History and development of the banking sector in Kosovo

Zogjani, Jeton and Kovaci-Uruci, Fife

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Jeton Zogjani
zogjanijeton@gmail.com

Fife Kovaci-Uruci
fife.kovaci@gmail.com

Abstract

This paper aims to discuss the main challenges and difficulties that the banking system in Kosovo was faced under the former Yugoslavia and the Serbian state(s). Also, this paper includes a discussion over the process of consolidation and development of the banking sector during the post-war period in Kosovo and the process of modernization in the post-independence period. The paper is based on the main banking indicators of the banking system in Kosovo, including bank assets, loans and deposits, banking performance and profitability indicators as well as banking electronic services over the last two decades. The highest growth rates of loans and deposits in Kosovo have been during the period 2004 - 2013, where household demand for loans and deposits have been higher during this period. Then, net banking profit in Kosovo has had an average annual growth of 80 million Euros during the period 2014 - 2020 and it is considered with the highest average growth over the last two decades. Since 2000, banking profitability indicators have shown a continuous improvement and their largest average annual growth has been during the period 2015 - 2020 while non-performing loans have had an average annual decline from 8.7% in 2005 to 2.7% in 2020. Also, electronic banking services have had an enormous growth and development, and these services have enabled banking customers to use them directly and continuously throughout 7/24. In conclusion, Kosovo has had the long way from a planned economy to a market economy but it has resulted in a difficult and quite challenging transformation. Since 1999, economic growth and the banking environment in Kosovo have enabled banks to improve, increase and expand their activities.

Keywords: Banking and Payments Authority of Kosovo, banking industry, banking performance and profitability, electronic banking services, MEB, National Bank of Kosovo (Bank Kos), UNMIK
JEL classification: E43, E44, E58, G18

Introduction

Kosovo has been an autonomous province within the former Socialist Federal Republic of Yugoslavia (SFRJ) for many decades and after 1989, Kosovo had the status of autonomy revoked by the Serbian state until 1999 when Kosovo has been administered by the United Nations Interim Administration Mission in Kosovo (UNMIK) (Bhaumik *et al* 2005) (IMF Report 2006). After the end of the war (1999), the financial and banking infrastructure in Kosovo was completely destroyed, the economy of Kosovo was almost destroyed (the lowest-income rate in the Balkan region) (World Bank Report 2017). Since 1999, the number of banks in Kosovo is constantly increased, these banks have operated with stable banking performance, profitability and liquidity, as well banks' loans and deposits are increased rapidly (CBK Report 2018; Haziri and Badivuku-Pantina 2011; IMF Report 2004). The paper is organized in these sections: a) section 2 provides a literature review on the banking system on the SFRY state (including

Kosovo) from the 1960s to the early 1990s; b) section 3 describes the challenges and difficulties that the Kosovo banking system is faced under the Serbian state during the 1990s; c) section 4 presents the development and consolidation of the banking sector in Kosovo in the post-war period; d) section 5 provides an overview of the key indicators of the banking sector in Kosovo; e) section 6 presents the conclusions of the paper.

The Banking system under the former Yugoslavian (SFRJ) state

During the period 1960 - 1980, the banking system in the former SFRJ state was considered one of the most advanced banking systems in the Central and Eastern European (CEE) countries (Radzic and Yuce 2008). However, the banking system of the SFRJ has had a strong market concentration, which has resulted in the reduction of the number of banks from 217 to 111 between 1960 and 1967 (Horvat 1971). At the beginning of 1970, the banking system of the SFRJ has continued with reforms and decentralization, when were established National banks for the republics and autonomous provinces (including Kosovo), but the National bank of Yugoslavia has represented the unified monetary and currency role for the whole former Yugoslavian state (Singleton and Carter 1982). On the other hand, banking activities (e.g. household loans) between republics and autonomous provinces were different, where the level of these banking activities had the lowest share in Kosovo (Četković 2015). During the 1960s, a lack of banking credits and other banking services have reduced their banking performance and they have contributed to increasing rural poverty and underemployment in the less-developed in the former SFRJ republics and Kosovo (Cullen 1979).

