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Article

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Credit Risk in the Banking Sector in Kosovo

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Abstract: Loans make up the bulk of a bank's assets, and thus credit risk is the most significant risk for commercial banks in Kosovo and throughout the world. Despite its complexity, effective management of credit risk is a prerequisite for the success of a bank and the banking system in general. A special role in this aspect is played by the separation of reserves to cover the risk of failure to repay the loan or in cases of non-fulfilment of contractual obligations by the loan recipient. Therefore, this research aims to address this issue and analyses the credit risk management of the banking system of the Republic of Kosovo in general and the effects of separation of reserves for loan losses in particular.

Keywords: Loan; interest; risk

JEL Classification: E5; E51; E52; E58

1. Literature Review

Bank management approach to risk management

The main activity of the banking system is to attract funds, invest them or resell. Investing is not without risk. Banks should take the risk to save their limits and to fulfil their role in the economy. A bank that takes excessive risks is likely to run into difficulty and could fail to pay its obligations, ultimately becoming insolvent.

Giving credit to customers is a profitable activity of the bank, as the loan recipient pays interest on the amount borrowed. However, this lucrative activity has consequences or problems that may arise as a result of delays or failure to pay the loan. This means that for a bank to be successful and profitable it has to develop a good strategy on how to get back the money given to the clients. This activity is called credit risk management. Very good management of credit risk should be put in place before and after the loan is granted for each client in order to make sure that the client is able to pay the money on time. The bank must be very sure about the quality of loans because if the client is unable to pay, the bank will find itself in a deficiency that is associated with other negative consequences. Therefore, banks should always try to control credit quality of potential business partners with a rating agency or

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credit provider, which helps them to prevent the risk of bad debt, to maintain cash flow and to collect overdue payments. (Thorne & Deborah, 2009, p. 41)

Risk is uncertainty or the probability that a negative event will occur. In financial terms, a negative event is a loss. Risk management is a broad term. While for firms, risk is mainly related to the types of risk insurance (car breakdown, environmental disasters), banking risk is mainly related to financial risk in terms of the potential loss of financial products. Banks face various risk elements that need to be identified, understood, measured and managed. The Basel II agreement regarding capital identifies three main sources of risk: credit risk, market risk and operational risk.

1.1. The Importance of Credit Risk Management

The worldwide credit crunch, which started in 2006 with the issue of non-prime mortgages in the United States, stressed the fundamental importance of decision-making in the lending process. As these mortgage problems were discovered, it was proved that unsound lending decisions had been made and lessons on how to effectively manage credit risk were ignored. This indicates that poor lending decisions, either by a financial institution or a corporation, can lead to significant losses.

The incredible losses suffered by banks and others affected by the credit crisis highlight the very large impact of credit risk and how credit risk management affects the welfare and profitability of a business. Being able to manage this risk is a key requirement for every credit decision. This is well understood in theory (if not always in practice) by banks and other lending institutions that make their profits by advancing money to individual and corporate borrowers. It should also be well understood by industrial and commercial firms that, in the course of their normal business, offer commercial loans. (Brown & Moles, Credit Risk Management, 2014, p. 9)

The results of a global study conducted recently shows that top executives at financial institutions are paying more attention to credit risk than any other type of risk. While 67% of respondents said that credit risk is the highest priority, other types of risk have also received considerable attention: operational risk (44%), liquidity risk (38%), market risk (33%) and reputation risk (26%). (Ernst & Young, 2010, p. 20)

1.2. Principles for Managing Credit Risk

While financial institutions have faced difficulties over the years for a variety of reasons, the main cause of serious banking problems continues to be directly related to negligence in setting credit standards for borrowers and related parties, poor risk management portfolios, or lack of attention to changes in economic or other circumstances that could lead to a deterioration of the credit situation.

Credit risk can be defined as the bank's potential borrower or counterparty failing to meet obligations under the contract. (BIS-Bank for International Settlement, 2000, p. 1) There are three features that define credit risk:

1. Exposure (to participator that can possibly fail or suffer a negative change in the ability to perform).

2. The likelihood that participators fail to fulfil their obligations (probability of failure).

3. Recovery rate (that is, how much can be recovered if the failure occurs).

The greater the first two elements, the greater the risk exposure. In contrast, the greater the degree of recovery rate, the lower the risk.

Formally, we may present credit risk as:

Credit risk = Exposure × Probability of failure × (1 – Recovery rate) (Ernst & Young, 2010, p. 16) (1)

In the following, we will present some of the principles of credit risk management based primarily on the standards of the Bank for International Settlements (BIS) and the sound practices of risk management. The goal of credit risk management is to maximize the risk-adjusted rate on return of a bank holding credit risk exposure within acceptable parameters. Banks should have sustainable management of credit risk across the portfolio. Banks also need to consider the relationship between credit risk and other types of risk. Effective credit risk management is a critical component of a comprehensive approach to risk management and essential for long-term success of any banking organization.

