	28.1% of borrowers use over 50% of their income to pay their installments
		Indebtedness Index (amount of monthly installments of active borrowings =>50% of gross monthly income of borrowers); (calculated for 213,534 borrowers)	25.9% of borrowers with active borrowing use over 50% of their income to pay their installments only for their borrowings
Arrears	Borrowers in arrears for more than 2 months in paying their credit contracts	*Borrowers are in arrears for more than 60 days (sample 346,490 debtor)*	12.2% of borrowers are in arrears for more than two months on paying their credit installments. While from 193,034 of borrowers who have only one credit contract 14.1% of them (or 7.8% of total borrowers) are in arrears for over 2 moths
Number of credit contracts	Households=>4 active credit contracts	*Borrowers=>4 active credit contracts (sample 346,490 borrowers)*	6.4% of borrowers have 4 or more than 4 active credit contracts

Source: CBK.

The key indicator for assessing the debt burden "Debt burden index" of borrowers is calculated as the ratio of the number of monthly installments to monthly income[8]. Load levels are classified into four categories based on the index value:

1) Unencumbered (index < 0.50): Expenses for monthly instalments less than 50% of monthly income.

2) At risk (index 0.50 – 0.75): Expenses for monthly instalments at the rate of 50-75% of monthly income.

3) In the critical phase (index 0.75 – 1.0): Expenses for monthly instalments at the rate of 75-100% of monthly income.

4) Non-solvent (index > 1.0): Expenses for monthly instalments that exceed 100% of monthly income.
In order to measure the load level as realistically as possible, the necessary treatments have been done in advance in the data for the incomes as well as the monthly instalments. In the case of the borrower's monthly income, the last income was taken as a basis, namely the income that was reported in the last loan issued to the respective borrower. In cases where this information was missing, the average of the revenues reported in all observations (active loans) was considered. However, there were cases when the value of the income reported in the last loan deviated negatively from the average income for the same client, as well as cases when the monthly instalments significantly exceeded the last reported income, which from a sample evaluation is noted that they are related to loans issued for the agricultural sector[9], or loans issued to professions such as manager/owner/director, etc., who, in addition to income as an individual, also have income from individual businesses. To eliminate these cases when the deviation of the last reported

[6] The socio-demographic and socio-economic characteristics are presented in table 3.

[7] DEBT LOAD OF BANKING CUSTOMERS IN KOSOVO | Central Bank of the Republic of Kosovo (bqk-kos.org)as well as the box in FSR no. 19

[8] DEBT LOAD OF BANKING CUSTOMERS IN KOSOVO | Central Bank of the Republic of Kosovo (bqk-kos.org)as well as the box in FSR no. 19

[9] Loans for agro-culture in most cases have irregular payment frequency, namely high installments divided into rarer periods of time.

value of income and the average value for the same client was negative and the amount of instalments significantly exceeded the value of the last income (because they may result in overestimation of the burden), then based on the maximum incomes, under the assumption that they represent the most real incomes of the borrower (considering that such clients also have incomes that are realized from the business but that were not reported in the last loan). From the entire population of customers with active credit, the participation of cases with missing information on the last reported income was 17.2 percent, while with the inclusion of average or maximum income where information was missing (in relation to the types of cases elaborated on high), the participation of cases with a lack of information on income is reduced to 13.3 percent.

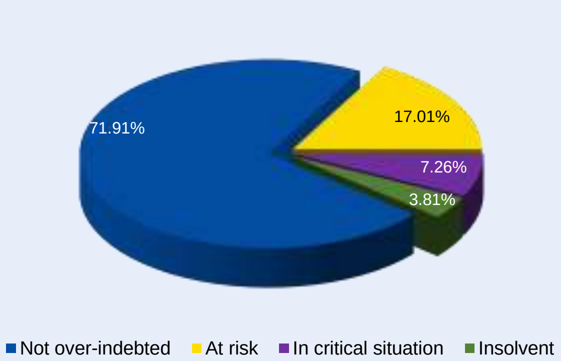
Lack of information on credit instalments is treated specifically according to credit products. In the group of credit products (loans, leasing and mortgage loans), the monthly instalment was missing in 4,764 cases (1.6 percent of the total portfolio of loans). For these cases, the calculations were made in relation to the available information on the effective interest rates. However, in some of the observations, the interest rate seemed to be incorrect, therefore, in order to eliminate the risk of overloading, in these observations as well as where the information on the interest rate was completely missing, the calculation of the instalment was based on the average interest rate in household loans, which corresponds to the type of loan, the year of disbursement of that loan, as well as the type of lending institution (bank or microfinance). For the overdraft credit product, the calculation of credit instalments in the observations where the information was missing (in 36.5 percent of the cases with used overdraft balance), was realized by applying the average interest rate for overdraft. While for those observations where the remaining maturity was lower than one month from the effective date of December 2023, it has been treated so that the entire remaining value (outstanding) is considered as an instalment. This, however, represents a very conservative approach and may have influenced the growth of this ratio, beyond the real one (that is, the monthly instalment that is paid every month). For the credit card credit product, the lack of information on instalments in 66.6 percent of the cases with a used balance, were treated as follows: for credit contracts that had no delays in payment, 15 percent of the debt amount was considered as instalment, which represents the minimum level that a credit card user must pay in the following month. In cases where there were delays in payment of instalments of more than 30 days and when the effective interest rate was available, then the instalments were calculated based on the remaining amount owed, while in cases where information on the effective rate was not possessed, then the rate was considered average interest on all credit cards of the population under analysis. With the relevant treatments, information on credit instalments was available for 88.5 percent of borrowers, while in 11.5 percent of cases, the instalment was equal to zero reflecting unused balances of credit products such as credit cards and overdrafts.

As a result of the lack of information about borrowers' incomes and the zero value of credit instalments in some observations, the load index was missing in 13.3 percent of cases or resulted in zero value in 8.6 percent of cases (which are the cases of zero instalments). Consequently, based on the availability of data and the relevant treatments carried out as above, the assessment of the level of the debt load has been calculated for 78.1 percent of the total borrowers.

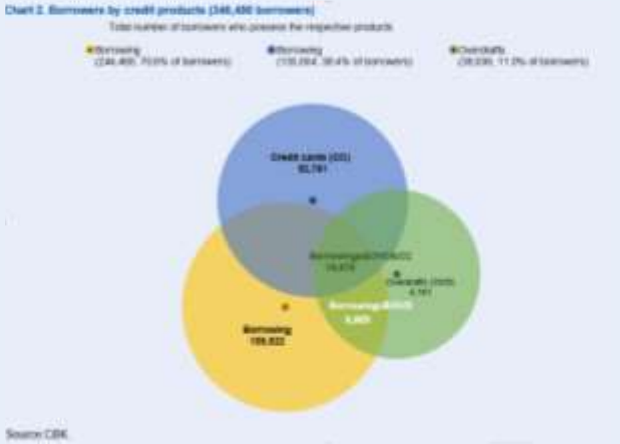
The results of the debt burden assessment suggest that 28.1 percent of borrowers are overburdened with debt.[10] In the first stage of overload - that is, at risk of overload because the monthly instalment accounts for 50 percent to 75 percent of the monthly income - they are 17.0 percent of borrowers. 7.3 percent of borrowers are in the critical phase. Cases where the borrower's instalment expenses completely exceed gross monthly income, passing into a non-solvent state, are presented in 3.8 percent of the sample of borrowers (Chart 1). However, the limitation of the data may be a factor that may objectively present an obstacle to these conclusions.

[10] Overload includes cases when the level of monthly debt for all credit products (the sum of monthly installments of loans, leases, overdrafts, and active credit cards with some adjustments) exceeds 50 percent of the monthly income presented or adjusted.

Chart 1. Spread of individual borrowers by burden index



Source: CBK.



Participation of overburdened borrowers (considering only credit products such as loans, leases and mortgages) it turns out to be similar to the previous two years, with a

The indicator is also calculated separately for credit products. Among all borrowers from the banking and microfinance sector, 70.6 percent have active loans (244,468 borrowers). 11.0 percent of borrowers (38,027 borrowers) have overdrafts with a used balance, while 38.4 percent of the total borrowers (133,004 borrowers) have credit cards with a used balance (chart 2).

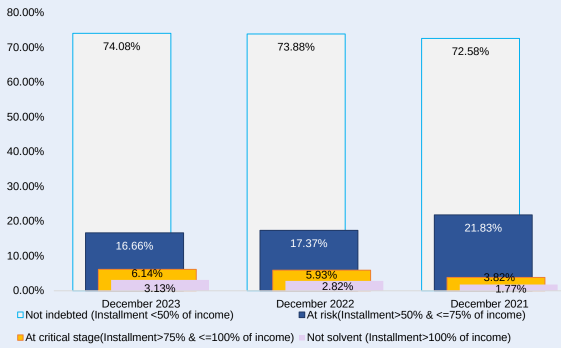
The level of debt burden only for the loan credit product (loans, leasing, mortgage loans), excluding other credit products such as credit cards and overdrafts, is calculated for 61.6 percent of the total population of borrowers. In this case, the participation of overburdened borrowers resulted in 25.9 percent.

The load assessment for borrowers who own the overdraft credit product with a used balance was carried out in the population of 36,477 customers or 10.5 percent of the entire population of borrowers, resulting in the fact that 4.1 percent of these borrowers are overburdened with debt.
While the load index for borrowers who use credit cards is calculated separately only for borrowers of the banking sector (246,801 borrowers), excluding borrowers who have credit products in microfinance institutions (taking into account the fact that microfinance does not offer a credit card credit product). The percentage of bank borrowers who have at least one credit card (133,004 borrowers) represents 53.9 percent of all bank borrowers, while the index was calculated for 51.2 percent of them, because some lack the necessary information. In this case, the results suggest that only 1.3 percent (1,656 borrowers) of these borrowers) are overburdened with debt.

slight downward trend. In December 2023, 25.9 percent of borrowers were overburdened with debt, while in 2022, the participation of overburdened borrowers was 26.1 percent. In the 2021 study, conducted on a sample of 1,805 borrowers, the participation of those overloaded with debt was 27.4 percent since the analysis is based only on KCR data containing information on the borrower. In the 2021 study, the load level was also analysed for family economies, integrating data from KCR with those provided by financial institutions for the incomes of other members of the borrower's family (Chart 3).

Despite the decrease in the participation of overburdened borrowers (the amount of credit installments greater than 50% of income), the participation of borrowers in the last two categories, in critical phase and those who have debt higher than the level of income, has shown a slight upward trend (chart 3).

Chart 3. Indebtedness of individual borrowers, for credit borrowing product



Source: CBK.

It is important to note that the estimated level of overburden is based only on the income of the individual borrower, and therefore may be subject to overestimation of the condition of overburden due to the fact that the income of the family unit or co-borrower is not considered, which may be taken as a basis for assessing repayment capacity. Another factor with potential impact on the subjectivity of overload is the lack of information about other sources[11] financial conditions of borrowers, which are not currently reported to KCR, but which are considered by the sector as factors in the assessment of repayment capacity.

Table 2 shows the incomes and the average amount of credit instalments, in which cases there is a slight increase in the average income and at the same time credit instalments, but a decrease in the average income of 6.4 percent and credit instalments of 10.4 percent. Also, there is an increase in the average amount of approved loans of 9.3 percent as well as the average of the remaining debt of 12.4 percent (table 4). The probability of overloading remains higher among borrowers who have three or more active credit contracts, as well as among those who have loans in both sectors – banking and microfinance simultaneously. This shows that the highest level of debt load is associated with multiple borrowing, i.e. with the possession of many active credit contracts in several different institutions (table 2), a proportion reduced by 1.4 percentage points from last year.

Borrowers with loans in different institutions had 45.9 percent of overdraft cases, compared to 39.7 percent of borrowers with several credit contracts but only in one institution. Last year, these ratios were 47.3 and 38.9 percent, respectively. By comparing the load level by sectors, the trends for overburdened were higher among borrowers with active credit in the banking sector, where 28.6 percent of borrowers were overburdened, compared to 18.0 percent of overburdened borrowers in the microfinance sector alone. This ratio remains similar to last year, where in the banking sector, overcrowding decreased by 0.5 percentage points, while it increased by 0.3 percentage points in the microfinance sector.

Having a credit history and credit contracts backed by collateral can be associated with higher levels of debt load. The eventual problems in payment performance may also be related to the higher level of debt burden, in which case the highest level of cases of overburden is expressed among borrowers with arrears of more than 180 days. in the payment of credit instalments (table 2). However, the indicator of non-performing loans is stable over the years and even improved (1.4%), so there are no real concerns at the portfolio level. Table 4. Statistics on income, instalments, approved and remaining amount of loans

Table 4. Income statistics, installment, approved and remained amount

Income and installment (EUR)	Average		Median	
	2022	2023	2022	2023
Income	787	837	488	502
Total installments	203	224	127	140
Borrowing installment	169	185	106	117
Shuma e aprovuar në hua	11,498	994	5,600	600
Shuma e mbetur aktive në hua (outstanding amount)	8,334	12,572	3,432	6,070

Source: RKK-BQK.

Of the socio-demographic characteristics that had statistically significant differences in indebtedness, marital status turns out to be an important factor (married borrowers are more indebted). This higher burden among married borrowers is related to the fact that they often take loans with co-borrowing – an aspect that was not considered when estimating the burden in this analysis, due to incomplete data on co-borrowing, thus leading in possible overestimation of the state of the load of this category, especially because the incomes from both borrowers/co-borrowers may not be declared. Also, the region has statistical significance in the level of congestion (the regions of Pristina and Mitrovica have more cases of congestion); age (the most frequent cases of overload are in the 31-40 and 51-65 age group); and income level (the most frequent cases of overburdening are among borrowers with incomes between 170 and 250 euros). The relative participation ratio of overburdened borrowers in these categories has increased from last year (table 3).

[11] These sources include income from remittances, informal income (part of the payment paid outside the banking sector), income from business, additional monthly payment.

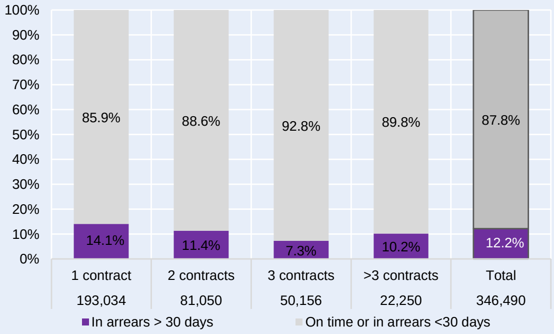
Table 2. Borrowers' over-indebtedness by socio-demographic and socio-economic characteristics and borrowing models

Characteristics	Not over-indebted (monthly installment<50% of HH income)	Over-indebted (monthly installment> 50% of HH income)		
		At risk (debt/income= 50%-75%)	In critical situation (debt/income= 75%-100%)	Insolvent (debt/income= over 100%)
Socio-demographic and socio-economic characteristics of individual borrow er				
Borrower's gender				
Woman	71.8%	17.3%	7.5%	3.5%
Man	71.8%	17.0%	7.2%	4.0%
Marital status				
Not married	76.6%	15.0%	5.7%	2.7%
Married	69.2%	18.2%	8.2%	4.4%
Divorced	75.4%	14.7%	6.0%	3.9%
Type of borrower				
Individual residency	71.9%	17.0%	7.3%	3.8%
Individual non-resident	82.1%	8.2%	5.0%	4.7%
Region of respective borrower				
Prishtina	69.8%	18.5%	7.6%	4.1%
Mitrovica	71.1%	17.9%	7.5%	3.5%
Prizren	75.4%	15.0%	6.6%	3.1%
Ferizaj	73.8%	15.7%	7.0%	3.5%
Gjilan	74.2%	15.3%	6.8%	3.7%
Gjakovë	71.7%	16.7%	7.3%	4.3%
Peja	71.9%	16.5%	7.6%	4.1%
Age of respective borrower				
< 30 years of age	79.3%	13.3%	5.1%	2.4%
30 - 40 years of age	69.5%	18.4%	7.9%	4.2%
40 - 50 years of age	68.6%	18.6%	8.5%	4.3%
50- 60 years of age	68.7%	18.9%	8.1%	4.3%
> 60 years of age	82.6%	8.8%	4.3%	4.3%
Borrower's income level				
Up to 170 EUR	31.5%	23.5%	21.8%	23.2%
170 -249 EUR	61.9%	17.8%	12.1%	8.1%
250-449 euro	68.4%	18.9%	8.7%	4.0%
450-749 euro	68.9%	20.5%	7.5%	3.0%
750-999 euro	77.4%	15.5%	4.9%	2.3%
1000-2000 euro	85.0%	9.5%	3.2%	2.4%
mbi 2000 euro	91.8%	4.6%	1.7%	2.0%
BORROWING MODELS				
Indebtedness by number of credit contracts				
Një kontratë aktive kreditore	88.5%	7.0%	2.8%	1.7%
Dy kontrata aktive	68.2%	21.0%	7.2%	3.6%
Tri kontrata aktive	52.1%	30.1%	12.3%	5.6%
Katër e më shumë kontrata aktive kreditore	33.9%	31.7%	21.8%	12.5%
Indebtedness by types of credit contracts				
Hua, lizing, kredi hipotekare	65.3%	21.1%	9.0%	4.7%
Mbitërheqje me bilanc të shfrytëzuar	74.7%	15.7%	6.4%	3.3%
Kreditkartelë me bilanc pozitiv të shfrytëzuar	75.4%	14.6%	6.4%	3.6%
Indebtedness **by lending institutions**				
Bank	71.4%	19.0%	6.4%	3.2%
Microfinance	82.0%	9.7%	5.2%	3.1%
Bank and Microfinance at the same time	50.5%	24.2%	16.4%	9.0%
Indebtedness by **multiple borrowing and in different institution**				
Many contracts - one lending insititution	60.3%	27.2%	8.5%	4.0%
Many contracts - some lending institutions	54.1%	24.0%	14.3%	7.7%
Indebtedness **by credit history**				
No closed contract	84.1%	10.1%	3.8%	2.1%
At least one closed contract	67.6%	19.5%	8.5%	4.4%
Indebtedness by **collateralized contracts**				
No active collateralized contract	75.5%	14.4%	6.4%	3.7%
At least one collateralized contract	71.1%	17.6%	7.5%	3.8%
Indebtedness by **credit classification** (arrears in loans repayment)				
On time, or in arrears <30 days	72.0%	17.2%	7.2%	3.6%
Vonesë 30- 60 ditë	71.5%	15.6%	8.2%	4.6%
In arrears 60-90 days	70.1%	16.7%	7.9%	5.4%
Vonesë 90 - 180 ditë	71.9%	15.8%	7.4%	4.9%
In arrears > 180 days	70.7%	15.0%	7.8%	6.5%
Write offs	76.0%	13.5%	6.6%	3.9%

Source: CBK.

Tendencies for late payment of monthly instalments differ according to the same socio-demographic characteristics as those of the overload, except for the case of marital status, where in the trends for late payment of instalments, the most frequent are the cases of borrowers in the group with marital status 'unmarried', that of the region where the most cases frequent cases of congestion are presented in the region of Prishtina and Prizren, and the age group 31-40 years has a higher participation of cases of delays compared to other age groups.

Chart 4a. Performance of borrowers repayment by number of credit contracts

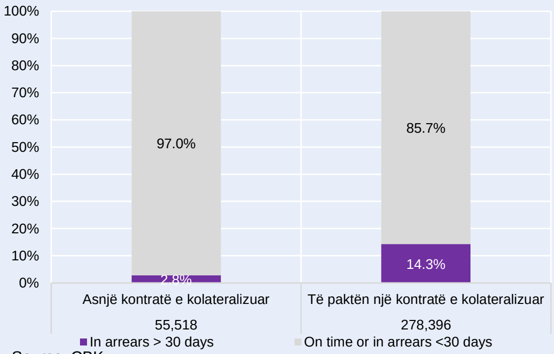


Source: CBK.

Within the borrowing models, the number of credit contracts, collateralization, type of lending institution, credit history, and multiple borrowings were statistically significant in the trends for lateness.

The most frequent cases of delays are presented in the group of borrowers with one and two credit contracts (Chart 4a).

Chart 4b.Performanca e pagesës së huamarrësve sipas



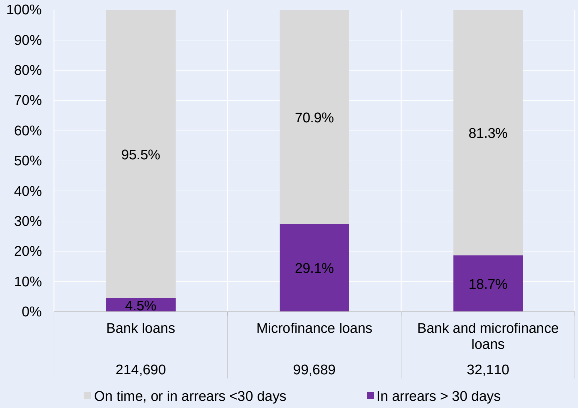
Source: CBK.

The most frequent cases of delays are presented in collateralized contracts (Graph 4b).

The highest trends of delays are presented to borrowers with loans only in microfinance (Graph 4c).

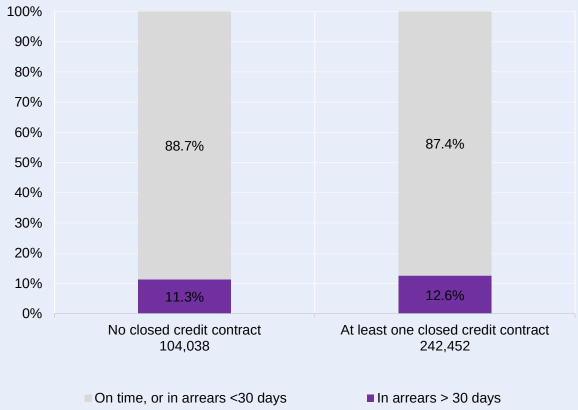
The most frequent delays are presented to the group of borrowers with a credit history with at least one closed contract (Graph 4d).

Chart 4c. Borrowers' payment performance by type of lending institution



Source: CBK.

Chart 2.d. Borrowers' payment performance, by credit history

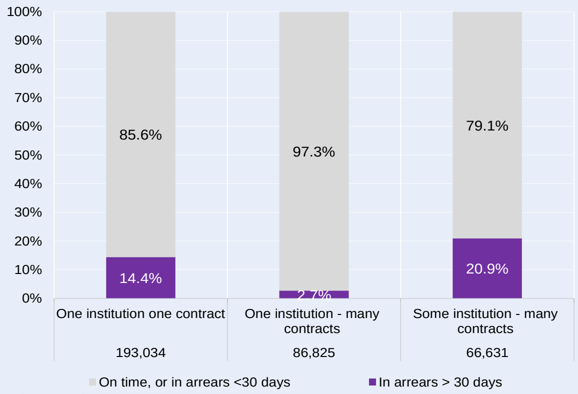


Source: CBK.

Likewise, the highest trends in loan payment delays were among borrowers with more than one active credit contract and from different institutions.

About 18.3 percent of borrowers with several credit products in different institutions are in arrears, compared to only 3.4 percent of borrowers with several credit contracts but in the same institution (Chart 4e).

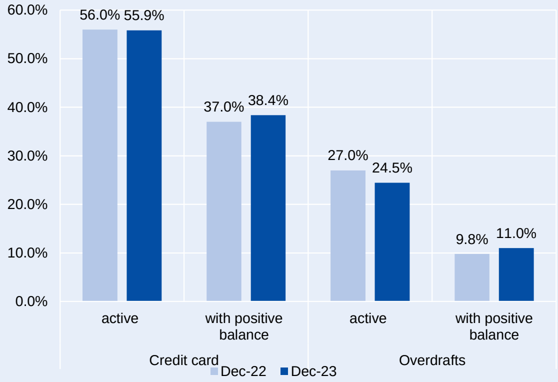
Chart 4e. Payment performance by number of credit contracts and lending institutions



Source: CBK.

Compared to last year, the participation of borrowers using overdrafts and credit cards has increased (graph 5). Likewise, the level of debt load has increased for the overdraft credit product compared to the data of the previous year, but that is in line with the increase in lending.

Chart 5. Other credit products and used balances



Source: CBK.

Eventually debt overload is attempted to be assessed through three indicators, such as the load index, delays in payment of instalments and the possession of many credit contracts, which together provide important information on the level of indebtedness of borrowers in the financial sector in Kosovo. Although the results suggest that overburden is associated with borrowing from certain credit products and poorer payment performance, the cause-and-effect relationship between these factors is not defined, and may develop in different directions. Having more credit contracts definitely affects the increase in the monthly debt for payment and has an impact on the increase in the level of the borrower's debt load. However, the above-elaborated aspect of not having complete data on all types of income that the borrower/co-borrower has (beyond salary) may also play a role here.

However, the results of the study may be subject to some limitations in terms of the quality of the available data and the assumptions made due to the deficiencies encountered. Accordingly, cases such as: lack of information on incomes in some observations as well as significant differences between the borrower's incomes (reported by different institutions or even the same institution) have been identified. This may be influenced by the possible inconsistency of updating the data for the borrower, or by the non-recording of all sources of the borrower's income (income from private business, remittances, income of other members of the family economy), which were considered during the review of the loan application, but which were not documented with a contract or bank transfer. These limitations as well as the lack of complete information on co-borrowings may have influenced the underestimation, respectively overestimation, of the borrower's burden. In terms of quality, cases of reporting extreme values, very high or zero incomes, very high or low interest rates (which are necessary for calculating the instalment in observations where it was missing), instalments very high, which in some cases clearly exceeded the borrower's monthly income, which consequently overestimates the debt load. However, some of such cases have been dealt with according to the possibilities and available data, which are elaborated at the beginning of this analysis.

Limitations in the availability and quality of data, and the complex and very important nature of the phenomenon of overloading, emphasize the importance for the highest quality data reporting, advancing to the reporting of additional and more complete information, as has been recommended in previous analyses of the debt load.

Table 3. Socio-demografic caracteristics and socio-economic of the borrowing models

Socio-demographic and socio economic characteristics of individual borrower	Share (%)	Number / Frequency
Number of borrowers: 346.490		
Number of active credit contracts: 603.141		
Socio-demographic and socio-economic characteristics of individual borrower		
Borrower's gender		
Woman	32.9%	111,873
Man	67.1%	228,237
Marital status		
Not married	40.0%	137,418
Married	59.5%	204,466
Divorced	0.5%	1,724
Type of borrower		
Individual residency	98.5%	341,346
Individual non-resident	1.5%	5,144
Region of respective borrower		
Prishtina	36.8%	127,471
Mitrovica	11.7%	40,299
Prizren	14.3%	49,623
Ferizaj	9.6%	33,125
Gjilan	8.9%	30,661
Gjakovë	9.1%	31,478
Peja	9.6%	33,358
Age of respective borrower		
< 30 years of age	23.6%	81,588
30 - 40 years of age	26.7%	92,636
40 - 50 years of age	22.5%	77,813
50- 60 years of age	23.3%	80,645
> 60 years of age	4.0%	13,806
Borrower's income level		
Up to 170 EUR	1.9%	5,567
170 -249 EUR	6.7%	20,036
250-449 euro	31.6%	94,997
450-749 euro	31.8%	95,315
750-999 euro	9.6%	28,777
1000-2000 euro	12.7%	38,057
mbi 2000 euro	5.8%	17,497
BORROWING MODELS		
Number of borrowers by credit contracts		
One active credit contract	55.7%	193,034
Two active contract	23.4%	81,050
Three active contracts	14.5%	50,156
Four or more active credit contracts	6.4%	22,250
Number of borrowers by type of credit contracts		
Borrowing, leasing, mortgage loan	70.6%	244,468
Overdraft with a positive balance	11.0%	38,027
Credit cards with positive balance	38.4%	133,004
Other credit products	0.05%	178
Number of borrowers by number of institutions		
Client with a contract in only one institutions	80.8%	279,859
Client with contracts in many institutions	19.2%	66,631
Number of borrowers by type of lending institution		
Bank	62.0%	214,690.0
Microfinance	28.8%	99,689.0
Bank and Microfinance at the same time	9.3%	32,110.0
Number of borrowers by credit history		
No closed contract	30.0%	104,038
At least one closed contract	70.0%	242,452
Number of borrowers by collataralized contracts		
No active collarateralized contract	16.0%	55,592
At least one collateralized contract	84.0%	290,898

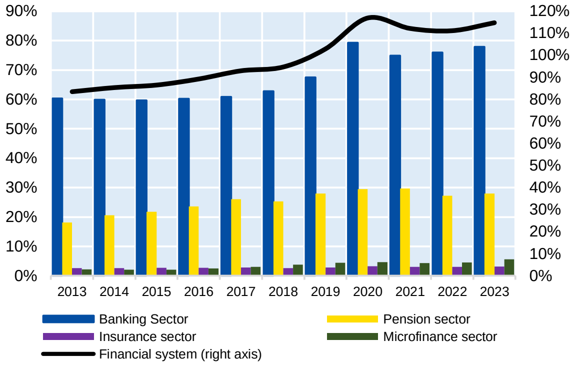
Source: CBK.

4. Developments in the financial system

The financial system continued to expand, closing the year with an accelerated annual growth of assets, despite operating in an environment with higher risks and uncertainties driven by the high rate of inflation and measures to combat it.

In December 2023, the value of financial system assets reached 11.1 billion euros, marking an annual increase of 12.4 percent from 10.8 percent in 2022. The higher growth of financial system assets compared to nominal GDP growth influenced the expansion of the financial intermediation rate by 3.6 percentage points, to 114.8 percent in December 2023 (Chart 15).

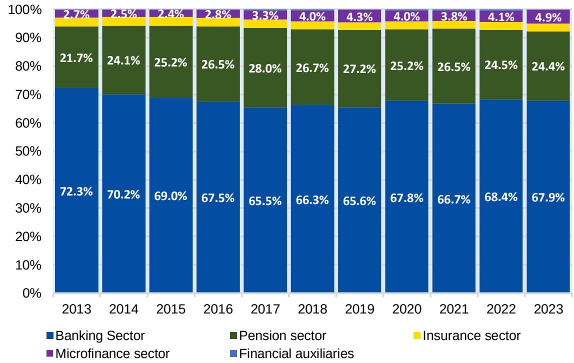
Chart 15. Weight of financial system sectors to GDP



Source: CBK.