In the 1980s, the SFRY's banking system began to deteriorate from different financial and economic crises, such as banks' funds for investment on credit financing was steadily decreased, massive inflations, credit activities and loans for consumption were decreased as well as the lack of reforms and economic crises remained until the breakup of the SFRY (Četković 2015). In the late 80s, the Republic of Croatia (as a part of the former Yugoslavia state) has begun liberalization of banking markets and the share of foreign banking capital in the Croatian banking market began to increase during the 1990s (Kraft and Galac 2007). During the 1990s, the financial system in the former Yugoslavian state (including Kosovo) has been with high inflation and it has had its effects on the monetary environment, such as the loss of confidence in the domestic currency and its replacement by another foreign currency (Tyrbedari 2006). According to (OECD Report 2002), the 1990s were considered a decade of economic decline for the former Yugoslav state and its banking sector was faced with a lack of liquidity and bankruptcy, while the business environment for the state- and the socially-owned enterprises were almost destroyed.

The Banking Sector of Kosovo during the 1990s

In the 1990s, the banking sector in Kosovo has been less developed by modem standards and the imposition of sanctions for the Serbian state (including Kosovo) has caused many difficulties for the banking sector of Kosovo and its economy (World Bank Report 2001/a). During this period of time, Kosovo's autonomy status was revoked from the Serbian state and most of banks have transferred their hard currency to the Serbian state, when the role of these banks in Kosovo's economy was significantly reduced in the 1990s (World Bank Report 2001/b). Throughout the 1990s, Kosovo was characterized by the confiscation and freezing of foreign exchange deposits, high level of inflation, and these have caused two consequences for the banking sector of Kosovo: a) loss of confidence in the banking services and b) attempts to dismantle the whole banking system (IMF Report 2004). However, the National Bank of Kosovo (Bank Kos) has provided banking activities for over three decades in Kosovo and it has provided banking services for the larger industrial- and agro-kombinats, but its banking activities are stopped in 1990 when Kosovo's status was appropriated by the Serbian state (World Bank Report 2001/a).

Moreover, Bank-Kos's debts were over $ 700 million and it had caused major consequences for many socially owned enterprises and at the same time, the unemployment rate in Kosovo had exceeded over 55% (most of them were Albanians) (Bateman 2005; ESI Report 2002; World Bank Report 2001/b). In terms of the banking market, Kosovo had 5 large Serbian banks (such as Privredna Bank, Beobanka, Ekonomik Bank, Yugobanka and Vojvidanska Bank) and over 50 branches of these banks have operated in the banking market of Kosovo until late 1998 and/or early 1999 (RIInvest 1998). Moreover, these banks in Kosovo have loaned money to the socially- and the state-owned enterprises, but the role of these banks were significantly reduced mostly from the informal economy and at the same time, these enterprises had reduced their activities during the 1990s (World Bank Report 2001/a). In addition, bank branches that have operated in the banking market of Kosovo have mostly functioned as bank units of Serbian banks and their main objectives were to transfer hard currency from Kosovo to the Serbian state, but in the first months of 1999, these bank branches have closed their banking activities and they have returned to Serbia state (World Bank Report 2001/b).

Development of the Banking Sector in Kosovo during the Post-war Period

After the end of the war (1999), Kosovo had no own bank and its financial and banking markets had to be built from scratch (Bhatnagar *et al*. 2003; Kubiszewska 2012). In addition, financial intermediation has not existed and all transactions were realized only in cash (IMF Report 2001). In September 1999, the United Nations Mission in Kosovo (UNMIK) had legalized the German currency "Deutsch Mark" as the official currency in Kosovo and later, it was replaced in the EU currency "Euro" (Demekas *et al*. 2002). In fact, the German currency had a wide use as a foreign currency in the pre- and the post-war in Kosovo economy and its population was very familiar with the Deutsch Mark because most of the remittances were from Germany, so its currency was adopted unilaterally (Svetchine 2005). In November 1999, the UNMIK had established the Banking and Payments Authority of Kosovo (BPAK) and approved legislation on licensing, regulation and supervision of commercial banks in the banking market of Kosovo (Corker *et al*. 2001). The BPAK's immediate objectives were to provide an efficient functioning of a stable banking market, a safe system for domestic payments, the banking liquidity and solvency, and a sound financial sector in the territory of Kosovo (Svetchine 2005).

