Global financial crisis and its impact on the financial system of Kosovo

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Abstract

The Kosovo's Financial Sector is one of the newest financial sectors in Eastern Europe whose developments began in early 2000. Kosovo's banking sector consists of 8 privately owned commercial banks, the insurance companies which make up 5% of total financial sector assets by 10 insurance companies with over 70% foreign equity ownership. Pension funds also participate by about 1.5% of the total financial sector assets.

In the long history of global financial crisis, and such have been over 120, the current crisis is regarded as among the most profound (similar to that of year 1929) and comprehensive on the speed and breadth of development. The sources of the crisis lie in the three pillars of the functioning of banking institutions: inadequate management of credit risk and liberalization of excessive lending policies; inadequate capitalization of the banking institutions; and inadequate management of their liquidity.

Kosovo is part of Europe and cannot act as a closed oasis. The concept of a new model of financial sector in Kosovo is thought to create additional mechanisms that will enable advancements in the development of Kosovo's financial sector with special focus in the field of investment and that mean financial market development namely the securities market.

Legal infrastructure on debt market in Kosovo will create a legal possibility that the central and municipal government have the opportunity to borrow in order to implement their development policies. It is unimaginable implementation of the project without information technology support. This support has to do with that that information technology offers its capacities in supporting of all the activities that include the operation of the securities market and the creation of its electronic data base.

Key words: Financial market, ffinancial crisis, financial system, financial institutions, financial intermediation.

Jel code: G20, G21, G22, G23, G24, G28, N20

1. Introduction

Financial sector in Kosovo is one of the newest financial sectors in Eastern Europe whose developments began in early 2000 when the Banking and Payments Authority of Kosovo at that time (now the Central Bank of the Republic of Kosovo) has licensed the first bank in Kosovo Micro-Enterprise Bank by January 17, 2000. Since then Kosovo's financial sector is continuously developing and advancing, supporting in this way the continuous economic development and drive towards trade economy system. Financial structure is dominated by commercial banks, which in 2008 constitute 90% of total financial sector assets.[1]

Kosovo's banking sector consists of 8 privately owned commercial banks, operating through bank branches throughout Kosovo. Commercial banks activity mainly involves the provision of traditional products and services, but with an active trend of launching new and modern products. Besides commercial banks in Kosovo, one other important component are the insurance companies which make up 5% of total financial sector assets by 10 insurance companies with over 70% foreign equity ownership. The main activity of insurance companies is to provide non-life insurance products, one of which is the product of responsibility to the third party, the auto insurance which is provided as a mandatory source. However in the last two years has been a significant increase of voluntary products such as property insurance, professional liability insurance, health insurance, goods and services insurance etc.

Pension funds[2] also participate by about 1.5% of the total financial sector assets.[3] This amount includes additional funds of pension schemes offered by the employer to employees, except compulsory contributions for Pension Savings Trust of Kosovo.[4] In Kosovo also operate other financial institutions, who engage in lending activity in the economy. Other financial institutions are micro-finance institutions that perform lending to the small businesses, where the main sources of their financing are foreign donors. Today the financial sector in Kosovo has reached satisfactory level of financial service delivery, increase volume of quality economic bid, raising the country into a corresponding level of neighboring countries. Although economic growth is insufficient to address the challenges facing in Kosovo, the financial sector makes available a basic offering to support projects and household economies. Taking into consideration that the developments in the financial sector up to a certain extent are dictated by overall economic development, it is worth to mention a few words about the characteristics of economic development. Gross Domestic Product (GDP) had increased about 1400 euro per capita, Kosovo's economy in 2007 marks a real GDP growth of 3.5% as a result of private sector. In 2007 inflation was 4.4% after a period of stable inflation.

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1 Bankat Komerciale, Kompanite e sigurimeve, Fondet Pensionale, Institucionet MikroFinanciare, Institucionet Financiare Jo-bankare

2 Dietz, Peter, O. (1966), Pension Funds: measuring investment performance, Published by Graduate School of Business, Columbia University.

3 Fondi Pensional Privat Slloveno Kosovar

4 Trusti i Kursimeve Pensionale

2. Roots of the crisis and its main causes

In the long history of global financial crisis, and such have been over 120, the current crisis is regarded as among the most profound (similar to that of year 1929) and comprehensive on the speed and breadth of development. It has hit powerful countries like USA, European Union countries and the Far East and then spread to emerging economies. It has included the banking sector and capital markets and soon included the real sector of economy, some of which have now announced the entry into recession.

