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BANKING SECTOR:
FACILITATOR OR BARRIER

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ABBREVIATIONS

AKB	Alliance of Kosovan Businesses
BiH	Bosnia and Hercegovina
CAK	Cadastral Agency Of Kosovo
CBK	Central Bank of Kosovo
EBRD	European Bank for Reconstruction and Development
EU	European Union
EURIBOR	Euro Interbank Offered Rate
FDI	Foreign Direct Investments
GDP	Gross Domestic Product
HDR	Human Development Report
HHI	Herfindahl-Hirschman Index
IMF	International Monetary Fund
KCA	Kosovo Competition Authority
KCC	Kosovo Chamber of Commerce
KEC	Kosovo Energy Corporation
KFOS	Kosovo Foundation for Open Society
KPST	Kosovo Pension Savings Trust
LIBOR	London InterBank Offered Rate
MFIs	Micro Financial Institutions
NPLs	Non-performing loans
PAK	Privatisation Agency of Kosova
p.p.	percentage points
RIINVEST	Riinvest Institute for Research and Development Kosovo
ROA	Return on Assets
ROAA	Return on Average Assets
ROAE	Return on Average Equity
ROE	Return on Equity
SMEs	Small and Medium Sized Enterprises
SEE	South-East Europe
TAK	Tax Administration Kosovo
UN	United Nations
UNDP	United Nations Development Program
WB	World Bank

EXECUTIVE SUMMARY

Raisen from the scratch the banking sector managed to gain profoundly the trust of individuals and businesses across the country. Today several international reports see the banking sector as strong and sustainable vis-a-vis financial crisis in the region and beyond. However, although sustainable and growing, banking sector has remained amongst top barriers in Kosovan business environment. High interest rates and low access to finance that businesses face are hampering seriously the growth of private sector and hence the economic development of Kosovo. Almost twelve years after its establishment, given the perception of stakeholders, one can hardly argue that banking sector has played its fascilitators role on the economic reconstruction; instead today this sector imposes a serious barrier in any potential initiative from the private sector.

This report provides an analysis of the current situation of the banking sector, and the potential impact that banking sector has on economic growth. Previously, many study reports have indicated that due to the market concentration in the banking sector in Kosovo, credit interest rates seem to be the highest in the region. Small and Medium Sized Enterprises (SME) surveys in the past have also indicated that credit interest rates are too high, and one of the main barriers to their business growth. Experts of banking sector also indicate that interest rates are the highest in the region and potentially unaffordable for SMEs in Kosovo. In this regard, Riinvest Institute with the support of Kosovo Foundations for Open Society (KFOS) saw the need for a research report as a primary attempt in accomplishing a comprehensive analysis of determinants of credit interest rates in Kosovo, as well as analyse a large variety of potential problems related to difficulties in accessing financial resources offered by commercial banks. Micro Financial Institutions (MFIs) consist of a very small portion of the financial sector, thus are not subject of this study.

Methods of analysis include desk research, a comprehensive survey of the Banking Industry covering various aspects of their products and services with the main focus on interest rates, as well as an SME survey conducted with 600 SMEs for obtaining the perceptions of the business community regarding credit interest rates offered by the banking industry. Face to face in-depth interviews were conducted with the bank representatives, SMEs, as well as other stakeholders, such as the Central Bank of Kosovo (CBK), Business associations, Kosovo Cadastral Agency (KCA), and regulatory agencies. Various attempts were made to interview the Ministry of Finance, the Ministry of Justice, and the Judicial Council, but they declined our requests. A semi-structured questionnaire containing specific questions and a number of open ended questions were completed for each interviewee.