The banking sector represented 67.9 percent of the assets of the financial system and, due to its high share, had the main contribution to the expansion of the system, despite the slower annual growth. The pension sector, the second largest in the financial system, recorded an accelerated growth of assets compared to the previous year. The microfinance sector was characterized by a marked increase in activity for the second year in a row, increasing its weight in the system to 4.9 percent from 4.1 percent in the previous year (Chart 16). While the insurance and financial intermediaries' sector, due to their lower weight, had a more limited impact on the overall structure of the system's assets. The insurance sector recorded a double-digit increase in assets for the fifth year in a row, while financial aids recorded an annual decrease, influenced by the re-classification of two financial institutions.[12]

Chart 16. The share of respective sectors to total financial system assets



Source: CBK.

The number of financial institutions increased to 136 from 131 a year ago, with the start of operation of two non-banking financial institutions, two financial assistants and an insurance intermediary (table 3).

Foreign capital continues to dominate most of the sectors of the financial system, especially the sectors dealing with lending activity. One of the non-banking financial institutions that was added to the Kosovo market during 2023 was with foreign capital, while in other sectors the number of foreign institutions remained the same as a year ago. In December 2023, banks with domestic capital represented 15.7 percent of the sector's total assets, an annual increase of 0.5 percentage points. Meanwhile, in the insurance sector and the microfinance/non-bank financial sector, there was a decrease in the market participation of local institutions, by 1.9 and 0.4 percentage points, going down to 46.4 and 21.3 percent, respectively.

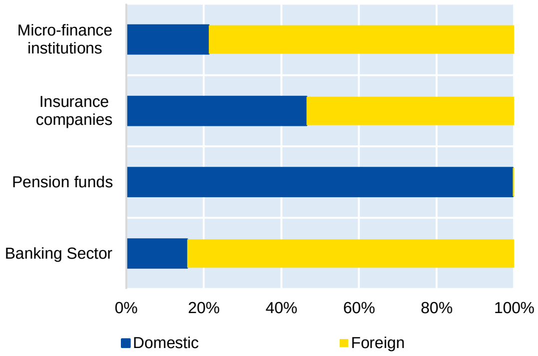
[12] From November 2023, two financial institutions have been re-classified from financial aid to other financial intermediaries (IMF&IFJB). This has influenced to increase the value of assets in the microfinance sector (it has mainly influenced the increase of the balance sheet with other banks).

Table 3. Number of financial institutions

Description	2016	2017	2018	2019	2020	2021	2022	2023
Commercial banks	10	10	10	10	11	11	12	12
Insurers	15	15	14	13	13	12	12	12
Pension funds	2	2	2	2	2	2	2	2
Financial auxiliaries	40	43	50	50	57	53	59	61
Insurance intermediaries	16	16	16	18	18	19	16	17
Microfinance institutions and non-bank financial institutions	22	25	29	29	29	30	30	32

Source: CBK.

Chart 17. Ownership of financial system constituent sectors, December 2023



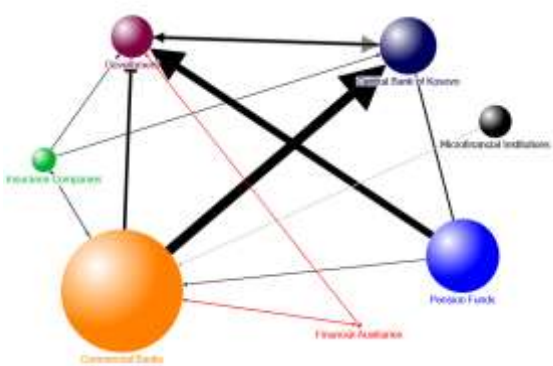
Source: CBK.

The banking sector is dominated by capital originating from the EU, which includes two of the three banks with the highest share of assets in the market. The increase in competition from other banks, including the operation of two relatively new banks that started their activity in the local market in 2020 and 2022, has influenced the reduction of the degree of concentration in assets as well as the reduction of the share of banks with origins from the countries of the Union. European, to 51.1 percent from 51.9 percent in the previous year. The entry into the market of a new bank with local capital in 2022 caused the share of local banks in total market assets to increase further, to 15.7 percent from 15.1 percent in December 2022. Banks originating from Albania increased the share to 17.0 percent from 16.1 percent a year ago, while Turkish banks, for the second year in a row, recorded a decline in their share in the sector, in 15.0 percent from 15.2 percent in December 2022.

The microfinance sector is also dominated by institutions with foreign capital (Graph 17), and is characterized by a high degree of concentration. The ratio of the assets of the three largest institutions to the total assets of the sector in December 2023 was 52.7 percent, which represented a decrease of 3.5 percentage points compared to the previous year. The insurance sector continues to have a lower level of concentration, due to the more balanced distribution of assets in the market. However, in the last four years, a trend of increased concentration of insurance sector assets has been observed, mainly due to the revocation of the license of two insurers (one in 2019 and one in 2021).

Insurance companies with local capital make up 46.4 percent of the total assets of the sector, from 48.3 percent in the previous year. Meanwhile, companies with foreign capital, with a participation of 53.6 percent, have their country of origin in Austria, Slovenia and Albania.

Figure 1. Institutional connections of the Financial System of Kosovo



Source: CBK.

Note: the size of each node (circle) reflects the total assets of each institution, excluding the Central Government, which is based on the total liabilities that the government has in the form of securities to these institutions. The direction of the arrows means the request 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. The situation is with December 2023.

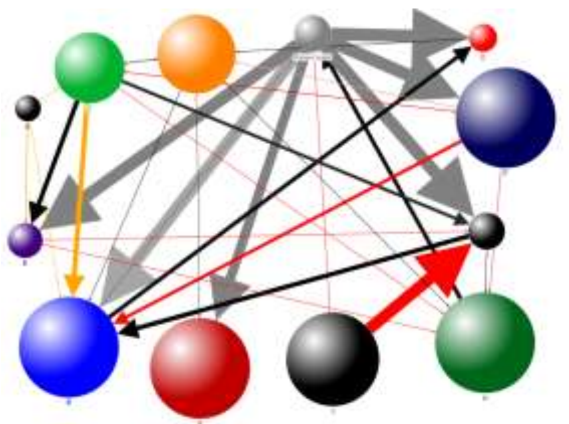
The dynamics in the relationships between the actors of the financial system in 2023 have undergone insignificant changes compared to the previous year. The main link with the higher change was the decrease in the exposure of the banking sector to the Central Government, namely the decrease in investments in securities of the Government of Kosovo, mainly as a result of the lower offer from the government (figure 1). The connection between the banks and the pension fund also decreased, as a result of the decrease in the placements of the pension fund in the banks in the country due to the orientation to investments in the foreign market in the circumstances of high rates of return. Whereas the connection of the pension sector with the CBK marked an increase compared to a year ago, but this increase is usually temporary until the decision on their investment. The connection of the banking sector with other financial sectors such as the pension sector, the insurance sector and the microfinance sector in general remain low, analysed from the perspective of the banking sector (the demand of commercial banks towards these sectors constitutes only 0.2 percent of the assets of the banking sector). However, the deposits that non-banking financial institutions hold in commercial banks represent high inter-institutional exposure for some of these institutions, so this interdependence emphasizes the importance of monitoring and understanding the effects of the spread of risks within the financial system.

In the framework of inter-bank connections, the connection between banks with foreign capital operating in Kosovo and their parent banks continues to be at a higher level.

Large banks have their main exposures in foreign markets, to parent banks or other banks/financial institutions (figure 2). Relatively smaller banks have exposures at a lower level among themselves but at a more pronounced level towards larger banks. Banks of Turkish origin show greater interconnections among themselves.

Mainly, the connections between banks are in the form of deposits, short-term loans and, at a lower level, loans. Compared to a year ago, in the banking sector in general there is a decrease in the interaction of banks with foreign capital with local banks, while an increase in interaction with foreign banks. Banks with foreign capital operating in the country have significantly reduced lending to parent banks, while slightly increasing borrowing from these institutions.

Figure 2. Banking connections of the banking sector of Kosovo



Source: CBK.

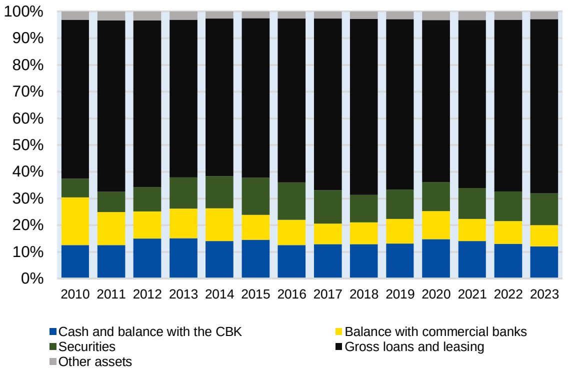
Note: the size of each node (circle) reflects the total assets of each banking institution, excluding the parent banks, where it is based on the total claims that the parent banks have in the form of credit lines or interdependent debt to the respective banks in the country. The direction of the arrows means the request 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. The situation is with December 2023.

4.1. Banking sector

The banking sector recorded a double-digit growth, but slower activity compared to a year ago, this development is in line with the slowdown of economic activity in the country and in the EU.

The assets of the banking sector increased by 11.5 percent, reaching the value of 7.54 billion euros. Credit activity recorded a slowdown in growth compared to the previous year of 13.4 percent, however, it maintained a double-digit growth level. The second category in terms of contribution to the growth of total assets, investments in securities recorded a significant annual increase of 19.0 percent from 9.8 percent a year ago; affected by high interest rates in international markets - a derivative of the ECB's tight monetary policies. This, together with the decrease in the offer from the Government, has influenced the decrease in investments in local securities, while the securities in the foreign market recorded a marked increase of 38.1 percent. The third category in terms of contribution to the growth of total assets, cash and balance with the CBK, recorded a slower annual growth of 3.9 percent from 4.5 percent in the previous year, an indicator that suggests the orientation of funds in financial instruments with return higher. Even the component of the balance sheet with other banks marked a slowdown in growth compared to last year, of 4.3 percent from 15.9 percent growth in 2022 - funds that were also oriented towards instruments with higher returns, such as lending and especially bonds value.

Chart 18. Share to assets structure

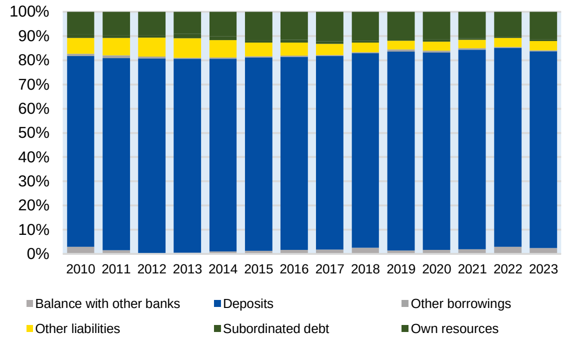


Source: CBK.

The structure of the banking sector has remained similar to previous periods; where lending and investments in securities make up 77.0 percent of bank assets, while deposits and own resources make up 92.7 percent of liabilities and equity. In the last two years, the banking sector's investments in Kosovo government securities recorded an annual decrease of 15.1 and 16.1 percent respectively, mainly influenced by the lower supply and enviable rates of return in foreign markets

Deposits remain the main source of funding for the banking sector, which continued the double-digit annual growth trend, but at a slower pace. Total deposits reached the value of 6.1 billion euros, marking an annual increase of 10.4 percent from 13.3 percent in December 2022). Household deposits recorded accelerated annual growth, while the deposits of financial corporations (mainly pension funds) and non-financial corporations (enterprises) were characterized by slowing growth. The deposits of other public corporations (public enterprises) were the only ones that were characterized by an annual decrease, which, among other things, is the result of the increase in investments in securities, since they offer higher rates of return than the interest earned from banks as a deposit. At the end of 2023, total deposits represented 81.3 percent of the funding sources of the banking sector (Chart 19).

Chart 19. Share to liabilities structure and own resources



Source: CBK.

Household deposits, with a participation of 66.2 percent in total deposits, recorded an annual increase of 11.3 percent from 8.2 percent growth a year ago.

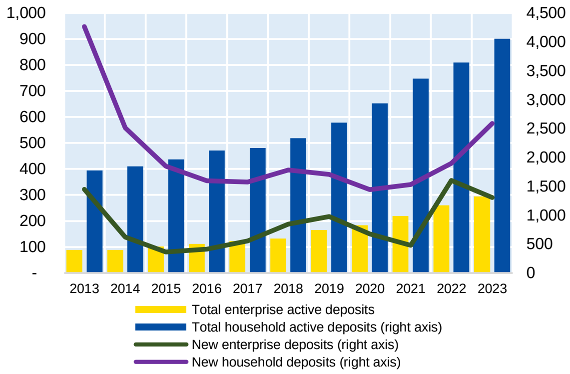
Factors influencing this increase were the rise in the wage level, as well as the accelerated annual growth of remittances to 9.9 percent from 6.0 percent growth in 2022. Deposits of non-financial corporations, the second largest in terms of participation in the structure of deposits, recorded annual growth slower, of 12.9 percent from 18.9 percent in 2022.

Deposits of non-financial corporations, the second largest share in the structure of deposits, saw slower annual growth of 12.9 percent from 18.9 percent in 2022.

Deposits of other financial corporations recorded significantly slower annual growth compared to the previous year, of 5.9 percent growth (54.0 percent growth in 2022). This development was influenced by pension funds, which reduced deposits in the banking sector in the country and increased exposures in the foreign market, mainly in mutual funds, which offer higher returns on investments compared to the rate earned from deposits in commercial banks. Deposits from other financial institutions, such as insurance companies, microfinance institutions and financial assistants, recorded growth, but due to their lower weight, their impact on the dynamics of total deposits of other financial corporations was limited.

New deposits, which include only time deposits, recorded an annual increase of 11.3 percent as a result of the high growth of time deposits from households, while time deposits from non-financial corporations recorded a decrease. Banks' attractive campaigns with increased interest rates for remittances continued in 2023, but the pace of annual growth of remittances was slower due to the high growth of 74.3 percent in the previous year when the increase in interest rates began. Specifically, the overall slowdown in the growth of new deposits came from the segment of non-financial corporations, whose new deposits in 2023 were worth 290.5 million euros against the value of 356.2 million euros a year ago.

Chart 20. Stock of total deposits and new deposits, EUR million



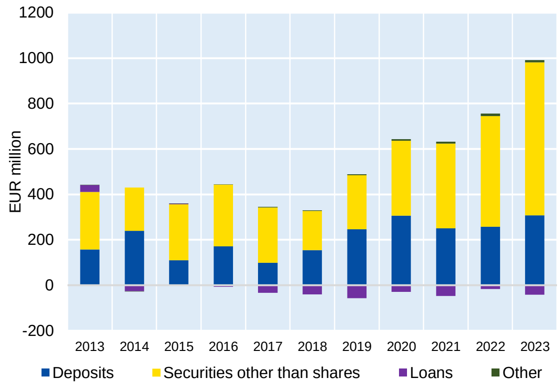
Source: CBK.

Meanwhile, the new deposits invested by households accelerated the annual growth to 36.4 percent from 24.0 percent, reaching the value of 574.9 million euros (Chart 20).

The exposure of the banking sector to the external sector marked a high growth for the second year in a row as a result of the increase in investments of funds in securities, influenced by the higher return on investments compared to previous years, but in terms of exposure participation continues to be relatively low. The net credit position to the external sector reached 949.6 million euros, marking an annual increase of 28.4 percent compared to the increase of 26.4 percent a year ago (Graph 21 and 22). The increase in the net credit position in the last two years is mainly attributed to the marked increase in investments in securities in the external sector, as well as the growth, although slower, of placements/deposits in the external sector.

Claims against non-residents constitute 16.8 percent of the total assets of the banking sector, where 91.0 percent of them are deposits and investments in securities. The liabilities of the banking sector towards non-residents account for 4.2 percent of the total liabilities of the banking sector, in the form of credit lines and foreign sector deposits held in the country. These two items constitute 99.0 percent of total liabilities to non-residents.

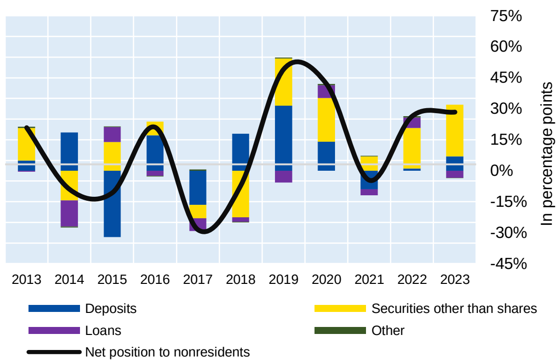
Chart 21. Net position to nonresidents



Source: CBK.

The banking sector continues to have a low exposure to the external sector. The low level of foreign currency assets further reduces the possible effects of carryover of problems from the external sector and avoids possible losses from unfavourable changes in exchange rates against the euro.

Chart 22. Items contribution in annual change activity with nonresidents



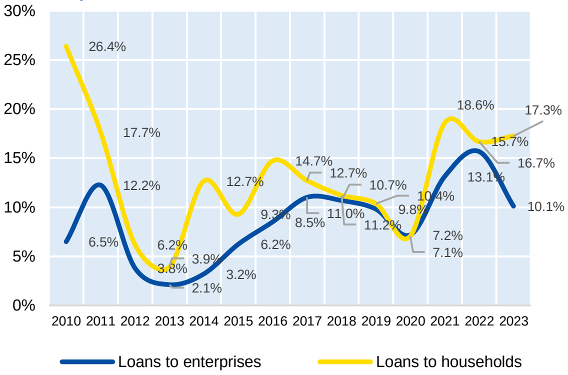
Source: CBK.

4.1.1 Credit developments

The lending activity of the sector recorded an annual increase of 13.0 percent, 3 percentage points lower than the previous year. This development reflects the slower trend of credit growth for non-financial corporations - in line with the slowdown in economic activity, as well as influenced by the re-arrangement and reduction of a part of loans of large credit exposures. Meanwhile, loans to households accelerated the annual growth trend.

According to the Kosovo Bank Credit Survey (KBCS), credit dynamics in the fourth quarter of 2023, as during the rest of the year, were mainly influenced by credit demand, while credit supply had minor changes.

Chart 23. Annual growth of loans to enterprises and households



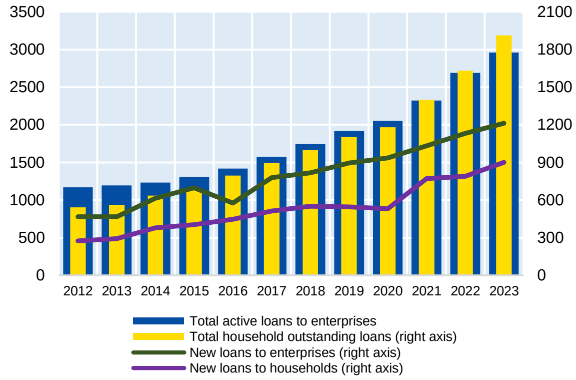
Source: CBK.

The stock of active loans in the country's banks reached 4.91 billion euros. The segment of non-financial corporations recorded an annual increase in the stock of loans of 10.1 percent, for 5.6 percentage points lower than the previous year. Meanwhile, the stock of loans for family economies recorded an accelerated annual growth of 17.3 percent from 16.7 percent growth in the previous year (Chart 23).

New loans accelerated the annual growth rate to 9.9 percent from 6.5 percent in the previous year, influenced by the acceleration of the growth of household consumer loans[13].

In 2023, total new loans for households recorded an annual increase of 14.1 percent, 11.7 percentage points higher than the previous year. The high growth of new consumer loans of 23.2 percent, from the decline of 6.3 percent a year ago, had the main contribution to the growth of this segment. Meanwhile, new mortgage loans during this period have recorded an annual decrease for the first time since the beginning of their recording, namely a decrease of 11.3 percent from the increase of 13.5 percent a year ago. The decline in this category of new loans, among other things, may be the result of high immovable property prices, discouraging individuals from buying immovable property, or influencing them to postpone purchases to another period. In addition, the data published by KAS for the Construction Cost Index, in the last two years, show an increase in the overall cost of construction, especially construction materials, wages and transportation, factors that have influenced the increase in the price of immovable property.

Chart 24. Stock of total loans and new loans to households and enterprises, EUR million



Source: CBK.

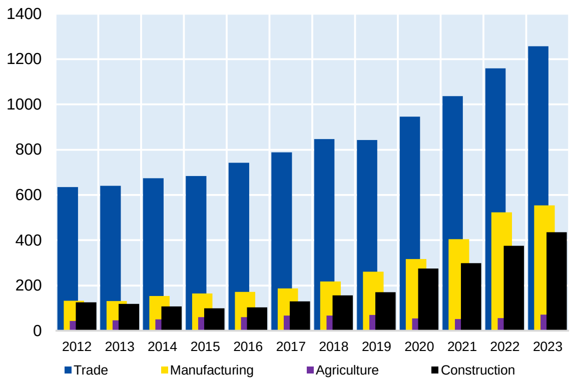
New non-financial corporate loans grew by 7.1 percent from 9.6 percent in 2022 (Chart 24). The slowdown in growth mainly stemmed from loans for investment purposes, which have the highest participation in total new loans of this segment, while new non-investment (non-mortgage) loans increased (mainly for investment purposes) increased accelerated annual.

The general slowdown of total lending for non-financial corporations in 2023 is in

[13] Personal/individual loans, for consumption and investment purposes.

line with the general economic developments in the country, namely with the slowdown of private investments as well as the slowdown of the turnover of enterprises in the sectors with the highest weight in lending (graph 25). Private investments, in nominal value for the year 2023, have recorded significantly slower annual growth, of 1.3 percent from 11.2 percent in the previous year. Also, the annual turnover of enterprises has recorded a lower annual growth of 7.4 percent from 22.3 percent growth a year ago, mainly as a result of the slowdown in the trade, manufacturing and construction sector. These developments, consequently, have been reflected in the lower demand for loans from enterprises in the respective sectors.

Chart 25. Stock of loans by economic sectors

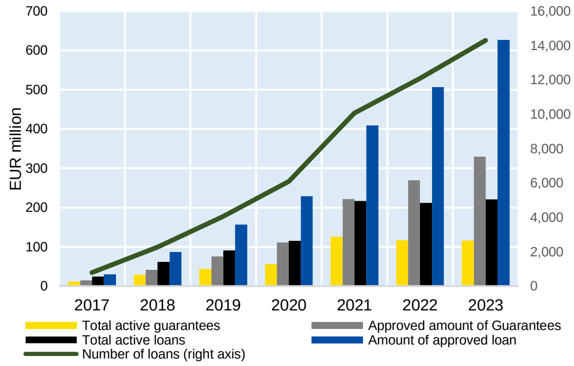


Source: CBK.

Lending to the manufacturing sector had the highest contribution to the slowdown in total loans to the non-financial corporate segment, resulting in low annual growth of 5.9 percent from 29.4 percent growth in 2022. The trade sector recorded annual growth of 8.3 percent in 2023 from growth of 11.8 percent in the previous year, and was the second largest contributor to the slowdown in corporate loans non-financial. The construction sector recorded slower growth of 15.9 percent from 25.8 percent a year ago. The agricultural sector this year was characterized by accelerated growth of 25.8 percent, in contrast to the growth of 9.9 percent in the previous year.

An important supporter of lending to micro, small and medium-sized enterprises, confirmed by the results of the Kosovo Bank Lending Survey, continues to be the Kosovo Credit Guarantee Fund, contributing positively to a better credit offer from banks for businesses which qualify for support.

Chart 26. Loans approved and guaranteed by KCGF



Source: KCGF.

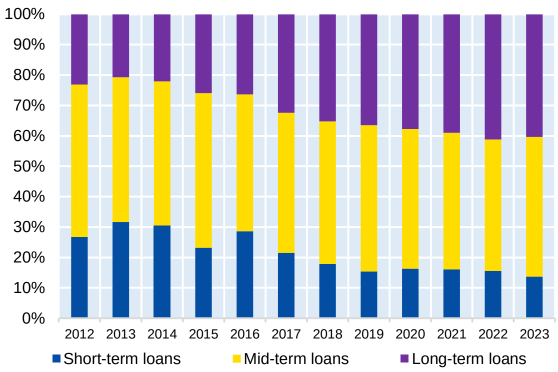
The use of the fund by the banks has gradually increased, along with the increased opportunities for use through new guarantee windows. During 2023, two new windows were created: Women in Business and the Export Window, which aim to support women in business, as well as entrepreneurs oriented to the export of goods and services. The cumulative number of bank loans for SMEs, guaranteed by KCGF, at the end of 2023 reached 14.3 thousand, with a total amount of 626.4 million euros, which constitutes 21.2 percent of the total bank loans for the segment of non- financial.

Mainly, the structure of loans guaranteed by KCGF is a representation of the general structure of loans in the banking sector. Guaranteed loans are dominated by the trade sector, with a participation of 42.0 percent in the total guarantee portfolio, followed by the services sector with 23.0 percent and manufacturing with 20.0 percent. The remaining part consists of the construction and agriculture sectors, which have an almost equal participation, with 7 and 8 percent respectively of the total guarantee portfolio (Chart 26).

Over the years, long-term loans have gradually increased their participation in the total lending stock, dominating the participation in the total structure of

loans according to maturity.[14] During 2023, however, the growth trend of long-term loans slowed down, influenced by the annual decline in mortgage loans.

Chart 27. Loans to enterprises, share by maturity



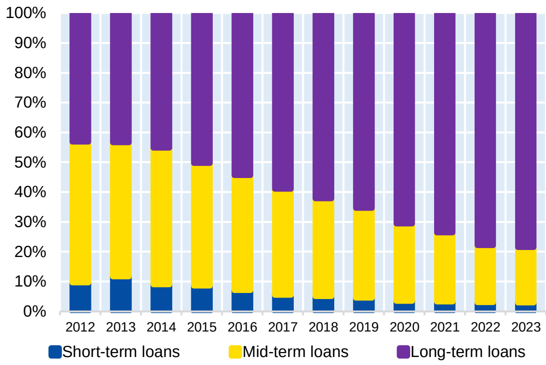
Source: CBK.

In December 2023, loans with long-term maturity recorded annual growth of 13.4 percent, 9.4 percentage points lower than the previous year. Their participation in total loans, however, remained the highest, at 55.3 percent of total loans. The annual decrease in new mortgage loans from households has influenced the slowdown in the growth of these loans, since they are mainly loans with a long maturity. Medium-term maturity loans recorded accelerated annual growth of 16.3 percent from 7.9 percent annual growth in 2022, and expanded participation to 35.2 percent, for 1.1 percentage points compared to last year.

The expansion of this category of loan maturity has been influenced by the marked increase in new consumer loans, as they mainly have a medium-term maturity. While short-term loans in 2023 marked an annual decrease of 1.1 percent from the annual growth of 11.5 percent a year ago, and reduced participation by 1.3 percentage points, respectively representing 9.5 percent of total loans.

The distribution of non-financial corporate loans according to maturity has undergone a slight change, with the dominance of medium-term loans at the end of 2023, after the gradual contraction over the years in Favor of the expansion of long-term loans (Chart 27).

Chart 28. Loans to households, share by maturity



Source: CBK.

In household economies, the most significant increase in consumer loans in 2023 has restrained the significant trend of year-on-year growth of long-term loans, which in December 2023 represented 78.5 percent of the total credit portfolio of this segment (Chart 28).

[14] The short-term period includes the maturity up to 1 year, the medium-term includes the maturity from 1 to 5 years, and the long-term period includes the maturity over 5 years.

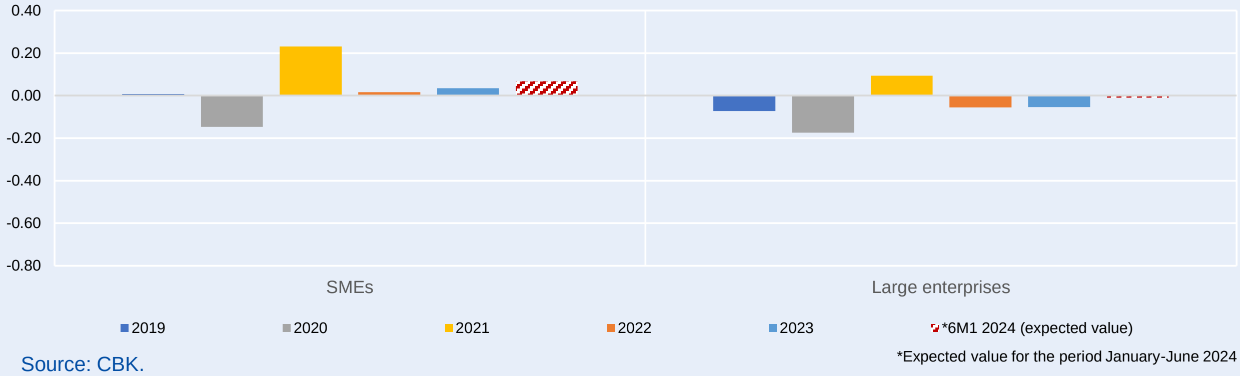
Box 4. Kosovo Bank Lending Survey[15]

Results of the Kosovo Bank Lending Survey[16]reflect developments in bank lending activity during the period Q1 2023 - Q4 2023 (referred to as the year 2023), as well as expectations for lending activity in the period January - June 2024 (referred to as the first six months of the following year - 6M1).

Dynamics of lending activity for enterprises during 2023has been positively influenced mainly by the increase in the demand for credit, while the credit supply has not undergone significant changes. These developments are in line with the general macroeconomic developments in the country, namely the slower economic growth as well as the lower turnover of businesses compared to the previous year.

