

Banking system and its role in Kosovo's economic development

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Abstract

Developing a sustainable banking system is a prerequisite for developing an economy. The purpose of this paper is to extract all the important factors in the nature of banks and their direct role in economic development. This market study aims to analyse the banking system in Kosovo by determining and then analysing its structure, the degree of concentration of commercial banks in the banking market, their behaviour towards price, number of participants, banks operating in this market, types of products and services they provide, in order to assess the level of competition in this sector, in accordance with the right of competition. For this purpose, the study describes the functioning of the banking system as a whole and its special segments, regulatory supervisory instruments and their role not only in the functioning of the banking system but also in effective competition. Since the beginning of the operation of commercial banks, which is over 16 years, the market still dominates high interest rates on loans, which, to some extent, is a burden on economic entities, and thus the economy as a whole.

Key words: Banking system; central bank; commercial banks; bank products; deposits; loans; interest rates;

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1. Introduction

The banking system in Kosovo is quite new, system operation began one year after the end of the war, respectively in 2000. In addition to the Central Bank, there are ten commercial banks operating in Kosovo, in which only two of them have local capital. During the operation of this system we have a rapid growth of deposits and loans. Growth and development of the banking sector has been accompanied by the rise of banks and the growth of their number, the expansion of the products offered, with the expansion of geographical coverage covering the entire territory of the country. Based on the characteristics and importance of the credit system in the economic development of the country, banks' loans or commercial loans, although having high interest rates, have contributed in a way and to some extent to the development of economic processes and to the development of this system. This system of operation has not only increased the number of credits but also the amount of allowed funds, these loans are issued to a large extent for the various businesses that have invested in the development of their businesses and in some way also in the economic development of the country, this indirectly determining the role of banks in the economic development of the country.

2. Banks and their role

In the book "Introduction to Economics" the authors determine that banks perform an economic activity which is based on the same principles with those of another business. The features of this business lie in the specificity and the activity performed by the bank. The Bank is a financial firm that performs certain services, performing the transfer of free financial means from those who saved them to those who need it.

Banking activity primarily involves the receipt of deposits of individuals, firms and others. Secondly, banking activity includes giving loans to firms and individuals who need it. For this service the bank requires interest, which is higher than the interest which it gives for deposits (Ahmet Mançellari, Sulo Hadëri, Dhori Kule, Stefan Qirici, "Introduction to Economics", Pegi, Tirana, 2002). Banks are one of the most important institutions in an economy. For various firms, banks are the main source of credit. When firms and consumers have to make payments for the purchase of goods, they can do so through the bank, but even if they need

some advice or financial plan they usually turn to banks. Cunderlik says that Bank is universal naming for business specialised in money trading, money and capital intermediation. (Cunderlik, D. 1991, Terminologicky slovník pre managerov a podnikatel'ov. Martin Martis. 1991). Bernard and Colli say that bank is a business, which professional externalisation is receiving funds from public in forms of deposits or other ways on own account and using them on discount operations, loans and other financial operations. (Bernard- Colli. 1992. Economicky a financny slovník. Bratislava: Praca. 1992). According to Dr. Felix Somary, in his "Bank Policy" work, the bank is an institution or entity whose main job is the provision of loans in the form of money. In the encyclopaedia of the lexicographic unit, banks are defined as enterprises or entities, which have the main activity of credit and monetary business, in fact, the governance of certain assets. The main functions of the bank are (Luboteni, 2013):

- The function of creating money- means issuing banknotes and creating money - bank deposits.
- Financial intermediation function - consists of intermediation between different sectors (economy, state, population, etc.) that have a financial surplus (savings are greater than their real and sectoral investments) or have a deficit of financial means (savings are smaller than their real means).

Bank plays a major role in all the economic and financial activities in modern society. They are playing key role in activities financing the industries. All trade and commerce would slow down badly if banks were not there to handle their financial transactions. The economic development of a modern society depends on industrial growth and modernisation of agriculture. Banks promote both these activities, they mobilise small deposits from the public and provide financial resource to big industries. Thus the banks perform the major task of capital formation. They motivate and lure the common people to save money and earn interest. This money otherwise would be wasted in marriages or hoarded and lie unused in iron safes. Banks mop up the funds lying idle in every home (<http://bizcovering.com/business-and-society-role-of-banks-in-modern-society>).

In all countries, the banking system operates on two levels. The first level is identified with the functioning of the central bank while the second level with the functioning of all other banks.

2.1. Central Bank of the Republic of Kosovo

The Central Bank of the Republic of Kosovo is an independent public institution, and its primary objective is to promote and maintain a sound financial system as well as an efficient payment system. According to the Law no 03/L-209 on the Central Bank, the Central Bank of Kosovo is a public legal entity that has administrative, financial and managerial autonomy, meaning it functions and operates outside the framework of Kosovo's governmental structures. The Central Bank of the Republic of Kosovo is independent of the governmental organs that are in different countries. In addition, the Central Bank of Kosovo as a financial institution establishes the internal rules and procedures governing the employment of personnel including staff, advisors, experts and prosecution, based on the general rules governing the public service. The Central Bank of the Republic of Kosovo has its own objectives. Among its main objectives are (Law no. 03 / L-209, Article 7):

- a) The primary objective of the Central Bank is to promote and maintain a stable financial system, including a secure, stable and efficient payment system,
- b) The additional objective of the Central Bank, which is subject to its primary objective, is to contribute to achieving and maintaining the stability of domestic prices,
- c) Without prejudice to the attainment of these objectives, the Central Bank supports the overall economic policies of the Government,
- d) The Central Bank operates in accordance with the principle of open market economy with free competition, favouring the efficient allocation of resources.

