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Banking Activities in Kosovo and the Importance of Credit Risk Management

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Abstract

Banks between the financial services they provide play significant roles in the country's economy. The importance of banks in Kosovo is one of the essential catalysts in economic growth. The banking industry based on efficiency and performance industryis the leading indicator of the country's financial stability. The pace of economic growth and long-term stability in the country varies from the level of credit and for what economic activities the bank finances. Credit risk is the primary determinant of banking performance. The higher the risk that the higher the risk is the probability of bank loss and vice versa. In this study banking activities will be discussed and events in general, as well as an analysis of the financial system especially at banks, with particular emphasis on the importance of credit risk management.

Keywords: *Risk management; bank; credit; financial system*

JEL classification*: C32, C33, G21*

Introduction

Kosovo after the far constitutes a new economy in which profound economic transformations were made from a centralized economy led to a market economy. Banks in Kosovo are considered to be valued with better financial performance in the country economy. In recent years, deposits and loans are increasing as well as financial services are continually being upgraded. The central bank has the primary role in overseeing, authorizing for licensing and managing financial institutions in Kosovo.

The commercial banks of Kosovo offer different service packages starting from the current account, savings, guarantees, loans, transfers. Thus, the banking sector continues to have the main do one's a part to stretch the activity of the economic system in the country (CBK, 2016) therefore it represents the most substantial portion of the financial sector. The central origin of deposits persists to be homely, although ability is dominated by short-term deposits(MEI, 2010)

Kosovo's banking system has chosen financial oversight with a safer and more gradual approach by tentatively matching it to international standards, especially by giving particular emphasis to the European Banking Supervision regulations (Basel framework). During January 2008, the Basel II Framework was standardized by setting the smallest on a par of capital essential that banks are appropriate to maintain for depositors' funds and financing at the particular price. Banks of Kosovo are also governed by Basel II legislation, which is required to take risks and develop risk management departments. Kosovo banks are compelled to comply with financial statements following International Financial Standards (SRNF) and Accounting Standards. CBK proceeds to be committed to securing the economy durability in the country, which is also the primary objective deriving from the Central Bank Law (CBK-Financial Stability Report, 2016)

Literature Review

According to Jorion, (2007), banks and financial institutions have faced financial risks. The banking business is one of the most vulnerable companies due to interest rate and exchange rate fluctuations. Banks are of particular importance in the economy because they are one of the leading financiers of industrial development from savers to seekers of these resources that need them. Because Kosovo's borrower does not have access to capital markets, banking institutions are becoming even more critical in Kosovo's economy. When financial institutions have a rise in profits, then economic growth occurs, and when financial institutions suffer losses, we have a lag in economic growth and poverty identification (Barth, Caprio, & Levine, 2004) .

According to the Basel Committee On Banking Supervision (2006) related to risk management identified four primary risk sources: credit, market, liquidity and operational risk. The main business of banks is the receipt of deposits and their home. Banks to maintain their business and to have particular importance in the economy must manage the risk carefully. Banks taking high risks can lead to loss and bankruptcy. According to Van Gestel & Baesens (2009), the risk is a probability or a negative and uncertain result. Banks need to understand how to measure, identify and manage risk because losses are related to banking products because of they frontal other risks. (Bessis, 2015)

To understand and study risk management in the field of banks, we must first understand the definition of risk. The risk is part of everyday life's decisions. Usually, it is used to express events that we do not want to occur under a certain probability including the magnitude of probability and its consequences if the risk occurs.

The most recognized risk definitions are based on A.H. Willet and F.H.Knight. According to Willet, the risk is "objective correlation of subjective uncertainty" which affects the economic activity through the psychological impact of uncertainty and this uncertainty is considered as a risk occurrence for each different individual that is subjective in certain circumstances (Willett, 2012).