Regarding the assessment of enterprise applications, within the credit offer, banks reported further easing of credit standards in 2023. For the first half of 2024, banks declared that they will apply marginal changes in credit standards in a negative direction for large enterprises, while relief for SMEs (graph 1).

Chart 1. Bank's credit standards applied when assessing credit applications of enterprises



Source: CBK.

The factors that negatively affected the credit standards applied by banks during 2023 were related to the risks associated with the poor outlook on global markets and the development of interest rates. On the other hand, the main factors that positively influenced the credit standards were the support from KCGF, the competitive pressure between banks and the satisfactory liquidity position.

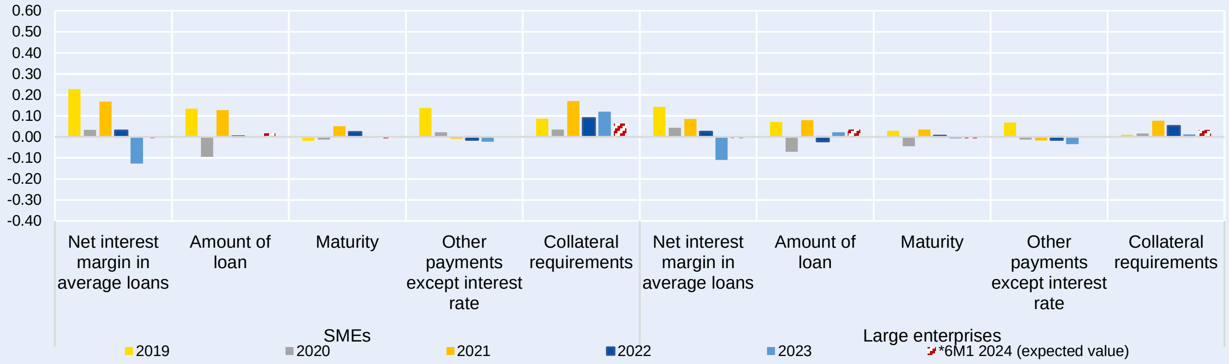
In the context of the credit offer, banks reported that the conditions and rules applied when granting loans to both segments of enterprises had negative movements in the interest rate on loans, while positive movements in the demand for collateral. Specifically, a slight tightening was applied to the interest rate on loans for both SMEs and large enterprises. However, as far as the demand on collateral is concerned, there was relief, but with a special emphasis on SMEs (chart 2).

In the first half of 2024, the conditions and rules applied by banks are expected to have marginal movement in both directions. Specifically, marginal relief for both categories of enterprises in average loan size and collateral requirement. The factors that supported the easing of conditions are the support of KCGF, the competitive pressure between banks and the satisfactory liquidity position. Meanwhile, a marginal tightening is expected in the maturity of loans and in the interest rate for both SMEs and large enterprises.

[15]The Bank Credit Survey of Kosovo is carried out by the Central Bank of the Republic of Kosovo with 11 banks operating in Kosovo. The survey is carried out on a quarterly basis. This survey includes aggregated data from each quarter of 2023 as well as expectations for the first half of 2024.

[16] The responses of individual banks are aggregated using the respective share of each bank in the total credit portfolio of the banking sector. Positive values of the credit standards index indicate easing and negative values indicate tightening. Also, positive values of the credit demand index indicate an increase in demand and negative values indicate a decrease. More widely, you can find the methodology used in the Bank Lending Survey Report on the CBK website.

Chart 2. Terms and conditions applied for loans to enterprises



Source: CBK.

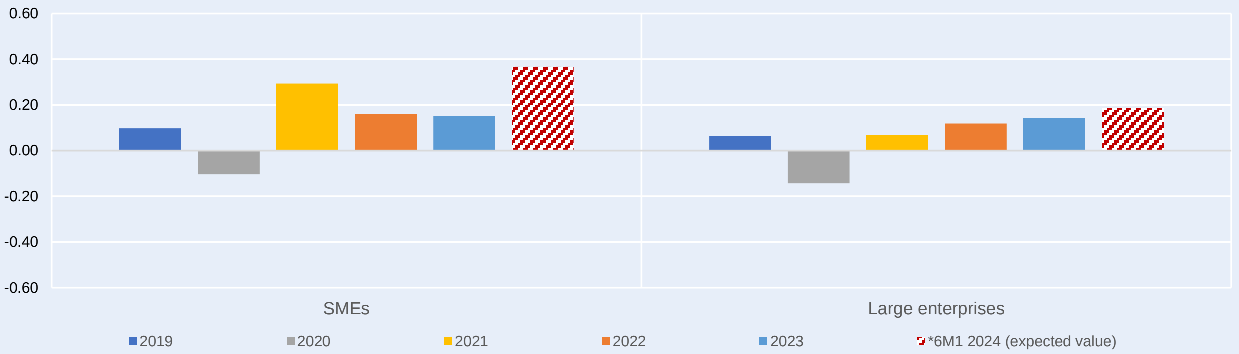
*Expected value for the period January-June 2024

During the reporting period, there was generally an increase to some extent in the demand for bank loans from enterprises, similar to the dynamics of the previous year. The demand for loans was slightly higher from SMEs compared to large enterprises (chart 3). This increase in demand was mainly driven by the increase in the demand for financing inventories - working capital and fixed investments. The ratio of non-performing loans of enterprises improved during 2023, generating a low negative index.

Expectations for the easing of inflationary pressures in the coming year, which will have the effect of reducing uncertainty for investments, consequently higher economic growth, will affect the increase in the demand for investments from businesses. So, in the first half of 2024, banks expect an increase in demand for loans from both categories of enterprises. These expectations were attributed to the expected increase in the demand for financing inventories - working capital and fixed investments, in line with the business cycle.

As for the quality of the credit portfolio of enterprises, banks for the first half of 2024 expect the ratio of non-performing loans to total loans to remain more or less the same.

Chart 3. Household demand for loans



Source: CBK.

*Expected value for the period January-June 2024

In the context of loan maturity, the results of the survey show that the greatest demand from enterprises during this period was for short-term loans, while the demand for long-term loans had a lower growth. The credit supply, divided according to the maturity of the loans, showed a marginal tightening for long-term loans, while a marginal relief for short-term loans, and is expected to remain similar in the first half of 2024. While, in terms of demand, banks expect more growth high demand for both short-term and long-term loans (chart 7).

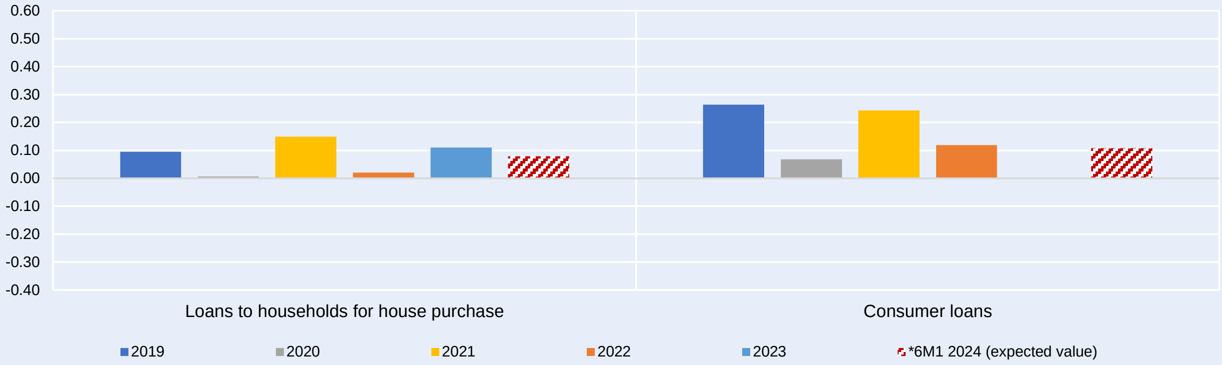
Dynamics of lending activity for family economies during the reporting period, according to the survey, they were mainly supported by credit demand, since the credit supply in general did not undergo significant changes, specifically marginal reliefs.

The credit standards applied during the review of loan applications from households were eased to some extent for loans for investments and immovable property purchases. Meanwhile, credit standards for consumer loans remained unchanged (chart 4).

Pressure from competition, easier access to financing from local banks and a satisfactory liquidity position were the factors that contributed to the easing of credit standards for the purchase of immovable property; while the potential growth of non-performing loans influenced the standards applied to consumer loans, which dominate the credit structure for the household economy segment, to remain unchanged.

Banks' expectations for the first half of 2024 do not predict significant changes in credit standards, with positive movements for both types of loans for the household segment.

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

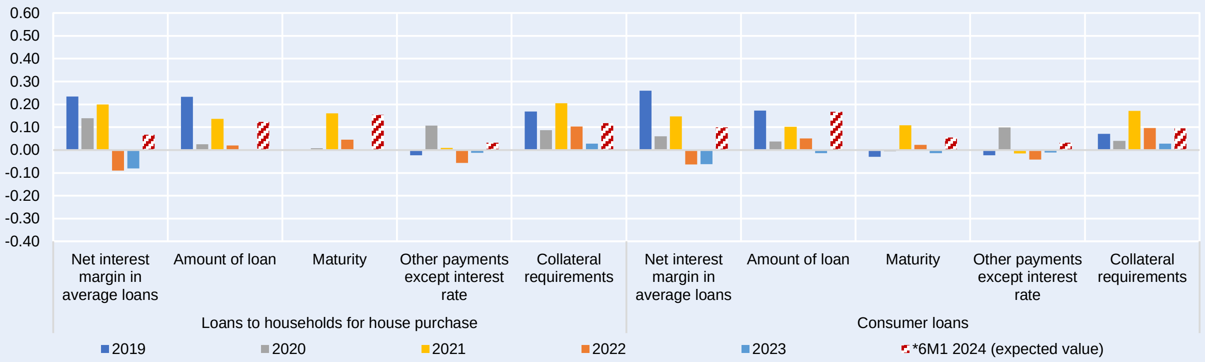


Source: CBK.

*Expected value for the period January-June 2024

Conditions and rules for new loans to households were generally tightened to marginal levels. Specifically, banks applied tightening through interest rate increases, while easing collateral requirements. The main factor in the increase in the interest rate was the increase in the EURIBOR rate, which is mainly applied to loans with a variable interest rate (chart 5).

Chart 5. Terms and conditions applied for loans to households

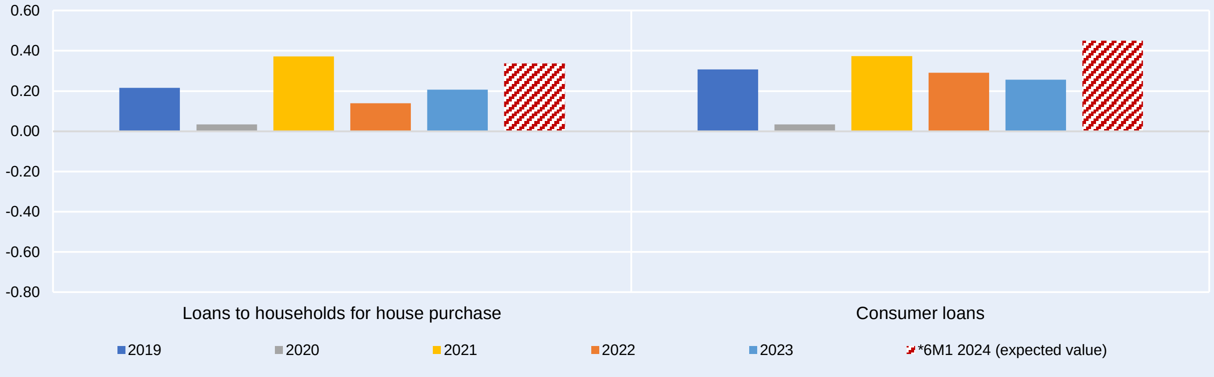


Source: CBK.

*Expected value for the period January-June 2024

For the first half of 2024, banks expected marginally positive movements in terms and rules for household loans, including an increase in the maturity of loans for home purchases and a decrease in collateral requirements for consumer loans. Relief in the interest rate is expected for both categories of family economies in the first half of 2024.

Chart 6. Household demand for loans



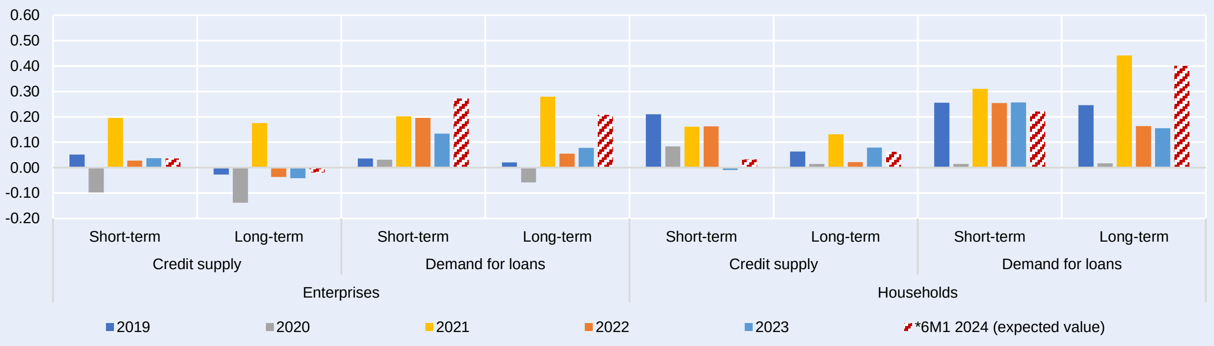
Source: CBK.

Banks declared an increase in the demand for household loans for both categories, but the increase was more evident for consumer loans - personal and non-mortgage (chart 6). The need for financing was mainly of an investment, renovation, or other non-consumer nature (according to the data obtained from the amounts of loans, which were dominated by those over 10,000 euros) giving the main contribution to the increase in the demand for consumer loans. For loans for the purchase of immovable property (mortgage loans in the sense of the regulatory definition), the positive perspective in the immovable property market, as well as the combined (partial) financing from banks and the borrower's funds, were declared as factors influencing the increase in demand, which do not qualify as mortgages.

According to the survey, the ratio of non-performing loans to total loans for households increased, while for 2024 it is expected to remain at similar levels.

In the first half of 2024, the demand for loans is expected to grow significantly higher than during the current year. Banks expect higher demand growth for consumer loans, while lower growth for those for immovable property purchases.

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

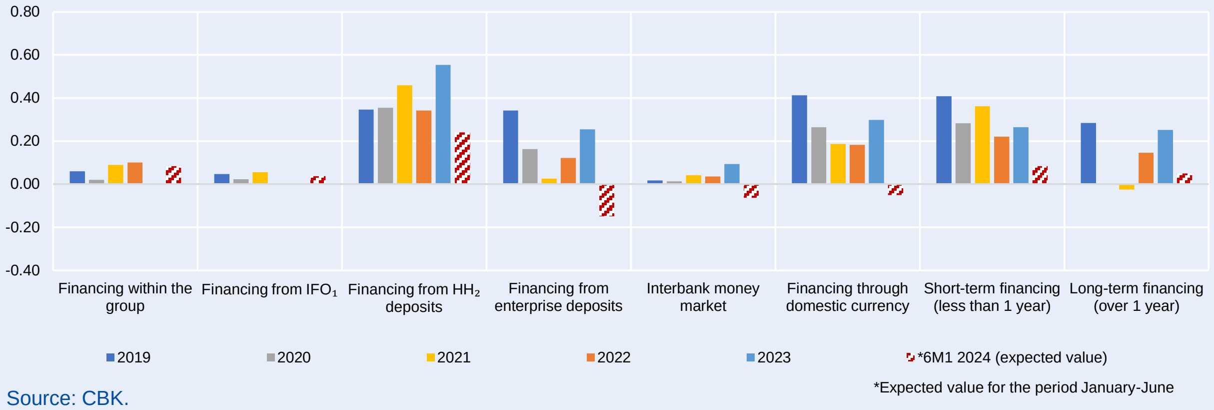


Source: CBK.

As for the time frame, the results of the survey show that households during 2023 had a higher increase in demand for loans with short-term maturities than for long-term ones.

The credit offers for households divided according to the maturity of loans had negative marginal changes for short-term loans, while slightly more favourable for long-term loans. Banks expect in the next six months an easing in credit supply, which will be oriented at a higher level towards long-term loans (chart 7).

Chart 8. Change of the banking sector financing



Source: CBK.

As for financing dynamics, banks reported a significant increase in access to financing during 2023 compared to the previous year. Household deposits had the largest increase, while financing from enterprises also increased, but at a lower level. Funding from parent banks and international financial institutions remained unchanged.

According to maturity, both short-term and long-term financing recorded growth.

During the next six months, some banks expect slower growth in access to financing, a dynamic that is expected to be affected by expectations for a slowdown in household deposits (chart 8). As for the maturity of financing, banks expect that the increase in financing will be mainly from short-term financing, while long-term financing will have a positive marginal contribution to financing.

5. Risks of the banking sector

The banking sector has shown stability in the face of increased risk factors to which it has been exposed, especially during the last years. Weakened economic activity in the Eurozone, macroeconomic and especially geopolitical uncertainties have not affected the marked increase in the risks of the banking sector in the country. However, uncertainties remain high, increasing the need for a prudent approach and maintenance of the absorptive capacity of the sector in relation to the expansion of the sector's balance sheet.

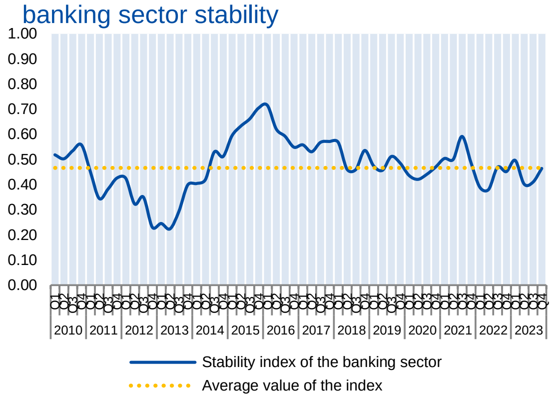
Addressing inflation through the increase in interest rates from the second half of 2022 and the first half of 2023 has created some pressures for banks in Kosovo in terms of financing their credit activity due to the increase in the cost of financing, especially due to the increase in competition as well as the high appetite for expanding the balance sheet (credit and investments).

Under these circumstances, the structure of investments, financing and the re-pricing gap (refinancing and reinvestment of balance sheet positions) have been more significantly affected. The changes in the structure or positions of investments and lending are driven by two main factors. First, the increase in interest rates may have discouraged the demand for credit, affecting the slowdown in lending due to the increase in the cost of debt, and the increase in competition between banks for withdrawing deposits has been challenging for some banks, affecting the credit offer due to the inability to sufficiently support lending with available deposits. Second, the attractive rates of returns from investments in instruments in foreign markets have favored some larger banks, which have increased returns and profitability by shifting positions from lending to investments in foreign securities.

This has ensured the realization of profit for some banks, while for others it has created more expenses due to higher financing costs and more limited space for investments and financing, causing the sector to realize profit at a slightly lower levelthan in the previous year.

In this way, the financing structure has undergone changes, especially in terms of maturities, characterized by the increase in deposits with longer terms that offer higher interest rates. Despite this, the gap of revaluation positions (re-investment and re-financing) has widened further, influenced by the more pronounced increases in maturity on the investment side.

Chart 29. Aggregated index of the banking sector stability

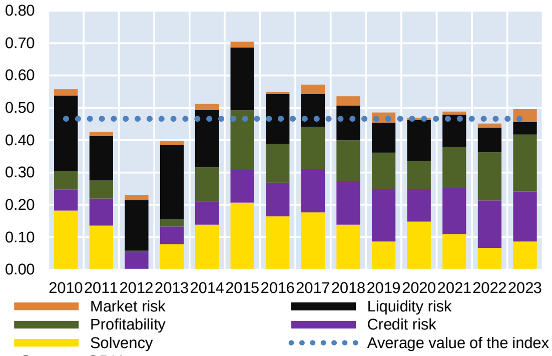


Source: CBK.

Perceived interest rate risk during the year was reduced and the outlook looks stable. In this context, with the ban on the increase in interest rates, it is expected that the banks will refocus their activity towards a higher increase in the credit offer in the country. However, an eventual drop in interest rates will negatively affect net interest income and the overall profitability of the banking sector.

According to the general aggregated index of the stability of the sector, a slight annual decrease in sensitivity to risks was noted (Chart 29). This overall decline in risk exposure has been influenced by declining risk indicators such as solvency and market. Meanwhile, a marginal increase in risk was observed in the indicators of credit risk, profitability, and slightly more in liquidity. The decrease in sensitivity to solvency risk is attributed to the higher level of the capital adequacy indicator. The improvement in the capital position is attributed to the good performance during the year but also to the capitalization approach of CBK - the dividend distribution at a much lower level than a year ago (Chart 30). The indicator that assesses the sensitivity to the market risk, measured by the open position in foreign currency to the first class capital, has also recorded a decline. However, this indicator has a very low weight in the general index of financial stability.

Chart 30. Stability index of the banking sector, by risk criteria



Source: CBK.

The increase in sensitivity to credit risk was the result of the increase in the value of non-performing loans. However, the increase in lending influenced the ratio of non-performing loans to remain the same as at the end of the previous year. The increased sensitivity to profitability risk is attributed to the decrease in the return on equity indicator. This is due to the higher growth of equity from retained earnings from previous years, as mentioned above, in addition to the slower annual growth of net profit during this year (Chart 30).

The overall aggregated index suggests a decrease in sensitivity compared to last year, while there is an increase in sensitivity to risks compared to 2021 and the historical average of the index (2008–2022), or the average of the last five years.

5.1. Credit risk

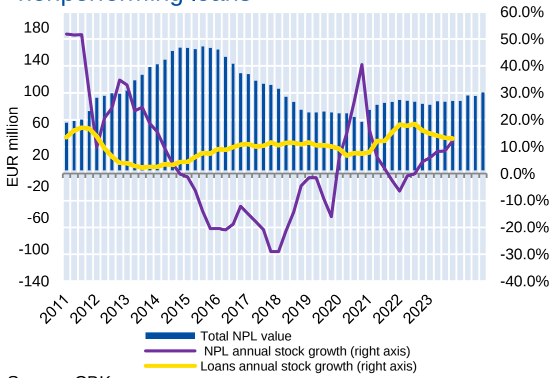
The general dynamics affecting the credit risk dimension during 2023 were characterized by the general increase in the price level, potentially affecting financing costs and eventually the solvency of borrowers. While the expectations of commercial banks suggested the materialization of credit risk as a result of macroeconomic dynamics, the deterioration of the credit portfolio was evidenced only in the last quarter of the year, but the NPL indicator remained the same, so the expected risk did not materialize. The maintenance of good financial performance and, therefore, repayment capacity, is attributed to a certain extent to the transfer of a significant part of the increased costs from enterprises to final consumers, while the absorptive capacity of consumers has been supported by the increase in wages, income from diaspora and increased economic activity in some sectors.

Although the key quality indicators of the credit portfolio indicate a low credit risk, the increase in the price level and the increase in the value of non-performing loans kept the credit risk as a separate risk for the banking sector and financial stability. The rate of non-performing loans remained at the same level of 2.0 percent as a year ago, influenced by the accelerated growth of lending, since the value of non-performing loans recorded an annual increase of 12.2 percent, reaching 98.5 million euros (Chart 31). The increase in inflationary pressures prompted the banks for a more careful credit management. In this regard, banks were more conservative in the allocation of reserves and the classification of the most affected sectors, as well as tightened the criteria for new loans. According to the results of the bank lending survey, despite the trust in customers, the banks, based on the continuous increase in inflationary pressures during the year, had declared that they expect a deterioration in the repayment ability of customers in the second half of the year.

These expectations materialized in the fourth quarter, where the value of non-performing loans marked a more pronounced increase compared to the previous three quarters, while banks allocated appropriate reserves as protective measures.

Also, the loans categorized in the second pillar recorded a more pronounced increase than the loans in the third pillar, and this increase came mainly from some banks. These banks have categorized some economic sectors in the second pillar as an additional protective measure, being more conservative towards sectors that have shown higher sensitivity to circumstances such as the energy crisis in 2022 and inflation during the year. However, in 2024, with improved market sentiment, many have begun to reclassify them into the first pillar.

Chart 31. Annual growth of loans stock and nonperforming loans



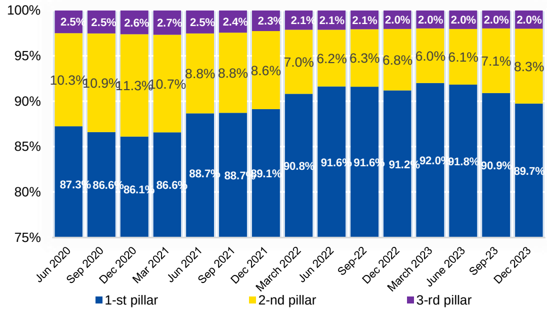
Source: CBK.

At the same time, individual customers with lower incomes are also categorized in the second pillar due to the perceived risk that the effects of inflation have on their disposable incomes, albeit adjusted for wage increases. Meanwhile, corporations and SMEs in the country have reported in various forums that one of the main risks affecting their performance comes from the labor market (the availability of labor and the gap in its qualifications), a risk that is predicted to remain further in 2024.

Over the past two years, banks have also taken into account the potential risk from migration, and despite the approval of free movement for Kosovo citizens in the Schengen states from the beginning of 2024, this risk did not materialize based on the data to this phase. The imbalance in the labor market, with consequences on the performance and profitability of businesses and, consequently, on their capacity to repay debts, makes the credit risk dimension a special focus, taking into account the growth of factors that have consequences directly in its deterioration.

The participation of loans in the second pillar of the credit classification increased to 8.3 percent from 6.8 percent a year ago, while loans in the first pillar decreased the participation to 89.7 percent from 91.2 percent (Chart 32).

Chart 32. Loans by new credit classification in three classes

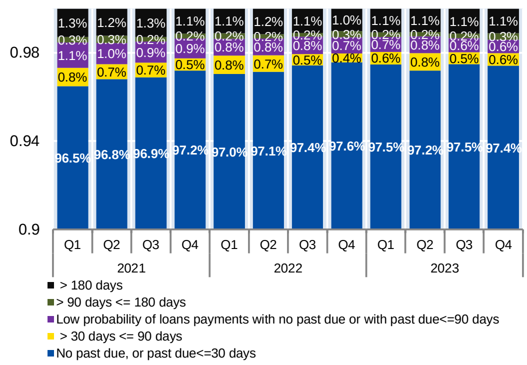


Source: CBK.

In December 2023, non-delinquent credit exposures (less than 30 days delinquent) have slightly reduced participation to 97.4 percent from 97.6 percent. Loans with delays from 30 to 90 days have recorded a marginal increase in participation of 0.2 percentage points, reaching 0.6 percent of total loans. Meanwhile, non-performing loans (with low probability of payment and those with delays over 90 days) maintained the participation of the previous year of 2.0% (Chart 33).

Households recorded a marginal increase in the ratio of non-performing loans, while the enterprise segment recorded a decrease in this ratio. The ratio of non-performing loans to households increased to 1.4 percent from 1.2 percent in the previous year.

Chart 33. Structure of loans classified by past due payments, new method



Source: CBK.

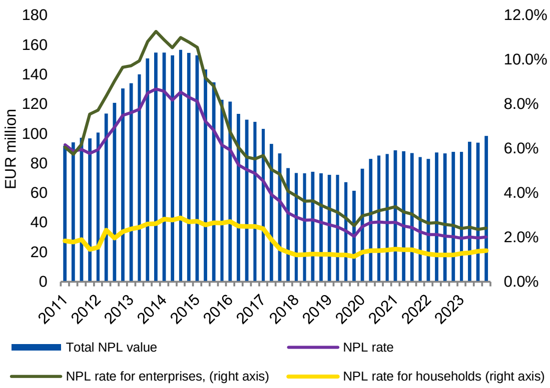
This dynamic is reflected in the increase in the value of non-performing loans during

2023, which rose by 26.7 percent on average over the four quarters, with an increase of 36.1 percent at the end of the year (Chart 34).

While the enterprises segment recorded slower credit growth than a year ago, it managed to keep the non-performing loan ratio at 2.4 percent, from 2.5 percent a year ago. The value of non-performing loans of this sector increased by 5.0 percent (from 4.3 percent at the end of 2023), while loans recorded an increase of 10.1 percent (from 15.7 percent a year ago). According to BLSK, the stable financial performance and, consequently, the good repayment capacity of the enterprise segment is attributed to the passing on of the additional cost of supplier prices to the final consumer.

Developments in the quality of the credit portfolio, based on the ratio of non-performing loans (NPL) of the economic sectors, were positive, mainly influenced by the increase in lending in most economic sectors, but also by the decrease of non-performing loans, excluding the energy sector (Chart 35). The energy sector resulted this year with the highest NPL rate, of 9.4 percent, an increase of 7.2 percentage points. The manufacturing sector recorded a more pronounced increase in non-performing loans, but due to the expansion of lending, the rate of NPLs remained relatively stable, increasing only by 0.8 percentage points to the level of 2.2 percent.

Chart 34. Nonperforming loans



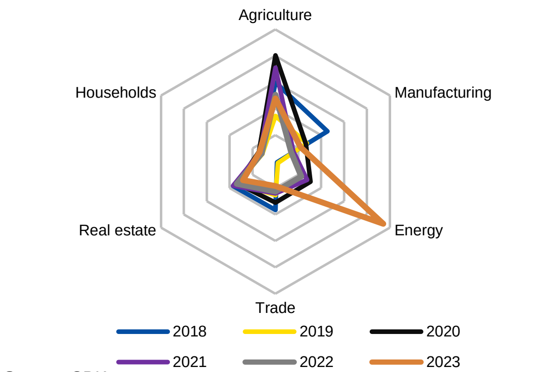
Source: CBK.

The trade sector, which represents the most credited sector, recorded an increase in lending of 10.6 percent and a decrease in the value of non-performing loans of 9.3 percent. As a result, the NPL rate for this sector was reduced to 1.9 percent from 2.3 percent. The agricultural sector and the real estate sector also recorded a decrease in the rate of NPLs.