Results show that the banking sector in Kosovo is characterized with a large presence of foreign capital, where 89.2 % of total assets are managed by foreign banks, where foreign capital is dominant in 6 of 8 banks operating in Kosovo. Their presence has contributed in the modernization of the financial system by bringing more advanced practices in finance and in managing banking operations. Results also show that banks in Kosovo have continuously expanded their activities, increased their deposits, assets and also credit to businesses and households year by year. In terms of deposit maturity structure, in December 2011, the time deposits with less than two years of maturity represented 82 % of deposits, whereas, loans with maturity of over two years represented 72.4 percent of total loans, remaining nearly the same compared to the previous period. This reflects a huge mismatch between loan maturity and deposit maturity, and according to banks, one of the reasons for high credit interest rates. The general practice throughout the world shows that household deposits are almost completely renewed near the end of its maturity, thus putting into question the arguments put forth by the commercial banks for high credit interest rates.

In terms of its liquidity position (the ratio between loans and deposits) in December 2011, this ratio stood at 80.8 % slightly exceeding the recommended requirement set out by the CBK[1] , and thus slightly lowering its liquidity position. Having said that, all loans over 10,000 euros as per commercial bank requirements are collateralized, and especially SME loans are often guaranteed by real estate, either the company's warehouse or offices, or the home of the owners. Thus the coverage ratio of credit with collateral in Kosovo in 2011 stood at 236.1 percent, marking the highest collateral to loan ratio in the region (the average ratio in the region was 126.6 percent)[2] . In terms of collateral, the SME loans in Kosovo are the most covered loans in the region, which potentially might make them less risky as well. This is also shown by the level of non-performing loans (NPL) to total loans ratio of 6% in September 2011, ranking Kosovo below the region's recorded average of 15%, indicating that loan portfolio on average in Kosovo, is of a better quality than in other countries of the region.

Regarding the bank competition, our research shows that despite a slow declining trend, the banking system continuous to remain highly concentrated with the market share of the three largest banks accounting for about 74% of total assets, 74% of deposits and 71.7% of loans at the end of December 2011. The high concentration in the banking sector is shown also by the Herfindahl-Hirschman Index (HHI), where in December 2011, the total assets were characterized with a concentration rate of 2,157 points, indicating that the market concentration in the banking sector remains high. Another indicator of measuring the level of competition in the banking sector, is the interest rate spread (the difference between interest rates on loans and deposits), which in Kosovo marked 10.8 percentage points (the highest in the region), indicating that despite the increasing number of banks in the recent years, its impacts in strengthening the competition in the banking sector has been insignificant. The spread of interest rates of loans and deposits is considered as an indicator of the efficiency of financial intermediation. The high interest rate spread, are considered to be a huge obstacle to financial intermediation, as they discourage potential savers with low returns from deposits, while increasing the cost of financing for borrowers (individuals and businesses primarily), thus reducing opportunities for investment and economic growth. This is particularly worrisome for economies in transition where opportunities for alternative funding sources through the capital market are minimal or almost non-existent in the case of Kosovo, leaving Kosovo completely under the "mercy" of the banking system that is prevalent in the financial system of Kosovo.

In this regard, CBK statistics show that loans have increased every year, where in 2011 loans showed an annual increase of 16.4 %, while interest rates for individual loans in general were 14.2 %, SME credit interest rates, especially for long term capital invest-

1 The regulatory recommended margin by CBK is 80 % of deposits should be given out in loans.

2 Financial Stability Report (page 96), December 2010

ment needs stood at 16.65 %, marking the highest credit interest rates in the region. Due to excessively high loan rates, compared to the region, Kosovo claims the lowest SME sector loan to GDP ratio of 28.3 %, reflecting a very low credit intermediation and poor credit access to SMEs.

On the other hand profitability ratios and indicators in Kosovo are among the best in the region. Kosovo's return on equity (ROE) reached 14.5 % in December 2011, which was way above the regional average (4%), whereas the return on assets (ROA) of 1.4 % also outperformed the regional average of 0.3, surpassing every country in the region. Considering the fact that the banking sector performance indicators are among the highest in the region, the survey results conducted with SMEs, Business Associations, the Kosovo Competition Authority, and other key stakeholders, substantiate their perception that credit conditions in the country are tight and not appropriate for business expansion; whereas the credit market is considered to be the main ingredient for Kosovo to catch up with sustainable economic growth and the cornerstone to address its socio-economic severe problems - unemployment and poverty. Despite the high profit indicators of the banking sector in Kosovo, the CBK hasn't had any bank applications at all in the last three years to enter the Kosovan market which might be seen as serious, and according to the CBK, this might be due to the evolution of global financial crisis since 2008, as well as the current public debt crisis in the Eurozone, which has affected a considerable number of banks in the European Union, and thus far has limited their further expansion of foreign financial institutions towards new markets.