The concept of risk can result in positive and negative outcomes derived from specific speculative risks (Rejda, 2014). According to (Hubbard, 2009), the risk should be identified to be assessed and followed by the coordination and industrial application of resources with the aim of minimizing, monitoring, controlling, and probabilities in reducing the impact of harmful events. So risk should be managed to maximize business opportunities. In business because of the security, uncertainty can lead to adverse effects of profitability and future losses. Financial risk in the banking sector may be detrimental to the outcome of an action or events that result from specific unsafe resources that may directly or indirectly cause the banks to fall short of meeting their business objectives. In the le change of financial markets, the risk is being doubted through financial intermediaries that have begun to have economic growth in lending markets by supporting the distribution of depositors and investors (Machiraju, 2008 pp 152).

Financial systems throughout the world possess a fundamental effect on the increase and ovulation of the commercial, particularly in the intermediation among the overstock, and those with an absence of the economy. Effectiveness and efficiency in performing these roles depend mainly on the level of financial system development. The financial sector to ensure its sustainability needs to be controlled by the government and its organs.

The progress of the financial sector largely rests on the role of efficiency and effectiveness. The financial industry to ensure its sustainability needs to be an inspection by the government and its organs.

Stages of economic sector evolution vary resting on the state and time. The most advanced and sustainable systems have to do with predominantly sustainable economies, while the undeveloped economically viable economies are the surface economies. Banks as part of the financial system that is tailored to economic change mainly perform three main functions (Machiraju, 2008 pp 48):

- The transmutation of short-term deposits into short-term loans,
- Credit monitoring,
- Provision of financial packages to relieve transactions.

Due to the financial markets' copyrights, banks are making stricter rules on granting loans and at the same time making strict controls in departments and especially in the credit risk department. According to Sahiti, Sahiti, et al (2017) Banks should try to get as much information as possible and be aware of the credit rating to evaluate the department's overall effectiveness. The deterioration of banking efficiency is dependent on the increase of bad loans, which also have an impact negative in financial development.

For the bank risk classification, the academy does not have a unified view. This research mainly relies on the classification of risks based on the Basel agreement. There are usually three basic kinds of threats under the Basel banking system: The following will be discussed and will show all the risks and how they are managed.

Commercial banks are financial institutions that depend on the profits and the economic size that derive from market transactions. The financial services packages offered by banks are very favorable to clients as compared to the services they have separately and individually. Banks not only receive large sums of public funds but also make use of these funds by making the creation of loans. Share capital represents a tiny share of total assets compared to non-financial institutions.

Banks are researching to have easier access to financial markets with the purpose of fundraising while the risk from lenders remains acceptable. The primary source of revenue for commercial banks is the difference between interest on credit and deposits. In addition to receiving deposits and providing credit, commercial banks also offer other services such as drafts, checks, credit cards, payment transfers in various locations. It should also be noted that these services carry unique risks to the management of banks

According to Machiraju (2008 pp 48), the banking sector is of particular importance in the financial system:

- First, the bank's deposit requirements
- Second, commercial banks are the central element through which monetary and credit policies are transmitted to the economy. Credit and monetary policy are implemented through actions in banking reserves.

Third, the nature of investment and lending by commercial banks is very functional because they deal with a variety of activities and put different kinds of borrowers. Furthermore, commercial banks' operations are very flexible as they provide facilities for financing various types of borrowers, enabling them to channel funds according to defined prior

Research and Methodology

For the analysis and observation of the risk, the study was base on the qualifying method. Qualitative research was established from quantitative analysis. Through quantitative research results and the use of existing knowledge, qualitative research is a guideline for ideas and thoughts on the object (Cormack, 1991). Unlike quantitative analysis, quality research does not need to calculate the number of research results.

According to the quantitative analysis combined with the previous literature research, there may be a robust qualitative analysis for the commercial banks' risk analysis. By qualitative study, suggestions can be made to control credit risk.

Findings

Financial institutions play an essential role because they offer economic development of the country. So the homeland financial system involves banks, pension funds, insurance companies, financial aides, microfinance institutions and the central bank. Problems in the financial system have a negative impact on economic development, damaging the efficiency of fiscal and monetary policies, it also affects the reduction of capital and psychological pressure on human resources associated with the rescue of financial institutions (IMF, 2018).