The risk of a deterioration in credit quality continues to exist due to the increase in the cost of debt service in the last two years, as the percentage of loans with variable interest rates has increased to 33.9 percent from 27.3 percent a year ago. However, banks' expectations of credit deterioration in the credit survey were reported at marginal levels for 2024, based on expectations of lower inflation rates as well as potentially improving disposable incomes as wages rise in several sectors, as well as the more prudent approach that banks had during 2023 regarding lending to the most sensitive groups. Likewise, the manufacturing and construction sectors are expected to be affected by changes in the structure of the labor market, which will be directly affected by migration.

Meanwhile, households turn out to be the most affected segment, especially those with lower incomes. Therefore, even the groups of households with lower incomes have been re-classified in the second pillar as a protective measure of some banks to manage the risk.

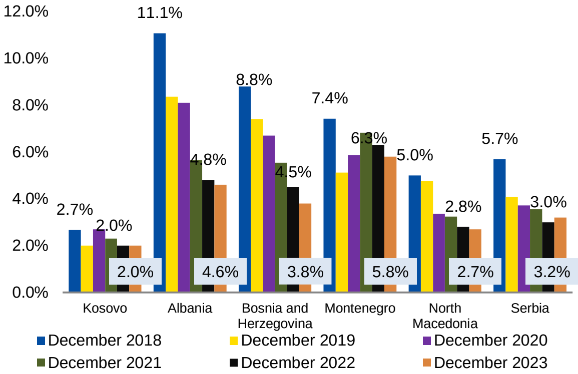
Chart 35. NPL ratio to loans stock, by sectors



Source: CBK.

Compared to the region, the banking sector in the country continues to show a much better performance in loan repayment. Over the years, Kosovo has had the lowest ratio of non-performing loans compared to countries in the region (Chart 36).

Chart 36. NPL to total loans ratio in the region countries

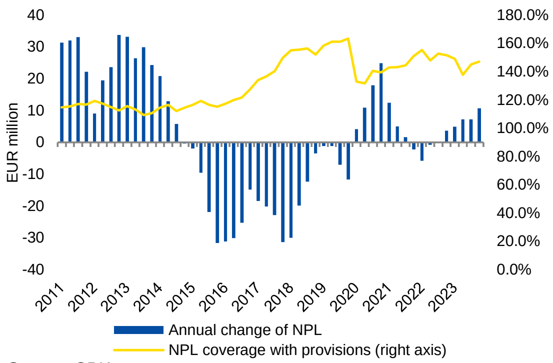


Source: IMF, respective Central Banks (2023)

The provision coverage ratio of the sector marked a decrease of 4.6 percentage points to the level of 147.1 percent. This movement resulted from the higher annual increase in the value of non-performing loans of 12.1 percent than the stock of allocated provisions of 8.7 percent (Chart 37).

With the increase in non-performing loans, expenses for provisions also increased by 72.5 percent. However, the increase in lending affected that the rate of provisions spent (expenses for provisions to loans) for the sector was slightly lower in December 2023 (-0.4 percent) compared to the previous year (-0.3 percent).

Chart 37. Annual change of NPL stock and coverage with provisions



Source: CBK.

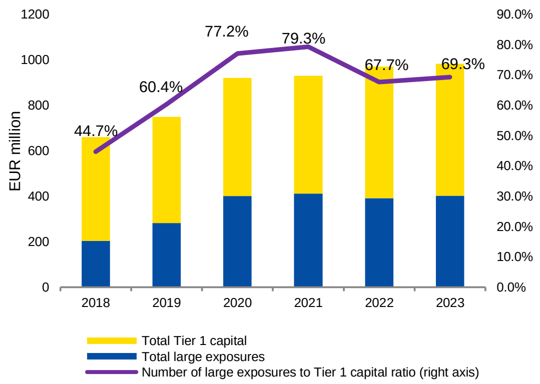
5.1.1 Large credit exposures

The credit exposure rate has increased, reaching 69.3 percent from 67.7 percent a year ago, although it continues to be significantly below the maximum regulatory level. The annual increase in the value of large exposures of 2.8 percent, alongside a lower increase in Tier 1 capital of 0.4 percent (only for the banks under analysis, excluding bank branches that have large exposures), influenced the rise of credit exposure rate (Chart 38).

The concentration of credit risk, expressed as the ratio between the value of large exposures to the number of these exposures, is estimated to be high. Average value of large exposures[17] increased to 8.9 million euros, from 7.1 million euros, reflecting the increase in the value of large exposures and the reduction in their number. The ratio of the three largest exposures to total large credit exposures increased to 55.2 percent from 50.8 percent. This change was driven by the highest annual growth of the three largest exposures of 11.8 percent, alongside the overall growth of large exposures of 2.8 percent.

Results of the sensitivity analysis of the sector to shocks in the three and five largest bank exposures indicate the sensitivity of the sector to shocks in these exposures. Therefore, although the sector remains below the regulatory maximum level of credit exposures, it is susceptible to potential shocks to these positions, which should be closely monitored.

Chart 38. Concentration of credit risk



Source: CBK.

[17] The ratio of total large exposures to the number of exposures.

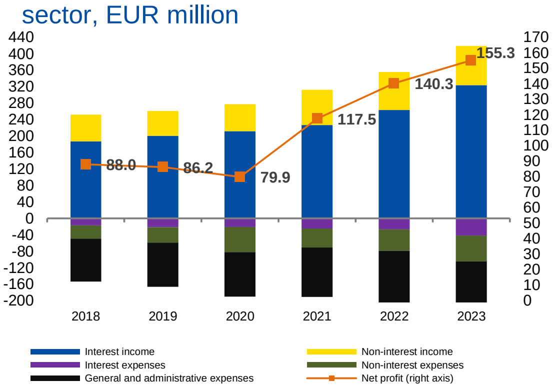
5.2. Sustainability of profit and interest rate risk

The increase in basic interest rates from the central banks has been followed by the sector, in addition to the increase in income and expenses, as well as changes in the structure of investments and financing. The structure of investments has been influenced by the increase in investments in securities of foreign governments, while financing has undergone changes in terms of increased expenses for deposit promotion and increased borrowing in other financial institutions to finance the activity.

In this way, the effects of monetary and macroeconomic developments have been felt in both aspects of the profit margin of banks in the country. Although the stability of the sector's profit was favored by the situation of high interest rates, the higher expenses generated by some banks compared to the increase in revenues influenced the sector's profit to have a slower growth of 10.7 percent than the growth in the previous year, which was 19.4 percent.

Income from interest on loans and securities were the categories that contributed to the realized increase in profit, while administrative expenses and interest on deposits affected the slowdown of this growth.

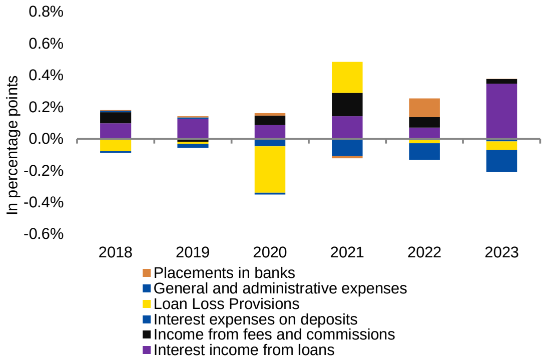
Chart 39. Profit structure of the banking sector, EUR million



Source: CBK.

The value of the net profit reached 155.3 million euros from 140.3 million in the previous year (Chart 39). The increase in interest rates, due to tight monetary policies, throughout 2022 and the first nine months of 2023 has been reflected in the increase in income from interest on loans and income from interest on securities. On the other hand, interest expenses on deposits were also affected along with the increase in administrative and personnel expenses (Chart 40).

Chart 40. Main contributors to the growth / decline of the profit



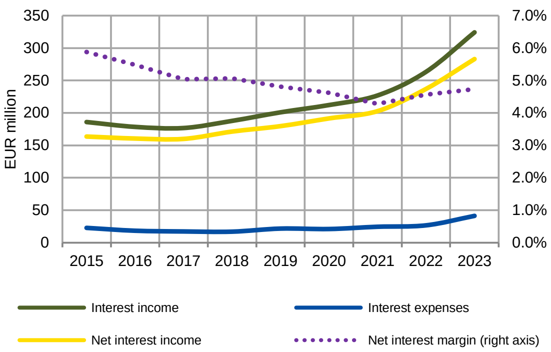
Source: CBK.

Revenues increased by 17.4 percent, mainly as a result of increased income from interest on loans and securities. Interest income increased by 60.8 million euros, i.e. by 23.1 percent. Income from interest on loans increased by 54.0 million euros, or 24.0 percent annual growth, and income from investments in securities increased by 8.5 million euros, or 48.5 percent annual growth.

Consequently, net interest income was the contributor that influenced the increase in profit while net non-interest income was lower compared to the previous year. Net interest income increased by 19.4 percent or 46.0 million euros, while non-interest income decreased by 19.0 percent or 7.7 million euros, as a result of increased expenses for provisions.

Net interest margin remained similar, for 0.1 percentage point on yearly basis to 4.7 percent, attributable more to the effect of interest rates – i.e. net interest income on interest-bearing positions (19.4 percent yearly increase) than to the quantity effect - increase in the stock of interest-bearing positions (15.1 percent annual increase) (Chart 41).

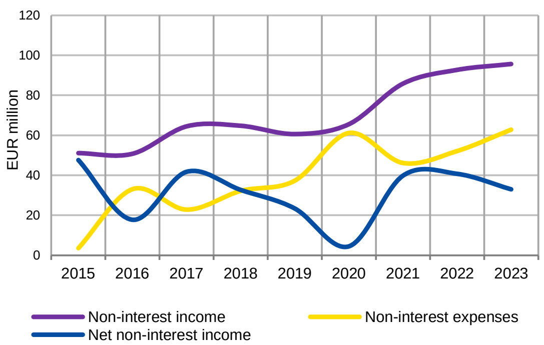
Chart 41. Interest income and expenses



Source: CBK.

The increase in income from securities was influenced by the favorable conditions for investments in foreign markets, which has encouraged the country's banks to expand the portfolio of investments in these instruments. Investments in foreign markets increased by 38.1 percent, while investments in securities in the country decreased by 16.1 percent, also influenced by the decrease in the Government's offer.

Chart 42. Non-interest income and expenses

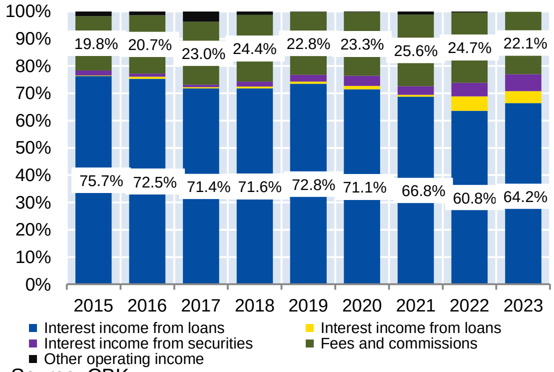


Source: CBK.

Non-interest income (fees and commissions as well as other operating income) recorded an increase of 3.2 percent compared to the increase of 8.0 percent a year ago (Graph 42 and 43).

All expenditure categories have increased throughout the year. The increase in expenses of 21.5 percent (or for 49.6 million euros) was mainly influenced by the increase in general and administrative expenses of 21.6 million euros, the increase in expenses for interest on deposits of 12.7 million euros and expenses for provisions for loan losses of 8.5 million euros (Chart 44).

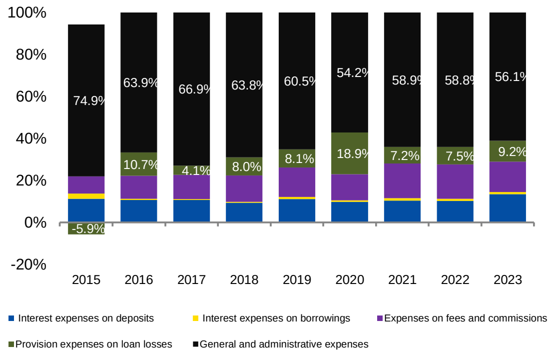
Chart 43. Income structure of the banking sector



Source: CBK.

Non-interest expenses have increased more than in the previous year, influenced by expenses for provisions, while expenses for fees and commissions increased by 2.2 million euros.

Chart 44. Banking sector structure of expenses



Source: CBK.

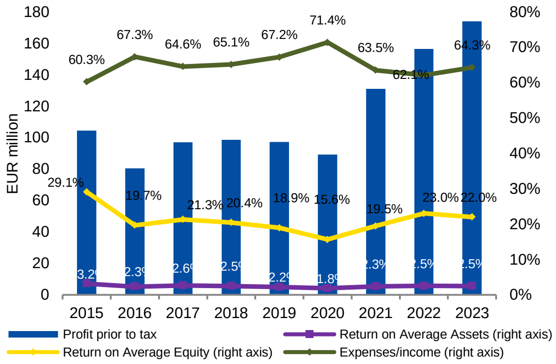
Interest expenses on deposits recorded an increase of 58.7 percent, from 10.7 percent in the previous year, and the impact of the growth of this category, together with administrative expenses, was transmitted to the slowdown of profit growth due to the higher effects compared to the positive effects of other categories in making profit.

Profitability indicators were influenced by profit dynamics. Average return on assets remained at the same level as a year ago at 2.5 percent while average return on equity decreased to 22.0 percent, from 23.0 percent a year ago, as equity held grew higher than profit realized during the year (Chart 45).

These levels are above the average of the region's banks, which recorded an average return on assets of 2.3 percent and a return on capital of 17.1 percent. All the countries of the region recorded an increase in profitability indicators during this year, which has reduced the difference between the average of Kosovo and these countries.[18]

The profit of the banking sector is characterized by increased uncertainties for the banks in terms of their possibilities to realize incomes at the current levels, in the circumstances that interest rates are taking a downward trend. On the other hand, growing competition is expected to increase the pressure on financing costs, despite the general decline in interest rates.

Chart 45. Profitability indicators of the banking sector



Source: CBK.

5.2.1 Risk from interest rate fluctuations

The exposure of the banking sector of Kosovo to the risk of changes in interest rates has evolved as a result of the increase in the participation of loans with variable interest rates. This development has contributed to a degree to the transfer of this risk to customers, reducing to a certain extent the direct exposure of banks. While the direct exposure of the sector to changes in interest rates has increased due to widening of the cumulative maturity gap between interest-bearing assets and liabilities. This development has been influenced by the increase in investments in securities with long-term maturity, while the banking sector still relies on deposits with a relatively short maturity. However, during the year 2023, a significant increase in deposits in longer terms was noted, improving to a certain extent the gap in some categories of maturity terms between resources and investments of the banking sector.

The cumulative gap between assets and liabilities sensitive to interest rates in 2023 has widened to 1,426.2 million euros (or 0.17 percent of equity), from 1,068.4 million euros in the previous year (0.15 percent of equity). Assets sensitive to interest rates dominate in most maturity categories, except for the term "1-5 years", where liabilities are greater, especially for maturity 4-5 years. This has been influenced by the increase in term deposits, which offer higher rates of return.

Assets sensitive to interest rates have recorded higher growth in the "31-365 days" and "1-30 days" maturity periods, mainly due to the increase in cash on bank balance sheets. At the same time, liabilities have recorded a greater increase in the "1-5 years" period, due to the extension of the term of deposits.

The balance of the banking sector in Kosovo is mainly characterized by fixed interest rates, being influenced by interest rate movements mainly in the maturity of these positions. However, the level of fixed-rate loans has been decreasing over the years, in favor of an increase in variable-rate loans, especially in the last two years where from 27.3 percent of loans that consisted of variable interest rates, the proportion has increased to 33.9 percent in 2023.

On the other hand, the increase in interest rates affects the refinancing of deposits at a higher cost, increasing the pressure on the sector's expenses, since most of the main category of assets, loans, are contracted with a fixed interest rate and have longer maturity. If we analyze only loans and deposits, which make up the largest part of

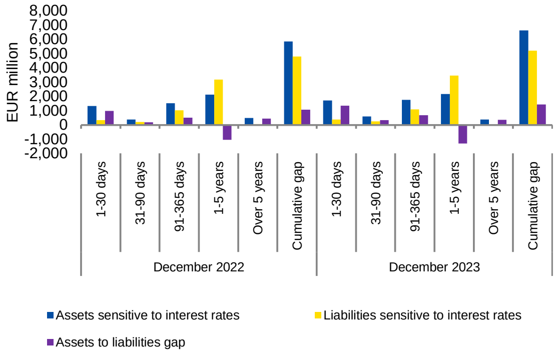
[18]The countries of the region include Albania, Serbia, Bosnia and Herzegovina, North Macedonia and Montenegro. The source of the information is the IMF's Financial Health Indicators database and the relevant central banks.

the banks' balance sheet, the cumulative gap between them for the group with maturity term '1-5 years' is negative, as a result of the higher level of deposits.

Compared to the previous year, the positive gap between assets and liabilities widened for all maturities except for the gap in maturity "over 5 years", while the negative gap for the category with maturity "1 to 5 years" deepened further as a result of the higher increase in liabilities with this maturity compared to the increase in assets (Chart 46).

This widening of the gap may present increased exposure to the risk of fluctuating interest rates. Whereas, the increase in the participation of variable rate loans shifts part of the interest rate risk from banks to borrowers, making the banking sector more sensitive to credit risk indirectly.

Chart 46. Assets and liabilities gap sensitive to interest rates



Source: CBK.

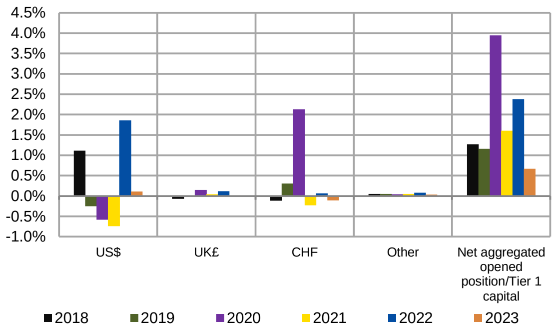
In the following period, the potential drop in interest rates may negatively affect the income of the immediate sector from loans, but also from the possibilities of reinvesting these funds at maturity. Also, although liabilities adjust the cost of funds to market rates more quickly, the circumstances of increased competition for financing from deposits may negatively affect the sector's expenses.

5.3. Risk from the position in foreign currencies

Banking sector exposure to the risk of changes in exchange rates has significantly decreased compared to the previous year. The aggregate net open position for all foreign currencies decreased to 5.4 million euros (equivalent) from 14.9 million euros, which consists of a ratio of 0.7 percent of Tier 1 capital compared to 2.4 percent in 2022 (Chart 47). The decrease in aggregated foreign currency positions results from reduced exposures to the British currency and the US dollar.

By specific currencies, the net position to Tier 1 capital for the US dollar and the British pound results in positive territory, but more tightened compared to last year as a result of the annual decline in asset positions in these currencies. This means that the banking sector has a reduced benefit from a possible depreciation of the euro against these currencies. While the Swiss franc moved into negative territory due to the higher level of growth in liabilities in this currency. This means that the banking sector has increased exposure to the risk that the effect of the possible depreciation of the euro against this currency may have on the sector's losses.

Chart 47. Opened positions in foreign currency to tier 1 capital

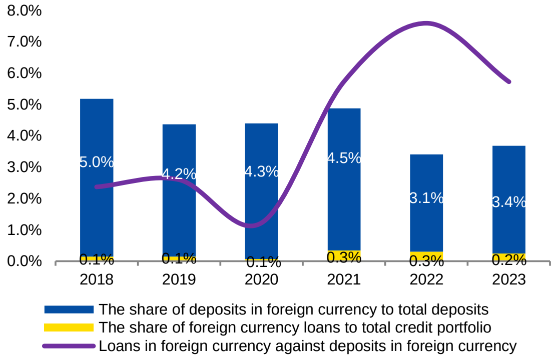


Source: CBK.

The ratio of net open positions for each individual currency to Tier 1 capital continues to remain well below the maximum level of 15 percent allowed under the relevant regulation.

Therefore, currency fluctuations have a marginal impact on the financial condition of the sector, considering the rather low level of open positions in foreign currencies. In addition, the indirect credit risk from currency exposure remains low, as foreign currency loans remain at a marginal level.

Chart 48. Loans and deposits in foreign currency



Source: CBK.

Loans in foreign currency have a participation of 0.2 percent, and marked a drop of 1.1 million euros from the previous year. Deposits in foreign currency also have a low participation, 3.4 percent, while they increased by 38.6 million euros from the previous year (Chart 48).

5.4. Capital

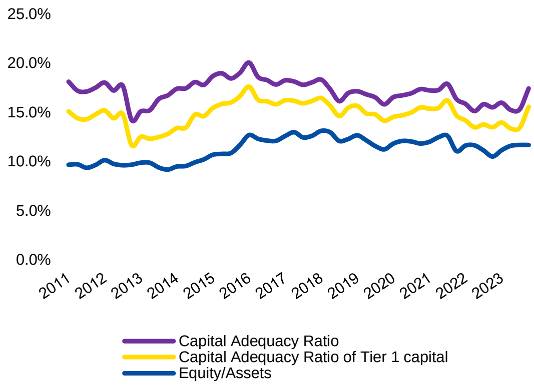
The good financial performance of the sector enabled the capital adequacy ratio[19] to be higher than in the previous year due to the capitalization of the sector, despite the double-digit growth of lending, namely of risk-weighted assets.

The capital ratio increased to 17.4 percent, from 15.5 percent a year ago, with mainly systemically important banks, including a local bank, having a higher capitalization ratio. However, the variance between the CAR of individual banks and the average of the banking sector has decreased, indicating an approximation of the CAR to the average of the sector. This improvement was mainly due to realized and retained earnings, as well as lower distribution of dividends, preserving capital within the sector.

At the same time, the macroeconomic and geopolitical risks that have created an environment of uncertainty make it even more necessary to increase resistance to potential shocks. Global trends suggest that, due to challenges in predicting risks, it is important for banks to use the current period of high profitability to increase regulatory capital levels which, in the case of Kosovo, are the lowest compared to the region and the European Union.

The sector, since the main source of capital growth is retained earnings, has a high quality of regulatory capital where 89.3 percent of it consists of first class capital. The largest part of this capital, 62.8 percent, is the retained profit. The ratio of first-class capital to risk-weighted assets, in December 2023, stood at 15.6 percent, at a higher level than last year (Chart 49).

Chart 49. Banking sector capitalization

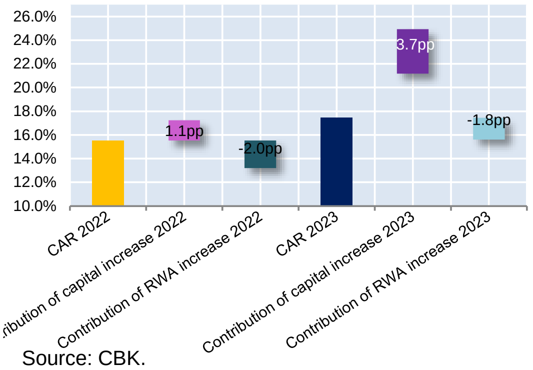


Source: CBK.

The increase in risk-weighted assets contributed by 1.8 percentage points to the decrease of the capital adequacy indicator, while the increase in regulatory capital contributed to the increase of CAR by 3.7 percentage points (Chart 50). The higher effect of capital growth than the growth of risk-weighted assets gave a higher growth contribution to the capital adequacy indicator, of 1.9 percentage points.

[19]The capital adequacy ratio must be above 12 percent of risk-weighted assets at all times. Core Tier 1 Capital must at all times be at least 4.9 percent of RWAs, while the Regulatory Tier 1 Capital must remain at least 9 percent in relation to RWAs.

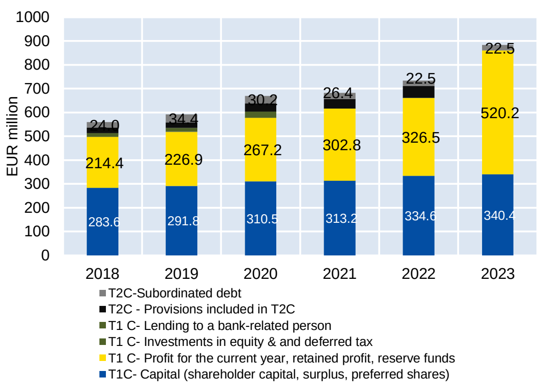
Chart 50. Contribution of Regulatory Capital and RWA to capitalization ratio



Source: CBK.

All categories of regulatory capital recorded growth. The highest increase, after the profit retained from the previous years, was recorded in the current year's profit, the value of the good name, the share capital, as well as other income and reserve funds[20] (Graph 51). In the profit category, retained earnings had the greatest effect, which increased by 70.7 percent, while current year's earnings increased by 29.5 percent.

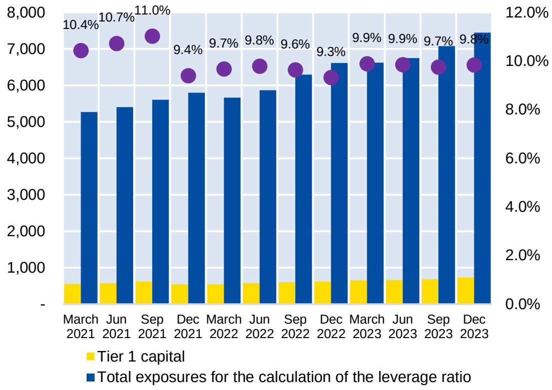
Chart 51. Structure of regulatory capital



Source: CBK.

The financial leverage indicator (the ratio of Tier 1 capital to exposures after regulatory corrections) in December 2023 stood at 9.8 percent, from 9.3 percent a year ago (Chart 52).

Chart 52. Leverage ratio

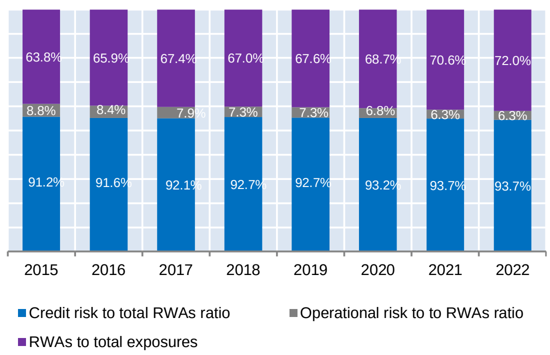


Source: CBK.

This ratio stands above the minimum of 3.0 percent according to the CBK Regulation on the Leverage Ratio which is based on the Basel III framework for financial leverage.[21]

Within the risk-weighted assets, those for credit risk recorded a growth rate of 13.4 percent, compared to the growth of 17.1 percent a year ago, following the trend of slower credit growth.

Chart 53. RWAs to total sector assets ratio



Source: CBK.

Operational risk-weighted assets increased by 12.6 percent from 7.4 percent. The share of risk-weighted assets remains similar, with 93.7 percent of RWAs weighted for credit risk, 6.3 percent for operational risk and a very low share, 0.01 percent for market risk (Chart 53).[22]

Assets weighted for credit risk (Chart 54) reached 4.9 billion euros (4.3 billion in 2022).

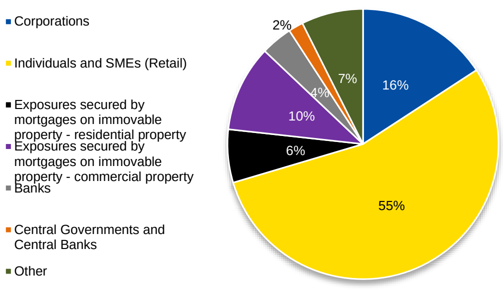
[20] Other Comprehensive Income - a common example of OCI (other comprehensive income) is a portfolio of bonds that have not yet matured and therefore have not been repaid. Gains or losses from changes in the value of bonds cannot be fully determined until the time they are sold; therefore, temporary adjustments are recognized as other comprehensive income.

[21] According to Basel III, the leverage ratio is calculated as the ratio between Tier 1 capital and exposures after regulatory changes. This rate must be equal to or above 3 percent. CBK started calculating this rate, according to the Basel III standard, from 2020.

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

Within these assets, individual and corporate loans dominate with 54.6 percent, followed by exposures to corporations with 15.8 percent.

Chart 54. Credit risk-Weighted assets, share

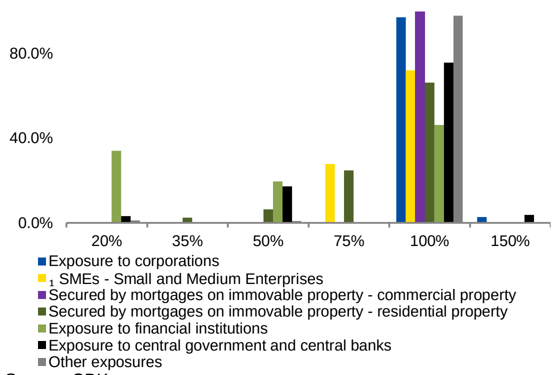


Source: CBK.

Mortgage loans backed by commercial real estate and residential real estate have shares of 10.3 and 6.4 percent, respectively. Exposure to other banks, governments and central banks was relatively low at 3.8 percent and 1.8 percent respectively.

Other remaining exposures constitute 7.4 percent of exposures, which include local authorities, the public sector, development banks, international organizations (Chart 55).

Chart 55. Assets classification by risk weight

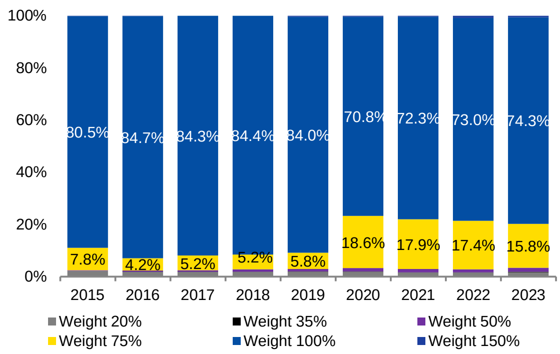


Source: CBK.