At the end of 1999, the BPAK had licensed the Kosovo Micro Enterprise Bank (MEB) as the first commercial bank in Kosovo in the post-war period and its initial banking capital was supported from different international institutions such as the European Bank for Reconstruction and Development (EBRD, the International Finance Corporation (IFC), the International Project Consult (IPC) and Entrepreneurial Development Bank (FMO) (Bhatnagar *et al*. 2003). On 24 January 2000, MEB (now named ProCredit Bank) has begun its banking services but the market demand for these services were extremely high, where the number of banking customers had increased over 16 thousand while banking branches were opened in some of the main regions of Kosovo by the end of 2000 (Hagen and Koehn 2006). In November 2001, the United States Agency for International Development (USAID) had established the American Bank of Kosovo (ABA) and the main aim of the ABA was to contribute the development of small and medium businesses as well as the economic development of Kosovo (Bell 2002). The ABA had over 12 thousand bank customers and at the same time, it had increased the number of branches and sub-branches throughout Kosovo, but later it was sold to another foreign private bank (such as Raiffeisen Bank International Kosovo) (Moalla-Fetini *et al*. 2005).

These banks with foreign-owned capital (such as ProCredit Bank and Raiffeisen Bank) had the largest share in the banking market and they still continue to have the largest banking assets than other banks in Kosovo (OSCE Report 2009). Between March and November 2001, five other banks with foreign- and domestic-owned capital are entered in the banking market of Kosovo (such as New Bank of Kosovo (BRK), Bank for Private Business (BPB), Economic Bank (EB), Kasabank (KSB) and Credit Bank of Prishtina (BKP)) and they have contributed to increase the banking competition and to improve the banking services in Kosovo (BPAK Report 2005). However, banks with domestic-owned capital have shown less management depth and lack banking experience (IMF Report 2004). Thus, the Prishtina Creditor Bank had bankrupted in 2006 but it had not endangered the banking market of Kosovo because its market share was only 4% (Haziri and Badivuku-Pantina 2011). In 2007, the Turkish Economic Bank (TEB) and Nova Ljubljanska Banka (NLB) were two new banks in Kosovo, but NLB Bank was established by merging two earlier banks (such as New Bank of Kosovo and Kasabank) that were operating in the banking market of Kosovo (Hoti *et al*. 2014).

During this time period, the banking sector in Kosovo is shown healthy and profitable and all banks have complied the minimum required amount of banking capital (based on EU directives), and their the ratio of nonperforming loans (NPLs) is declined while bank loans are increased rapidly, banking performance indicators are improved significantly, several new branches are opened, banking liquidity has remained sufficient (IMF Report 2004). Moreover, banks in Kosovo have operated with stable performance, banking profitability and liquidity, and well-capitalized (DOC Report 2017; Haziri and Badivuku-Pantina 2011). Since 1999, the number of banks is constantly increased and banks with foreign-owned capital have dominated in the banking market of Kosovo (CBK Report 2018). Also, the banking market in Kosovo is considered with the lowest nonperforming loans than other Balkan countries (ProCredit Report 2013). Despite these banking improvements, the banking efficiency in Kosovo is still less efficient than other Balkan countries (Toçi and Hashi, 2013). In terms of business environment, banks might have be limited to provide financial support for SMEs' activities in Kosovo and it is mainly caused by weak contract enforcement, low-risk assessment capacity, political risk and short term maturities of banks’ portfolios (maximum 5 years) (World Bank Report 2006).