In addition to the general objectives, the Central Bank also has its tasks in meeting the objectives set by law. Among its main tasks worth highlighting are the following (Law no. 03 / L-209, Article 8):

- Determining and implementing the policies of a stable financial system including overseeing a deposit insurance scheme, conducting market operations, and providing emergency liquidity,
- Regulation, licensing, registration and supervision of financial institutions,
- Promotion and supervision of secure, stable and efficient payment, clearing and settlement systems,

- Ensuring a proper supply of banknotes and coins in Kosovo,
- Keeping and managing international reserves,
- Collection and publication of statistics,
- Contributes to achieving and maintaining domestic price stability,
- Informing the Assembly of the Republic of Kosovo, the Government and the general public about its policies, tasks and operations,
- Acting as banker, financial advisor and fiscal agent for the Government and any public body and public organisation of Kosovo,
- Co-operation and participation in international councils and organisations in matters within its area of competence, and
- Realisation of any auxiliary activity arising from the exercising of its duties.

Against the payment of reasonable fees, the Central Bank may provide financial institutions and the general public with custody services for banknotes and coins denominated in the currencies that it determines, as well as securities, precious metals and other valuable assets as may be determined by the Executive Board. The Central Bank will be responsible for the proper supply of banknotes and coins in Kosovo (euro) (Law no. 03 / L-209).

Since in Kosovo the euro is the main currency permitted for use as a means of payment and circulation, only the Central Bank is authorised to make the supply of this currency. The Central Bank's responsibilities are closely related to cash operations and management, which relate to the euro currency that is in use in the eurozone countries and beyond. In this regard, based on its competencies, which are harmonised with Central Bank law, it is possible to operate the entire banking system as well. In addition to the operations, activities, products and services that are harmonised with the law on the bank, the Central Bank is also responsible for the licensing of commercial banks and other financial institutions.

2.2. Financial Stability and Banking Competition in Kosovo

To assess competition in the Bank it is important to focus on financial stability and its impact on the development of the banking sector and the level of competition. Factors that are conducive to financial stability are: stable macroeconomic environment, effective and safe supervision by supervisory authorities, functional bank infrastructure, which implies

banks, insurance companies and micro-finance institutions, and their market behaviour to be transparent, competitive and functional. While the financial system in Kosovo has developed strongly, the process is further hampered by limited judicial capacity and failure to respect the definition of property rights. Full institutional and operational independence CBK, is critical, to maintain financial stability. Financial supervision has made progress. Accompanying the pattern of basic risk supervision, under the Basel framework, the supervision of banks is guided at least by a comprehensive field inspection to each bank in each year (*International Monetary Fund for financial stability in Kosovo*). The main risks that bring the instability of financial stability are: credit risk, liquidity, interest rates and capital risk (Luboteni, 2013).

Credit risk – Credit risk is the main risk faced by the banking system. Loans are generally the largest group of profitable assets. Credit risk is the likelihood that the borrower or counterpart of a bank in a contract / agreement will not partially or fully meet his / her obligations in due time in accordance with the terms agreed upon in their contract. Or else it can be said that this risk has to do with uncertainty in the possibility of a counterbalance to meet its obligations (Luboteni, 2013)

Interest rate risk – Is created by the discrepancy between the assets and liabilities that are sensitive to the interest rate. The degree of discrepancy may significantly affect the income depending on its size and the direction of the interest rate movement (Luboteni, 2015)

Liquidity risk – Occurs when the bank is unable to meet the requirements of depositors and commitments to lend. Lack of liquidity means when a bank does not possess sufficient liquid assets or faces difficulties in securing them in the market in order to meet the obligations when they mature and to meet any unforeseen demand of funds from its depositors and other creditors up to liquidity difficulties may be due to the large differences between credit and deposit maturity, non-viability of deposits, poor asset quality and most importantly due to poor liquidity management and more tall.

Capital Risk – Insufficient capital resources and limited market access opportunities can cause the bank to lose its depositors, increase the cost of funding, not be able to support expansion of the business, reduce capacity to absorb losses, reduce profitability and in extreme cases be in disability or bankruptcy (Luboteni, 2013)

2.3. History of development of the banking system in Kosovo

In Kosovo, commercial banks or private banks have been developing financial activity since the last post-1999, ie 2000. Even before the war in Kosovo were the most diverse banks, but they were of an excessive economic and political system. Second-tier banks or commercial banks perform their affairs in accordance with the law on banks and with the instructions of the Central Bank. The Central Bank of Kosovo (CBK) is responsible for licensing banks. The Central Bank regularly publishes the list of banks operating in Kosovo, among the most important are (CBK, List of Commercial Banks operating in Kosovo)

1. Economic Bank (established in 2001),
2. Business Bank (established in 2001),
3. NLB Bank (established on January 1, 2008),
4. ProCredit Bank (the first bank in post-war Kosovo)
5. Raiffeisen Bank Kosovo (established in June 2003),
6. National Commercial Bank (established in 2007),
7. TEB Sh.a Bank (established in January 2008),
8. IS bank.

These banks have all done a valuable function for the Kosovo economy, for investments in this economy and for citizens' deposits. There is an increase in deposits that in some way reflects the development of banks and their products. Below we will see the number of banks, branches and sub-branches in Kosovo for the period from 2008 to 2015, and will continue to have the structure of the banking industry liabilities in Kosovo for the period (2012-2015).