According to the weight of the risk, the category weighted by 100 percent, which also constitutes the category with the most pronounced weight in the total risk assets (79.3 percent) and which includes exposures to individuals and SMEs (retail), loans to corporations and mortgage loans supported by commercial property, marked the most significant increase this period of 513.6 million euros (Graph 55 and 56).

The category of assets with a risk weight of 50%, which included mortgage loans backed by residential real estate and exposure to financial institutions, recorded an annual increase of 87.0 percent. The category of assets with a risk weight of 20 percent, which includes lending to financial institutions, governments and the central bank, recorded an increase of 27.7 percent. This development suggests a higher growth of lending in the retail segment - for individuals, corporations as well as mortgage lending backed by commercial property (Graph 55 and 56).

Chart 56. RWA structure for credit risk, by risk weight



Source: CBK.

5.5. Financing and Liquidity Risk

The banking system remains stable in terms of liquidity, with the main indicators within the regulatory requirements, mainly supported by the growth of private sector deposits. However, the increase in interest rates during the year has created challenges regarding financing costs and maintaining the liquidity position.

Deposit growth was more pronounced at the beginning of 2023 compared to the previous year, but this trend began to slow towards the end of the year, influenced by the withdrawal of larger deposits by a small number of corporations, as well as the withdrawal in smaller amounts from individuals. This may be related to increased needs for financing consumption at increased cost, as well as potentially to expectations of no further increase in interest rates.

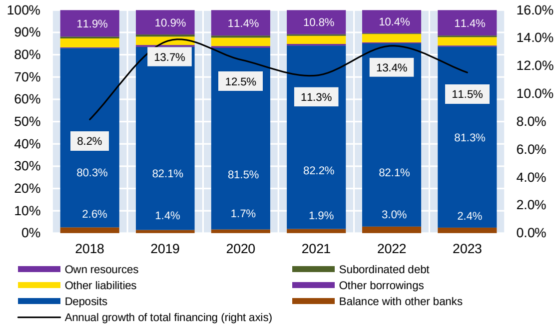
While liquidity indicators at the sector level show stability, there are still differences in liquidity surpluses between individual banks, and thus, in their ability to withstand the consequences of any materialization of financing risk.

The liquidity position of the sector throughout the year was supported by the continuous growth of deposits, especially of the private sector. Household deposits, which are characterized by a more stable nature due to their primary purpose as 'saving/preserving' assets, have contributed to stability of liquidity. Banks also have room to meet potential liquidity needs through other mechanisms, such as liquidity reserve management, interbank liquidity agreements, and funding from parent banks (Chart 57).

Despite the high level of liquidity in the sector, most banks have recorded a decrease in the liquidity ratio (LCR, NSFR) compared to the previous year, although they are significantly above the required regulatory level.

This decrease stems from the higher growth of short-term liabilities, also supported by the faster growth of deposits in the first half of the year. Four banks have reported an increase in the liquidity ratio, while some others remain more sensitive due to their balance sheet structure and more limited funding sources, being less flexible to operate in an environment with increased interest rates. On the other hand, the liquidity coverage indicator (LCR), which has been reported since 2023, remains at a high level, although with significant differences between banks in terms of the level of the indicator and excess liquidity.

Chart 57. Structure of financing



Source: CBK.

Transferable deposits have continued to grow and remain the dominant category of deposits. Meanwhile, under the influence of higher interest rates during the year, the participation of term deposits has also expanded, although at a slower pace than the previous year.

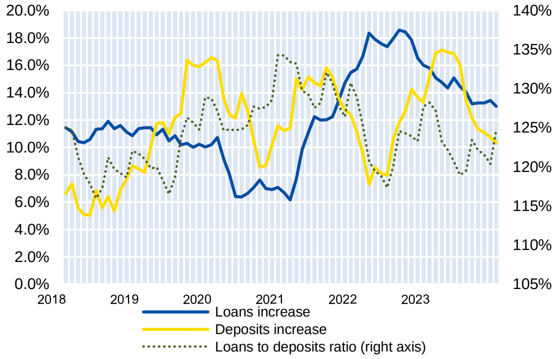
The continued growth of long-term lending and the still high participation of deposits with relatively shorter maturities have contributed to highlighting the mismatches between assets and liabilities in some categories of maturities. However, the main indicators of liquidity[23] provide positive signals for the current state of banking liquidity, where the high level of liquidity reserves that banks hold in the CBK, as well as total liquid assets, makes the sector resistant to possible negative effects that may result from discrepancies in maturity dates between investment and financing.

5.5.1 Bank financing

This year, deposits exceeded loans by 124.7 percent, an indicator that decreased by 3.0 percentage points from the previous year, due to the higher growth of lending compared to the growth of deposits (Chart 58).

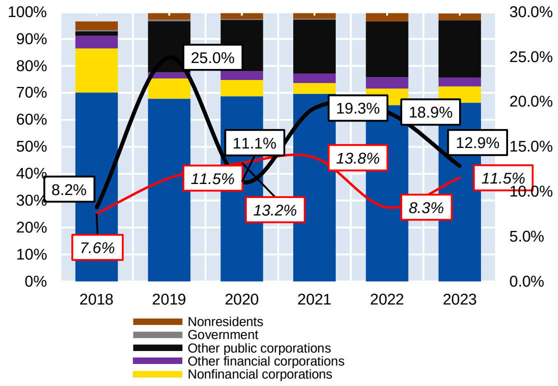
[23] From 2023, banks have started reporting the liquidity coverage ratio (LCR) as well as the net stable funding ratio (NSFR) according to Basel III.

Chart 58. Increase of banking sector loans and deposits



Source: CBK.

Chart 59. Structure of deposits



Source: CBK.

During the first nine months of the year, the growth of total deposits was accelerated, driven by attractive interest rates, but then this trend slowed down. Household deposits grew faster, while corporate deposits slowed their growth rate, with a more pronounced seasonality during the second and third quarter, where August had the highest deposit level (Graph 58).

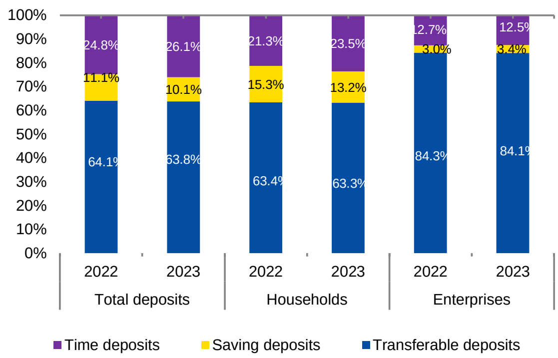
Deposits of other financial institutions and the government increased, while those of other public corporations decreased.

The structure of total deposits according to maturity remains dominated by transferable deposits, with a participation of 63.8 percent, which increases the sector's sensitivity to liquidity risk as a result of high discrepancies in maturity terms.

However, term deposits were characterized by the most pronounced growth of 15.9 percent, a dynamic that resulted in the increase in the participation of these deposits to 26.1 percent, from 24.8 percent last year (Chart 59). The discrepancies between the maturities of deposits and loans are especially pronounced for the terms 'up to 1 year' and 'over 2 years'. Deposits with a maturity of over 2 years increased their participation in the structure of term deposits to 52.5 percent, while loans with a maturity of 5-10 years constitute 37.7 percent of the total loans (Chart 59).

The high participation of transferable deposits and the increase in the requirements for sustainable financing underline the importance of the banks' prudent practices regarding their financing possibilities and the accompanying costs against their increased credit and financial activity.

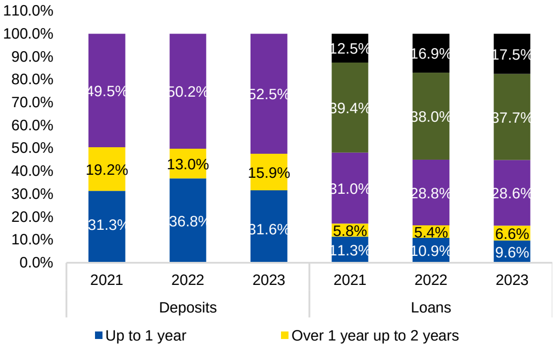
Chart 60. Structure of deposits by maturity



Source: CBK.

During the year, the sector increased financing from interdependent debt. However, as long as foreign financing is at a low level and competition for deposits is high, financing costs remain a challenge for banks' activity. The net sustainable funding ratio (NSFR) at the end of the year was at the level of 150.3 percent, reflecting that the sector has nevertheless managed to maintain a sustainable funding ratio available to that needed higher than the minimum regulatory level of 100 percent, with more pronounced differences between large and smaller banks.

Chart 61. Maturity structure of deposits and loans



Source: CBK.

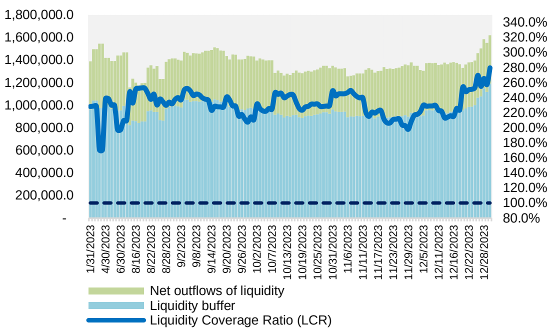
The indicator remained at lower levels at banks that are at the beginning of activity or were challenged in the market by the competition for deposits.

5.5.2 Liquidity Risk

In 2023, the ratio of liquid assets to current liabilities decreased to 34.7 percent, from 36.5 percent in 2022. This result was influenced by the higher growth of current liabilities compared to the growth of liquid assets, which increased by 10.0 percent (or 490.7 million euros), while liquid assets increased by 4.6 percent (or 82.0 million euros).

The high capacity to cover net liquidity outflows during a period of short-term stress has increased until the end of 2023. The liquidity coverage ratio (TML-LCR) increased by 23.8 percentage points since August and 51.5 percentage points since the beginning of reporting in January 2023, reaching 279.7 percent at the end of the year, and remains well above the regulatory requirement of 100 percent (Chart 62).

Chart 62. Liquidity- coverage-ratio ((LCR)



Source: CBK.

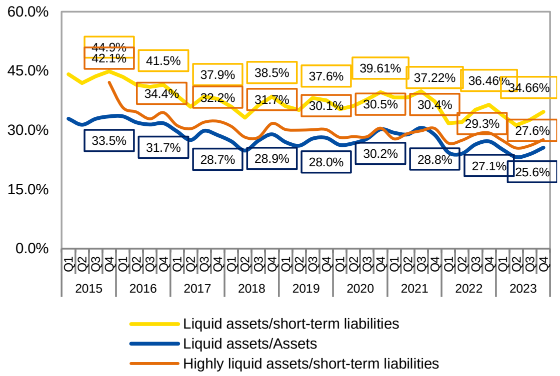
The high level of the TML-LCR ratio is mainly supported by the high liquidity reserve, which this year mainly consists of local and foreign government securities (41.5 percent), as well as cash and reserves at the central bank. The increase in investment in government securities, driven by higher and attractive rates of return, increased liquidity addition more than the increase in net liquidity outflow, which was a major factor in the improvement of LCR. Liquidity reserve increased by 23.6 percent, and net outflow increased by 0.8 percent compared to data at the beginning of reporting in January 2023.

The tight liquidity ratio, which includes only highly liquid assets (cash and cash equivalents, current accounts and placements), relative to short-term liabilities, eased to 27.6 percent from 29.3 percent a year ago, due to higher growth in liabilities compared to highly liquid assets.

The ratio of liquid assets to total assets decreased to 25.6 percent from 27.1 percent in 2022, as assets grew faster than liquid assets (Chart 63).

The increase in liquid assets during the period was mainly influenced by the increase in investments in marketable securities of foreign governments for 92.1 million euros (an increase of 36.5 percent) and deposits with short-term maturity up to 30 days, placed in banks abroad, for 99.1 million euros. Also, an important contribution was made by the increase of 38.1 million euros in cash.

Chart 63. Liquidity indicators



Source: CBK.

While, the category of investments in bonds of the government of Kosovo had a decreasing effect on liquid assets, which decreased by 40.6 million euros (annual decrease of 20.9 percent), current accounts with banks, which decreased by 69.8 million euros or 32.6 percent, as well as deposits and placements in local banks, which decreased by 24.6 million euros or 30.9 percent.

At the end of December, banks' liquidity reserves continue to be at high levels, exceeding by 49.99% the amount of the required reserve (10%) that must be kept in liquid form at the Central Bank of Kosovo (CBK).

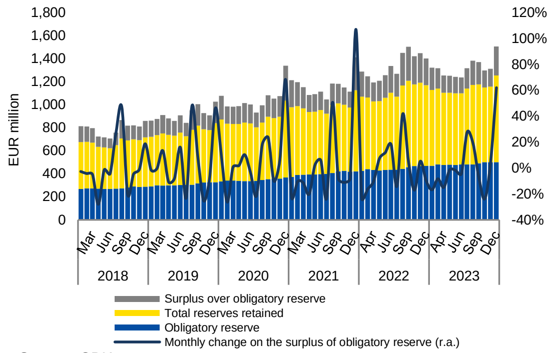
The transmission of changes in basic interest rates by the ECB has been partially reflected in segments of the financial market in the country, influencing the deposit rate with which the CBK charges its depositors. The level of the rate depends on the rates that eurozone banks apply to the CBK, as well as on the investment returns in the current investment portfolio. Consequently, with the increase in interest rates globally, the CBK has started to apply a positive interest rate in 2023 for commercial banks, applicable to the minimum reserves held at the CBK. Currently, this rate stands at 0.3 percent.

The level of excess bank reserves has not undergone major changes from the previous year, exceeding the minimum reserve by 50.0 percent from the level of 49.2 percent that was in 2022. This level remains lower than in 2021, when it was 68.3 percent, reflecting the dynamics of credit growth and investments in securities (Chart 64).

During 2023, the maturity of deposits became more attractive due to the higher rates offered in the market, a development that resulted in a much lower expansion of the positive gap in the "1-5 years" maturity group, compared to the categories other maturity dates. This lower expansion was driven by higher liability growth of 14.0 percent and lower asset growth of 5.5 percent in this maturity category.

Maturity mismatches between investment and financing in several maturity categories are further increasing, as deposit maturities are expanding, and long-term lending is increasing. This move has added to the challenges in managing liquidity. The cumulative liquidity gap in 2023 widened to 963.6 million euros, from 709.6 million euros a year earlier. This result was mainly influenced by the widening of the positive gap between assets and liabilities in all maturities, except for the "1-7 days" maturity group.

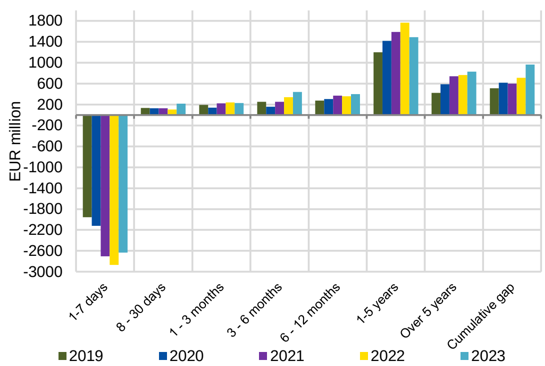
Chart 64. Liquidity reserves



Source: CBK.

The negative gap between assets and liabilities remains in the maturity term "1-7 days". The high participation of transferable deposits in the total liabilities of the sector means that 71.3 percent of the liabilities are categorized in the term "1-7 days," while the assets with this term constitute only 20.0 percent of the total assets.

Chart 65. Liquidity gap



Source: CBK.

Meanwhile, the largest positive gap remains in the maturity term "1-5 years," where about 36.2 percent of assets are categorized with this term, compared to liabilities of this maturity term that constitute 14.0 percent of total liabilities. However, this category had the lowest expansion compared to the other maturity categories mentioned above.

Mismatches in the maturity terms of the balance sheet items remain more pronounced in the "1-7 days" and "1-5 years" maturity categories (Chart 65). Given that the gap has widened in these two categories compared to last year, challenges remain in securing funding and the longer-term one, in a competitive environment for supporting long-term lending and other investments.

5.6. Shock absorbtion capacity - Stress-Test analysis[24]

CBK is in the process of transition in terms of the credit risk and liquidity stress-test framework, moving to a more advanced model to adapt to the needs of macroprudential policymaking and early signaling of future risks. The preliminary model of the stress test, namely the component of the stress test for credit risk, has analyzed the sensitivity of the banking sector to shocks through the coefficient of elasticity between the BPV gap and the increase in non-performing loans. However, this approach is limited in assessing complex macrofinancial shocks related to macroeconomic conditions.

Therefore, with the technical assistance from the International Monetary Fund (IMF), CBK is working on building a new credit risk stress-test framework that includes more advanced approaches, including three main pillars (Diagram 1), whose final product has the effect on the balance sheet and capital position of banks. This new framework will integrate the impacts of macro-financial shocks to provide a more complete and accurate picture of the risks facing the banking system. With this change, CBK aims to strengthen the supervision and stability of the banking sector in an increasingly complex financial environment.

1. Macroprudential Stress Test Framework block diagram

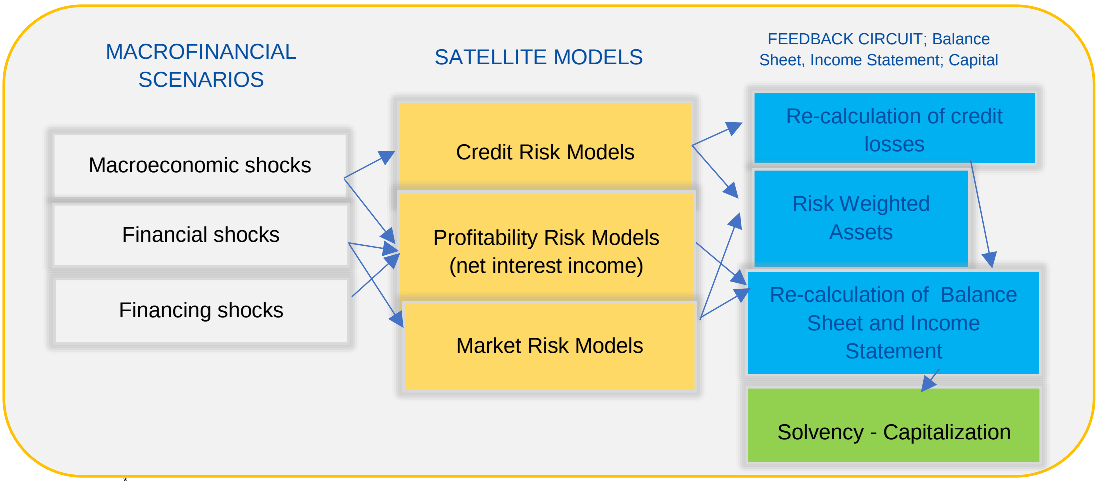


Diagram adapted from Henry and Kok;A macro stress testing framework for assessing systemic risks in the banking sector (europa.eu); ECB Occasional Paper 152

24 Stress Test does not represent a prediction model, but contains assumed scenarios of macroeconomic and financial shocks in order to measure the resistance of the banking sector to these negative shocks, without prejudice that such situations may occur or are expected to occur in the future.

The first pillar of the new framework includes the construction of macro-financial scenarios, which are based on forecasts for the future state of the economy. These forecasts, covering a 3-year horizon, include a baseline scenario with expected economic conditions and a negative scenario with a lower probability of occurrence, but reasonable and explainable. The second pillar, "Satellite Models," translates macroeconomic scenarios into impacts on credit risk (probability of default – PDs), net interest income, and market gains/losses. This transmission of macroeconomic shocks affects the credit portfolio, bank performance and market instruments. The third pillar introduces the "Feedback Loop", which includes the combination of predicted gains/losses from macro-financial scenarios and their effects on banks' capital position. While the credit risk stress test component is still ongoing work, the liquidity stress test component has been finalized, and an explanation of the framework and results is presented below.

Stress Test for Liquidity Risk

With the advancement of the supervisory regulatory framework according to the requirements of Basel III, within which the reporting and monitoring of the Liquidity Coverage Indicator (LCR) has begun[25] as the most adequate indicator of the assessment of the liquidity position, the stress-test framework for the assessment of liquidity sustainability has also been advanced. The new framework is based on LCR's regulatory reporting[26], which expresses the ratio between the bank's liquidity buffer and net cash outflows during the 30 calendar days of the stressful period, expressed as a percentage, and the minimum regulatory limit of which must be 100 percent. The development of the methodology as an instrument with a micro- and macro-prudential perspective improves the capacity for monitoring and testing the sustainability of the liquidity position.Further, the objective is to examine the possibility of expanding the regulatory and analytical framework to include the Cash Flow Analysis module according to maturities, which, by providing banks' planning or forecasts about the movements of inflows and outflows balance sheet positions according to the maturity dates, would complete the judgment and evaluation in determining the weights (English: haircut) in the stress test platform of the liquidity based on LCR. In the following, the historical context of the creation and effectiveness of the LCR indicator, the narrative of shocks/assumptions for determining the weights in the balance sheet positions for the banking sector of Kosovo, as well as the corresponding stress results of these positions will be elaborated.

During the Global Financial Crisis (GFC) of 2008, many banks in the world faced failure due to the inability to meet the outflows of liabilities that were caused by mismatches in maturity dates between liquid assets and liabilities. This situation created the phenomenon of uncertainty in the market affecting the further decline of confidence in the financial system and therefore the further decline of liquidity in the market. To manage and control this phenomenon, the Basel Committee on Banking Supervision (BCBS) reacted by reforming the regulatory standards in 2013, introducing a new measure aimed at ensuring the short-term sustainability of banks' liquidity risk profile. This new regulatory measure, the Liquidity Coverage Indicator, is intended to be a forward-looking measure and requires banks to maintain a sufficient level of the stock of High Quality Liquid Assets[27], to withstand a liquidity stress period of 30 calendar days. European banks have begun to implement the LCR indicator in accordance with the requirements of the Basel Framework by applying the minimum requirements of this ratio of 100 percent, with implementation from January 2018. Such liquidity reserve is aimed at improving the ability of the banking sector to absorb the shocks caused by any financial or economic shock, which would enable reducing the spread

[25] Regulatory reporting for LCR in Kosovo has entered into force in January 2023.

[26] The new liquidity stress test framework has been designed with the help of technical assistance provided by the International Monetary Fund (IMF), and is in line with international standards for assessing/stressing the liquidity position.

[27] Easily convertible to cash

of risk from the financial sector to the real economy. The minimum 100 percent indicator itself has been implemented as an additional/liquidity buffer in order to protect against the withdrawal crisis. This level is determined based on the experience of the global financial crisis around the level of withdrawals/outflows, which have a high probability of occurrence.

The Basel Committee (BCBS) and the European Central Bank (ECB) have analyzed whether this indicator, during the period of the pandemic crisis, has worked for the purpose for which it was activated. Due to the acute nature of the pandemic crisis, as well as the fiscal and monetary support measures that were taken, it is difficult to accurately conclude about the effectiveness of this indicator during that period. However, the LCR's reserve/buffer level proved insufficient during the March 2023 banking crisis.[28] Deposit withdrawals at affected banks in the US (mainly uninsured deposits) and Switzerland (mainly non-financial corporate deposits) were significantly higher than the assumptions made in the LCR for those deposits. According to the Basel Committee report[29], Silicon Valley Bank lost 85 percent of its total deposits within a two-day period. For First Republic Bank and Credit Suisse, deposit withdrawals were 57 percent and 21 percent within 90 days, respectively. The spread of panic did not materialize in banks in the eurozone where the level of withdrawal occurred at a much lower magnitude of an average of 4.2 percent of deposits within 30 days. However, the spread of the panic and the magnitude of the spread are unpredictable, and therefore assumptions about the LCR must exceed past experiences. This is especially because the expectations for rapid withdrawal of deposits are much more realistic in an environment of digitization and the immediate impact that the media and social networks have on the spread of panic.

Both crisis situations – the pandemic crisis and the banking crisis of March 2023 – have increased the interest and commitment to analyze whether the Liquidity Coverage Ratio (LCR) is performing the function for which it was implemented. More importantly, the main concern is whether banks will be willing to use this buffer in case of any specific or systemic crisis, lowering the LCR level below 100 percent in these circumstances. In the surveys carried out by the ECB[30] most banks that have chosen not to use liquidity buffers (that is, not to reduce the LCR ratio below 100 percent) have argued that doing so could stigmatize them as institutions with liquidity problems, damaging their reputation and further worsening their liquidity position. As a result, if the pandemic crisis has not been able to give a clear conclusion on the functioning of the LCR due to different reactions from banks, it has raised questions about whether banks will be able to use this current liquidity buffer (the possibility of below the 100 percent level) during a crisis, or to create new mechanisms of additional liquidity reserves.

Consequently, the stress test model for liquidity risk aims to assess the reactions of the liquidity reserve at the bank level and at the sector level, in a stress situation caused by a negative shock. This test evaluates the resistance of the banking sector to the situation where the outflow of money is much higher and as a result the banks do not have enough assets or excess liquidity to meet the obligations. In this case, the level of deficiency is evaluated in relation to the required regulatory minimum, in order to measure the banks' ability to cope with certain stresses.

In line with the practices and experience of European banks, and more specifically the analyzes of the ECB and the Basel Committee, the construction of hypotheses on the levels of deposit withdrawals and the construction of scenarios for other balance positions has been

[28] The March 2023 banking crisis was caused by the collapse of US banks Silicon Valley Bank and Signature Bank, along with the near-total collapse of Switzerland's Credit Suisse, raising concerns about liquidity, risk management and regulatory deficiencies in the banking sector.

[29] Report on the 2023 banking turmoil (bis.org)

[30] Second EBA report on monitoring of LCR implementation in the EU.pdf (europa.eu)

done at the most extreme levels that occurred in reality (like that of the banks in America and the bank in Switzerland). This approach was used only for the purpose of measuring the sensitivity of the liquidity position of banks in the country to the most extreme negative but potentially possible situation. The March 2023 banking crisis highlighted the impact of tail events, for which the LCR was not sufficient. Therefore, the early identification of special cases that reflect extreme risks is necessary and raises the need for more detailed and higher frequency reporting and monitoring even during normal periods.

THE SCENARIOS

The scenarios of shocks to the liquidity position are based on assumptions about a possible geopolitical crisis, with a chain effect on the economy and the financial sector of Kosovo, as well as on a possible shock in the sector resulting from an idiosyncratic risk event of a bank with a chain effect in the sector banking. The magnitude of the shock for the banking sector of Kosovo is considered (assumed) to be amplified due to factors such as the low rate of deposit insurance in relation to other countries, as well as the most limited mechanisms for emergency assistance with liquidity. The effects of conservative scenarios are classified into two possible categories of situations, at two levels of scenarios: severe and extreme.

1) The effects of market risk from changes in interest rates on the value of more liquid assets, more specifically government instruments. In this scenario, the increase in interest rates can reduce the value of these instruments, causing banks to face declines in the value of their liquid assets, which directly affects the ability to meet short-term obligations.

2) The effects of reputational risk, related to situations such as mass withdrawal of deposits, where panic can influence confidence in the banking sector to weaken. This can result in rapid and high withdrawals of deposits, putting pressure on banks' liquidity and ability to meet unexpected liquidity demands.

Table 4.Scenarios and weights (haircut) used in each scenario for the main categories of TML - LCR

MAIN CATEGORIES OF LIQUIDITY COVERAGE RATIO (LCR)	Baseline scenario - regulatory weights	Severe scenario	Extreme scenario	Weights applied by banks
LIQUIDITY BUFFERS	98.6%	93.7%	88.9%	93.1%
Central Government Assets	100%	90%	80%	100%
Regional government / local authorities assets	100%	90%	80%	100%
Recognizable domestic and foreign currency central government and central bank assets	100%	90%	80%	85%
OUTFLOWS	14.2%	22.7%	31.4%	13.8%
Retail deposits	8.3%	16.6%	23.6%	8.0%
Deposits subject to higher outflows	17%	19%	27%	12%
Stable deposits	5%	7%	12%	5%
Other retail deposits	10%	25%	35%	10%
Operational deposits	15%	22%	31%	21%
Maintained for clearing, custody, cash management or other comparable services in the context of an established operational relationship	24%	34%	49%	18%
Non-operational deposits	25%	27%	34%	46%
Not covered by DGS	40%	45%	60%	40%
Other products and services	14%	30%	47%	14%
INFLOWS	80.8%	70.3%	58.5%	80.7%
Monies due from non-financial customers (except for central banks))	55%	48%	31%	55%
Monies due from retail customers	50%	45%	30%	50%
Monies due from non-financial corporations corporates	50%	40%	20%	50%
Monies due from central banks and financial customers	99%	84%	70%	99%
Monies due from financial customers	100%	85%	70%	100%
Loans with an undefined contractual end date	20%	10%	0%	20%

Source: CBK simulated/hypothetical model.

Both situations, that of changes in the value of government bonds as well as the withdrawal of deposits, are based on international experiences and will be applied in parallel to the stress/impact of the banks' liquid position. It should be emphasized that other possibilities or sources of refinancing and reinvestment are not considered, which as a result, reflects the inability of banks to renew the same financing that matures, expressed through the application of specific weights (haircut). For both situations, two scenarios (severe and extreme) were used in terms of the determined level of weights (haircut) in the dominant positions, which are presented in table 4.

1. Shocks to the liquidity buffer and Inflows

This scenario is based on the weights applied by the European Banking Authority (EBA)[31] related to the decline in the collateral value of government securities, which may reduce liquidity reserves and reduce banks' ability to meet their obligations. The scenario analyzes the potential of the fall of the liquidity reserve (liquidity buffer) as a consequence of the fall in the value of a liquid position, specifically of government bonds with first level quality.

Based on the data showing a relatively high participation of government securities in the total liquidity reserve (on average 44.2 percent of the liquidity reserve of the banking sector of Kosovo consists of investments in securities, where for some banks this ratio reaches up to 62.1 percent), the assumption of a decrease in the value of these assets, namely the application of a value reduction margin (haircut), would have a significant impact on the reduction of liquid assets available and an effect in the same direction (reduction) in the liquid ability of banks and their liquid position.