For most banks, loans are their largest source of risk and credit. However, other sources of credit risk exist throughout the activities of a bank, including in the banking book and trading book, and on-balance sheet and off-balance sheet items. Banks always face credit risk (or the risk of the other participants) in various financial instruments, including acceptances, transactions in banking, trade finance, exchange transactions in foreign currencies, “features” financial swaps of bonds/equities, commitments and guarantees, as well as other transactions.

As exposure to credit risk continues to be the main source of problems for banks worldwide, banks and their supervisors should be able to draw useful lessons from past experiences. Banks should be acutely aware of the need to identify, measure and control credit risk, and hold sufficient capital for these types of risk to be compensated adequately. This is also the recommendation from the Basel Committee, encouraging banking supervisors globally to promote good practices for managing credit risk. Good practices specifically address the following areas:

(I) Creation of an appropriate environment of credit risk;

(II) Acting on the basis of a good process of granting loans;

(III) Maintaining a proper process of credit administration, and its measurement and monitoring;

(IV) The application of adequate controls over credit risk. Although the specific management practices of credit risk may differ among banks depending on the nature and complexity of their credit activities, a comprehensive programme of credit risk management will address these four areas. These practices should be implemented for the assessment of asset quality, adequacy of provisions or reserves, and disclosure of credit risk.

The approach chosen by supervisors depends on a variety of factors, including their supervisory techniques at home and abroad and the extent to which external auditors are used in the supervisory function. Supervisory expectations for a risk management approach applied by creditor banks should be commensurate with the scope and complexity of the bank's activities. For banks that are smaller or less sophisticated, supervisors must determine that the approach of credit risk management is sufficient for their activities and that they have installed sufficient discipline of return risk processes.

1.3. Creating an Appropriate Environment for Credit Risk Management

The board of directors should have responsibility for approving and periodically (at least annually) reviewing the strategy and significant policies of the bank's credit risk. The strategy should reflect the bank's tolerance for risk and the level of profitability the bank expects to achieve. Senior management should have responsibility for implementing the credit risk strategy approved by the board of directors and for developing policies and procedures for identifying, measuring, monitoring and controlling credit risk. Such policies and procedures should address credit risk for all activities and products of the bank. Banks should ensure that the risk of new products and activities are subject to the appropriate procedures of risk management and control before being presented or approved by the board of directors or the relevant committee.

2. Research Methodology

This study is based on qualitative research methods, including a literature review and observations made by the World Bank in a number of countries in the region and across Europe.

2.1. The purpose and Justification of the Study

The aim of this study is to evaluate the mechanisms of credit risk management of commercial banks in Kosovo in order to generate recommendations. The objectives of this study are:

- To examine the importance of the process of credit risk management of commercial banks;
- To ascertain that standards for credit risk management are in accordance with international standards and practices;
- To assess how well non-performing loans are covered by provisions for loan losses;
- To analyse what methods are applied in calculating provisions to cover credit risk;
- To ascertain if the loan portfolio is stable in commercial banks in Kosovo.

2.2. Brief History of the Kosovar Banking Sector

In November 1999, and based on UNMIK Regulation 1999/20, the Banking and Payments Authority of Kosovo (BPK) was established, and through Regulation 2001/24 it was amended as a public legal entity. At that time, there were no commercial banks in Kosovo, and all transactions were made in cash. In January 2001, the first bank in Kosovo, the Micro Enterprise Bank (MEB), was founded, and it later became the ProCredit Bank, owned mainly by development agencies and international financial institutions. Up to November 2001, the number of banks rose significantly in Kosovo, with six new banks increasing competition.

By December of 2004, there were seven commercial banks in Kosovo. To facilitate analysis of banks, BPK can be divided into two groups. In the first group are banks owned exclusively by foreigners, while the second group comprises banks with a majority stake of local ownership.

Table 1. The composition of bank groups

Group I	Group II
1. ProCredit Bank (PCB) 2. Raiffeisen Bank of Kosovo (RBKO)	1. New Bank of Kosovo (BRK – Banka e re e Kosoves) 1. Business Private Bank (BPB – Banka Private e Biznesit) 3. Economic Bank (BE – Banka Ekonomike) 4. Kasabank (KSB) 5. Credit Bank of Prishtina (BKP – Banka Kreditore e Prishtinës)

Viewed by asset size in 2004, with 62% of the assets belonging to the first group and 38% belonging to the second group.[1]

The number of commercial banks in Kosovo increased gradually, and by the end of 2015 had reached 10. However, the financial sector was characterized not only by an increasing number of commercial banks but also other financial institutions that play an important role in the economy.