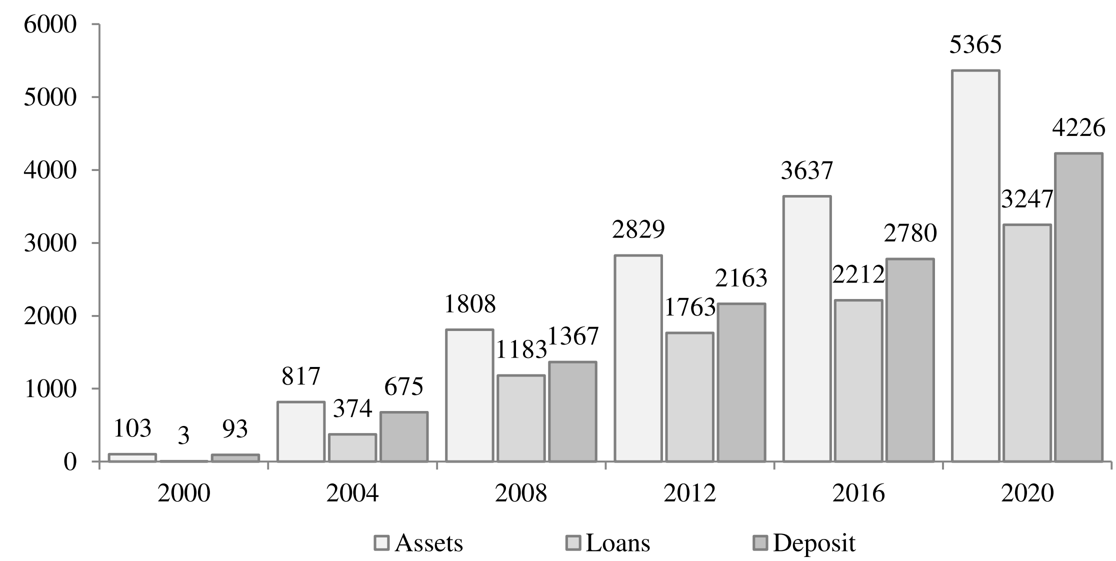
In 1999, the UNMIK had approved Regulation No 1999/20 for providing a modern payment system and a stable banking environment by established the BPAK and it would provide economic development for Kosovo in the post-war period (UNMIK Report 1999). In 2001, the UNMIK had amended Regulation no. 1999/20 and through it had enhanced the authority of the BPAK for the licensing, supervision and regulation of financial institutions in Kosovo (UNMIK Report 2001). According by (UNMIK Report 2006), the UNMIK had approved Regulation No 2006/47, which had amended the status of the BPAK as the Central Banking Authority of Kosovo (CBAK). After the declaration of independence of Kosovo (2008), the Assembly of the Republic of Kosovo has approved Law No 03/L-209 for the establishment of the Central Bank of Kosovo (CBK) and its main objective was to promote and maintain a stable financial system in Kosovo (Assembly of Kosovo 2010). Then, Law No 04/L-093 provides a sustainable promotion and sound management of financial institutions in the financial market in Kosovo (Assembly of Kosovo 2012). In addition, the CBK has approved the regulatory framework of corporate governance of banks, which is very important for maintaining the sustainability and stability of the banking sector of Kosovo (CBK Report 2016).

The Banking Sector of Kosovo in the Post-independence period

In 2008, the banking sector in Kosovo has continued its consolidation where new banks are entered in banking market and at the same time, the banking system has remained stable despite the appearance of crisis in the financial global markets (Luboteni and Hoti 2017). Despite the economic slowdown in Kosovo during these years, it has affected the quality of credit and profitability, but Kosovo’s banking system is still appeared adequately capitalized and solid liquidity (IMF Report 2013). The sustainable development of the banking system has led to increased confidence of Kosovo's banking environment and it has had a positive effect on attracting foreign banking capital, where the banking sector has been dominated by foreign capital (Kazinczy 2013). Thus, the banking sector in Kosovo is considered with stable banking performance relative to other Balkan countries, where the banking loans and deposits in Kosovo have shown solid growth, while nonperforming loans are constantly declining (World Bank Report 2017). Also, the entry of new banks has increased banking competition, modernization of banking technologies (such as electronic banking services) and development of the banking environment, as well as these factors have contributed to decrease a high degree of banking concentration by major banks in Kosovo (CBK Report 2019).