The combination of factors with the probability of occurrence such as the increase in interest rates, the increase in the country risk premium and the economic slowdown can negatively affect the value of government bonds. As a result, this affects the fall in the value of the collateral and, consequently, the decrease in the banks' liquid reserves. This situation is also valid when these securities are used for REPO financing with banks, since any decrease in their value directly affects the amount of funds that banks can receive through these agreements.

Two scenarios are used here according to the level of determination of weights (haircut) in certain positions. In the worst-case scenario, it is assumed that the ability to use these instruments at the central bank will be weakened by the fall in the value of the collateral. These instruments will no longer be considered zero-risk and fully liquid; their value will be reduced to 90 percent, which means that only this percentage can be considered highly liquid and convertible. This scenario will also be combined with a decline in inflows in the dominant categories of current income: income from financial clients (which account for 47.9 percent of inflows), non-financial clients (18.3 percent), and credit agreements without a defined deadline (13.2 percent) (Table 4). In the extreme scenario, it is assumed that the liquidity of financial instruments will be reduced to 80 percent. As a result, for total liquid reserves that currently have a liquid ability of 98.6 percent according to standardized weights, liquidity will be reduced to 88.9 percent in this scenario. This scenario is combined with an increase in the reduction weights on inflows from financial customers, who under normal conditions do not have delays and for whom no deterioration in payment performance is expected, therefore no haircut is usually applied. However, in this scenario, a haircut will be applied to current revenues from this category due to the reduction in

[31] To assess such impacts,the EBA in the third report on the monitoring of the LCR, developed some general projections of LCR and NSFR values for the years 2023 and 2024, taking into account key events such as central bank funding maturities, as well as a possible scenario of higher liquidity risk, particularly affecting government bonds, derivatives and repo markets.

economic activity, with the expectation that only 70 percent will be realized. For the other category of income, which comes from non-financial customers (households and non-financial corporations), for which a standard regulatory haircut of 50 percent is usually applied, in this scenario it is assumed that the ability to accept funds is reduced to 30 percent and 20 percent, respectively. All other positions remain unchanged and comply with the standardized LCR regulatory limits.

2. The "dash for cash" situation[32]" based on the experience of the banking crisis in America and Switzerland in March 2023 (outflow shock)

The banking crisis of March highlighted the importance of the question of whether the liquidity coverage indicator is being shocked and estimated sufficiently to know with certainty the ability of banks to cope with withdrawals of deposits at extreme levels. The example of the failure of the Credit Suisse bank has been considered as a basis for the orientation of the determination of the weights of outflows. In 2022, this bank had uncertainty about its transformation plan and was destabilized by the flow of negative news. In 2023, the failure of two US banks increased uncertainty about liquidity in the banking sector globally, further worsening the market's perception of Credit Suisse. In this context, the declaration of non-capitalization was the instigator of the crisis, in which case the digitization of processes accelerated the situation, offering customers immediate access to information and the possibility to transfer funds very quickly to other bank accounts.

In adapting this narrative of shocks to the scenario of the idiosyncratic banking shock in Kosovo, similar assumptions are used for deposit withdrawals from the financial and non-financial sectors (households and non-financial corporations) in combination with the specific circumstances of the sector in Kosovo.

Household deposits category represents a fairly stable source of funds for banks. Therefore, the estimate for withdrawals of these deposits within 30 days has a standard regulatory weight in the range of 5-10 percent, and setting high haircuts is rare in advanced financial systems due to deposit insurance schemes. However, considering that in Kosovo, the coverage value of insured deposits is relatively low, it supports the assumption of a higher rate of withdrawals in case of shock situations. Also, as stated above, the experience of March 2023 serves us to assess the bank's liquidity in the most severe cases of withdrawals. Therefore, for deposits that are considered more stable (stable deposits), due to the coverage by the deposit insurance scheme, a higher weight of exits of 7-12 percent has been applied from the standard 5 percent, bearing in mind that in a state of panic, depositors do not act rationally and any category may be subject to rapid and high withdrawals. Furthermore, for categories such as other household deposits (other retail deposits), which constitute the main category of outflows (38.2 percent), a more rigorous weight has also been applied, assuming that the level of withdrawals from this category will be 25 percent in the severe scenario and 35 percent in the extreme scenario. For the part of household deposits that are treated by the LCR framework as subject to higher withdrawals, it has been assumed that there will be withdrawals in the range of 19-27 percent for both scenarios, compared to the 12 percent that banks have used in their reporting (similar to standardized weight).

In the case of deposits of non-financial corporations, the dynamic character of these entities makes them more sensitive, and more responsive to shocks, constituting a more uncertain source of funds for banks. The case of bank failures in March shows that a

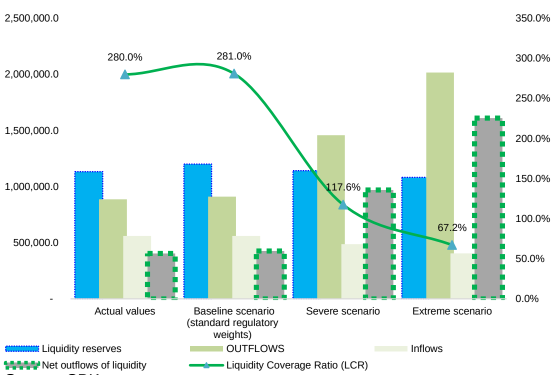
[32] The phrase "dash for cash" is a term used in professional articles to refer to a situation of uncertainty or financial crisis where investors tend to convert assets into cash or withdraw physical cash from banks, due to fear of the uncertainty of markets and the stability of banks, which could lead to further destabilization of the financial system.

high level of withdrawals were made by non-financial corporations. Therefore, in the severe and extreme scenarios, a higher level of withdrawals has been assumed, ranging from 22 to 34 percent in both scenarios for both categories of deposits: those for operational and non-operational purposes. This high level of deposit withdrawals coincides with the level of withdrawals that occurred during the March 2023 crisis, which was about 21 percent in Switzerland and the extreme of 85 percent in America.

Results according to the scenarios

Standardized weights (haircuts), which are defined by regulations, provide information and instructions for banks to stress/shock financial positions, setting intervals within which they can operate, but without significant deviations from the applied weights. In general, the banks have applied the weights referenced according to the standards, with small variations between them. According to standardized weights[33], liquidity reserves are liquid at a rate of 98.6 percent, compared to the weights applied by banks, which turn out to be more conservative at a level of 93.1 percent.

Chart 66. LCR results of the sector based on the scenarios



Source: CBK.

This ratio is influenced by banks that have exposures to instruments that are categorized in the second-level liquidity group, where their liquid level is 50 percent (quality level 2B) and 85 percent (quality level 2A). In terms of deposit withdrawals and current income, almost the same recommended weights were used. For exits or withdrawals, the recommended level is 14.2 percent, while banks have assumed 13.8 percent. For entries, they applied a weight of 80.8 percent against the standard of 80.7 percent. The Liquidity Coverage Ratio (LCR) according to standard weights turns out to be 281.03 percent, very close to that held by banks in December 2023.

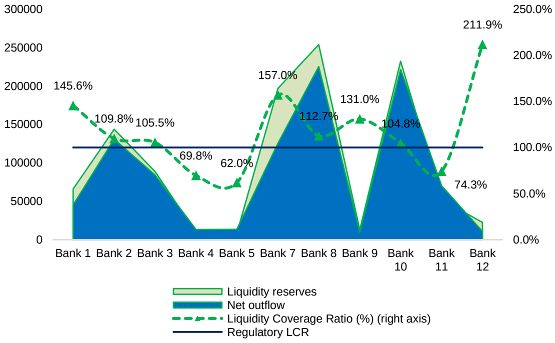
In the aggravated scenario, the level of total liquid assets turned out to be 93.7 percent, based on assumptions about the reduction margins for specific categories as in table 4. While the level of withdrawals (outflows) resulted in a total of 22.7 percent for the sector, coinciding with the level of withdrawal that occurred in Credit Suisse bank, which was in the ratio of 21.0 percent. Meanwhile, on the side of revenues (inflows), from the specific assumptions for the category of revenues (table 4), it resulted that the general realization rate of the expected revenues for the 30-day period is only 70.3 percent. Under these assumptions, the Liquidity Coverage Ratio (LCR) will decrease to 117.65 percent, from the sector's level of 280.01 percent in December 2023.

In the extreme scenario, the reserves are assumed to be liquid at the level of 88.9 percent. Starting from the level of withdrawals of deposits in American and Swiss banks, which range from 21 percent to 85 percent, the application of more rigorous weights to the dominant constituent groups was carried out, resulting in the level of withdrawals being a total of 31.4 percent. The revenue collection rate in this situation was assumed to be 58.5 percent.

Based on these assumptions, the Liquidity Coverage Ratio will be reduced to 67.22 percent, below the regulatory level of 100 percent. Almost all banks result around this level, with the exception of three banks that result with LCRs above 80 percent.

[33] The standard weights and the weights applied by the banks were calculated in relation to the weight of the balances in the reporting period of December 2023, for the respective categories.

Chart 67. LCR categories by severe scenario



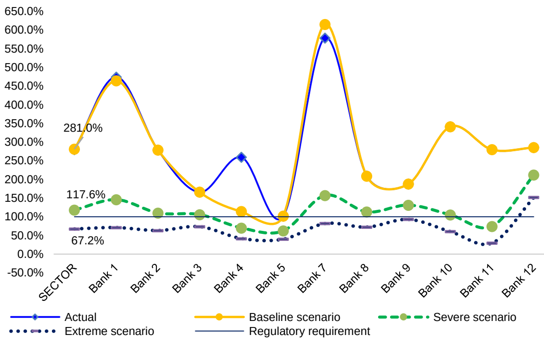
Source: CBK.

Conclusion

One of the lessons from the recent bank failures in March 2023, due to a lack of liquidity, is that banks should be required to assess the level of assets that can be used as collateral at the central bank.[34] Also, the operational cost aspect of the bank is not taken into account when conducting the liquidity stress test. In fact, the Liquidity Coverage Ratio (LCR) does not include the operational risk dimension, in addition to liquidity risk. Operational liquidity needs are typically higher during a crisis, as a struggling bank struggles to meet payments. Furthermore, customer demands for rapid withdrawals create operational overload, increasing the potential for technical problems and failures.

However, it should be noted that the Liquidity Coverage Ratio (LCR) was introduced as a minimum regulatory standardization instrument for liquidity risk management. For this reason, the LCR framework with standard regulatory weights should not be expected to have early warning qualities regarding adverse liquidity situations.

Chart 68. Liquidity Coverage Ratio



Source: CBK.

The LCR is designed to protect banks from potential failures caused by liquidity mismatches in their balance sheets, while also serving as a framework for stress testing.

Other aspects of liquidity risk, such as concentration of funding (usually deposits), analysis of cash flows by maturity or daily liquidity, and repo transactions, are not explicitly included in the LCR indicator, despite being quite important in assessing and monitoring this risk. For this reason, the LCR should be monitored in parallel with other liquidity indicators and stressed in order to present the state of banks and their reaction to stress situations as clearly as possible. In particular, in current times, rapid and high deposit withdrawals are much more real, as digitalization and media have the potential to influence depositor behavior, increasing shocks to deposit withdrawal levels.

[34] Swiss National Bank, Financial Stability Report 2023

Box 5. Strategy, Action Plans and Activities to Date of the CBK in Risk Management Related to Climate Change

"Climate change represents a new type of systemic risk, characterized as a "Green Swan". Unlike rare crisis events, such as the so-called "Black Swans" of the Global Financial Crisis, Green Swans are destined to occur if not addressed through appropriate policies" (Bolton et al., 2020, The Green Swan: Central Banking and Financial Stability in the Age of Climate Change).

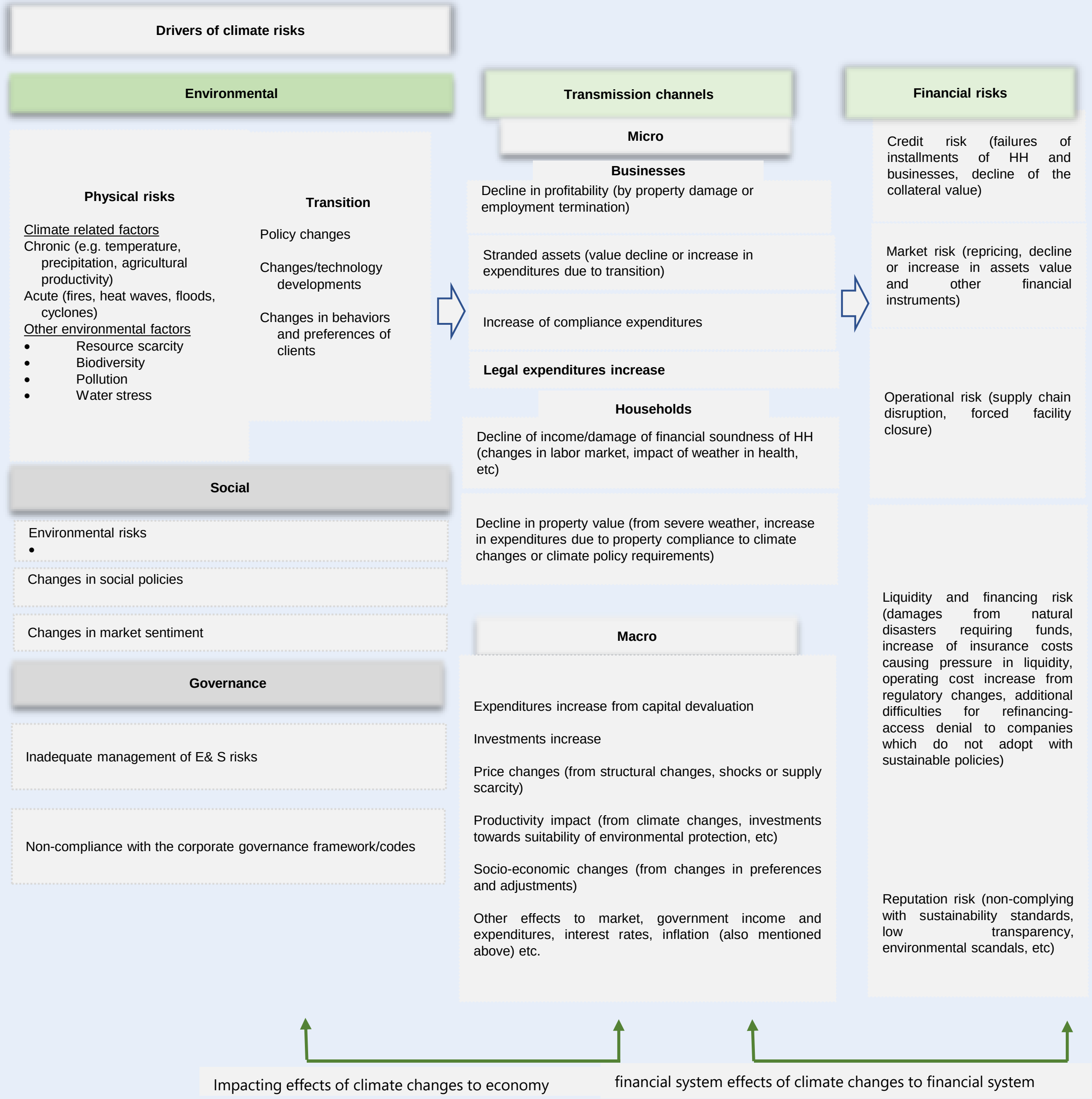
In the two previous publications of the Financial Stability Report (FSR), the CBK has addressed the climate change risk dimension, starting with the analysis of the impacts of climate change on social welfare and overall financial stability, and further, assessing the integration of the management of these risks in the banking sector. As part of its commitment to its macroprudential and microprudential monitoring, analysis and supervisory role, the CBK has drafted the Strategy for the Management and Supervision of Climate and Environmental Risks in the Financial Sector for the years 2024-2026[35], a strategy that is expected to be approved at the end of 2024. Consequently, in this edition of the RSF, the analysis for this risk dimension will focus on the objectives, processes and activities undertaken by the CBK, and the expected actions, in line with the approved strategy for addressing climate risks. The role of the CBK does not aim to directly promote sustainable investments, but rather, through the creation of a regulatory framework and supervisory mechanisms, to ensure the proper identification, management and addressing of climate risks to which the financial system is exposed.

Efforts to manage the physical risks of climate change require a shift towards environmentally sound activities, thereby increasing exposure to transition risks, which carry additional costs and risks. Thus, climate change and sustainability issues create two main types of risks for the financial system: physical risks, which arise from the direct consequences of climate change, and transition risks, which arise from actions taken to mitigate the impacts of climate change.[36] (Diagram 1).

[35] The strategy was prepared with the assistance of the World Bank with the expertise of the Financial Sector Advisory Center (FinSAC).

[36] Furthermore, refer to number 18 of the RSF where the risks are elaborated in detail.

Diagram 1: Transmission channels of environmental factors in the economy and financial stability

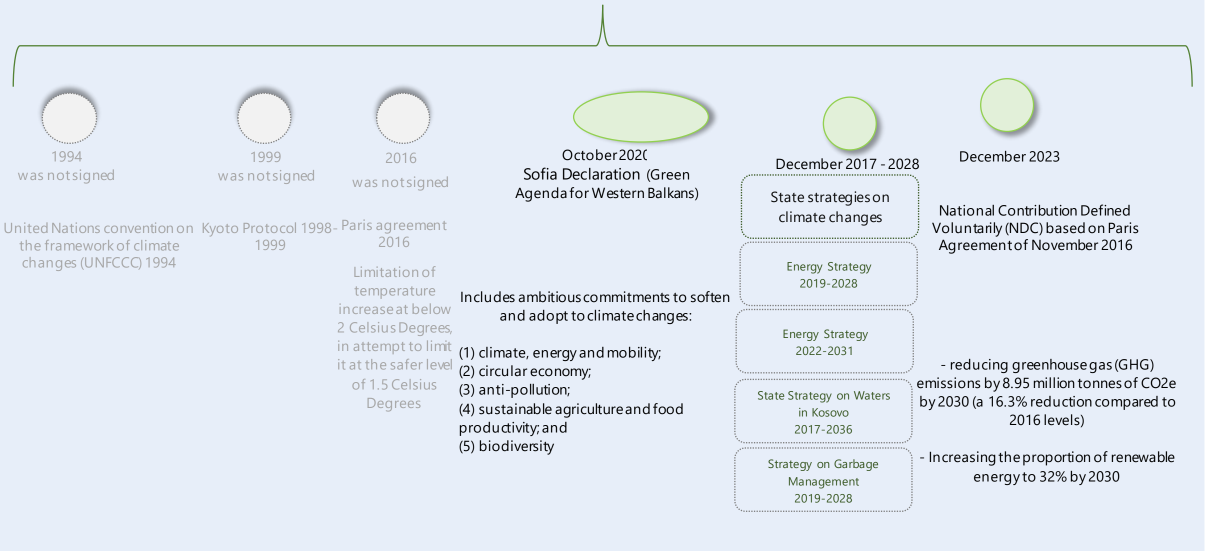


Source: combined from NGFS (2023) and EBA (2021)

Within the framework of regional initiatives, Kosovo was one of six Western Balkan countries that signed the Sofia Declaration in November 2020, accepting the European Green Deal as a starting point for the Green Agenda for the Western Balkans (GAWB). Further, in 2021, after discussions with international parties, Kosovo prepared and unveiled at the end of 2023.[37] Voluntary Nationally Determined Contribution (NDC) under the Paris Agreement, demonstrating its commitment to the objectives of the green agenda (Diagram 2). Furthermore, actions taken at the state level to address climate risks include the adoption of the Energy Strategy, the Climate Change Strategy and the approval of the Climate Change Law (Diagram 2).

In fulfilling the green agenda, the financial system is expected to play an important role in facilitating the transition towards sustainable growth (commitment defined in the European Green Deal and in the voluntary NDC), but also in minimizing the effects of risks through proper identification and implementation in their risk management framework.

Diagram 2. Agreements and strategies for the green agenda, at the state level



CBK's strategy for climate change

While the role of central banks in addressing climate risks is expanding, the Central Bank of the Republic of Kosovo (CBK) has undertaken a series of activities throughout 2023/2024 to build capacity within its scope to identify, measure, and manage climate risks, including physical and transition risks. The CBK's strategy and actions are in line with the ECB's vision for the actions to be taken to manage climate risks, presented in the plan for climate and nature for the years 2024 and 2025.[38]

As part of its commitment and institutional policy-making, the CBK has integrated climate and environmental risks into the CBK Strategic Plan for the period 2024-2028. In accordance with the strategic plan, within the framework of the main institutional strategic objectives such as maintaining financial stability and financial regulation and supervision, Environmental, Social, and Governance (ESG) principles have also been integrated into the operations and policies of the CBK (referred to in diagram 4).

To concretize its commitment to analyzing, monitoring and managing climate-related financial risks, the CBK has drafted a three-year Strategy for the Management and Supervision of Climate and Environmental Risks, which is expected to be approved at the end of 2024. The goals of this strategy include: providing an overview of international commitments to mitigate

[37] https://president-ksgov.net/en/speech-by-president-osmani-at-the-presentation-of-kosovos-nationally-determined-contribution-ndc-at-cop-28/

[38] The ECB's climate and nature plan 2024-2025 (europa.eu)

climate change, listing international dynamics and initiatives, analyzing the financial sector's position on climate risks, reviewing current banking sector practices, and applying 10 principles that support the roadmap structured in five dimensions of the field of action: Regulation, Banking Supervision, Financial Stability, Commitment National/International and Culture/Knowledge, to fully address these risks (Diagram 3).

All the activities envisaged by this strategy and included in the guidelines for monitoring and managing risks arising from climate change, are classified in the six dimensions of the following action areas:

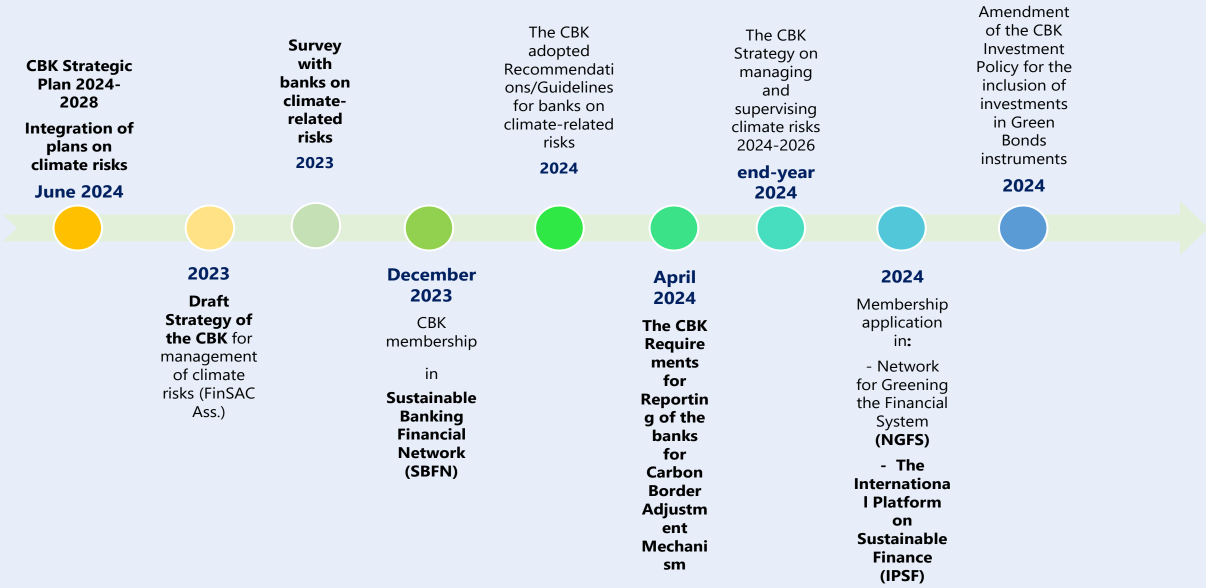
Diagram 3: Fields of Action for the realization of the activities defined for the management of climate risks

The CBK is committed to actively implementing action plans and developing the necessary framework for risk management and sustainable finance by gradually implementing the actions set out in the Strategy for the Management and Supervision of Climate-Related and Environmental Risks in the Financial Sector. CBK's strategic activities to date for managing Climate Risks. As part of its strategic actions on climate risks, the CBK has drafted an Advisory Letter (Recommendations/Instructions) for Banks on Climate and Environmental Risks. This paper aims to guide the banking sector in identifying, measuring, managing and controlling these risks, by integrating environmental sustainability into banks' business activities. To advance capacities related to sustainable financing practices and strengthen the resilience of the financial system to climate risks, the CBK joined the Sustainable Banking and Finance Network (SBFN) in December 2023.

This membership provides opportunities for capacity building, exchange of experiences and networking to achieve common objectives in sustainable finance. In April 2024, CBK has published a guide for the banking sector, defining practices for monitoring and reporting data on companies. exposed to transition costs, included in the Carbon Limit Adjustment Mechanism (CBAM).

In the process of addressing climate risks, within the framework of strategic actions for this purpose, the CBK is making changes to the CBK Investment Policy, to include investment opportunities in financial instruments such as Green Bonds. These investments aim to support projects that contribute to environmental protection and addressing the challenges posed by climate change. The CBK is committed to building its institutional capacities by developing staff skills and knowledge on environmental issues through cooperation with local stakeholders, including the Association of Banks, and with international partners and other central banks. In an effort to advance the green agenda, CBK has applied for membership in the Network for the Greening of the Financial System (NGFS) and the International Platform for Sustainable Finance (IPSF), and is awaiting confirmation of memberships (Diagram 4).

Diagram 4: Up-to-date CBK activities

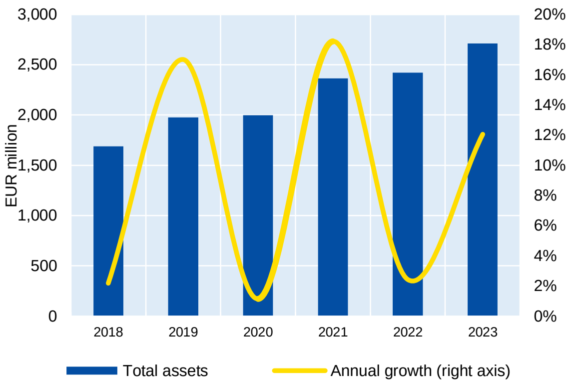


6. Non-bank financial institutions

6.1 Pensions Sector

Pensions sector assets recorded accelerated growth in 2023 after a sharp slowdown a year ago. Despite global expectations for an economic recession - influenced by high interest rates, inflationary pressures and geopolitical tensions - pension funds recorded positive returns from investments in foreign markets, benefiting from high interest rates and the effects of conservative monetary policies to control rising inflation.

Chart 69. Assets of the pension sector

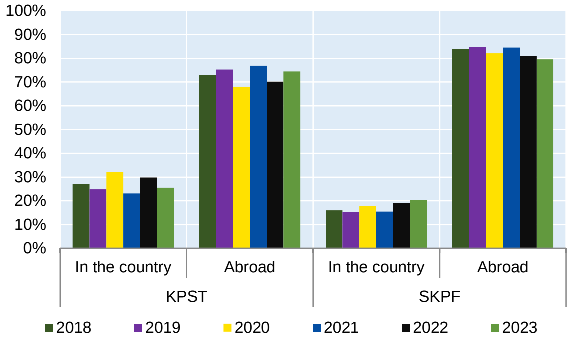


Source: CBK.

The value of assets reached 2.71 billion euros, corresponding to an annual growth of 12.1 percent from 2.4 percent in 2022 (Chart 69). This increase is attributed to a positive return on investments of 88.5 million euros, while losses in the previous year amounted to 119.7 million euros. The number of contributors and the value of contributions paid continued their growth trend, also contributing to the expansion of assets. Factors influencing the increase in the value of collections were also the general increase in the level of salaries - including adjustment to inflation, as well as the increase in civil servant salaries at the beginning of 2023. The value of new collections for 2023 reached 286.8 million euros, marking an annual increase of 18.5 percent from 13.1 percent in the previous year..

The Kosovo Pension Savings Fund (KPSF), which has the highest participation in the total assets of the sector (99.7 percent), continues to lead developments in the performance of the pension sector. The remaining 0.3 percent of assets are managed by the Slovenian-Kosovar Pension Fund (SKPF) and have a marginal impact on the overall performance of the sector.

Chart 70. Structure of pension sector investments



Source: CBK.

KPSF's assets reached 2.70 billion euros, marking an accelerated annual growth of 12.1 percent from 2.5 percent a year ago. Unlike last year, investments abroad have increased their participation by 4.3 percentage points in a total of 74.5 percent of assets, while those inside the country decreased. This is as a result of the high annual growth of 19.0 percent in the value of the investment portfolio in foreign markets, from the annual decline of 6.5 percent in the previous year. At the end of 2023, the value of total investments abroad reached 2.01 billion euros. The structure of investments abroad consists mainly of investments in shares of mutual funds, with a participation of 99.98 percent, and the rest in placementsehcash.

Meanwhile, the value of domestic investments decreased to 689.2 million euros, marking an annual decrease of 4.2 percent (Chart 70). The decline was characterized by securities of the Government of Kosovo and certificates of deposit, while cash held in the CBK marked an increase. Securities decreased their participation to 64.9 percent within domestic investments, a decrease of 12.1 percentage points from the previous year. The category of certificates of deposit decreased its share in total domestic investments to 13.1 percent, marking a decrease of 6.0 percentage points from the previous year. Meanwhile, the share of money held in the CBK in total domestic invested assets increased significantly to 22.0 percent, an increase of 18.0 percentage points from the previous year.

The new receipts of the KPSF for the year 2023 marked the value of 286.2 million euros, which represents an annual increase of 18.5 percent from 13.1 percent in the previous year.