Referring to various stakeholders' interviews, mostly CBK's and commercial banks' statements, the actual banking system performance indicators ranked the highest in the region, make (from this point of view) Kosovo's banking system the safest, the healthiest, and the most stable in the region. CBK and commercial banks in contrast to SMEs evaluations, do not consider loan interest rates as being high, in fact they declared that interest rates are on a declining trend. They declare that the reason that interest rates in Kosovo are the highest in the region, are due to the fact that the neighbouring countries have a lower risk of business environment, and with regards to each of the aforesaid factors in credit evaluation process, with the exception of NPLs, they fare much better than Kosova, hence resulting in lower loan rates than Kosovo. In addition to that, the banking system is very sensitive to legal issues and their enforcement and is heavily relied upon the effectiveness of the justice system in Kosova, which suffers from a high degree of inefficiency, procrastinated procedures (up to many years) to resolve a banking sector court case, as well as huge delays in collateral execution.

Part of this study is also the SME survey with 600 Kosovan companies, results of which point out that cost of financing and access to finance are amongst the most significant barrier of doing business in Kosovo. These two indicators highlight the difficulties that SMEs face in trying to raise capital for their development, forcing them to obtain business loans with high interest rates, thus reducing their development potentials, or in the worst case scenario, foregoing any investment project that they might have due to unaffordable credit interest rates. Survey also shows us that the majority of businesses have highlighted "access and cost of finance" as the main barriers for their potential expansions, followed by uncertainty in general business environment surrounding these firms. The survey also found that 95 percent of SMEs did not apply for a loan, due to the fact that 70 % of firms consider the financing conditions as unfavourable or very unfavourable, making the financing of SME investment projects practically unaffordable

POLICY RECOMMENDATIONS

Policy recommendations are suggested for tackling many of the barriers mentioned above. We recommend that:

- The government should strengthen economic growth on a macro-economic level by reforming the business environment through reducing the level of informal economy, fighting unfair competition, excessive taxation, and inappropriate governmental regulations. Reforms should mainly target promotion of competition and development of private sector as a means of economic growth and thus tackling current business stagnation. Improving the business environment will result in lowering the credit risk, as one of the main determinants of interest rates in Kosovo.

- Institutional reforms such as improving the rule of law, fighting corruption, fighting the informal economy, tax evasion, encouragement of non-cashtransactins, will create more favourable conditions for existing businesses and at the same time attract foreign investments in financial markets in Kosovo. For the former, the incentives for formalization will improve financial reporting; while for the latter the competition in financial market will provide further incentives to reduce current interest rates.

- Solving the problems of the cadastral system, as well as increasing the efficiency of the judiciary system would result in easier execution of pledged collateral and mortgages. With courts efficiency remaining highly unsatisfactory, the absence of an effective and efficient mechanism in quickly solving bank court cases hinders the incentives for lowering current interest rates. Establishment of special economic courts whereby business cases from general cases would be separated and thus contribute to reducing significantly the current workload. This would eliminate one of the primary barriers of court inefficiency, which banks and businesses declare all the time.

- Adding further competition to financial system could prove to be problem solving. Government must put together rigorous pro-investment policies in place (for attracting as much foreign direct investment as possible in banking sector), through aggressive marketing of the investment conditions in Kosovo's banking sector and others as well.

- The government must take measures to improve the legal system and its instruments for the protection and security of credit collaterals, thus reducing the risk associated with credit collaterals in terms of executing collaterals.

- In order to avoid potential crises coming from the financial sector and economy as a whole, the government must start the process of implementing the qualitative demands on the conditions from the IMF, WB and EU regarding government budget expenditures, and inturn establish a safe net that will be provided by these organizations if such an event were to happen.