Table 2. The number of financial institutions

Description	December 2012	December 2013	December 2014	December 2015
Commercial Banks	9	9	10	10
Insurance Companies	13	13	14	15
Pension Funds	2	2	2	2
Financial Auxiliaries	38	39	42	44
Micro Financial Institutions	17	17	18	18

Kosovo's financial system in 2015 was characterized by increased activity and a high level of sustainability in all its constituent sectors. The banking sector recorded accelerated credit growth, thus reinforcing its role in financing economic activity. The value of total loans in 2015 reached 2.02 billion euro, which represents an annual increase of 7.3%. Also, new loans issued by the banking sector up to December 2015 were characterized by annual growth of 10.9%, within which the most significant increase was recorded in loans to enterprises for investment purposes.

Credit expansion reflects the easing of credit supply from banks expressed through significant reduction of interest rates on loans, as well as increased demand for loans to enterprises and households. The enterprise lending structure remains similar to previous years, with loans intended for the retail sector representing the largest category with a share of 51.7% in total loans to enterprises. The structure of loans by maturity has changed in favour of longer-term loans. Loans with maturity “over 2 years” have become more common in the sector, with maturity loans 'to 1 year' becoming less common. Increased lending activity in the country is funded by increased deposits collected in the

[1] (Tyrbedari & Zymeri, 2005, pp. 3-8)

country. Deposits in the banking sector in 2015 reached a value of 2.70 billion euro, representing an annual increase of 6.5%.[1]

The banking sector in 2015 was characterized by a significant reduction in the interest rates on loans and a slight increase in deposit interest rates. The average interest rate on loans decreased to 7.7% in December 2015 from 9.3% in December 2014. Meanwhile, the average interest rate on deposits in December 2015 increased to 1.2% from 1.1% in December 2014. Consequently, the difference between the average interest rate on loans and deposits in December 2015 was reduced to 6.5 percentage points, from 8.2 percentage points as it was in December 2014.

Interest rates on loans and deposits of the banking sector in Kosovo remain at levels similar to those of other countries in the region. Financial soundness indicators of the banking sector continue to reflect a high degree of sustainability. The banking sector has seen a significant increase in financial performance, recording a net profit of 94.3 million euro in 2015, mainly as a result of significant expenditure reduction, particularly for provisions and interest expenses on deposits. The liquidity position of the banking sector remains at a satisfactory level, with the ratio of liquid assets to current liabilities comprehensively standing at 44.9% in 2015, which is significantly above the minimum 25% required by the Central Bank. The capitalization level of the banking sector remains high, and in 2015 rose to 19.0% from its 2014 level of 17.8%. The capital increase resulted from higher realized profit in 2015. Consequently, the quality of capital improved further, with the ratio of capital to total topping capital rising to 87.7% from 82.1% of the previous year.[2]

The quality of the loan portfolio of the banking sector improved further in 2015, with the share of non-performing loans to total loans falling to 6.2%, representing the lowest level since 2012. The banking sector holds a low level of non-performing loans compared with the average of 15.9% for the region. It has also increased the level of coverage of non-performing loans by provisions to cover potential loan losses – to 115.1% from 114.4% in 2014. The rate of credit concentration in the banking sector has declined for the second consecutive year. Concentration of credit risk is measured as the ratio of the value of total large exposures to capital topping; in 2015, it decreased to 65.7% from 97.1% of the previous year. The exposure of the banking sector to market risk remains at a low level considering the extremely low 1.93% position of net open foreign currency to the first-class capital, the low turnout of only 0.3% of loans to non-euro currency in total loans, and the low sensitivity of assets and liabilities to movements in interest rates, considering the fact that the bulk of loans and deposits carry fixed interest rates. The results of the stress test continue to suggest the high capability of the banking sector to withstand potential shocks through the quality of the loan portfolio and the level of capitalization, which may result from the hypothetical scenario of increasing the rate of non-performing loans (NPLs), a depreciating euro, reducing interest rates on assets and increasing liability interest rates, and loan failure of the biggest recipients.

The banking sector as a whole is able to withstand a ratio of NPLs to total loans of 18.2% without a need for additional capital injections to maintain the ratio of capital to the required regulatory level of 12%. Also, the banking sector has demonstrated the ability to preserve liquidity under the hypothetical

[1] (Nushi, Syla, & Gjocaj, 2016, p. 16)
[2] (Nushi, Syla, & Gjocaj, 2016, p. 16)

assumption of significant withdrawals of deposits. The sector may be able to withstand the withdrawal of about one-third of the total deposits in one day without the need for additional liquid assets. Banking infrastructure continued to expand during 2015. Increasing the number of ATMs and POS devices resulted in an increase in the number and value of withdrawals through ATMs and through POS sales. During this period, the number of transactions conducted through the banking payment system in Kosovo increased by 8.7%, reaching 9.8 million, while the value of transactions increased by 9.4% to 7.5 billion euro. There was also an increase in the total number of bank accounts, e-banking accounts, and debit and credit cards. All these developments led to increased efficiency of banking services.[1]

The main indicators of the banking industry

Recently, the structure of assets of the banking sector has seen no significant change compared with previous periods, taking into account that the majority of the assets of the banking sector (from 83.0%) remain invested in instruments that bring profit, such as loans, securities and balances with commercial banks.