So the country's financial system needs to be regulated and overseen as it is essential for the country's economic and financial stability. One of the most critical institutions in financial intermediation in Kosovo, especially commercial banks offer payment systems (national and international transfers, payments and invoices), also enables saving of savings of citizens and businesses, while at the same time lending to those who need capital.

The financial system of Kosovo, especially banks since the war, has continuously increased in most of the values, which shows that they have sound bases in their operation, providing security and trust to customers. This has enabled the financial system in Kosovo to contribute continuously to the country's economic development through the lending process by lending institutions (through commercial banks and microfinance institutions), but also through the services provided by insurance companies.

In Kosovo, the number of banks has increased by 2015, which has reached the number ten. The number of insurance companies, commercial banks, and pension funds has remained similar to the previous year, unlike the financial aids that have increased, while microfinance institutions are declining. Kosovo's financial system is characterized by relatively stable growth, with an annual growth of 9.8%, with asset value reaching 5.38 billion. The effect of this growth was the excellent performance of pension funds and the expansion of banking sector activity. The microfinance sector, the insurance sector and the financial aid sector in the financial system contribute to a lower rate of asset growth (SHBK, 2015).

Table 1: Number of Financial Institutions

Description	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
Commercial banks	8	8	8	8	9	9	10	10	10
Insurance companies	11	11	12	13	13	13	14	15	15
Pension funds	7	2	2	2	2	2	2	2	2
Financial aides	22	27	28	34	38	39	42	44	48
Microfinance institutions	16	19	17	20	17	17	18	18	16

Source: Annual Report of CBK (2009, 2014, 2016)

Banks in Kosovo mainly dominate the financial system due to the rapid and continuous lending rate, Kosovo has moved in this direction along with the countries of the region, although this pace in the medium term can have an adverse effect if the economic sector is not accompanied by economic growth.

In 2016 loans amounted to 2.23. Billion euros with a 10.4% increase. This positive credit growth has affected the launch of the Kosovo Guarantee Fund for loans, especially lending to households (CBK - Financial Stability Report, 2017, pp 15). The growth of lending activity has been affected by the lower interest rates on household and enterprises loans.

The credit form of enterprises marked an annual growth of 8.3%, mainly loans are willful for the trade branch, deputize the most prominent group with a part of 52.7%. High impact in loan structure plays the maturity period where The long-term maturity of loans with 'maturity over two years' has increased the share of 37.9% in enterprises and 54.4% in households, which remained similar to previous years.

Starting from 2015 and continuing in 2016, interest rates on credit began to decrease as deposit interest rates began to rise with a slight percentage rate that provides a convenience to the citizen. The average interest rate on new loans fell to 7.2 from 7.7% in the previous year, while the average interest rate on deposits rose for 0.1% to 1.2%. The most significant decline in the interest rate on loans was reflected in a decrease in the contrast among the lending and the percentage norm on deposits at 6.0% from 6.5% in 2015 (CBK-Financial Stability Report, 2017 pp 49).

Kosovo's banking sector for percentage norm on loans and deposits has almost reached the same levels as the countries of the region. Because of the inherent legacy of Kosovo's commercial banks, they keep high levels of benefits and efficiency. In December 2016, the banking profit was 75.5. Millions of euros, which is characterized by a decrease compared to the previous year, which was the highest profit in the history of the banking sector with 94.7 million euros (CBK-Financial Stability Report, 2017 pp 52). This decrease is the result of the decline in net interest income and increases in expenses for provision for credit wastage and charges for fees and percentage, on the other hand (CBK-Financial Stability Report, 2017 pp 16).