Table 1: Number of banks, branches and sub-branches of banks

Years	Bank	Branches	Sub-branches
2008	8	46	233
2009	8	49	238
2010	8	49	254
2011	8	43	259
2012	9	43	258
2013	9	44	245
2014	9	45	223
2015	10	45	210

Source: Annual Report 2015, Central Bank of the Republic of Kosovo.

Banks conduct their activity with sub-branch, branches open within the territory of the country (see table 1). The CBK approved the opening of 4 sub branches, 12 branch and sub-branch relocations, and the closure of 16 sub-branches this year. Banks continued this year with the closure of sub-branches, where 13 sub-branches were closed, mostly small units after their performance evaluation and efficiency, and because banks have recently invested in expanding automated services so, to offer customers the opportunity to transact through: e-banking, ATMs, sales terminals.

Table 2: Structure of Banking Industry Obligations Between 2012 and 2015

Structure of Banking Industry Obligations (2012-2015), Euro million								
Description	2012		2013		2014		2015	
	In millions	In (%)						
Deposit	2,279.00	80.55%	2,449.00	80.05%	2,537.50	79.66%	2,701.40	79.75%
Balance from other Banks	6.00	0.20%	16.50	0.50%	31.60	1.00%	43.40	2.10%
Othe loans	18.90	0.70%	13.40	0.40%	14.10	0.40%	17.60	0.50%
Provisions canceled	1.70	0.10%	2.00	0.10%	2.90	0.10%	2.70	0.10%
Other obligations	221.40	7.80%	244.10	8.00%	229.20	7.20%	189.10	5.70%
Debt interdependent	31.00	1.10%	56.30	1.80%	47.30	1.50%	36.90	1.10%
Receipts from bank receipts	0.50	0.00%	0.10	0.00%	-	0.00%	-	0.00%
Own resources	270.70	9.60%	277.80	9.10%	323.00	10.10%	392.70	12.00%
Total liabilities	2,829.30	100%	3,059.30	100%	3,185.60	100%	3,387.30	100%

Source: Annual Report 2015, Central Bank of the Republic of Kosovo.

Within the structure of liabilities from Table 2, it can be seen that deposits dominate the main part with a total of 79.75% of total liabilities in 2015, while the rest comprise own funds with 12%, other liabilities by 5.7% and so on. The table shows the amount of funds deposited in commercial banks. The data in the table are processed, showing the parameters for the development of deposits, as well as the amounts deposited from year to year. While at the end of 2012, the amount of client deposits in banks was EUR 2.279 billion, at the end of 2015 the deposits are in the amount of EUR 2,701.40 billion, which means that we have an increase of deposits of 18.50%. Compared to 2013, there is an increase of 10.30% and compared with 2014 there is an increase of deposits of 6.5%. This growth rate represents a recovery in deposit performance compared to the previous years when the growth rate of deposits slowed down. Deposit growth, among other things, has also contributed to the cessation of falling interest rates in deposits since the second quarter of 2015 (CBK, Annual Report 2015). The table shows that our clients' deposits are huge in our country, in the face of the trust and dilemmas they have and the dilemmas facing

banks on the one hand, as well as the position of the country's economic development on the other.

3. Credit system in function of economic development

Loans are among the core activities of the bank, from the bank to the clients allowing financial means. Commercial banks through given loans and a certain interest rate provide their own income needed to pay to its depositors the promised interest on the deposits received, and to meet its own expenses and to ensure the profit that banks have for their target. In a word, lending to individuals, businesses and other entities that require credit in banks is the process of lending funds placed at the bank, which is based on the terms agreed between the bank itself and the borrowers. The lending function of funds dedicated to clients is the main function of using financial funds. One of the main activities of commercial banks is the provision of loans to their clients. In the sphere of action of the credit system of Kosovo, for its clients, commercial banks which operate and operate their activities, offer these types of loans (Luboteni, 2013)

1. Consumption loans of various types,
2. Mortgage Loans,
3. Investment Loans,
4. Loans for improving housing conditions,
5. Loans for business development,
6. Bank Guarantees etc.

Due to the development of the credit system in Kosovo, mortgage loans have begun to spread in Kosovo, which is considered a successful achievement of the development of commercial bank products. Based on the characteristics and the importance of the credit system in the economic development of the country, banks' loans or commercial loans, although having high interest rates, have in some way influenced the development of economic processes and the development of this system. With the development of the banking and credit system the credit system has developed. This system of functioning has not only increased the number of credits but also the amount of allowed funds, where most of these loans are issued to businesses that want to invest and develop their businesses and contribute to the economic development of the country. In this regard, as a result of the large needs and demands of citizens and businesses for

loans, despite the high interest rates operating in the credit system, yet their dynamics have developed well.

Table 3: The structure of banking industry assets (2012-2015)

The structure of banking industry assets (2012-2015), million euros								
Description	2012		2013		2014		2015	
	In Millions	In (%)	In Millions	In (%)	In Millions	In (%)	Millions	In (%)
Gross Loans	1,763.40	62.33%	1,805.80	59.03%	1,882.40	59.09%	2,019.40	59.62%
Cash Money	425.70	15.00%	463.30	15.10%	447.10	14.00%	491.00	14.50%
Balance with B.K	287.90	10.20%	339.90	11.10%	390.70	12.30%	316.00	9.30%
Securities	256.60	9.10%	354.50	11.60%	383.80	12.00%	473.30	14.00%
Fixed Assets	57.70	2.00%	55.50	1.80%	53.70	1.70%	57.00	1.70%
Other assets	38.10	1.30%	40.30	1.30%	27.90	0.90%	28.50	0.80%
Total Assets	2,829.30	100%	3,059.30	100%	3,185.60	100%	3,387.30	100%

Source: Annual Report 2015, Central Bank of the Republic of Kosovo.