Table 3. The asset structure of the banking industry (2010–2016)[2]

							(millions of euro)
Description	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**April2016**
Cash and balances in CBK	307	332	426	463	447	491	436
Balance with commercial banks	439	330	288	340	391	316	312
Securities	173	202	257	355	384	473	446
Loans and leasing	1,459	1,698	1,763	1,806	1,882	2,020	2,103
Fixed assets	44	47	58	56	54	57	57
Other assets	33	41	38	40	28	29	29
Total assets	**2,455**	**2,650**	**2,829**	**3,059**	**3,186**	**3,385**	**3,382**

From the table below it can be concluded that loans represent the bulk of assets of the banking sector in Kosovo, where on average they make up 60% of the overall total assets. Cash and balances with CBK have not undergone any great changes in the period shown in the table. The balance of commercial banks at the end of 2015 has a more pronounced decline, with total assets in 2014 amounting to 12.3% as compared to 9.3% at the end of 2015. In securities we have seen an increasing trend year by year. Fixed assets and other assets remained almost unchanged.

[1] (Nushi, Syla, & Gjocaj, 2016, p. 17)
[2] (Nushi, Syla, & Gjocaj, 2016, p. 40)

Table 4. The composition of the assets structure of the banking industry (2010–2016)

							(millions of euro)
Description	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**April 2016**
Cash and balances in CBK	13%	13%	15%	15%	14%	15%	13%
Balance with commercial banks	18%	12%	10%	11%	12%	9%	9%
Securities	7%	8%	9%	12%	12%	14%	13%
Loans and leasing	59%	64%	62%	59%	59%	60%	62%
Fixed assets	2%	2%	2%	2%	2%	2%	2%
Other assets	1%	2%	1%	1%	1%	1%	1%
Total	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

The structure of loans by economic activity remains similar to previous years, with almost all economic activities gradually increasing credit exposure. The overall structure of the economy affects the structure of loans by economic activity, whereby we see that Kosovo has an economy with a larger volume of imports of goods and services, which has affected loans in the trade sector. In contrast, the manufacturing sector in Kosovo is not so developed, but it can be noted that banks have contributed by gradually increasing finance for this sector, which will affect the economic development of the country.

Table 5. Loans by economic activity (2010–2016)[1]

							(millions of euro)
Description	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**April 2016**
Trade	521	606	635	641	675	683	713
Production	128	137	133	132	153	164	175
Other services	114	100	109	103	102	124	126
Construction	109	116	125	119	107	100	100
Financial services	22	55	55	69	61	94	96
Agriculture	38	41	44	46	50	60	53
Hotels and restaurants	40	40	39	49	51	51	48
Other trade	19	23	23	19	18	21	21
Mining	15	17	16	20	20	19	20
Energy	18	15	16	21	20	18	19
Total	**1,023**	**1,150**	**1,194**	**1,217**	**1,256**	**1,333**	**1,371**

[1] (Shoqata e Bankave të Kosovës, 2016, p. 5)

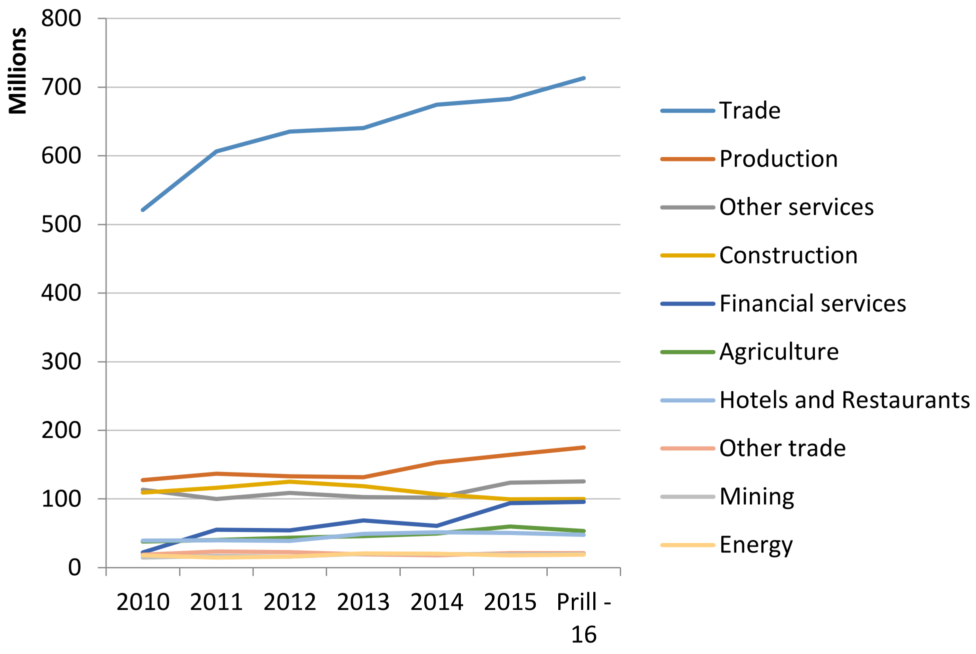
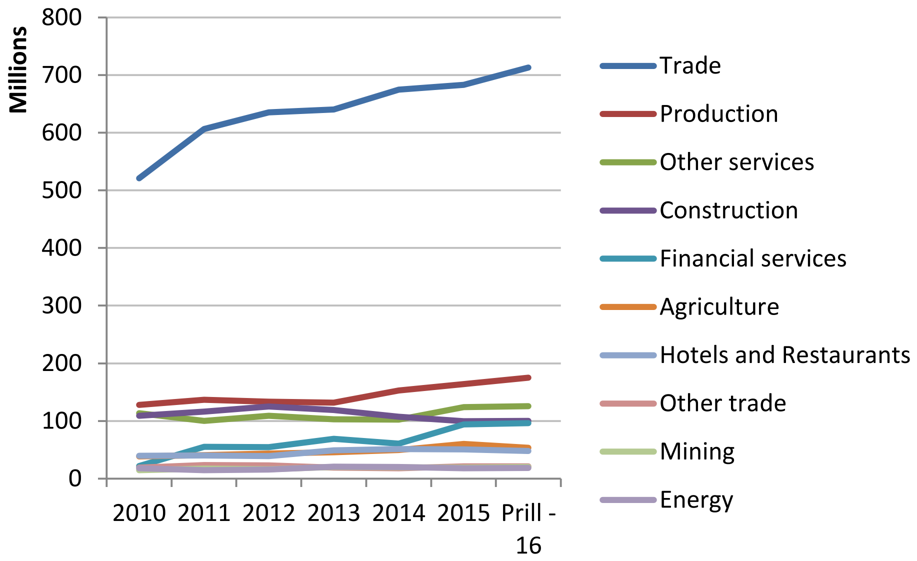