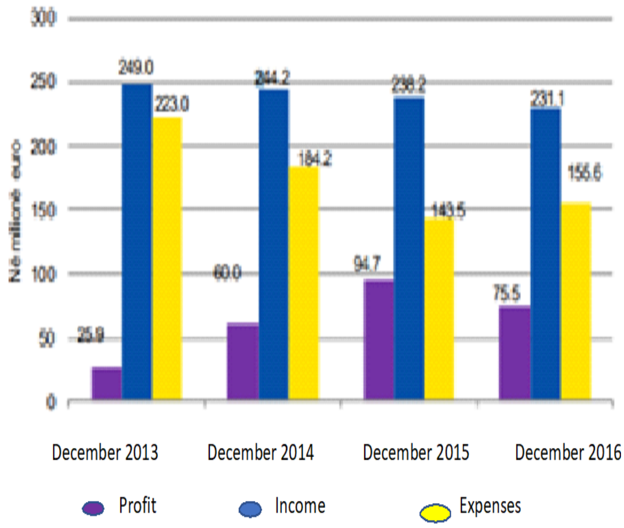

Figure 1. Financial performance of the banking sector

Source: Annual Report of CBK (2016).

Liquidity in the banking sector stands at a satisfactory level, despite the shortages that have been avoided by liquidity indicators as a result of accelerated lending growth. In 2016, the ratio of liquid assets to short-term liabilities stood at 41.5%, well above the regulatory minimum of 25% required by the Central Bank even though the decline as mentioned above, the level of capitalism grew on average by 19.5% from 19.2% in the previous year (CBK, 2016). The banking sector's loan portfolio has improved, with the average non-performing loans being reduced to 7.4% from 9.0%. Germany is characterized by an undermost standard of non-performing credit with a rate of about 2.3%. Also, in the loan portfolio, it is shown that there is the excellent hedge of the sector from potential loan losses, as there was an increase in the non-refinancing coverage rate with provision for loan loss at 127.6%. According to the CBK-Financial Stability Report(2017) the non-performing loans non-performing credits ratio stand at the lowest level compared to the countries of the region which averaged 14.2% in 2016 on nonperforming loans.

The Central Bank of the Republic of Kosovo for According to Article 35, paragraph 1.1 of Law no. 03 / L-209All foreign-owned banks operating in Kosovo must be licensed and act according to the law on risk management by fulfilling these requirements (Regulation on Credit Risk Management, 2013):

- Banks should have a credit risk management system that is appropriate to the type, capacity, and difficulty of their activities.
- The credit risk management system in banks should involve the approach, methods, order, and organization exhausted, by banks to lead credit risk.
- The credit risk management system should continuously and timely evaluate the quality of loans and other assets, including the determination of the level of credit and other assets, involve the decision of the sufficiency of stock for defeat connected to this risk.

The Central Bank is always looking for policies and strategies for managing credit risk to communicate in all banks effectively. The primary purpose of the credit risk management banking strategies is to determine the level of appetite to take risks, while also developing plans to optimize returns by keeping credit risk within the predetermined limits (IFSB, 2005 pp. 6).

Credit risk results in an economic loss in the banking institution when the debtor or issuer of financial instruments is unable to repay the debt. In the portfolio of banking institutions, the losses stem because of the current deterioration or poor credit quality (Haimes, 2012 pp. 1452). Credit risk can be derived from both balanced and off-balance sheet activities

The credit risk management structure by CBK through internal and external analysis of credit portfolio factors aims to minimize the distance between returns expectations and inherent business losses (Regulation on Credit Risk Management, 2013 pp.2)

There are cases where customers may need more support. Then you can use the combination of the following strategies (Regulation on Credit Risk Management, 2013 pp. 6 - 8):

- Change or waive some of the terms and conditions of the loan agreement in a method that does not jeopardize the bank's interest. However, this should be communicated in the lending department.
- Issuance of additional collateral security, if possible.
- Provision of additional funds if the borrower requests the crediting analysis.
- The extent of the repayment period of the loan supported by the cash flow statement.

Recovering loans should be a priority of the recovery unit to ensure the implementation of proper recovery strategies. However, assistance can also bare by corporations (Banks that have agreements between them).