Within the total assets of the banking industry, the main part consists of loans and leasing with a total of 59.62% in 2015, then cash with 14.50%, securities 14% and so on. Banking sector loans continued to be characterised by accelerated growth compared to previous years. In 2015, the total value of loans reached EUR 2.02 billion, an annual growth of 7.30% compared to the previous year 2014 (Banks and Banking Business, Pristina). The credit growth during 2015 is attributed to the easing of lending conditions by banks, realised through interest rate cut, loan expanding and maturity term on loans offered, as well as increased demand for loans from Enterprises and households. Growth in demand for loans to a significant extent has been driven by the fall in interest rates on loans over recent years. According to the Economic Forum (*World Economic Forum*) countries that have low financial development have faster credit growth. Based on many studies carried out, rapid credit growth has deformed the report between the demand and offer affecting asset price rises especially in real estate.

3.1. High interest rates and bad loans

Credit and economic crises - Our theory of banking, like that of the currency principle, leads ultimately to a theory of business cycles. It is true that the currency school did not inquire thoroughly into even this problem. It did not ask what consequences follow from the unrestricted extension of credit on the part of the credit-issuing banks, it did not even inquire whether it was possible for them permanently to depress the natural rate of interest. It had more modest aims and was content to ask what would happen if the banks in one country extended the issue of fiduciary media more than those of other countries. Thus it arrived at its doctrine of the "external drain" and at its explanation of the English crises that had occurred up to the middle of the nineteenth century (Bohm Bawerk, the theory of interest, the theory of capital (1889) Wicksell, the influence of the rate of interest).

If our doctrine, of crises is to be applied to more recent history, than it must be observed that the banks have never gone as far as they might in extending credit and expanding the issue of fiduciary media. They have always left off long before reaching this limit, whether because of growing uneasiness on their own part and on the part of all those who had not forgotten the earlier crises, or whether because they had to defer to legislative regulations concerning the maximum circulation of fiduciary media. And so the crises broke out before they need have broken out. Its only in this sense that we can interpret the statement that it is apparently true after all to say that restriction of loans is the cause of economic crises, or at least their immediate impulse; that if the banks would only go on the reducing the rate of interest on loans they could continue to postpone the collapse of the market (Bohm Bawerk, the theory of interest, the theory of capital (1889). Wicksell, the influence of the rate of interest).

With their activities and operations, commercial banks realise huge profits by applying high interest rates on the loans granted. For the high interest rates currently prevailing, bankers in front of clients, economic entities and others are reasoned that there are different factors and different risks that banks are following from the non-repayment of loans to a certain period of clients as a result of the dominance of bad credit, other factors that influence the determination of interest rates are also the interest rate on deposits, as well as the interest rate on loans issued by banks to each other. So even though banks have high interest rates on loans, Kosovo's bad loans

are lower than in the countries of the region and beyond. Earlier, The European Bank for Reconstruction and Development has warned that Eastern European countries may face a second wave of financial crisis as a result of rising bad credit and business financial difficulties.

Table 4: Bad loans in the period (2012-2015)

Nr.	Years	The value of non-performing loans	Non-performing loans at (%)	NPL Increase / Decrease (%)	The percentage of credit growth
1	2012	132.3	7.50%	36.60%	3.80%
2	2013	157.1	8.70%	18.80%	2.40%
3	2014	154.4	8.30%	-1.70%	4.20%
4	2015	125.2	6.20%	-18.90%	7.30%

Source: CBK - Annual Report 2013, 24014 and Annual Report 2015.

In the Republic of Kosovo, since the beginning of the functioning of the banking and credit system, bad loans or non-performing loans up to 2005 did not reach more than 3.00% of the total allowed loans. As seen in Table 4, in 2012 bad loans were 7.50% in relation to general loans. This percentage of bad loans in 2013 rose to 8.70%. In 2014, it has fallen to 8.3% (2013, 8.70%), and in 2015, there is a drop in the percentage of bad loans at 6.20% (2014, 8.30%). Kosovo according to World Bank data (*the data published by the World Bank*) at the end of the year 2015 recorded the percentage of non-performing loans of 7.1% in relation to the total credit that the industry bank has issued to its customers. This lower level is compared to all other countries presented for comparison, indicates the high quality of the credit portfolio that the banking industry has in Kosovo for its clients.

From the data analysed, as well as the volume and dynamics of deposits, loans and bad loans, it is seen that the banks operating in our country are sound and financially stable. To stay in this position and to develop even more, and to reduce non-performing loans, banks need to be careful about lending to their clients and lower interest rates. In order to avoid lending to those individuals or businesses that are not sure to make timely loans, in order to avoid further growth of non-performing loans, this can be achieved by reducing interest rates but also the deadline of the return of extended, then more easily borrower shall make loans to more enable their development.

Table 5: Non-performing loans, Kosovo compared to the countries of the region

Non-performing loans in relation to total loans				
State	2012	2013	2014	2015
Kosova	7.50%	8.70%	8.30%	6.20%
Albania	22.50%	23.50%	22.80%	18.20%
Bosnia and Herzegovina	13.50%	15.10%	14.00%	13.70%
Croatia	13.80%	15.40%	16.70%	17.10%
Macedonia	10.10%	10.90%	10.80%	10.30%
Montenegro	17.60%	18.40%	16.80%	16.70%
Serbia	18.60%	21.40%	21.50%	21.60%

Source: Annual Report 2015, Central Bank of the Republic of Kosovo.