The sources of the crisis lie in the three pillars of the functioning of banking institutions: the inadequate management of credit risk and liberalization of excessive lending policies, inadequate capitalization of the banking institutions and inadequate management of their liquidity.

Given the fact that lending by financial institutions is the source of funding for many economic activities, problems in this area had "domino effect" for many of those economic activities. The widespread problem has been evident in real estate. The news that Lehman Brothers (investment bank in the U.S. with over 150 years' experience) was in near collapse, later to officially announced that have applied for liquidation, were just as shocking as the news that Bank of America will pay about $50 billion for Merrill Lynch, another name in the iconic Wall Street. And as if all this were not enough, American International Group, very powerful insurance company in the United States announced that it will sell some of the problematic assets to increase liquidity and enhance reliability to investors.

Concerns about financial crisis began to grow, the US Government already started interventions first in Fannie Mae and Freddie Mac (giant financial system in real estate) with $200 billion for recapitalization, and also was the creator of agreement of purchase for Bear Stearns by JP Morgan's for $29 billion. Further the Fed along with 10 other banks announced possibility of a fund of $700 billion to help financial institutions affected.

Global losses so far reached billions of dollars, not including the unknown part of the financial statements (Bail out, the agreement of the value of the stock decline, union agreements, purchase of banks and financial institutions) began to ripple effect in Europe; Belgium, England, Germany and France were forced to recapitalize banks as in case of Fortis, Northern Rock and the other was very evident that a major action with drastic intervention by the state would be inevitable. Finally after debate in the House of Representatives on October 3 was approved Bailout Law (the law of salvation) plan for salvation history of the financial system and greater intervention in the American economy since the Depression of 1930s. This plan allows the U.S. Treasury to buy problem assets in the amount of $700 billion to help restart credit in banks and financial institutions.

In the same way, the European countries have applied equally measures to rescue their financial institutions, to guarantee all deposits at six big EU banks. This has stabilized the situation in the EU but because the free movement of cash can potentially attract depositors and borrowers from other EU countries, by creating advantage to calm depositors Bank of England has raised the deposit guarantee limit from £35,000 to £50.000. Originally problems began in unsound practices in real estate lending (mortgage), and was shown only when real estate prices fell in the U.S.

The problem became complex taking into consideration that real estate packaged as "securities" and sold to investors, including major investment banks. These securities evolved in derivatives. The impact of these securities on financial institutions was very large, when their value fell sharply after the collapse of the price of real estates. This has affected investment banks, entities that were involved in real estate (Fannie Mae & Freddie Mac) and insurance companies like AIG. Furthermore, the following are some of the metallized factors that caused the crisis:

1. Rapid rise for years of assessment of real property disproportionate to incomes and other economic factors (inflation, growth) known as the Housing Bubble in the U.S.;
2. The emergence of different types of loans in real estate sector known as subprime;
3. Undervalued credit risk due to the intensification of competition in financial markets;
4. Creation of more complex financial instruments, where many banks were unable to adequately manage risk;
5. Regulations and these instruments have not fit properly because of excessive deregulation failed to understand the challenge.

Losses of major global banks which were exposed in real estate loans in the U.S. contributed to a variety of banks to be unable to manage and cover obligations to their investors. This led to the situation where the credit market, including especially interbank lending, has collapsed. Inability to find new investment funds because of very small demand of investors is pushing all other financial markets still to suffer a significant decrease.

3. Impact of global crisis in Kosovo's financial sector

Kosovo is part of Europe and cannot act as a closed oasis. This proves the ownership structure in these institutions, of which about 80% is foreign, owned and is well integrated financial system in the region of the European Union. Yet financial markets crisis has not had a material impact on financial sector due to Kosovo limited exposure outside of the Kosovo unless the Pension Savings Trust, which ended with the decline of the value of shares in the financial markets, mainly on 50% in U.S. markets. The real sector of economy during this period signals showing no collapse or collision of the global financial developments. Having in mind size to which the financial crisis has grown the CBK which supervises the Kosovo Pension and Savings Trust and Commercial Banks, has intensified contact and monitoring with financial institutions.