Figure 1. Loans by economic activity



Loans intended for the retail sector represent the largest category with a share of 51.7% in total loans to enterprises, followed by loans intended for industry (mining, manufacturing, energy and construction) with a share of 22.8% in 2015.

Table 6. The share of loans by economic activity (2010–2016)[1]

Description	2010	2011	2012	2013	2014	2015	April 2016
Trade	51%	53%	53%	53%	54%	51%	52%
Production	13%	12%	11%	11%	12%	12%	13%
Other services	11%	9%	9%	8%	8%	9%	9%
Construction	11%	10%	11%	10%	9%	8%	7%
Financial services	2%	5%	5%	6%	5%	7%	7%
Agriculture	4%	4%	4%	4%	4%	5%	4%
Hotels and restaurants	4%	4%	3%	4%	4%	4%	4%
Other trade	2%	2%	2%	2%	1%	2%	2%
Mining	1%	2%	1%	2%	2%	1%	2%
Energy	2%	1%	1%	2%	2%	1%	1%
Total	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

The structure of liabilities and resources of the banking sector continued to be dominated by deposits in 2015, comprising 79.8% of total funding and representing the main source of funding for the banking sector.

Table 7. The liability structure of the banking industry (2010–2016[2])

							(millions of euro)
Description	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**April 2016**
Balance from other banks	71	40	6	17	32	43	71
Deposits	1,937	2,104	2,279	2,449	2,538	2,703	2,652
Other borrowings	23	30	19	13	14	18	18
Provisions paid back	0	0	2	2	3	3	3
Other liabilities	160	191	221	244	229	189	194
Subordinated debt	34	31	31	56	47	37	38
Admission obligations of the bank	-	-	1	0	-	-	-
Own resources	230	253	271	278	323	393	405
Total liabilities	**2,455**	**2,650**	**2,829**	**3,059**	**3,186**	**3,385**	**3,380**

[1] (Shoqata e Bankave të Kosovës, 2016, p. 5)
[2] (Shoqata e Bankave të Kosovës, 2016, pp. 5-6)

Table 8. The liability structure of the banking industry as a percentage (2010–2016)

Description	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**April 2016**
Balance from other banks	2.9%	1.5%	0.2%	0.5%	1.0%	1.3%	2.1%
Deposits	78.9%	79.4%	80.6%	80.1%	79.7%	79.8%	78.4%
Other borrowings	1.0%	1.1%	0.7%	0.4%	0.4%	0.5%	0.5%
Provisions paid back	0.0%	0.0%	0.1%	0.1%	0.1%	0.1%	0.1%
Other liabilities	6.5%	7.2%	7.8%	8.0%	7.2%	5.6%	5.7%
Subordinated debt	1.4%	1.2%	1.1%	1.8%	1.5%	1.1%	1.1%
Admission obligations of the bank	-	-	0.0%	0.0%	-	-	-
Own resources	9.4%	9.5%	9.6%	9.1%	10.1%	11.6%	12.0%
Total liabilities	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

During the past three years, the banking sector was characterized by deterioration of the performance of revenue generation. The banking sector's revenues in 2015 reached a value of 238.2 million euro, representing an annual decline of 2.9%, with a fall of 1.5% recorded in 2014. The decline in total interest income was primarily a result of the fall of 5.4% of revenue from interest on loans, which are the main determinant of the trend of total interest income, especially considering that they comprise the bulk of this category of revenues.