According to the Regulation on Credit Risk Management, (2013 pp.1-16), the wrong credit department should perform the following functions:

- Determining the account action plan.
- Follow all of the alternatives to maximize recovery, including placing customers in liquidation of credits or liquidation which is the most convenient.
- Ensure that appropriate measures are taken and that credits are calculated by actual and expected losses and,
- Regular review of deteriorated loans.

It should be noted that after a loan classified as a loss loan, a bad credit manager for proper calculations in the recovery unit should be assigned. The Bad Credit Collection Manager serves as the primary contact with the customer during the recovery process. There are some methods for covering debts from banks (Regulation on Credit Risk Management, 2013 pp. 1-16) Some of these are:

- Complaints to the Customer
- Legal action
- Client's guarantor
- Seizure and collateral sale
- Use of the Kosovo Deposit Insurance Corporation services

The country's economy has a massive impact on the credit structure by economic activity. From the available data, we can see that the credit structure is almost the same as the previous years, see table 2. The largest share of the credit structure by economic activity occupies credit to the trade sector by an average of 52%, the reason being that massive imports of goods and services characterize Kosovo's economy. Loans to other industries are characterized by a lower percentage, especially in the agriculture sector, by an average of 4%, but it is noticed that the banks have affected the financing of this activity gradually and this shall influence the economic growth the state.

Table 2: Structure of loans by economic activities

Description	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
Trade	53%	52%	51%	53%	53%	52.60%	53.70%	51.20%	52.70%
Production	12%	11%	13%	12%	11%	10.80%	12.20%	12.30%	12.2.%
Construction	9.40%	10%	%	10%	11%	9.80%	7.80%	7.50%	7.30%
Agriculture	3.50%	4.10%	4%	4%	4%	3.80%	4.00%	4.50%	7.30%
Other sectors	22%	23%	21%	21%	21%	23.00%	21.70%	25%	23.60%
Total	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

Source: Financial Stability Report (CBK-Financial Stability Report, 2008, 2009, 2010,2011 2013, 2014, 2015, 2016,)

Both borrowers and lenders of credit have an exceptional interest in the effective interest rate, see Table 3.

Table 3: Effective interest rates on loans (2008-2016)*

Description	**2008**	**2010**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
Effective rates on new loans	14.7%	14.40%	13.80%	12.70%	12.70%	11.80%	10.60%	8.30%	7.20%
Effective rates for non-financial corporations.	14.6 %	14%	13.20%	11.60%	11.60%	11.40%	11.30%	7.40%	6.80%
Effective rates for households	13.10%	13.90%	13.90%	12.40%	12.40%	11.60%	10.90%	8.40%	7.90%

Source: Financial Stability Report (CBK- 2008, 2009, 2010,2011, 2012, 20132014, 2015, 2016)

From the data, we see that interest rate on loan from 2014 started with a downturn trend wherein 2016 it has fallen to 7.2%. This rate stands at the approximate level with the countries of the region. Also, this rate has positively impacted the growth of investments in the general level of the economy.

Risk management to strengthen the institution's financial risk analysis and the relevant requirements of securing best market practices have centralized, besides credit risk, market risk, liquidity risk, operational, socio-environment and capital management. As far as credit risk is concerned, risk management is responsible for assessing the behavior of the loan portfolio by promoting identification, measurement, control, and mitigation of credit risks by linking it to each counterparty.

Conclusion

The failure can hinder the economic development of the country, so the health of the banking system has a vital role. The cost of keeping the risk is essential for any organization, especially the banking sector. Banks provide liquidity at the depositors' request through the current account and lend credit to their borrowers via credit lines.

Based on the role of credit risk and market risk, banks' success requires that the department be able to identify, assess, monitor and manage these risks in a sound and sophisticated manner.

The central bank is the risk management regulator in particular of credit risk in financial institutions. CBK as a regulator uses the International Standard Capital Adequacy Model (Basel Committee On Banking Supervision, 2006 pp.1-192) to absorb unexpected losses arising from their credit, market, and operational risk exposures. Besides, profits deriving from various bank business activities are estimated in proportion to the capital needed to cover the risks associated with them.

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