Banking sector is playing proactive role in addressing issues affecting the progress of the activities of financial institutions to verify how the financial crisis in global markets has affected the financial sector of Kosovo and its potential impact on the real economy. Furthermore monitoring by on-site inspections and off-site impact analysis has tested that impact. Fields which could potentially be affected by financial crisis banking activity are:

1. External exposure like placements or interest-bearing demands with other banks, the greatest would be outside exposure the greater would be losses;
2. Exposures based on funding from outside sources, which also include net of credit lines from international financial institutions (KFW, EFSE, FMO) supporting the financial resources have implications for growth, namely the limitation of lending activity by banks.
3. Safety/stability of the financial resources with special focus on exposure of the biggest depositories. The more diversified the source of the deposit to be, the smallest risk will be;
4. Loans to deposits ratio to be adequate and also adequate level of liquidity to pay short term obligations;
5. The level of nonperforming loans (bad loans);
6. Support that banks can provide for branches operating in Kosovo. Banks should serve as a source of funds when faced with their branch loss. However the crisis has affected many banks in the international level, so the assistance they can provide the branch where the crisis had no impact may be questionable.

Sources of funding are considered to be stable after coming mainly from the base of deposits, and smaller size of foreign credit lines (EFSE, KFW, and EBRD). And further, banks in Kosovo are not investment banks and their participation level to consolidate the group is not very large, so their need for capital, for different scenarios of potential, with reasonable certainty, is expected to meet by banks. However it is necessary from time to time to be monitored their financial situation at the level of financial statements with the group, with agreements of understanding of the supervisory authority which supervised group, though to ensure that CBK was informed in time for possible dilution.

The pension system and in particular the second pillar (Pension and Savings Trust) and the third pillar (Slovenian-Kosovo Pension Fund) are greatly influenced by the financial crisis in the U.S. especially because of exposure of Trust very large investments in these markets. Trust assets invested through 5 managers who were selected by the Trust Steering Board, who under the governing law are the exclusive authority for developing and implementing government policy, and in particular the investment policies of the Trust assets.

Investment policy adopted by the Board of Trustee in 2002 and 2003 was mostly conservative and has invested in the international market of cash, and cash manager has been ABN-AMRO Global Liquidity Fund, and return on investment has been 1.

Given the age profile of participants KPST and the time when they are eligible for pension benefits, in order to obtain the greatest return on investment in the long term, the Board has decided in 2004 that 24% of funds to invest in the stock market through indexed funds. Board has selected Liquidity Global Index Fund Vanguard as a fund's manager with approximately 2000 global companies. This has resulted in investment returns in 2004 to be 1.3%. But in 2005 the Board decided to increase the percentage of investment in the stock market to 50%, which resulted in a net return on investment of 8.7%.

In 2006 the Board of Trustee has made further diversificon of investment policy tools. Then Board has contracted another fund manager Schroders (Strategic Bond Global Fund) and the European Credit Menagment as a manager of securities markets. Thus, the Trust now has 55% invested in share assets, 5% in cash, and 40% in the securities market. This has result by the investment net return in 2006 to be 8%.

In 2007, after good returns in the first half of the year, as a result of initial swings in financial markets, the return was only 1.7%. Board of Trustee considering long-term nature of pension funds investments still remain faithful to the stock market, with the argument that it always gives better results in the long run despite the time-after-time the falls. In early 2008 the Board begins with investing the amount of 5% of funds in foreign exchange market which offers very good returns on investment, by engaging FX Concepts. In 2008 the Board also decided to invest 5% of assets, for the first time in Kosovo through Raiffeisen and Pro Credit bank.

Rapid developments in the international financial crisis in 2008, in particular during the months of September and October, when the Trust had now left without a board, determine that for 2008 the net return on investment to be negative -26.8%. The value of Pension unit was in October 0892, and as a result, the value of the Trust's assets managed by Trustee fell to 251milion euro in relation to contributions paid in the amount of more tha 315€ million. These are calculated losses reported by Trustee until 31 October 2008. If for any reason Trustee could have sold these shares in one of the dates where the value of shares in the financial markets was small, then the loss of "accrued" would become "real loss".

Slovenian-Kosovo Fund Pensions, part of Prva Group operates in Kosovo since November 2006. Investment policy of the Fund is conservative and gives the opportunity of investing in each class of instruments. In the mid 2008 when the financial crisis began to deepen even more Fund moved their investments from stock market in the instruments that were safe as government securities, corporate and bank deposits, and kept only a small part of the stock market. In this way the fund is faced with the loss in value of the pension unit.