In 2015, the ratio of non-performing loans (NPL) to total loans dropped to 6.20%, from 8.30% in 2014. This decline was the result of the fall of non-performing loans, as well as the accelerated growth of credit stock during 2015. Kosovo continues to be the country with the best quality of the credit portfolio compared to other countries in the region, which have an average of the NPL's ratio to total loans of about 16% (CBK, Annual Report 2015). This lower level compared to all other countries presented on a comparative basis indicates the high quality of the credit portfolio that the banking industry in Kosovo has in their clients.

4. Market, Structure and Concentration in the Banking Sector

4.1. Product market

Above banking products and services are grouped into: 1. Deposits; 2. Loans; 3. Other products; 4. Payment and transfer service; 5. Securities. Specifically, Banks in Kosovo offer a significant number of banking products and services. Although most of these products enter the class of banking services, banks have recently started expanding their range of services with some marketplace innovations, such as leasing, mobile banking and other services. Generally, the products and services offered by Banks include:

- Deposit,
- Credit,

- Payment and transfer service, internal and external,
- Guarantees and letters of credit,
- Electronic services,
- Other products.

4.2. Structure and concentration

During 2015, 10 banks operated in the territory of the Republic of Kosovo. The geographic spread of the branches of these banks is different for different banks, which is explained by their investment power, longevity in the market, the strategies they pursue in the early years of their existence (for new banks). ProCredit Bank and Raiffeisen Bank have the biggest geographic spread, due to the banking potential they have. Huge geographic spreads have NLB, TEB, BpB, EU, BKT, while other Banks have branches in a few districts of the country. Foreign-owned banks dominate the banking market in Kosovo, managing 90.10% of total banking system assets. The remaining 9.90% of assets are managed by two locally-owned banks (CBK, Annual Report 2015). The banking system in Kosovo continues to be characterised by a high degree of market concentration, where about 65.84% of total banking system assets are managed by the three largest banks. The two largest banks ProCredit Bank and Raiffeisen Bank have a 46.74% share in the total credit market.

Table 6: Market Participation (2015)

Bank withdrawal in the market - 2015							
In million euro							
Nr.	Name of the bank	Assets	Deposits	Loans	% assets	% Depos	% Loans
1	Raiffeisen Bank	810,239	674,368	427,412	25.79%	25.53%	23.08%
2	ProCredit Bank	791,793	678,057	436,730	25.20%	25.66%	23.66%
3	NLB	466,292	398,932	289,971	14.85%	15.10%	15.67%
4	TEB	411,388	342,016	314,113	13.09%	12.95%	16.98%
5	BKT	284,323	249,190	131,685	9.06%	9.43%	7.12%
6	BpB	132,854	115,848	85,975	4.22%	4.39%	4.64%
7	Economic Bank	183,919	163,751	122,077	5.85%	6.19%	6.60%
8	IS Bank	60,802	19,727	41,908	1.94%	0.75%	2.25%
	Total	3,141,610	2,641,889	1,849,871	100.00%	100.00%	100.00%

Source: Data published on Commercial Banking Web Pages, Annual Reports 2015.

Table 7: The ratio between local and foreign capital

The ratio between local and foreign capital										
Nr.	Banks	Raiffeisen Bank	ProCredit Bank	NLB	TEB	BKT	BpB	Economic Bank	IS Bank	In %
1	Exter.Capital	100.00	100.00	81.21	100.00	100.00	24.53		100.00	90.10%
2	Inter.Capital	-	-	18.79	-	-	75.47	100.00	-	9.90%

Source: Annual Reports from Commercial Banks in Kosovo.

The banking sector structure in Kosovo in 2015 was similar to the previous periods. According to ownership, the structure of the banking sector continued to be dominated by foreign-owned banks, whose assets account for 90.10% of total banking sector assets, while the remaining 9.90% is managed by local capital banks (CBK, Annual Report 2015)

4.3. Structure of loans

The recovery of the world economy and consequently the improvement of banks' perceptions of the economic environment in the country were reflected in a higher growth rate of credit in 2015 compared to 2014, an annual growth of 7.30 percent. The highest growth rates continue to record loans to households, while loans to enterprises, despite having positive growth rates, continue to grow at a lower rate than household loans. As a whole, the structure of active loans in 2015 was dominated by loans to enterprises, which had a 65.90% share in total loans issued by banks. These loans recorded an annual growth of 6.10% in 2015 (3.20% in 2014).

Table 8: Loans by economic activity (2012-April, 2016)

Loans by economic activity (2012-2016)											
Descri.	Agricultur	Mines	Produce	Energy	Construcion	Trade	Hotels & restaurants	Other trade	Financial Services	Other Services	Total
2012	43.6	16.2	133.1	15.9	125.2	635.3	38.8	22.7	54.5	108.8	1,194.1
2013	45.8	20.1	131.7	20.8	118.7	640.6	49.2	19.1	68.8	102.6	1,217.4
2014	49.8	19.7	153.0	20.3	107.0	674.5	51.4	18.1	60.6	102.0	1,256.4
2015	59.9	19.2	165.1	17.8	99.5	683.0	50.7	21.3	94.0	123.8	1,334.3
Apr-16	53.4	19.9	174.9	18.7	100.2	712.9	47.9	21.3	95.9	125.6	1,370.7

Source: Kosovo Banking Association, June 2016.