Table 9. Revenues of the banking industry (2010–2015)*

(millions of euro)

	Interest income				**Non-interest revenues**			
Period	Loans	Placements with banks	Securities	Other	Fees and commissions	Other operating income	Revenues from revaluation	**Total**
2010	169.6	2.7	3.1	0.4	37.5	3.9	-	**217.2**
2011	186.3	4.1	4.2	0.5	41.7	3.3	-	**240.1**
2012	194.9	2.0	3.0	0.6	44.2	2.4	-	**247.0**
2013	192.5	1.4	2.3	2.0	45.6	3.9	1.2	**249.0**
2014	190.7	1.1	2.9	2.5	44.6	3.1	0.5	**245.3**
2015	180.4	0.5	4.4	0.7	47.1	4.0	1.1	**238.2**

Similar to the previous three years, in 2015, the banking sector did reduce costs. The value of total expenditure in the sector in 2015 was 144.0 million euro, which is 22.1% lower than 2014. The decline in total expenses of the banking sector is attributed to improving the quality of the loan portfolio, which led to decreased costs to cover potential loan losses, and the decline of interest expenses on deposits.

Table 10. Costs of the banking industry (2010–2015)*

(millions of euro)

Period	Interest expense			Non-interest costs		General and administrative expenses			Provision for taxes	Total
	Deposits	Loans	Other	Fees and Commissions	Provisions for loan losses	Personnel expenses	Overhead cost	Other non-interest expenses		
2010	49	5	1	8	28	38	38	13	6	**185**
2011	51	6	2	9	35	41	34	23	5	**204**
2012	58	3	2	9	50	42	36	25	4	**229**
2013	58	3	3	9	46	42	36	23	3	**223**
2014	36	3	5	11	21	43	35	24	7	**185**
2015	17	4	2	12	(8)	44	36	28	10	**144**

Table 11. Interest income of the banking industry (March 2015–2016)*

(millions of euro)

Period	Interest income			Other	Non-interest income		Revenues from revaluations	Total
	Loans	Placements with banks	Securities		Fees and commissions	Other operating income		
March 2015	45.8	0.2	1.0	0.3	11.0	1.0	0.5	**59.7**
March 2016	42.8	0.1	1.0	(0.1)	11.5	1.2	1.0	**57.6**

During the past five years, effective interest rates have been falling continuously in all segments of the loan portfolio. This fact is associated with the decline in interest income mentioned above.

Table 12. The effective interest rates on loans (2010–2016)*

Description	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**April 2016**
Effective rates on new loans	14.0%	13.3%	12.2%	10.9%	9.3%	7.7%	7.7%
Effective rates to non-financial corporations	14.1%	13.0%	12.3%	10.8%	9.6%	7.4%	7.3%
Effective rates for households	13.8%	13.9%	12.0%	11.3%	8.9%	8.4%	8.0%

Although the decline of interest on loans has followed the decline of interest rates on deposits, the rate of decline in loan interest has been more pronounced. This has led to the gap between the interest rate on loans and the interest rate on deposits becoming smaller, which affects the generation of profit from these banking activities.

Table 13. The difference between interest rates on loans and deposits (2010–2016*[*]

Description	2010	2011	2012	2013	2014	2015	April 2016
Total effective rate for new loans	14%	13%	12%	11%	9%	8%	8%
Total effective rate for new deposits	3%	4%	4%	2%	1%	1%	1%
Difference	**11%**	**10%**	**9%**	**9%**	**8%**	**7%**	**7%**

It is important to note that non-performing loans (NPLs) started to decline after 2013. This shows the commitment of banks to keep credit risk within acceptable parameters and also demonstrates the willingness of bank customers to meet contractual obligations on time.

Table 14. Non-performing loans (2010–2016)*[1]

Description	2010	2011	2012	2013	2014	2015	April 2016
The value of non-performing loans	86	97	132	157	154	125	122
Provisions for loan losses in %	115%	117%	113%	111%	114%	115%	118%

The NPL ratio compared to total loans decreased after 2013 despite the fact that there has been slow credit growth. This shows that this ratio decreased due to credit payments in non-performing loans, which means that there has been a real improvement in the quality of the loan portfolio.