The development trend of the banking sector in Kosovo has managed to gain the trust of many banking customers (such as individuals and businesses) and it has had its effect on the enormous increase of banks’ assets, where they are increased from 103 million Euros in 2000 to 2.6 billion Euros in 2011 (CBK Report 2012; RIInvest 2011). In recent years, the banking assets in Kosovo have also continued to increase and their value has reached over 5.3 billion Euros in 2020 (CBK Report 2021). In the same way, increasing the trust of banking customers towards banks in Kosovo has affected to increase of bank loans and deposits, which in turn has directly impact on improving economic growth, investment and reducing informality as well as the unemployment rate (Haziri and Berisha 2017). During this period, bank loans have had a solid growth and they have been very important for the level of consumption and investment in Kosovo (CBK Report 2009/a). The dynamics of credit growth over several years has resulted with increasing of their value from 3.3 million Euros in 2000 to 3.2 billion Euros in 2020 (CBK Report 2021). Since the establishment of the banking system in Kosovo, banks' deposits are increased year by year and their total value is increased from 93 million Euros in 2000 to 4.2 billion Euros in 2020, while households and nonfinancial corporations dominate the deposit structure of the banking sector in Kosovo during this period (CBK Report 2009/b; CBK Report 2021; RIInvest 2011).

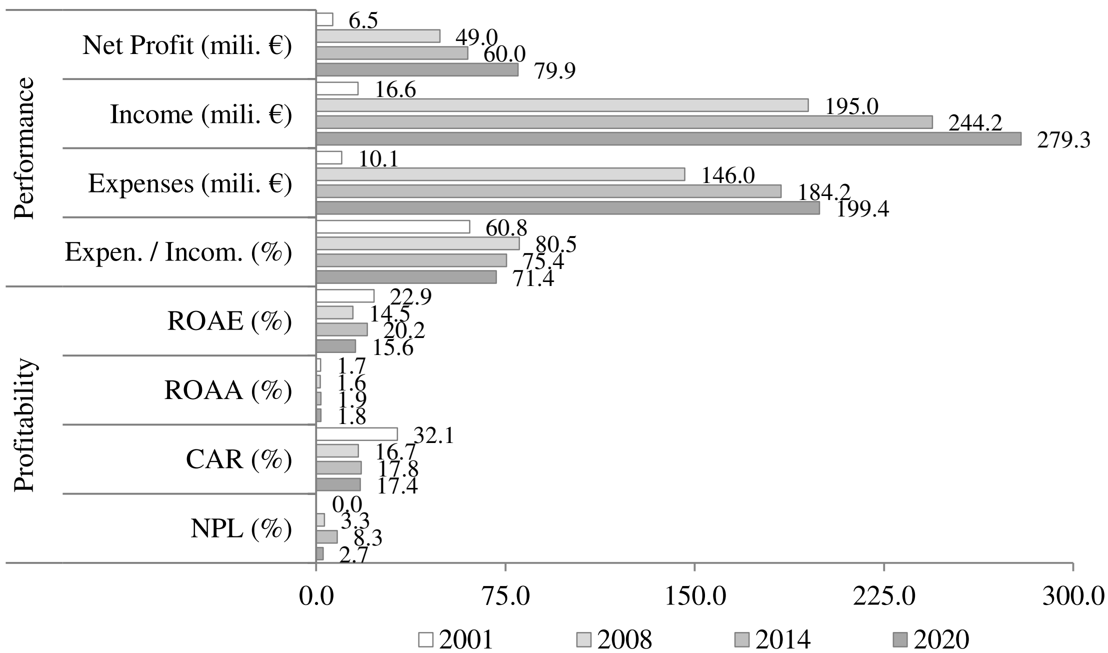
Figure 1 Total Assets, Loans and Deposits of the Banking Sector in Kosovo (mili. €)