4. Other Financial Sectors

The insurance sector and microfinance institutions also had no major impact because of the nature of their investment activity. Insurance companies have had very limited potential impact of financial crisis in Kosovo, and it was through reinsurance companies, operating in Kosovo who bear a part of the risk they take upon selling insurance contracts. Also the microfinance sector can have a significant impact on their requests for funding from donors. In macroeconomic terms, indirectly financial crisis has a longer duration may affect inflation. Many small businesses that have been funded by family members residing outside Kosovo can be affected. Constructions may slow or even stop, the number of unemployment may increase, and this can affect the banks. The value of collateral may decline and the credit portfolio for customers can be affected. All these are all hypothetical presuppositions which may occur if the financial crisis extended for a longer time.

5. The concept of a new model of financial sector in Kosovo

As seen from above, the financial system in Kosovo, despite all the above mentioned developments continues to remain a traditional financial sector that provides basic financial products and services that meet the basic needs of clients who were accessing these financial products and services. But it is more than necessary to create additional mechanisms that will enable advancements in the development of Kosovo's financial sector with special focus in the field of investment and that mean financial market development namely the securities market.

Creation of the securities market would enable companies, governments (central and local) and other organizations to trade securities (financial insurance). In the market for the securities, companies and governments can raise long term funds. It is a market in which money loans are made for longer periods than year. Capital market includes the stock market and bond market securities. Securities market is supervised by Regulators of these markets in certain countries to ensure that investors are protected from fraud.

In the securities market, the organization designated as the private sector but also in public sector, sell securities in all capital markets in order to raise funds for business or other enterprises. For example, a company can make an initial public offering (IPO) in order to reach the investing public and raise funds for its business. Government can issue Treasury bonds, in order to raise investment funds. These types are generally primary sales. Secondary markets are those where the new shares and bonds issued in the primary markets are traded, where existing securities are sold and purchased from an investor, usually through exchange (e.g. New York Stock Exchange).

In the primary market, companies, governments or public sector institutions can provide financing through the sale of new shares or the issuance of bonds. This is typically achieved through the union of the securities agents. The sale of emission to investors is called new issuance, in case of making new shares issue, this sale is an initial public offering (IPO). Agents earn provision which relies on the supply for securities, although can be found in prospect. While secondary market, otherwise known as after-market, involves the treasury bonds resale of existing securities. This is typically found in a stock exchange, although this is not rule. Individual investors usually buy, sell and trade with each other, even though it may include organizations.

In the environment of Kosovo the model will first be very basic and will include only the primary market operations with a total of four stages:

1. Government securities;
2. The purchase of these treasury bonds from financial institutions (commercial banks, insurance companies, pension funds, financial institutions);
3. Management of purchase transactions by the Central Bank as fiscal agent of the Ministry of Economy and Finance;

4. Selling treasury bonds from financial institutions at the time of maturity to the government, to ensure return of loan and profit from the interest accumulated.

Secondary market, known as after-market is the financial market where securities previously issued and financial instruments such as stocks, bonds and other financial instruments are bought and sold. Name "secondary market", also is used in reference to attempt market for used goods or assets, or any alternative use of existing assets where the product or customer is the basis of secondary market (e.g. cereal market traditionally has been used in order for the manufacture of food or animal feed, but the secondary and the third market has managed to use for ethanol production).

By the primary issue of the securities or financial instruments, investors buy these securities directly from issuers such as corporations that issue shares in an IPO or private placement, or directly by governments in case of treasury bonds. After IPO initial issuance, investors can buy from other investors in the secondary market. Secondary market in terms of diversity of assets may differ from these fragmented or centralized, and from non-liquid in another liquid.

The major stock exchanges are the most obvious example of liquid secondary markets - in this case, the shares traded from public companies. Stock exchanges as New York Stock Exchange, NASDAQ and American Stock Exchange provide a secondary market, liquid and centralized for the investors who own shares traded on these exchanges. Though liquidity of these exchanges is under question after the global financial crisis of 2008 which still continues with economic recession of these countries.

In the Kosovo environment secondary financial market development in practical terms would have to function after it is established the primary market. Like primary market operations the secondary market operations are performed by making financial transactions that start after the completion of phase fourth as shown in the scheme of functioning primary financial market, where financial institutions which buy purchase treasury from banks and other financial institutions, with bank to bank or insurance company and edge trading cycle can replay until all actors involved in this market.

6. The Implementation of the Model

The successful implementation of the model of creating opportunities for investment which implies the creation of the securities market requires this infrastructure:

1. Infrastructure legal necessary which means the creation of the law on debt market in Kosovo;
2. Information Technology needed to implement the Model;
3. Necessary framework to implement the project.

6.1. Legal Infrastructure on debt market in Kosovo

This legal infrastructure will be created, a legal possibility that the central and municipal government have the opportunity to borrow in order to implement their development policies. By this legal framework actually will start operation of Kosovo securities (bonds and bills) market and thus would also create legal opportunities for investment in these financial instruments.