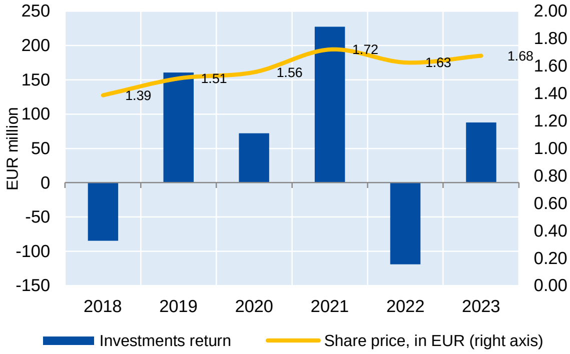
The value of SKPF's total assets reached 9.4 million euros, marking an annual increase of 9.9 percent from 2.4 percent growth a year ago. The new receipts marked the value of 667.0 thousand euros, which coincides with an annual increase of 9.6 percent, the slowest progress compared to that of the KPSF (Chart 71).

In contrast to the performance of KPSF investments throughout 2023, SKPF increased its presence in the domestic market, reducing the level of investments in the external sector to 79.6 percent from 81.0 percent in December 2022. The structure of investments abroad consists mainly of investments in the form of shares of 97.0 percent, and the rest of 3.0 percent in the form ofehcash. On the other hand, investments in Kosovo increased by 1.4 percentage points, with a participation of 20.4 percent of the total assets of SKPF. Investments in the domestic market were distributed in securities of the Government of Kosovo (88.3 percent), deposits in commercial banks (7.3 percent) and cash in the SKPF treasury (4.4 percent).

6.1.1 Financial performance of the pension sector

The good performance of international financial markets positively affected the performance of the pension sector in the country. The orientation of investments towards international markets and the strategy for further increasing the participation of foreign investments within the framework of total investments, resulted in high returns for the sector.

Chart 71. Financial performance of Kosovo Pension Saving Fund

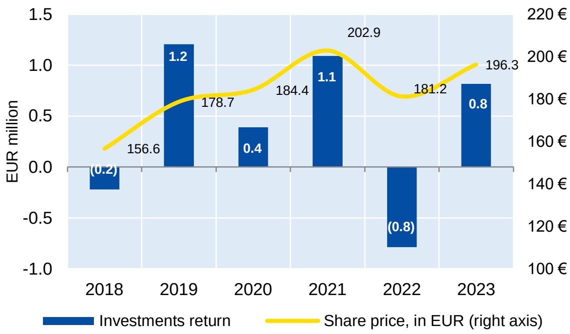


*Base price of the share is: € 1.0

Source: CBK.

KPSF achieved a positive return on investments in the amount of 87.7 million euros. KPSF's share price also increased to 196.3 euros from 181.2 euros a year ago (Chart 72).

Chart 72. Financial performance of Slovenian-Kosovo Pension Fund



*Base price of the share is: € 100

Source: CBK.

SKPF had a similar performance, which recorded a positive return on investments in the amount of 0.8 million euros. Also, the share price of SKPF shdecreased growthto 196.3 euros from 181.2 euros a year ago (Chart 72).

Global economic uncertainties continue into 2024, driven by geopolitical tensions and slower economic growth. Inflation, although generally declining, remains high in some economies, causing uneven impacts on markets and potentially different actions in countries' monetary policies. Overall, expectations are for an easing of financing conditions in the second half of the year, with a potential impact on the return on investment for Kosovo's pension sector.

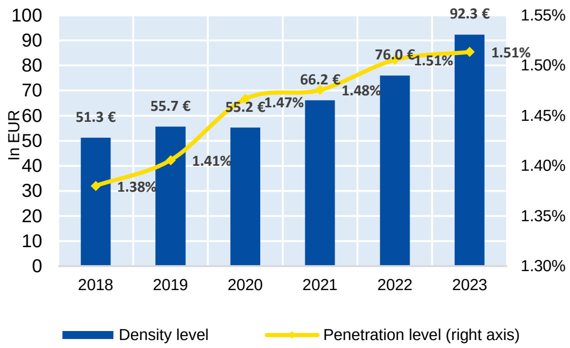
6.2 Insurance Sector

6.2.1 Activity of the insurance sector

The insurance sector continued its growth trend, driven mainly by higher premiums written from policies sold.

The weight of insurance within the financial system remains low, with a share of only 2.7 percent in total financial system assets. The level of intermediation and density of the insurance sector remains similar to previous years, marking a marginal annual increase (Chart 73).

Chart 73. Development indicators of insurance sector



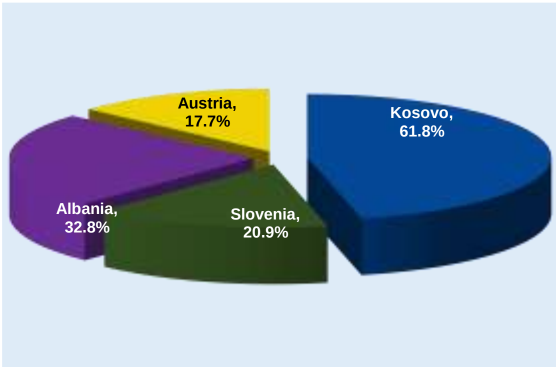
Source: CBK.

Expressed through gross written premiums in relation to GDP, the sector's intermediation continues to remain at a relatively low level compared to the average of European Union countries, at 1.51 percent similar to last year. Density also remains low, measured through premiums written per capita, which in 2023 reached a value of 92.3 euros (75.5 euros in 2022).[39]

The structure of the insurance sector continues to be dominated by the services of 'Non-Life' insurers, representing 91.6 percent of the assets of the insurance market, while the remaining 8.4 percent is represented by the assets of 'Life' insurers.

Locally owned companies have further increased participation in the insurance market reaching 61.8 percent participation from 56.5 percent in 2022. Within companies with foreign capital, insurers from Albania continue to have the highest participation in assets, followed by insurers from Slovenia and Austria (Chart 74).

Chart 74. Structure of assets of insurance sector, by ownership (December 2023)



Source: CBK.

The insurance market in Kosovo is characterized by a lower degree of concentration, but with an increasing trend during this period. Herfindahl index[40] for gross written premiums (GWP) has reached 992 points. The same index calculated based on insurance market assets shows lower values of 954 points, but compared to a year ago it has increased by 27 basis points. At the same time, the CR5 index[41] for the year 2023, calculated in relation to GPW for the insurance sector, results 59.6 percent (58.2 percent in 2022), while calculated in relation to assets, results 55.5 percent (53.5 percent in 2022). Thus, the slight increase in concentration both in relation to assets and gross written premiums reflects the downsizing of insurance operators in recent years, while concentration is higher

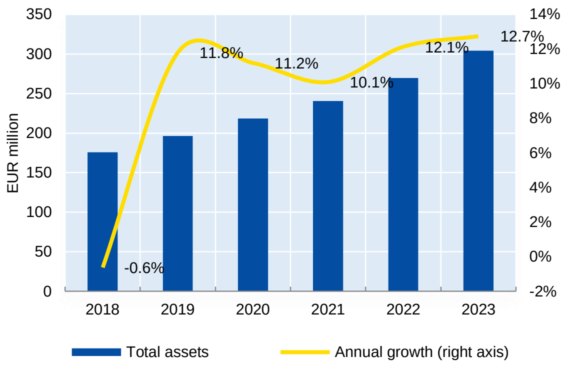
[39] According to the latest statistics published in the Organization for Economic Co-operation and Development (OECD) database, the density level in 2022 in 38 OECD countries (27 European, including the US, Japan, and Australia) was 3,722 euros (written premiums per capita), while the market penetration (intermediation) level during this period stood at 9.3 percent.

[40] The Herfindahl index is calculated with the following formula: $HI = \sum_{i=1}^{n} (s)_i^2$, where S is the company's participation in the total means (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.

[41] The CR5 index combines the market participation 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.

in the market of insurers offering 'Life' insurance services due to their low number.

Chart 75. Assets of insurance sector



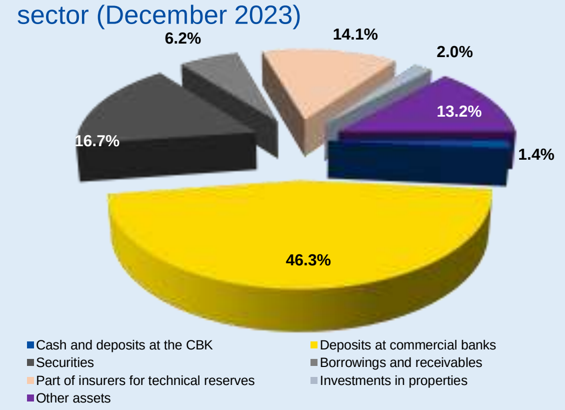
Source: CBK.

The value of insurance sector assets reached 304.1 million euros, representing an annual growth of 12.7 percent (Chart 75). The most significant increase was recorded in the category of deposits held in commercial banks, recording an annual growth of 11.6 percent at the end of 2023, although slower than last year (annual growth of 14.6 percent). A high growth of 11.5 percent was also recorded by the Kosovo Government Securities category, which represents 16.7 percent of pension sector assets (Chart 76). The growth of these two categories within assets has been mainly influenced by favorable interest rates in recent years. Other items such as cash and deposits with the CBK, as well as property investments, which are the two categories with the lowest weight within assets, recorded a similar decline of 11.8 percent.

The assets of the "Non-Life" insurance segment reached 278.7 million euros, marking an annual increase of 12.8 percent. 'Non-Life' insurers represented 91.6 percent of the sector's total assets. Meanwhile, the "Life" insurance segment recorded an annual growth of 12.0 percent and reached the value of 25.5 million euros.

Within the obligations and own resources of the sector, technical provisions represent the largest part with a total of 66.2 percent, followed by shareholder's capital with 24.7 percent, and other balance items with lower weight (Chart 77).

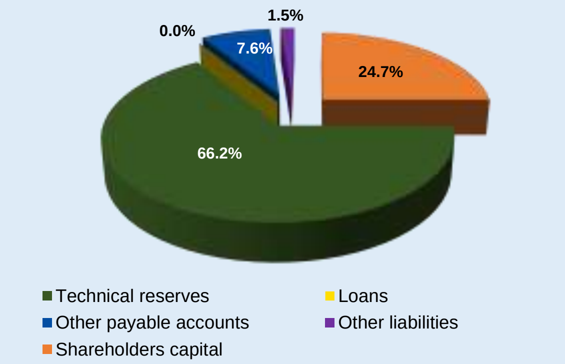
Chart 76. Structure of assets of insurance sector (December 2023)



Source: CBK.

The value of the capital has recorded higher growthcompared to the previous year as a result of the significantly higher profit realized in 2023. At the same time, the profitable operation for the fourth year in a row has influenced the further reduction of losses carried over from previous years, which decreased to 39.6 million, for 2.6 million lower than in 2022.

Chart 77. Liabilities and capital of insurance sector (December 2023)

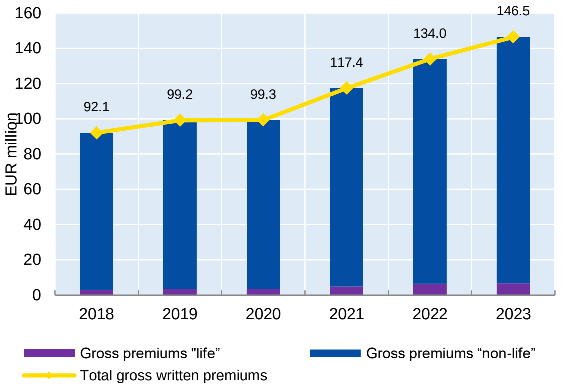


Source: CBK.

The growth trend in written premiums continued in 2023, but at a slower pace as a result of the slowdown in the growth of voluntary health insurance premiums. The value of total written premiums reached 146.5 million euros, an annual increase of 9.4 percent from 14.1 percent in the previous year.

The structure of written premiums continues to be dominated by "Non-Life" insurance premiums, with a share of 95.5 percent. The value of these premiums in 2023 reached 139.9 million euros, which represents an annual increase of 9.7 percent (Chart 78). Among these premiums, compulsory insurance continues to dominate with a share of 59.0 percent in total gross written premiums, while the rest includes voluntary insurance.

Chart 78. Gross collected premiums



Source: CBK.

Compulsory insurance products recorded an annual growth of 9.7 percent from 7.1 percent, mainly influenced by "MTPL" products (table 5). While, within voluntary insurance, the category 'Health Insurance', which is the second category with the largest share in total written premiums (20 percent share), was characterized by a slowdown in annual growth to 6.5 percent from 31.0 percent and reached a value of 28.6 million euros.

The other category of voluntary insurance, 'Insurance of land vehicles' has recorded an increase of 20.8 percent, reaching the value of 10.4 million euros.

An increase was also noted in the volume of policies sold in 2023, namely 1.48 million sosh, an annual increase of 12.3 percent.[42] The number of policies sold in 2023 for the 'Illness Insurance' category within the voluntary insurance has reached 293.2 thousand, marking an increase of 10.3 percent. In addition, the level of per capita premiums for health insurance has increased to 16.1 euros in 2023, from 15.1 euros in 2022.

The value of premiums written by "Life" insurance reached 6.6 million euros, an annual increase of 3.5 percent. "Combined Life" and "Debtor's Life" ("life insurance") premiums had the main contribution to the total increase, as a result of annual growth of 3.9 percent and 4.9 percent, respectively.

Claims paid by the insurance sector, which includes claims of insurers and the Kosovo Insurance Bureau (KIB), recorded an accelerated annual growth of 11.6 percent from 5.4 percent a year earlier, reaching 71.7 million euros at the end of 2023. The ratio of claims paid by the KIB within the total claims has fallen to 8.5 percent or 5.3 percentage points lower than the previous year. While the remaining part of 91.5 percent is covered by insurers, with the highest participation of 'Non-life' insurers (89.4 percent).

The highest annual increase in total claims is mainly due to the annual increase of 140.9 percent in the "Property Insurance" category, or an increase of 3.5 million euros from the previous year. The next category with the largest contribution to the increase was the claims of voluntary insurance "Accident and Health", as well as "MTPL" within the framework of compulsory insurance (table 6). The value of claims paid by voluntary insurance increased by 27.7 percent compared to the previous year, and reached 29.5 million euros. Meanwhile, the value of damages paid by the compulsory insurance increased by 1.8 percent, reaching 40.8 million euros.

[42] Only non-life insurance is included.

Table 5. Gross written premiums by business classes (in millions of euros)

Activity	2022	2023	Annual change	Share: 2022	Share: 2023
Total non-life	*127.7*	*139.9*	*9.5%*	*95.2%*	*95.5%*
Obligatory insurance					
MTPL	63.2	69.2	9.5%	47.1%	47.3%
TPL+	3.6	4.1	14.0%	2.7%	2.8%
Border insurance	8.4	9.2	9.6%	6.3%	6.3%
Voluntary insurances					
Accident and health	28.4	30.3	6.9%	21.1%	20.7%
Casco	8.6	10.4	20.8%	6.4%	7.1%
Loans and guarantees	7.6	8.7	13.7%	5.7%	5.9%
Fire and other damages in property	6.0	6.6	10.2%	4.5%	4.5%
Overall liabilities	1.9	1.3	-31.6%	1.4%	0.9%
Total life	*6.4*	*6.6*	3.5%	4.8%	4.5%
Total market	**134.0**	**146.5**	**9.4%**	**100.0%**	**100.0%**

Source: CBK.

The value of claims paid by "Life" insurance in 2023 reached 1.49 million euros, which represents an annual increase of 29.53 percent, significantly higher than the increase of 3.3 percent in the previous year.

Claims paid by reinsurers account for 15.1 percent of the total amount of claims paid by insurers[43] (12.9 percent in the previous year).

Table 6. Damages paid, according to business classes (in millions of euros)

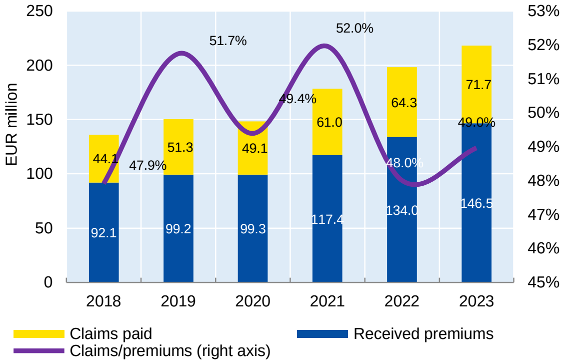
Activity	2022	2023	Annual change	Share: 2022	Share: 2023
Total non-life	*63.2*	*70.3*	*11.2%*	*98.2%*	*97.9%*
Obligatory insurance	*0.0*	*0.0*			
MTPL	30.9	34.4	11.3%	48.1%	47.9%
TPL+	0.3	0.3	-4.3%	0.5%	0.4%
Border insurance, FG MoU	8.8	6.1	-31.2%	13.7%	8.5%
Voluntary insurances	*0.0*	*0.0*			
Accident and health	13.0	15.7	20.3%	20.3%	21.8%
Casco	5.5	6.3	15.5%	8.5%	8.8%
Loans and guarantees	1.8	0.9	-50.2%	2.9%	1.3%
Property insurance	2.7	6.5	140.9%	4.2%	9.1%
Insurance of goods in transit	0.0	0.0	36.0%	0.0%	0.0%
Overall liabilities	0.0	0.0	-45.4%	0.0%	0.0%
Total life	1.1	1.5	29.5%	1.8%	2.1%
Total market	**64.3**	**71.7**	**11.6%**	**100.0%**	**100.0%**

Source: CBK.

The ratio of claims paid to premiums written increased marginally by 1.0 percentage points compared to a year earlier, reaching 49.0 percent (Chart 7). This was a result of the lower growth in revenues (premiums collected) compared to the growth rate of expenses (claims paid) in 2023 compared to a year earlier (Tables 5 and 6).

[43] KIB is not included.

Chart 79. Received premiums and claims paid



Source: CBK.

6.2.2 Financial performance of the insurance sector

The insurance sector closed this year with a positive financial result of 11.0 million euros, a significantly higher performance compared to the net profit of 2.1 million euros in the previous year (table 7).

Non-life insurers recorded a net profit of 10.0 million euros, compared to 2.5 million euros in 2022. Life insurers also performed better this year, recording a net profit of 1.0 million euros, compared to a loss of 0.4 million euros in the previous year. The increase in profit carried out compared to the previous year is mainly the result of the increase in revenues, namely the increase in the value of collections from premiums sold during the year. Also, compared to last year, the payment for reinsured premiums is 3.2 million euros lower, which has contributed to the sector's net profit.

The level of liquidity in the insurance sector was characterized by a slight annual decline. The ratio of cash and cash equivalents to reserves decreased to 97.4 percent from 102.5 percent in 2022. This was as a result of the slower annual growth of cash and cash equivalents of 10.9 percent, compared to the higher growth of 16.7 percent in the technical reserves of the insurance sector. Similarly, the ratio between cash and cash equivalents to total liabilities decreased to 85.6 percent, from 87.6 percent a year ago. The progress of treatment, reservation and payment of claims remains in the high focus of CBK.

Table 7. Financial result (in millions of euros)

Description	2019	2020	2021	2022	2023
Non-life insurance	-5.1	2.0	5.8	2.5	10.0
Life insurance	0.5	0.3	0.5	-0.4	1.0
Total market	**-4.7**	**2.3**	**6.3**	**2.1**	**11.0**

Source: CBK.

6.3. The microfinance sector and financial assistants

6.3.1 Activity of the microfinance sector

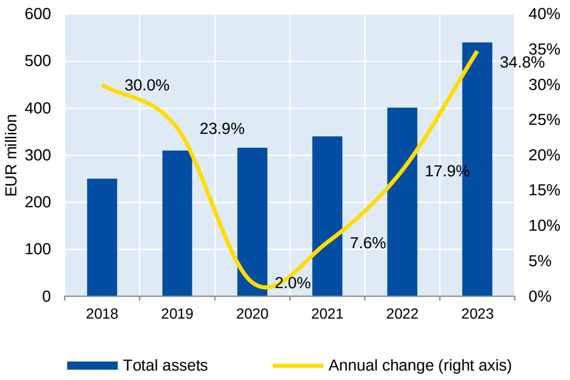
The microfinance sector recorded significant growth during 2023, mainly as a result of the acceleration of credit and leasing growth, despite the high costs of external financing. The coming year is expected to be more favorable in terms of interest rates in global financial markets, which is expected to reflect in the reduction of financing costs and the performance of the microfinance sector.

The microfinance sector continues to be financed mainly by borrowing from the external sector, while to a lesser extent it is financed by own capital, as well as other borrowings within the country (mainly from the banking sector). Tight monetary policies globally during 2023, to curb and mitigate inflation, had a direct impact on the increase in the cost of financing the activity of the microfinance sector, considering the financing structure of the sector. This massive increase in the sector's spending was reflected in maintaining interest rates at a high level for the main credit products (lending and leasing), while the expansion of the sector's activity accelerated as a result of high demand.

The sector's assets reached 540.2 million euros, corresponding to an annual

growth of 34.8 percent from 17.9 percent in the previous year (Chart 80). [44]

Chart 80. Assets of the microfinance sector



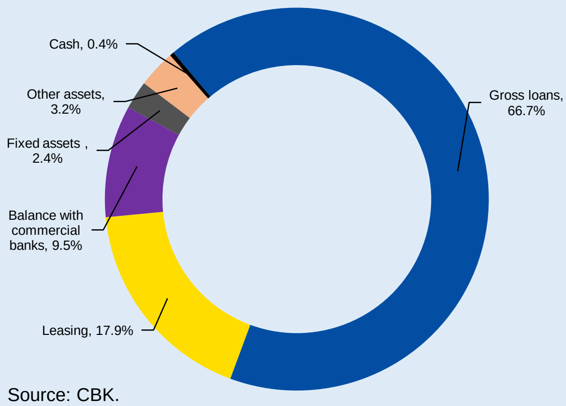
Source: CBK.

There are 32 microfinance institutions operating in the local market,[45] of which 14 are foreign-owned and represent 78.7 percent of the sector's total assets. The Herfindahl-Hirschman index for assets resulted in 1,415 points in 2023, which represents a decrease in concentration from the same period of the previous year (1,528 points). Also, the participation of the assets of the three largest institutions in the total assets of the sector decreased to 54.5 percent, from 56.1 percent in 2022.

Although all asset items recorded an increase, the increase in the level of credit and leasing are the main contributors to the increase in total assets. Loans continue to be the largest category by weight within the assets of the sector, followed by that ofleasing and the category of the balance held in commercial banks (Chart 81).

As for obligations, the activity of the microfinance sector is mainly financed by borrowings, which constitute 63.9 percent of total liabilities and capital, while only financing from the external sector constitutes 61.3 percent of total liabilities and capital. Despite higher financing costs, the sector expanded its external financing to 326.1 millioneheuro, annual growth of 31.9 percent from 21.0 percent growth in the previous year.

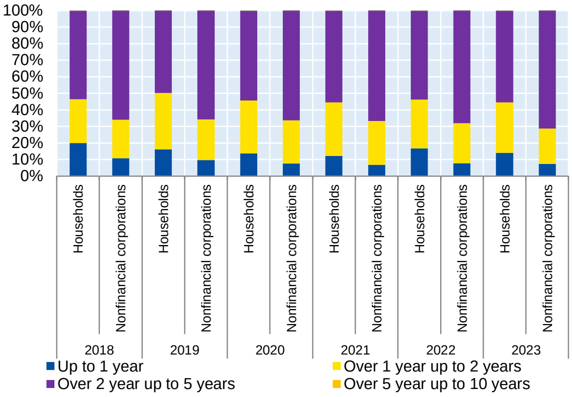
Chart 81. Assets structure of microfinance sector (December 2023)



Source: CBK.

The loan stock reached 360.5 million euros, representing an accelerated annual growth of 25.9 percent from 19.8 percent in 2022. The significant increase in lending for the second year in a row reflects the demand for loans from both segments, that of households (which had the main contribution to the overall growth of loans) and non-financial corporations. Lending to households increased by 21.1 percent and reached 220.4 million euros.

Chart 82. Loans by economic sectors, by maturity



Source: CBK.

Meanwhile, loans to non-financial corporations increased by 34.2 percent annually and

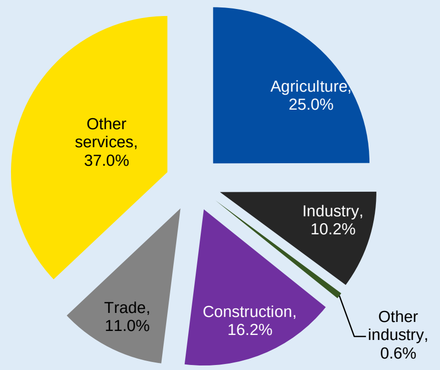
[44] The reclassification of two financial intermediaries into other financial intermediaries (MFI&IFJB) in November 2023 also had a significant impact on the growth of microfinance sector assets. The sector's assets without the inclusion of these two institutions reach 513.5 million euros, or an annual increase of 28.1 percent.

[45] This also includes non-bank financial institutions that carry out lending, leasing and factoring activities. Also, if the data is compared with previous years, you can notice that there is a significant difference in the number of MFIs reported this period due to methodological changes. The number of MFIs also includes NBFIs with money transfer/payment/exchange activities, which have contributed to a significant increase in the number of financial institutions in this sector.

reached 140.2 million euros. By maturity, loans to households and non-financial corporations with a maturity of 'over 2 to 5 years' dominate the structure of total loans, followed by those with a maturity of 'over 1 to 2 years' (Chart 82).

Lending to non-financial corporations according to the sectors of the economy has continued the trend of the past years, marking an increase in all sectors. The stock of agricultural loans has the largest share in total lending to non-financial corporations of MFIs/NBFIs of 25.0 percent (Chart 83). In 2023, loans to this sector recorded an accelerated annual growth of 30.0 percent from 25.4 percent growth the previous year, reaching 35.0 million euros (Chart 84). The guarantee offered by the KCGF to cover the risk for loans in the agricultural sector for MSMEs also had an impact on the increase in credit for the agricultural segment.[46]

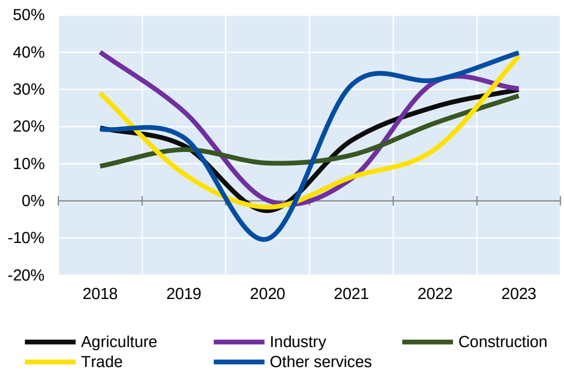
Chart 83. Structure of loans to nonfinancial corporations, by economic sectors (December 2023)



Source: CBK.

Compared to a year ago, the amount of loans approved by the KCGF for microfinance institutions reached 7.2 million euros, an increase of 27.4 percent compared to the previous year. As a result of the guarantees from KCGF, especially in the last two years, MFIs have responded positively to the demand for loans for agriculture, which is considered as the sector that carries the highest risk. The construction, trade and industry sectors were also characterized by double-digit growth during this period. Lending to the other services sector[47] had the highest contribution and growth during this period.

Chart 84. Microfinance sector growth rate of loans to nonfinancial corporations, by economic sectors



Source: CBK.

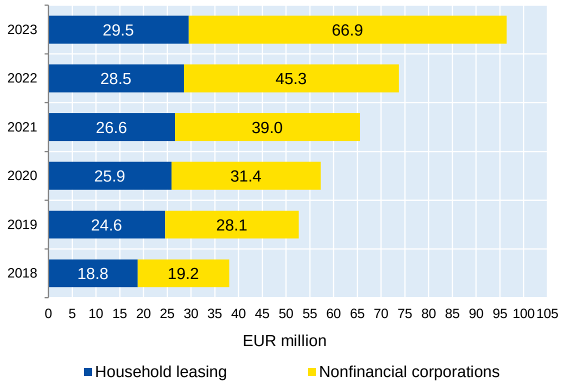
Leases continued to grow at a high rate in recent years, recording an annual growth of 30.8 percent in 2023. The main contribution to the growth was made by leases to non-financial corporations, while the contribution of leases to households was significantly lower (Chart 85). Even in terms of composition, leases to non-financial corporations have the main weight, representing 69.4 percent of the total value of leases. This category of leases reached 66.9 million euros, marking an annual increase of 47.9 percent. According to the maturity of leases for non-financial corporations, the largest share is dominated by medium-term leases 'over 2 to 5 years' with a share of 58.4 percent, followed by leases with a maturity of 'less than or up to 1 year' with a share of 33.1 percent.

Meanwhile, leasing to households recorded a significantly slower growth of 3.5 percent, or only 1.0 million euros more than last year, and reached a value of 29.5 million euros. Within household leasing, 'mortgage leasing', which represents the dominant category, marked an annual decline of 0.1 percent from a 6.4 percent annual growth in the previous year. Meanwhile, the 'equipment leasing' category marked an annual increase of 33.7 percent and was the leasing category that had the main contribution to the growth of household leasing.

[46] Micro, small and medium enterprises (MSMEs)

[47] Hotels and Restaurants, Other Trade, Use of financial services, real estate, rent, Other Services, etc.

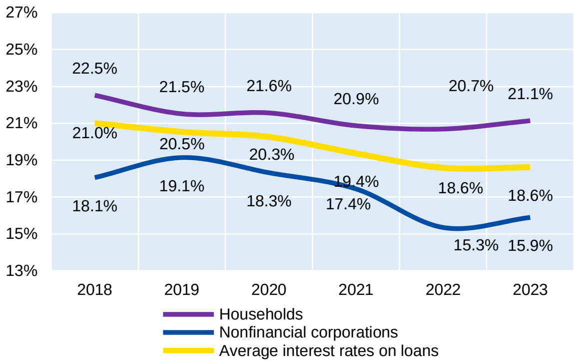
Chart 85. Microfinance sector leasing



Source: CBK.