Source: CBK Reports 2009, 2014 & 2021

In terms of banking performance, many authors have sought to identify the key factors that affect banking performance. As argued by (Borges and Tavares 2020; Ferrouhi 2018), banking profit, expenses (operating costs) and liquidity are considered as the main factors in evaluating banking performance. Since 2000, the banking industry in Kosovo has been quite profitable and their banking activities have been constantly expanding (RIInvest 2011). Between 2000 and 2014, the net profit of banks in Kosovo had an annual average of 24.5 million euros and then, net profit of banks had an annual average of 85 million euros during the period 2015 - 2020. During the last decade, banks have changed their traditional role in their markets and they constantly aim to find new sources for increasing their revenue (income) and performance (Trujillo-Ponce 2013). Authors (Chiorazzo *et al*. 2008; Elsas *et al*. 2010) conclude that banks have increased their performance/profit through diversification of revenue (income) throughout their markets. Since 2000, banks in Kosovo constantly have increased their banking incomes and expenses, where their value in 2001 was 16.6 million euros respectively 10.1 million euros while banking incomes and expenses in 2020 reached 279.3 million euros, respectively 199.4 million euros. Also, the income and expenses ratio of the banking sector in Kosovo is increased significantly but the percentage of this ratio is increased even more during the period 2008 - 2020.