This law will provide the Republic of Kosovo authority to borrow money, for the loan guarantees, to pay costs of issuing debt and to pay principal and interest on its public debts. In addition this law will enable the Minister of Economy Finance to take care for the entire management and administration of the public debt and authorized programs, loan guarantees of the Republic of Kosovo, including limitations, the development of a debt management program and a strategy for debt management.

The law will create the basis for establishing the primary market which market refers to initial issuance of securities like treasury bills by the Ministry of Economy and Finance to their buyers, as well as secondary market of government securities after initial issuance usually occurs between initial institutions. Also there have to be appointed the Fiscal Agent of the Ministry of Economy and Finance, which usually is the Central Bank, authorized to perform the following on behalf of Ministry of Economy and Finance and its approval;

1. To develop the auction market for government securities;
2. To be responsible for the registration of issuances and transfers of securities. It is preferred that the process goes in electronic form so that transactions occur in automated process;
3. To establish and maintain an electronic registration system for government securities, or appoint an agent acceptable to the Ministry of Economy and Finance, which will register the issuance, transfer and other transactions, and repurchase all securities to form "electronic registration".

Fiscal agent must also facilitate the establishment of secondary market for government securities by expanding access to electronic registration system, and the guardian that keep government securities, Central Bank, who are subject to its responsibilities for conducting payment of all transactions in government securities.

6.2. Necessary Information Technology for the Implementation of the Model

It is unimaginable implementation of the project without information technology support. This support has to do with that that information technology offers its capacities in supporting of all the activities that include the operation of the securities market and the creation of its electronic data base. This means establishing the system of registration which is the computerized system established or authorized by the Ministry of Economy and Finance, to record, holders name, issue, account status, service and redemption of securities guarantee records. Furthermore, it governs all descriptive data for the register of state guarantees that should be stored and maintained in adequate information technology software.

In addition, the use of information technology helps to create different tests which are very necessary for various financial and other reports. Adequate information technology software and hardware facilitates and accelerates the processing of much needed information upon request of the parties. There is possibility of sorting and providing information to the various levels and institutional structures.

6.3. The necessary framework for project implementation

In order to complete the project and to succeed its implementation, the most important part of the project is sufficient and professional framework. Without sufficient contextual and professional framework the implementation and modern management or its practical application will be unable. Staff levels of management require a different number of sufficient and professional staff for the concrete project implementation. Staff who is directly involved in this project should first know very well the model as the concept of project implementation. During the project implementation until it is finalized, there is need for dedication and seriousness required for implementation. The main aim of this model is to provide additional opportunities for the development of the necessary infrastructure and suitable environment for the provision of financial instruments issued by the Government for net long-term benefits and in the same time to offer individuals and legal entities additional forms of investment. Walking with time and changes that occur in the district especially in the developed and advanced area are strategic interest of the whole system.

Conclusion

This model is not one of the simplest models of the establishment of financial markets and that will fit the circumstances of the development of Kosovo. This is a model that is built on the basis of experiences in developing countries. Keeping this model in basic level provides the basic success of this model because the complexity can be very important issue. The whole concept works through the development of lending and borrowing activities.

Lenders are financial institutions

Individuals will invest their money by buying treasury bonds or stocks of various companies to benefit from interest rates or dividends, while companies that face surplus that is not needed for a certain short time; they invest it in financial markets to benefit from interest rates provided by these markets. This is mainly relevant for companies that have steady flow of cash.

Borrowers can be governments and companies

The company will borrow to finance their cash flow for the short term or medium term, to increase their business. In other hand governments very often exceed their revenues. In order to cover the difference, governments often borrow additional funds from financial markets. Governments also borrow for public industries, municipalities, local government or social organizations. Governments borrow by issuing treasury bonds. As a strategy used by the government to cut debt is by influencing inflation. This activity introduces the feature of primary and secondary market securities with an adequate legal and personnel infrastructure create very good wrestler in the development of financial market systemic benefits.

The primary benefit is observed in promoting overall economic development, in which case financial institutions their excess liquidity will invest in government treasury bonds and will invest abroad, then government by receiving loans from financial institutions will invest in projects that go in favor of economic development of the country. All this is being looked at in light of the primary financial market. Furthermore the development of secondary financial market will encourage mediation between financial institutions to develop mentioned transactions that will affect both the level of macroeconomic development and the level performance of individual financial institution.

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