Table 9: Participation of loans by economic activity (2012-2016)

Participation of loans by economic activity (2012-2016)											
Descrip.	Agricult.	Mines	Produce	Energy	Construction	Trade	Hotelet & Restaurantet	Other Trade	Financial Services	Other Services	Total
2012	3.70%	1.40%	11.10%	1.30%	10.50%	53.20%	3.20%	1.90%	4.60%	9.10%	100.00%
2013	3.80%	1.70%	10.80%	1.70%	9.80%	52.60%	4.00%	1.60%	5.60%	8.40%	100.00%
2014	4.00%	1.60%	12.20%	1.60%	8.50%	53.70%	4.10%	1.40%	4.80%	8.10%	100.00%
2015	4.50%	1.40%	12.30%	1.30%	7.50%	51.20%	3.80%	1.60%	7.10%	9.30%	100.00%
Apr-16	3.90%	1.50%	12.70%	1.40%	7.20%	52.00%	3.50%	1.60%	7.00%	9.20%	100.00%

Source: Kosovo Banking Association, June 2016

The lending structure of enterprises by economic activity remains dominated by loans destined for the trade sector (with a share of 51.20 percent), followed by those for the manufacturing sector (12.30 percent) and the construction sector (7.50 percent). The agricultural sector continues to have lower participation in bank financing with a share of 4.50 percent, but during this period has been characterised by accelerated growth (CBK, Annual Report 2015)

The most significant annual increase of 55.10% in loans to enterprises recorded lending to the financial services sector, which represents a significant improvement compared to the 11.90% decline in 2014. On the other hand, despite the fall in interest rates and the relaxation of general lending standards by banks, lending to the construction sector continues to decline. In 2015, loans to the construction sector recorded an annual decline of 7.00 percent (a decrease of 9.90 percent in 2014). According to maturity, the structure of total loans continues to be dominated by medium-term loans, ie maturity loans 'over 2 to 5 years'. However, compared with the previous periods, there is a tendency of shifting towards long-term lending. In 2015, 'up to 1 year' short-term loans declined to participate in the structure, while the category of long-term loans over 5 years continued to grow at a rapid pace (CBK, Annual Report 2015).

4.4. Interest rates

Interest rates are determined in a free market where supply and demand interact. The supply of funds is influenced by the willingness of consumers, businesses, and governments to save. The demand for funds reflects the desires of businesses, households, and governments to spend more than they take in as revenues. Usually, in very strong economic expansions, businesses' desire to invest in plants and equipment and individuals' desire to invest in housing tend to drive interest rates up. During periods of weak economic conditions, business and housing investment falls and interest rates tend to decline. Such declines are often reinforced by the policies of the country's central bank, which attempts to reduce interest rates in order to stimulate housing and other interest-sensitive investment (Fabozzi, Frank J. *Bond Markets, Analysis and Strategies*, New York, Prentice Hall, 2000). Interest rates on loans during 2015 marked a more pronounced decline. In 2015, the average interest rate on credit declined to 7.70 percent, from 9.30 percent in 2014. On the other hand, interest rates on deposits grew slightly, unlike 2014, when they had declined sharply. In 2015, the average interest rate on deposits reached 1.20%, from 1.10% in 2014. The difference between the interest rate on the loan and the interest rate on deposits in 2015 decreased to 6.50%, from 8.20% in 2014. This shows that interest rates in Kosovo, both in loans and deposits, have changed with the rates applied by other countries in the region. In 2015, the interest rate on loans in Kosovo was lower than in Albania and Montenegro, while it was higher than the interest rates in Bosnia and Herzegovina and Macedonia. As for deposits, Kosovo and Montenegro had the lowest interest rates among the countries of the region (CBK, Annual Report 2015). Below we will also see through tabulating interest rates on loans and deposits in Kosovo.

Table 10: Interest rates on loans and deposits (2012-April, 2016)

Difference between interest rates on loans and deposits (2012-2016)					
Description	2012	2013	2014	2015	April-2016
Effective rates for total new loans	12.24%	10.90%	9.29%	7.69%	7.66%
Effective rates for total new deposits	3.72%	2.40%	1.11%	1.15%	0.85%
Difference	8.52%	8.50%	8.18%	6.54%	6.81%

Source: Kosovo Banking Association, June 2016.

Effective interest rates on deposits in addition to those on loans have also decreased, but at a lower trend compared to those for loans. This is because the difference between these two norms has also narrowed considerably over the years, with the end of 2015 having the lowest value at only 6.54 percent (Association of Kosovo Banks, June 2016).

4.4.1. Interest rates on loans

In 2015, average interest rates on corporate loans declined to 7.40%, from 9.60% in 2014. Within loans to enterprises, investment loans continue to be characterised by lower interest rates by an average of 7.20 percent in 2015, while the average interest on non-investment loans was 7.80 percent in 2015. The lowest level of interest rates on investment loans may have prompted the faster growth of new loans of this category, which marked an annual increase of 20.80 percent in 2015, compared to new non-investment loans which increased annually by 7.10 percent in 2015.

Table 11: Effective interest rates on loans (2012-April, 2016)

Effective Interest Rates on Loans (2012-2016)					
Description	2012	2013	2014	2015	Apr-16
Effective rates on new loans	12.24%	10.90%	9.29%	7.69%	7.66%
Effective rates non financ.corporate	12.34%	10.75%	9.56%	7.39%	7.27%
Effective rates for economic family	12.00%	11.33%	8.88%	8.39%	7.95%

Source: Central Bank of the Republic of Kosovo, effective interest rates on loans

Interest rates on loans during 2015 marked a more pronounced decline. In 2015, the average interest rate on loans declined to 7.70%, from 9.30 percent in 2014. As seen in Table 11, the lowest rate has been recorded for non-financial corporations, which shows once again the dedication of the banking industry to the country's economic development. During 2015, the interest rate on loans decreased both in loans to enterprises and in loans to households. In 2015, the average interest rate on corporate loans declined to 7.40%, from 9.60% in 2014. Despite the continuous development of the banking industry, this sector has been able to continually lower the interest rates on loans, which has made the cost of citizens of the Republic of Kosovo to get the loan smaller. This also shows the dedication that the banking industry has and its important role in the development of Kosovo's economy through the lending process.