Leases for households continue to be dominated by long-term leases 'over 10 years' which have a participation of 48.9 percent, followed by leases with a maturity period of 'over 5 to 10 years' with a participation of 44.1 percent.

Chart 86. Average interest rate on microfinance sector loans

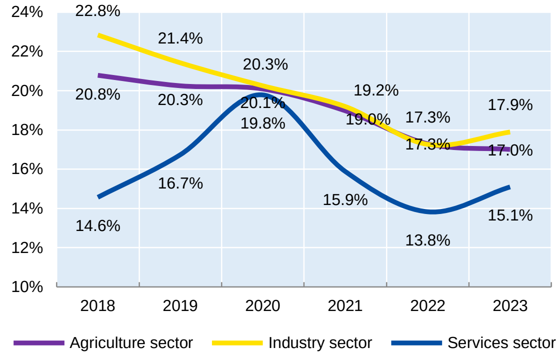


Source: CBK.

Interest rates on microfinance loans were influenced by global interest rate dynamics. They broke the gradual downward trend of recent years, increasing slightly to 18.62 percent from 18.59 percent in the previous year.

Both household and non-financial corporate loans were characterized by an increase in interest rates. The household interest rate reached 21.7 percent, marking an annual increase of 0.5 percentage points. The interest rate for non-financial corporations also increased by 0.5 percentage points and reached 15.9 percent (Chart 86).

Chart 87. Average interest rate on loans, by economic sectors



Source: CBK.

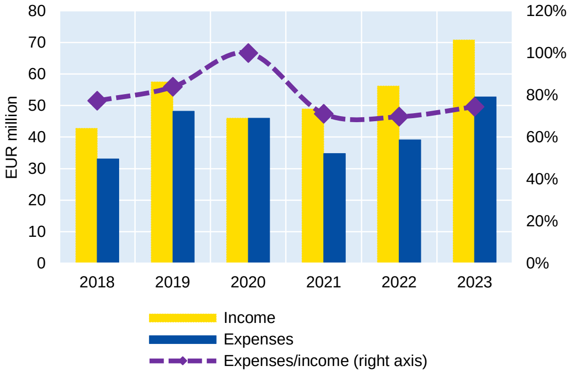
Within the framework of loans to non-financial corporations, the average interest rate marked a slight decrease only for the agriculture sector, decreasing to 17.0 percent from 17.3 percent in December 2022 (Chart 87). Whereas, for the industry sector and with particular emphasis on the services sector, there was an increase in the average interest rate by 0.6 and 1.3 percentage points respectively, reaching 17.9 and 15.1 percent in December 2023.

6.3.2 Performance of the microfinance sector

The microfinance sector recorded a net profit of 18.1 million euros, a slower annual growth of 6.4 percent from 20.6 percent last year. The increase in interest rates in the global markets from which the sector is financed to a greater extent led to a significant increase in expenses, while the particularly high interest rates on the asset side (loans and leasing) limited the possibilities for an increase in interest income of the same magnitude, which led to a decline in profitability indicators for the sector.

Microfinance sector revenues reached 70.8 million euros, an annual increase of 26.1 percent compared to the previous year. Within revenues, interest income represents the dominant category of revenues (87.0 percent), and recorded an annual increase of 11.0 percent from 10.7 percent in the previous year. The increase in interest revenue is mainly a result of the high growth in lending and interest rates in the last two years. The non-interest income category marked an annual increase of 23.4 percent, but its contribution to the growth of total revenue was limited due to its low share in total revenue (13.0 percent).

Chart 88. Microfinance sector income and expenditures

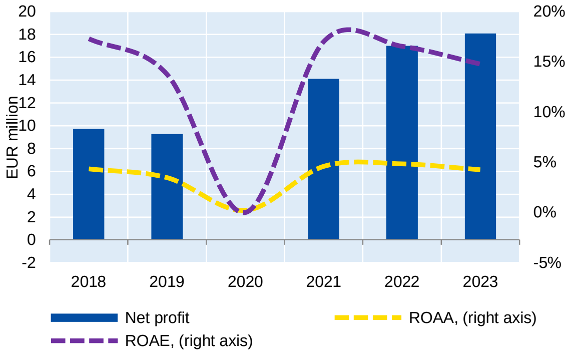


Source: CBK.

Sector expenses increased significantly and reached 52.7 million euros or an annual increase of 34.7 percent from 12.6 percent increase last year. Within expenses, the most significant increase was recorded in the category of interest expenses, reaching 14.2 million euros or an annual increase of 69.2 percent from last year. This high increase in interest expenses is mainly attributed to the continuous increase in international interest rates, which is the largest source of financing for the sector. The non-interest expense category also increased by 20.5 percent from the previous year. This increase was mainly a result of the increase in salaries and the number of employees in this sector, which influenced the increase in the subcategory of personnel and administrative expenses by 11.6 percent. Also, the increase in this category of expenses was also influenced by the subcategory of provisions for loan losses, which increased by 2.0 million euros from the previous year. The microfinance sector's expense-to-income ratio deteriorated from the previous year, increasing by 4.7 percentage points, as a result of higher expense growth relative to revenue growth. In 2023, this indicator reached 74.5 percent (Chart 88).

In addition to the income/expense ratio, other profitability indicators of the sector also declined. Return on Average Assets (ROA) fell to 4.3 percent from 4.9 percent in 2022, while Return on Average Capital (ROAC) recorded a more pronounced decline of 1.8 percentage points, falling to 14.8 percent from 16.5 percent (Chart 89).

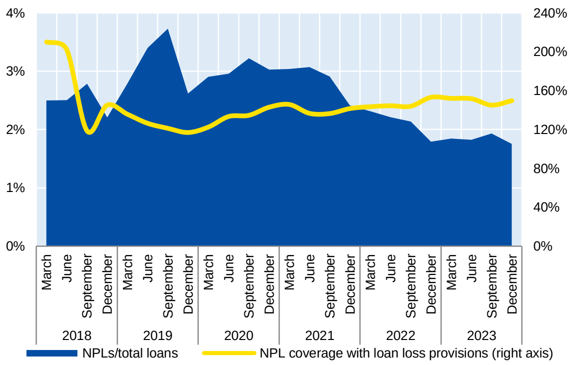
Chart 89. Profitability indicators of microfinance sector



Source: CBK.

The microfinance sector has managed to maintain a low level of non-performing loans and ensure good coverage with provisions, despite high lending growth and recent challenges such as the high cost of living and slower economic activity

Grafik 90.Treguesit e kualitetit të portofolios kreditore



Source: CBK.

The ratio of non-performing loans to total loans remains at the same level as the previous year, at 1.8 percent. Meanwhile, the level of coverage of non-performing loans with provisions marked a slight decrease to 149.7 percent from 153.2 percent at the end of 2022 despite the increase in the value of provisions. This is due to the fact that the value of non-performing loans marked a higher annual increase of 20.6 percent (Chart 90).

The financial intermediaries sector, which consists of exchange bureaus and money transfer agencies (MTA), contains

the largest number of financial institutions in the country, although it manages only 0.1 percent of total assets. During 2023, two financial intermediaries were reclassified into other financial intermediaries (MFIs & IFIBs), which affected the sector's financial statements. Consequently, the value of assets of this sector marked an annual decline of 63.7 percent, falling to 13.3 million euros.

The structure of financial intermediaries' assets is dominated mainly by other assets, which constitute about 58.6 percent of total assets. The second largest category, that of the balance sheet with commercial banks, marked a significant decrease of 85.8 percent, falling to 3.2 million euros from 22.6 million last year. The sector is mainly financed by equity and borrowings, which constitute 67.0 percent and 17.5 percent of total liabilities, respectively.

Financial aid revenues fell to 7.4 million euros, marking an annual decline of 34.3 percent. The revenues of financial assistants are largely dominated by revenues from services, with a share of 95.7 percent in total revenues. Despite the decline in overall revenues, the subcategory of revenues from services reached 7.1 million euros from 6.7 million euros in the previous year. The second most important category by weight, that of other revenues, decreased by 93.1 percent compared to the previous year and fell to 0.3 million euros. Expenses recorded an annual decrease of 20.8 percent (21.0 percent increase in 2022), falling to 6.6 million euros, which is mainly the result of a decrease in other operating expenses by 65.7 percent. Meanwhile, the category of interest expenses marked a significant increase, from 0.8 million last year to 3.0 million euros in 2023.

7. Financial infrastructure in Kosovo

7.1. Payment system

The Kosovo interbank payment system [48] during 2023 has continued to operate with the highest level of stability, security, and efficiency, contributing to maintaining financial stability. In addition to the gradual increase in the use of the system, regulatory and operational actions have been taken to expand the base of inclusion, increase digitalization, and advance the system towards applicable international standards.

Statistical indicators of the activity of the Kosovo Interbank Payment System – IPNK, during 2023 have reflected an increase in transactions in volume by 9.5 percent and in value by 7.4 percent compared to the previous year, where over 19 million transactions were processed with a total value of over 21.8 billion euros. Mass payments represented the largest number of transactions with about 77.9 percent participation (table 8).

Table 8. Share of payment instruments in total IPS transactions, in percentage

Description	Number of total transactions		Value of total transactions	
	2022	2023	2022	2023
Regular	14.0%	14.8%	11.6%	12.6%
Prioritized	3.1%	3.3%	44.5%	44.2%
Regular - massive (payments from taxes, fees, customs, etc)	32.1%	31.4%	5.5%	6.0%
Priorities - massive (salaries and pensions from the government)	46.6%	46.5%	8.3%	8.7%
Giro payments	4.0%	3.8%	7.8%	7.8%
Securities	0.0%	0.0%	4.2%	2.7%
Direct debiting	0.0%	0.0%	0.0%	0.0%
Bank-Bank	0.0%	0.0%	18.1%	18.0%
Returned	0.2%	0.2%	0.1%	0.1%

Source: CBK.

In terms of transaction value, priority payments are the category with the highest participation in transactions carried out (44.2 percent of the total transaction value), a category that reached a value of 9.64 billion euros, followed by the bank-to-bank category, which reached 3.93 billion euros.

The total number of valid bank accounts[49] reached 2.51 million, representing an annual growth of 5.9 percent. Current accounts, mainly individual accounts, had the main contribution, with a 5.4 percent annual growth.

The trend of increasing digitalization of payments has continued at a rapid pace. The number of E-banking bank accounts, through which banking services are performed 'online', reached 851.6 thousand[50] (table 9), which represents an annual increase of 23.6 percent. The number of payments made through e-banking reached over 9.7 million transactions, which compared to the previous year represents an increase of 17 percent, with a value reaching over 21.4 billion euros or an annual increase of 13 percent.

[48] In Kosovo, there is a single system for interbank payments, the Interbank Payment System (SPN), operated and supervised by the Central Bank of the Republic of Kosovo.
[49] The total number of bank accounts includes: the number of current, savings and other accounts in the bank.

[50] With the entry into force of the 'Regulation on the reporting of payment instrument statistics' from 2018, the methodology for reporting the number of accounts accessible via 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 term accounts.

Table 9. Banking sector network

Description	2019	2020	2021	2022	2023
Number of bank branches	47	50	43	49	50
Number of bank sub-branches	159	149	145	141	152
ATM number	497	513	516	534	583
POS number	13,769	13,421	13,836	14,769	17,187
Number of E-banking accounts	337,693	411,346	537,733	688,891	851,645

Source: CBK.

The total number of cards (debit and credit cards) providing cash withdrawal and various payment services increased by 4.3 percent. The number of cards with debit function marked an annual increase of 5.1 percent and reached 1.37 million, while those with credit function marked a decrease of 1.0 percent, to 180 thousand. The highest participation within the cards according to operators was for Visa cards with 53.0 percent, followed by Master Card with 43.2 percent, while local cards[51] had a participation of 3.8 percent.

The banking infrastructure in the country has expanded in terms of the number of Automated Teller Machine (ATM) networks and the number of POS (Point-of-Sale) devices compared to the previous period (Table 10).

This positively influenced the growing trend of card payments. The number of payments at points of sale/POS increased by 33.7 percent to 33.3 million, while the value increased by 37.6 percent compared to the previous year, reaching a value of 1.0 billion euros. The value of payments through POS to total card transactions in 2023 had a share of 12.9 percent.

ATM withdrawals also show an increase in number and value compared to the previous year, for 7.6 percent and 12.4 percent, respectively.

Table 10. Share of the value of card transactions by terminals in the total value of card transactions, in percentage

Description	2019	2020	2021	2022	2023
ATM withdrawals in cash	59.5%	62.7%	58.8%	56.1%	54.9%
ATM deposits	29.9%	27.3%	30.8%	32.2%	32.0%
Credit transfers through ATMs	0.1%	0.0%	0.0%	0.0%	0.0%
POS cash withdrawals	0.2%	0.1%	0.2%	0.2%	0.2%
Card payments through POS	10.3%	9.8%	10.2%	11.6%	12.9%

Source: CBK.

The number of deposits in the banking sector through ATMs during this period reached 2.98 million transactions or an annual increase of 8.5 percent, while the value reached 2.53 billion euros, marking an annual increase of 14.2 percent.

[51] Local cards mainly include cards dedicated to pensioners.

Table 11. Number of electronic money accounts

Description	2021	2022	2023
E-money accounts	11,543	25,164	45,310

Source: CBK.

Table 12. Number of electronic money accounts

Description	2021	2022	2023
Number	52,779	293,097	1,620,139
Value	29,170,803	70,005,357	617,969,803

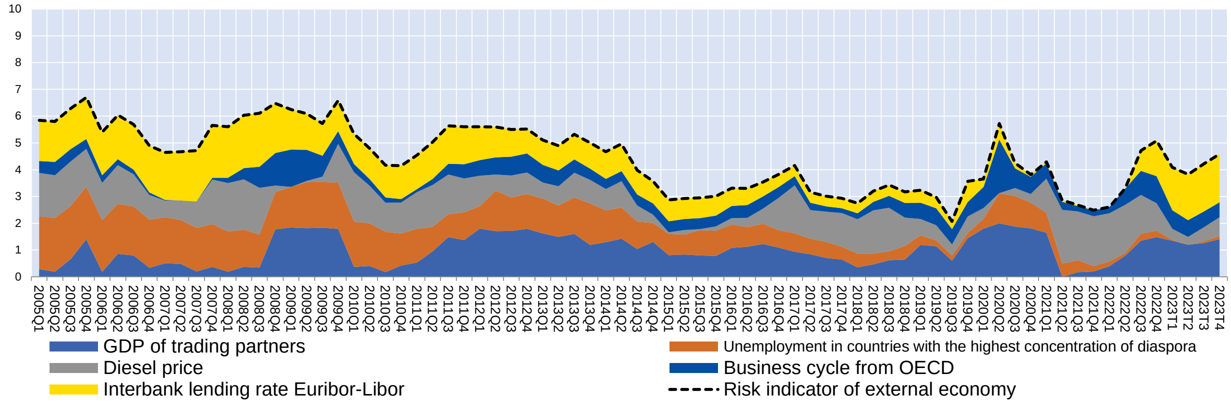
Source: CBK.

The increase in the digitalization of payments has also been contributed by the IFBIs registered for the issuance of electronic money. At the end of 2023, 45,310 electronic money accounts were reported in these institutions, marking a rapid increase based on the fact that this is only the fourth year of their operation in the market (Table 11). These institutions together have carried out a volume of 1.6 million electronic money payments, with a value of around 617 million euros (Table 12).

8. Statistical Annex

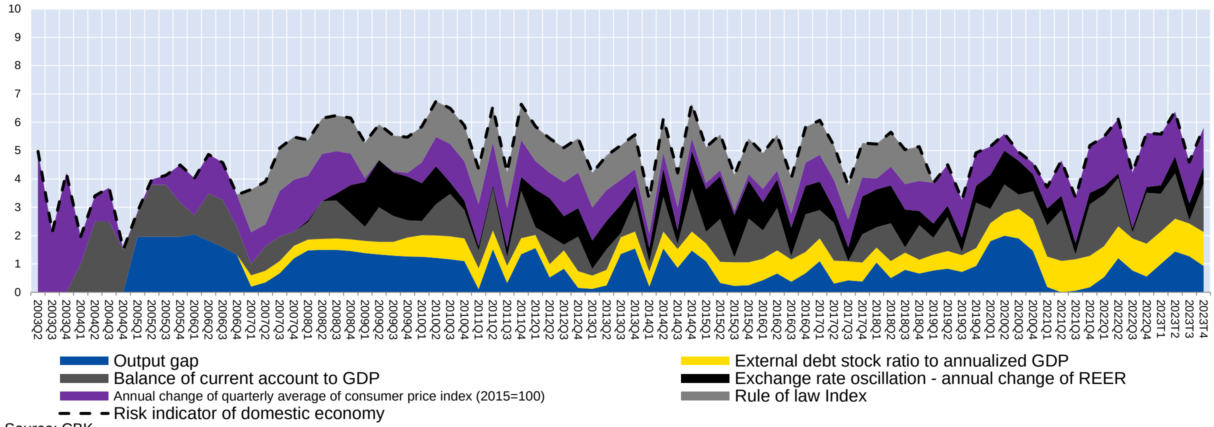
Annex 1. Financial Stability Map - Dynamics of risk change of indicators and contribution to risk from respective components

Chart 1. External economy



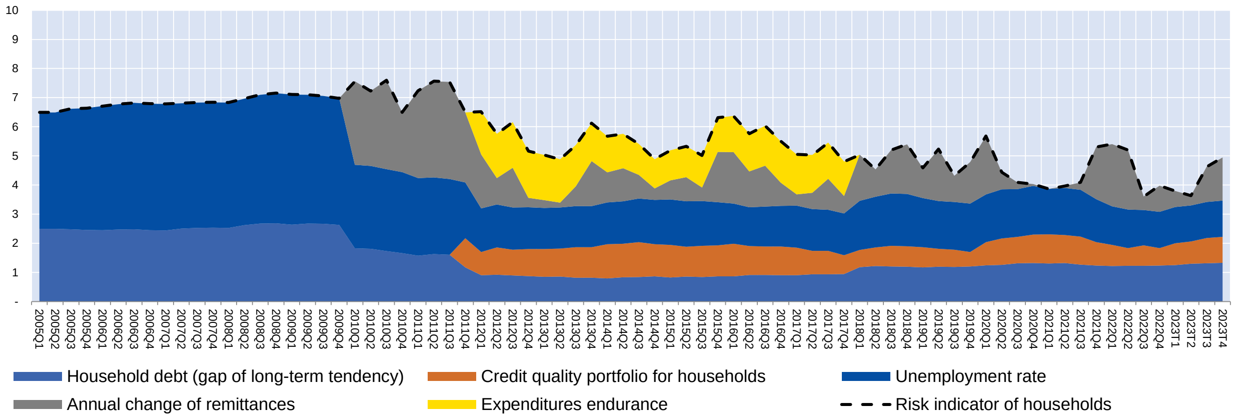
Source: CBK.

Chart 2. Domestic economy



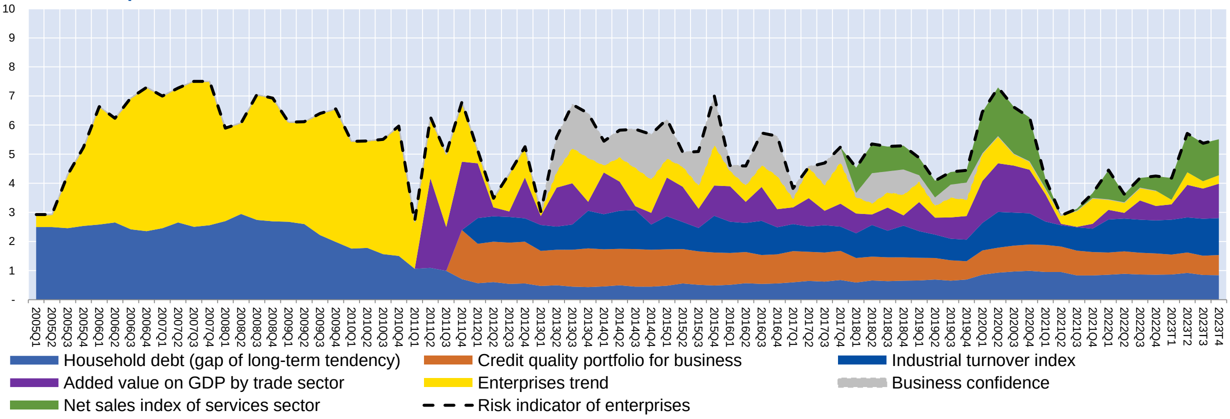
Source: CBK.

Chart 3. Households



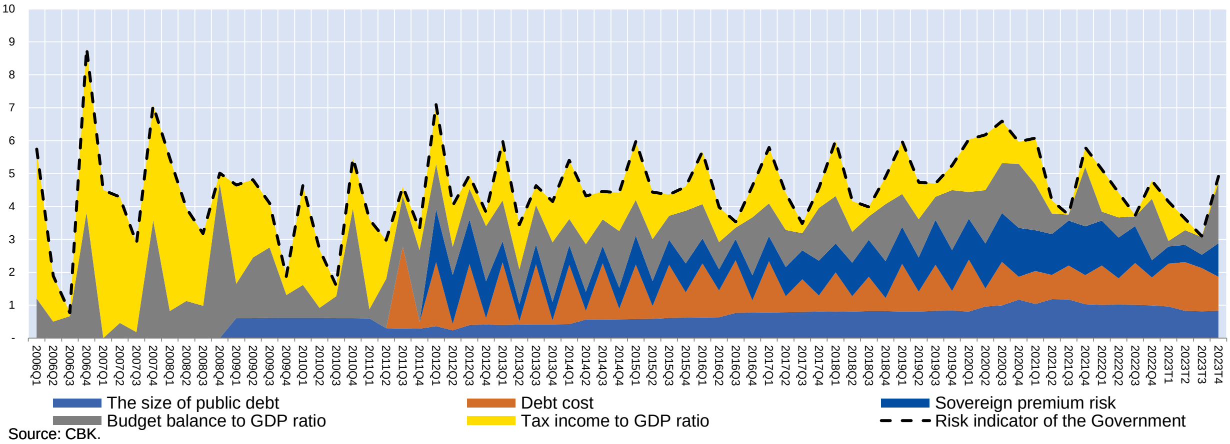
Source: CBK.

Chart 4. Enterprises



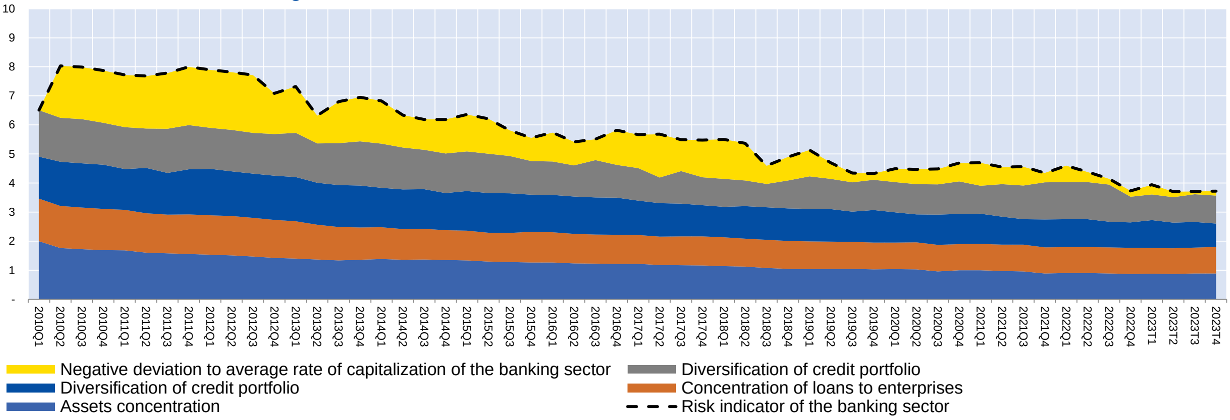
Source: CBK.

Chart 5. Government



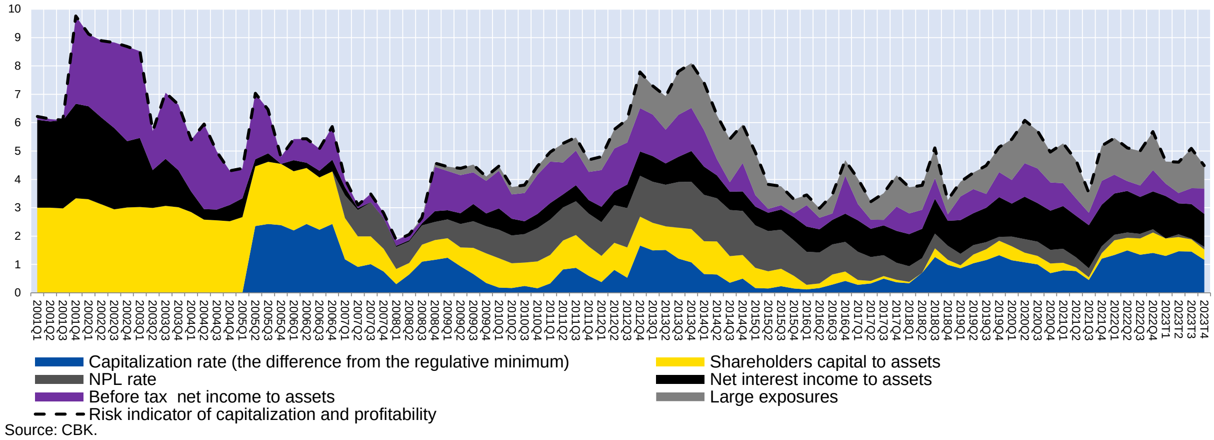
Source: CBK.

Chart 6. Structure of the Banking Sector



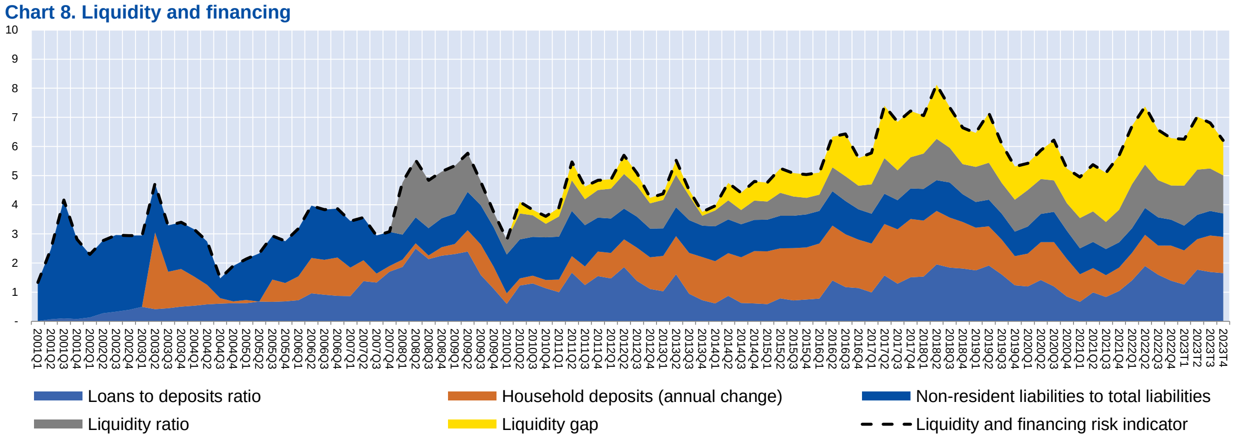
Source: CBK.

Chart 7. Capitalization and profitability



Source: CBK.

Chart 8. Liquidity and financing



Source: CBK.

Table 1. Financial sustainability indicators, in percentages

Banking sector	Core set	December 2020	December 2021	December 2022	December 2023
Capital Adequacy	Regulatory capital to risk-w eighted assets	16.5	16.4	15.5	16.5
	Regulatory Tier I capital to risk-w eighted assets	14.7	14.7	13.5	14.6
	Nonperforming loans net of provisions to capital	4.6	3.4	3.4	3.2
Assets quality	Nonperforming loans to total gross loans	2.5	2.1	1.9	1.9
ectoral distribution of loans to total loar	Other financial corporations	0.2	0.3	0.3	0.4
	Public nonfinancial corporations	0.00	0.00	0.00	0.00
	Other nonfinancial corporations	63.3	62.3	62.1	60.2
	Households	36.4	37.4	37.6	39.2
	NPISH	0.03	0.02	0.01	0.02
	Nonresidents	0.1	0.0	0.1	0.2
	Total	100.0	100.0	100.0	100.0
Earnings and profitability	Return on assets (ROA)*	1.7	2.1	2.6	2.5
	Return on equity (ROE)*	14.0	17.3	20.7	19.8
	Interest margin to gross income	79.2	76.5	76.4	79.4
	Noninterest expenses to gross income	46.1	45.4	43.8	44.0
Liquidity	Liquid assets (core) to total assets	30.1	28.8	26.8	25.1
	Liquid assets (broad) to total assets	23.2	23.7	21.5	20.0
	Liquid assets (core) to short-term liabilities	31.1	30.6	29.3	27.6
	Liquid assets (broad) to short-term liabilities	40.4	37.2	36.5	34.7
Sensitivity to market risk	Net open position in foreign exchange to capital	3.5	1.5	1.8	0.6
	Encouraged set				
	Capital to assets	11.7	11.1	9.4	10.4
	Large exposures to capital	89.5	89.8	78.2	61.7
	Personnel expenses to noninterest expenses	43.3	43.2	44.4	44.3
	Spread betw een reference lending and deposits rates	4.7	4.5	3.9	3.2
	Customer deposits to total (noninterbank) loans	133.9	130.9	127.9	124.8
	Foreign-currency-denominated liabilities to total liabilities	4.2	4.3	3.0	3.3

Data from January 2022 are in line with the new methodology recommended for FSIs (FSI Guide 2019).

Street Garibaldi, No.33, Prishtina, Republic of Kosovo
Tel: +383 38 222 055; Fax: +383 38 243 763
Web:www.bqk-kos.org