Figure 2 Indicators of Banking Performance and Profitability in Kosovo

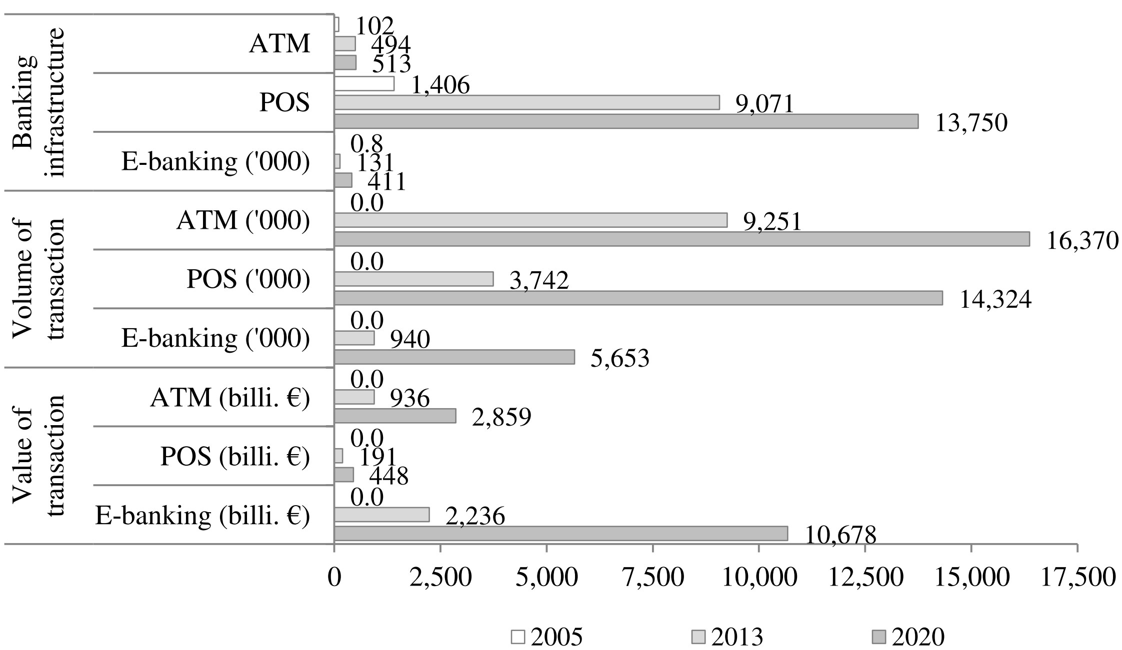


Source: CBK Annual Reports 2001 - 2021

Authors (Athanasoglou *et al*. 2005; Goddard *et al*. 2004; Petria *et al*. 2015) have used the return on average assets (ROAA) and return on average equity (ROAE) as a key bank profitability ratio and these indicators represent an important source for supervising the banking profitability on the country. Between 2001 and 2014, the ROAA and ROAE indicators in the banking market of Kosovo had an annual average of 1.5% respectively 17.4%, while these indicators have increased their annual average to 2.4% respectively 20.4% during the period 2015 - 2020. Then, well-capitalized banks have contributed to improving other banking profitability indicators, especially when ROA is used as the profitability measure (Trujillo-Ponce 2013). The capital adequacy ratio (CAR) is considered as one of the main criteria in the evaluation of banking institutions (Ferrouhi 2018). Over the last two decades, the CAR in the banking market in Kosovo has had a solid stability and its ratio had an annual average above 18% during this period. Different authors (Jolevski 2017; Khan *et al*. 2020; Souza and Feijó 2011) have concluded that the low level of non-performing loans (NPLs) improves the banking stability and these loans directly affect the financial position of banks. Thus, NPLs of banks in Kosovo have had an annual average of 5.2% from 2005 to 2020 and it is considered one of the lowest NPL rates in the Balkan region.

In terms of electronic banking services, most of banks in Kosovo have oriented their banking activities from traditional products and services to new banking technology and modernization of banking products and services (Ramosaj 2010). During 2004, banks in Kosovo have started to provide their banking services through automated teller machine (ATM) and points of sale (POS) while e-banking services were launched to use in the banking market in 2005 (CBK Report 2005; CBK Report 2006). A huge demand for these services has pushed banks to increase their number of these services in the banking market of Kosovo and the number of ATMs had reached 540, the number of POS services over 9000 while the number of e-banking services had exceeded over 410 000 bank accounts in 2020 (CBK Report 2021). In addition, the volume of banking transactions through these electronic services had increased enormously, where the number of transactions was over 2.2 million in 2005 while their volume is increased even more year by year (CBK Report 2005; CBK Report 2019). As a result of these services, banks have reduced their costs, enhanced banking services, provided more diverse banking services solutions, etc (Sadiku 2019). Through these electronic services, banks in Kosovo have improved their performance, efficiency and banking profit over the years (CBK Report 2018). Moreover, the use of electronic banking services in the banking market in Kosovo has contributed to the continuous reduction of cash payments (CBK Report 2012).

Figure 3 Structure of electronic banking services in the banking market in Kosovo



Source: CBK Reports 2005 - 2021

Despite the development of electronic banking services and the rapid increase in the use of these services, the number of banking customers in Kosovo who use these services is smaller than in many other countries in the region (CBK Report 2018). In addition, the economy of Kosovo is characterized as a small and concentrated economy and it has provided a limited ability of banks to diversify their risks in different sectors of Kosovo's economy (e.g. the trade sector includes about a third of all banks' loans while the households sector includes another third of banks' loans of the banking market in Kosovo) (IMF Report 2013). Also, debt collection difficulties were identified as the main obstacles to reducing the growth of banks' lending in Kosovo (World Bank Report 2017). On the other hand, high collateral requirements are identified as the main barrier to access to finance by SMEs (EIB Report 2016). Many businesses in Kosovo have identified low loans ratio that provides for businesses (based on loan/GDP ratio), uncompetitive behaviour in the banking sector, a high level of contract enforcement risk, a high level of interest rate spread (difference between loans/deposits) and high informality as the main obstacle in their business environment (OECD Report 2016).

Conclusion

In this paper is discussed about process of challenges and reforms of the banking system under SFRJ state (including Kosovo), the main difficulties of the banking system in Kosovo under Serbian occupation during the 1990s, process of consolidation and development of the banking sector in Kosovo during the post-war period and the main banking indicators in Kosovo in recent years. Over the last two decades, banking assets, loans and deposits of the banking sector in Kosovo have had a stable increase and at the same time, indicators of banking performance and profitability have shown a solid growth. In terms of electronic banking services, banks in Kosovo constantly have expanded their banking activities through their services and these services have enabled the reduction of banking expenses, the increase of the quality of banking services, as well as the increase of the value and volume of banking transactions. In conclusion, the banks in Kosovo should increase and improve their banking indicators include in this paper. They will have an effect on further improvement of banking productivity, banking performance and profitability. Also, these indicators will play a key role to enhance and to improve the banking competition in the banking market of Kosovo.

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