4.4.2. Interest rates on deposits

Along with effective interest rates on loans, the banking industry for its customers also pays interest rates on deposits for assets that Kosovo citizens deposit in the industry. A run on a bank occurs when a large number of depositors, fearing that their bank will be unable to repay their deposits in full and on time, simultaneously try to withdraw their fund immediately. This may create a problem because banks keep only a small fraction of deposits on hand in cash, they lend out the majority of deposits to borrowers or use the funds to purchase other interest-bearing assets such as government securities. When a run comes, a bank most quickly increase its cash to meet depositors' demands. It does so primarily by selling assets, often hastily and at fire-sale prices. As banks hold little capital and are highly leveraged, losses on these sales can drive a bank into insolvency (Allen, Franklin, and Douglas, Gale, Optimal financial crises, *Journal of Finance* 53. No. 4 (1998)). As can be seen from the structure of banks' liabilities, deposits form the main part of the financing of this industry, so this interest rate is mainly the cost of assets that the banking industry holds on behalf of its customers. The upward trend of interest rates on total deposits since the second quarter of 2015 mainly reflects the increase in the interest rate on household deposits, which dominate the banking sector's deposit structure. While, the interest rate on corporate deposits cut off the downward trend only in the fourth quarter of 2015. However, it is worth noting that during most of 2015 (excluding the third quarter), the interest rate on corporate deposits was higher than the interest rate on household

deposits. In 2015, interest rates on corporate deposits fell to 1.50%, from 1.60% in 2014. The interest rate on term deposits decreased to 1.50% in 2015 (1.60% in 2014), while for savings deposits the interest rate fell to 0.10% in 2015 (0.70 percent in 2014) (CBK, effective interest rates on deposits).

Table 12: Interest rates on deposits (2012-April, 2016)

Description	2012	2013	2014	2015	Apr-16
Effective rates for total deposits	3.72%	2.40%	1.11%	1.15%	0.85%
% Increase / decrease	2.76%	-35.48%	-53.75%	3.60%	-26.09%

Source: Central Bank of the Republic, interest on deposits

During the analysis we have compared the rates of interest rates on loans and deposits offered by banks and it is observed that each bank has its rates that are not the same, but differ in small percentage. These percentages depend on the type of loan and the deposit, their duration, and the expenses associated with the provision and other administrative work. In addition to these reasons, the difference in interest rates both on loans and on deposits exists because each bank seeks certain achievements in the market and achieving these goals requires taking certain measures, including interest rates. To be more precise, Banks with a smaller market share always aim to increase their share, while being aware that interest rates are one of the factors potentially bringing more or less clients, those banks offer higher interest rates than the average interest rate on deposits and lower rates on loans.

4.5.Factors that determine the setting of interest rates on loans and deposits

- We have also analysed the factors under which commercial banks set interest rates on loans and deposits and have identified some of the key factors. It is important to note that the main source of financing of credit activity in Kosovo is the deposits of citizens. Banks compete with each other to benefit as much from customer deposits that are limited. In other words, interest rates on deposits are more affected by the fact that the amount of available deposits is limited, ie directed by the bid. **As far as the factors affecting the interest rate on loans,**

there are a number of factors, among which the most important ones are singled out:

- The rate of deposits, credits that the bank receives from other institutions and the cost of capital,
- Estimated risk rate,
- Operational expenditures on credit processing,
- Market conditions.

5. Banking Sector Performance

The banking industry in Kosovo has also consistently recorded positive value of revenues in relation to expenditures. Revenues in these years have been roughly the same, while spending over the years has marked a decrease especially in the last three years, which has led to increased earnings for this sector (CBK, Annual Report 2015).

Table 13: Revenues from the banking industry (2012-2015)

Revenues from the banking industry (2012-2015)								
Period	Interest income				Non interest income		Revenue from Revaluation	Total
	Credits	Placements from the bank	Securities	Others	Fees and commissions	Other operating income		
2012	194.90	2.00	3.00	0.60	44.20	2.40	-	247.10
2013	192.50	1.40	2.30	2.00	45.60	3.90	1.20	248.90
2014	190.70	1.10	2.90	2.50	44.60	3.10	0.50	245.40
2015	180.40	0.50	4.40	0.70	47.10	4.00	1.10	238.20

Source: Association of Kosovo Banks, April, 2016.

In 2015, banking sector revenues amounted to EUR 238.20 million, representing an annual decline of 2.90 percent. The main contribution to the fall in total revenues was interest income that in 2015 marked an annual decline of 5.50 percent. The decline in interest income is largely attributable to the decrease of interest income on loans mainly as a result of the fall in interest rates, despite the acceleration of credit activity during this period. Non-interest income in 2015 marked an annual growth of 7.20 percent,

mainly as a result of rising fees and commissions, which, among other things, reflected the increase in the services provided to banks' branches.

Table 14: Banking industry costs (2012-2015)

Banking industry expenses (2012-2015)										
Period	Interest Expenses			Non-interest expenses		General and Administrative Expenditures			Provision for taxes	Total
	Deposits	Borrowing	Others	Fees and commissions	Provisions for credit losses	Personnel expenses Personnel	General expenses	Other costs of non-interest		
2012	57.60	3.20	2.30	8.70	50.30	42.30	35.50	24.50	4.00	228.40
2013	58.00	2.60	3.20	9.40	46.10	42.30	35.60	22.50	3.20	222.90
2014	36.40	3.30	4.50	11.10	20.50	42.70	35.10	24.40	6.80	184.80
2015	16.70	3.80	2.10	12.00	(8.40)	44.00	35.70	27.80	9.70	143.40

Source: Association of Kosovo Banks, April, 2016.