Table 15. Increase/decrease of non-performing loans (2010–2016)*[2]

Description	2010	2011	2012	2013	2014	2015	April 2016
Non-performing loans (NPLs) (%)	6%	6%	8%	9%	8%	6%	6%
NPL increase/decrease (%)	52%	13%	37%	19%	–2%	–19%	–3%
The percentage of credit growth	13%	16%	4%	2%	4%	7%	4%

*[1] (Shoqata e Bankave të Kosovës, 2016, pp. 8-11)
[2] (Shoqata e Bankave të Kosovës, 2016, pp. 10-11)

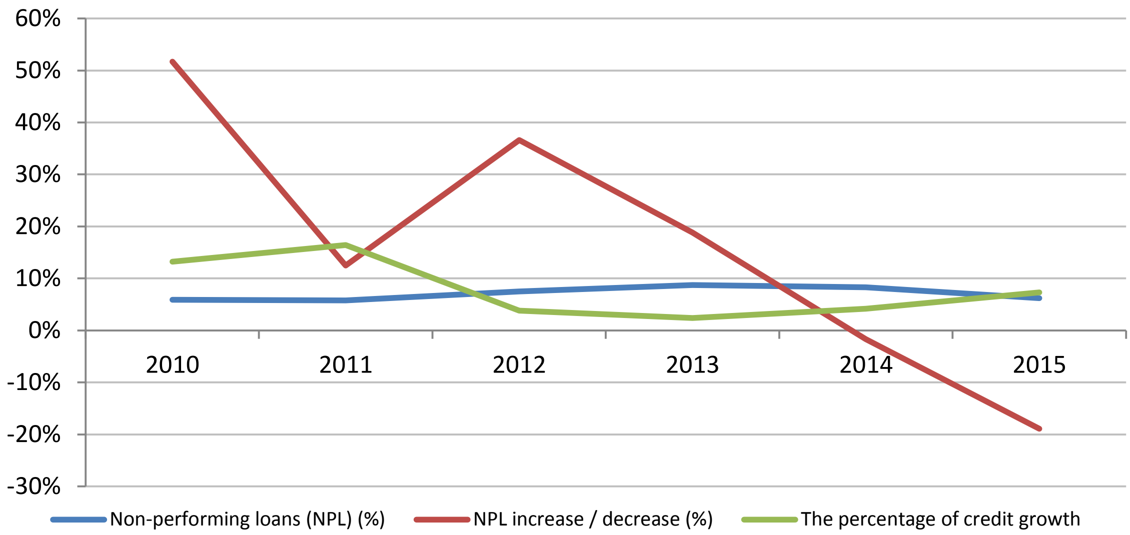


Figure 2. Increase/decrease of non-performing loans (20102015)

3.1. System of Credit Risk Management in Kosovo

According to the Central Bank of Kosovo (CBK), all branches of foreign banks licensed and operating in Kosovo should establish a risk management system for creditors according to the following requirements:

– Banks must have a system for credit risk management appropriate to the nature, scope and complexity of their activities.

– The system of credit risk management should include policies, procedures, rules and structures used by banks to manage credit risk.

– The system of credit risk management must continuously assess the quality of loans and other assets, including determining the adequacy of reserves for losses related to risk.

The CBK also requires banks to develop strategies and policies to manage credit risk. Strategy and policies for managing credit risk must be communicated effectively throughout the bank.

Access to credit and credit risk management should be communicated to relevant personnel in order to comply with policies and procedures.

The strategy for credit risk management aims to determine the bank's appetite for risk. Once the level of risk is determined, the bank can develop a plan to optimize its return while keeping credit risk within predetermined limits.

3.2. Credit Risk Strategy

Credit risk strategy should consist of a minimum of:

a. Declaration of the willingness of the bank to give loans based on different segments of borrowers and products and exposure type (commercial, manufacturing, consumer products, real estate, etc.), economic sector, geographical location, currency, deadline maturity and anticipated profitability;

b. Identification of target markets and the overall characteristics that the bank plans to reach in its loan portfolio, including distribution and tolerance levels of concentration;

c. Knowing the objectives of credit quality, earnings and growth;

d. Providing continuity in approach must take into account the cyclical aspects of the economy and resulting movements in the composition and quality of the loan portfolio.[1]

3.3. Policies for Managing Credit Risk

The CBK has set minimum requirements when developing policy for the management of credit risk:

a. Mission;

b. Determining the types of acceptable and unacceptable credit exposures;

c. Limitation of total loans outstanding in relation to total assets, deposits or capital;

d. The combination of the desired portfolio;

e. The distribution of the portfolio by loan maturity;

f. Defined market segmentation;

g. Lending conditions: price, time of return, and payments/capital requirements;

h. Required financial information;

i. The definition of a borrower qualifying for a loan;

j. Acceptable collateral and margins;

k. Lending authorities and approval process;

l. Limits on large exposures;

m. Credit limits for officials regarding their loan portfolio;

n. Exposures to insiders and their related interests;

o. New programming guidelines for credit;

p. Internal reports on the management of credit risk;

q. Organization of the credit function;

[1] (Rregullore për Menaxhimin e Rrezikut Kreditor, 2013)

r. Instructions for purchases and sales of loans with joint participation of financial institutions.[1]

3.4. The Organizational Structure for Managing Credit Risk

The CBK obliges all commercial banks to establish an adequate organizational structure for managing credit risk, clearly defining the powers and responsibilities of governing bodies in order to ensure that the function of selling the loans is divided into clear organizational and operational support functions and operational control of credit risk, including protection from potential impacts from senior management.

Furthermore, banks must provide the necessary structure for evaluating, measuring and controlling the concentration of credit risk according to parameters set by the regulator and other internal policies for managing credit risk.

The board of directors of the bank has the responsibility to develop strategies and a culture of credit risk within the institution, creating sound and equitable management of credit risk and supervising the parameters of risk on a regular basis determined by risk regulations.

The board of directors should be submitted with reports on credit exposures and the quality of their proposals for the improvement of the loan portfolio, proposals to increase or reduce credit limits, reports on capital gains, the results of stress tests in order to take strategic decisions to keep risk at a high level, as well as other issues that require their approval.

Kosovo’s commercial banks are required to establish a risk management committee (RSC), which has an obligation to monitor the policy of credit risk management and provide proposals for its continuous review of the system while always assessing credit risk management, analysing reports on credit risk exposures and limits, and describing the lines of authority and responsibility for credit risk management.

Moreover, the bank's management must approve and monitor the implementation of risk management procedures that assist in implementing credit policy of credit risk management. They also need to create an adequate system of reporting to the board of directors and the risk management committee and ensuring internal control and systems for identifying, measuring, monitoring and controlling credit risk.

The bank's management must provide sufficient resources for information technology and competent personnel to manage and control daily operations and periodically make an independent assessment of the function of allowing bank loans. The bank, through the stress test, will continuously and adequately evaluate its exposure to credit risk, taking into account possible changes in the future, the risk factors that affect the quality of the loan portfolio, and the financial situation of the bank, since it affects the net profit and capital adequacy ratios.[2]

[1] (Rregullore për Menaxhimin e Rrezikut Kreditor, 2013)
[2] (Rregullore për Menaxhimin e Rrezikut Kreditor, 2013, p. 6)

4. Conclusions and Recommendations

Observation, the literature review, the results of the survey conducted with the World Bank staff for a number of countries in the region and across Europe, as well as quantitative analysis on the management of credit risk and the impact of provisions for loan losses in commercial banks in Kosovo provided the following conclusions:

- Credit risk is considered by commercial banks and the regulator as one of the main risks to which the banking sector is exposed, and it can therefore be concluded that credit risk management is considered of primary importance to other types of risk.
- In the calculation of the coverage ratio of non-performing loans by provisions for losses on loans from the Central Bank of the Republic of Kosovo, there is a difference because the provisions included for the "sub-standard" category are not considered part of non-performing loans. The disproportion of calculating this justifies the fact that, according to the Regulation on Credit Risk Management, credit coverage in "loss" is defined to be 100%. Since the category "loss" is the weakest category, it appears that the coverage of non-performing loans, even if the entire loan portfolio in the category was classified as weaker, will not be able to exceed 100%, but is constantly reported by the CBK at a level over 100%.
- The banking sector's reserves (provisions) are sufficient to cover credit risk. Compared with countries in the region, Kosovo's coverage of non-performing loans is better than average.
- Banks in Kosovo have no guide or manual from the regulator that clearly defines the application of the methodology of calculating the total provisions or which model to use for certain types of loan portfolio, but they are recommended to use statistical models for the calculation of percentages of general provisions such as "roll rate", "average loans written off", "vintage analysis", "regression analysis" or any other renowned model which must be approved in advance by the CBK.
- The Central Bank of the Republic of Kosovo has managed to create a legal and regulatory framework for good management of credit risk and for the allocation of reserves for loan losses, which corresponds to European standards and, in some cases, is rather advanced compared to other countries in the region.

Recommendations

- For the calculation of the coverage ratio of non-performing loans by provisions for loan losses, it is recommended that the Central Bank of the Republic of Kosovo, in the calculation of this report, includes in both sides of proportionality only the classifications of "doubtful" and "loss", because the classification "sub-standard" is not considered part of non-performing loans. This would help commercial banks and other relevant institutions to have a clearer picture of credit risk coverage by provisions for loan losses and will present the real situation of the level of credit risk.
- The regulator should publish a guide that clearly defines the application of the methodology of calculating the total provisions and which model to use for certain

types of loan portfolio. This will help banks to more easily implement the appropriate model in their portfolio.

- Minimum and maximum rates of total provisions for certain categories of credit exposures and off-balance sheet exposures should be defined. Banks are not historically initial creditors, so determination of the minimum general provisions would provide them with a basis to begin developing a minimum provisioning model for determining general provisioning rates. In addition, the maximum rate would prevent that provision for the categories "standard" and "suspicious" from being higher than the category of "sub-standard". If such a thing happens, then there will be a tendency for banks to classify loans as "sub-standard" in order to avoid higher rates of provision.
- Banks should focus more on progressive approach methodologies (forward-looking) for provision sharing of loan losses to avoid situations in which they are unable to cover losses from loans.

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