Expenditures, in contrast to revenues that have been roughly the same over the years, have marked a decrease especially in the last three years, which has led to increased earnings for this sector. The total value of banking sector expenditures in 2015 amounted to EUR 143.50 million, representing an annual decline of 22.30 percent. Reducing total expenditures was largely a result of the reduction of non-interest expenses, which marked an annual decline of 88.60 percent. Within them, a more pronounced decline marked loan provision expense, which recorded an annual decline of 14.10 percent, mainly as a result of the decline in non-performing loans (CBK, Annual Report 2015). Also in the decline of total expenditures significant impact was also on interest expenses that marked an annual decline of 48.70 percent, mainly as a result of the fall of 54.00 percent of interest expenditures on deposits. Despite the slight increase in interest rates on deposits during most of 2015, their sharp decline during the last two years was reflected in the decline in expenditures. General and administrative expenditures, which account for most of the total expenditures, were the only category that marked growth, recording an annual growth rate of 5.20 percent in 2015.

Revenues and expenditures trends and the difference between these two indicators, namely the profit realised by the banking industry.

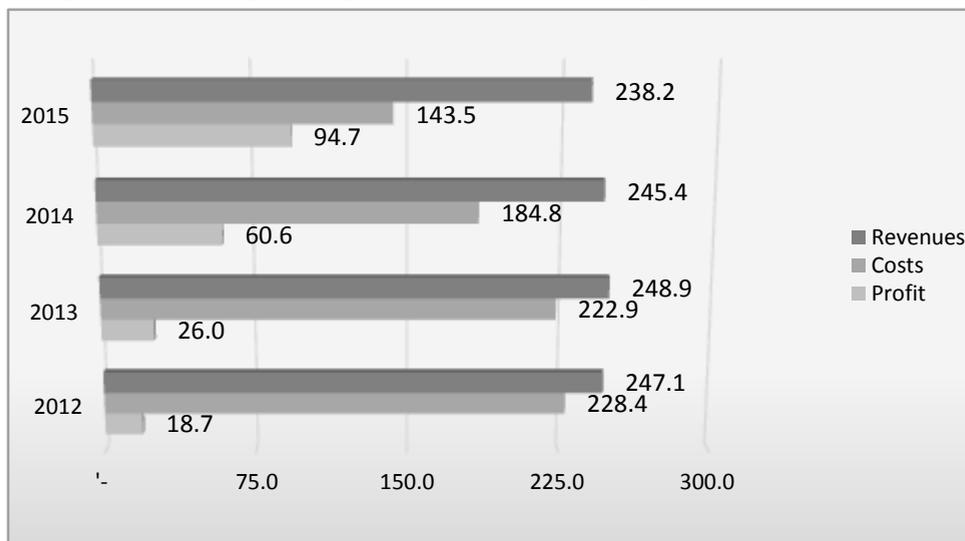
Figure 1: Neto operating income of the banking industry

Figure 1 indicates that the ratio of expenditures on banking sector revenues has markedly improved compared to last year as a result of the sharp decline in expenditures. In 2015, this indicator improved to 60.30 percent, compared to 75.30 percent as it was in the previous year. The profit made in 2015 has impacted on further improving profitability indicators such as Return on Assets Average (ROA) and Return on Equity Average (ROE). ROA reached 2.90 percent, from 2.00 percent in 2014, while ROE at 26.40 percent, from 20.30 percent as it was in 2014 (CBK, Annual Report 2015). The profit made by the banking sector in 2015 amounted to EUR 94.70 million (EUR 60.50 million in 2014), which represents a much higher profit recorded since the beginning of the operation of this sector. The increase in profit during this year resulted from a significant decrease in the banking sector expenditures.

6. Conclusion and Recommendations

Growth and development of the banking sector (2012-2015) has been associated with the creation of banks and their increase in number, with the expansion of the offered products, with the extension of geographical coverage covering all the territories of the country. From the analysis made, we came to the conclusion that the banking sector in Kosovo has had good

performance in recent years. In these years there has been a considerable decrease in banking sector expenditures, which have contributed to the increase of banking sector profits, while revenues continue to be roughly the same over the years, which means that banks need to issue more loans to increase their incomes.

Also, the reduction in interest rates on deposits in recent years shows that banks need to give credit (cash) more than to receive cash (deposits). Also, this sector has had the lowest level of bad credit in the region, which is a very important indicator in increasing banking performance and lowering expenditures of this sector, as well as showing the banks' continued effort to develop this Sector and the economy of Kosovo as a whole.

Although there is a constant attempt by banking operators to provide a broad customer base by increasing competition, this growth has not yet had any significant impact on lowering interest rates on loans and reducing the gap between Interest on credit and deposits which is high. The liberalisation of the banking market should be done through the licensing of new banks, ie the number of banks operating in Kosovo should be increased.

In reviewing the problem and sensitivity of the banking system and credit system as well as the possibility of further development of this system, we make the following recommendations:

The Central Bank should be committed to licensing new banks to increase commercial banks, especially local ones, in order to increase competition, with the effects and impact on economic development to be greater.

We propose to apply lower rates of interest rates and extend the term of loan repayment for some prospective sectors in order to rely more on.

Undertake an initiative to establish an information centre for citizens and economic entities that require loans or deposits in financial institutions in order to have sufficient information on their terms and conditions.

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