- A campaign by the government and Central Bank to shake/encourage banks to move from their status quo position with regards to credit interest rates is also required. This does not imply intervention into the internal affairs of commercial banks, but a mutual understanding of demanding and defining an agenda with tasks related to the government, banks, CBK, the association of banks, business associations, donors, and international institutions, so that the supply of credit to the private sector is improved through an increase in bank competition.

- The government should try to encourage more competition in the financial sector and take actions to improve the supply of credit to the private sector, especially through the issuing of government bonds. The joint interest of all stakeholders is higher economic growth and timely preventive measures which will ameliorate the impact of the current European debt crises. In this respect there is much room for action by all stakeholders.

- The government establishes programs for fund guarantee schemes for lending to SMEs, focusing on economic sectors with the highest potential for generating employment.

- CBK and Business Associations in Kosovo, in conjunction with the government must play a more active role towards ameliorating the obstacles faced by commercial banks, as well as SMEs in general.

- CBK is encouraged to reduce non-licencing barriers and increase competitiveness between banks in Kosovo. Amongst many, the reduction of costs in using ATM's could be significant in fighting non-licencing barriers.

- CBK and commercial banks must lower the level of collateral to loan requirement to the average level of the region, as well as providing SMEs with more reasonable offers for longer maturity of loans, and thus enabling SMEs an easier access to credit.

- Finally, the government should pay attention on improving financial literacy of entrepreneurs and individuals through the creation of business advice centres. Offering free business plan training from donors, NGOs, universities, government, associations of banks and businesses, would increase the capacity of individuals and entrepreneurs to take advantage of available financial services, and be in a better position of avoiding financial risks.

1. INTRODUCTION

This research report aims at conducting a study that will focus on the banking sector in Kosovo. The study probes the determinants of interest rates on loans in Kosovo with the purpose to identify the most significant factors that have affected their level and rigidity throughout the last 12 years. Furthermore, the study depicts a cross-country comparison analysis on the regional level which takes a detailed look across the practices of the region with regards to the research objective of the study and ultimately, provides recommendations for policy makers in order to undertake concrete measures that may enable decrease of interest rates in the local credit market. The main research effort was focused on a comprehensive survey of the Banking Industry, covering various aspects of their products and services with the main focus on interest rates. Also an SME survey was conducted with 600 SMEs for obtaining the perceptions of the business community regarding deposit and credit interest rates offered by the banking industry. Face to face in-depth interviews were conducted with the bank representatives (Risk Managers), representatives of SMEs (company managers), as well as with other stakeholders, such as the CBK, Business associations, Kosovo Cadastral Agency, and regulatory agencies[3] . A semi-structured questionnaire containing specific questions and a number of open ended questions were completed for each interviewee. The project has been financed by the Kosovo Foundations for Open Society (KFOS), and implemented by the Riinvest Institute for Development Research. During the preparation of this research report the project team conducted desk research on various reports on banking and insurance companies such as the reports of the Central Bank of Kosova (CBK), annual reports of banks, and other literature covering this area.

The structure of the research report is designed as follows. The report begins by initially presenting the executive summary, and then this is followed by the introduction of the report in section 1. Section 2 of this report provides an overview of the banking system in Kosova, including the variety of products and services offered by the banking industry. Section 3 continues with the analysis of the current situation in the banking sector, including analysing the legal and regulatory framework in Kosova, Section 4 sets forth the key survey findings (conducted with Bank representatives) related to the current state of interest rates offered by the banking system, and the perceptions of the business community (SMEs) regarding bank interest rates, while section 5 displays a cross-country comparison analysis of the banking industry with a focus on bank competition. Finally, the last section presents conclusions and some recommendations of the report.

We would like to extend special thanks to KFOS for sponsoring this project and also for the continuous support rendered throughout its implementation stages. We thank especially Professor Shkelqim Cani for his great cooperation with our project team.
However, we would like to emphasize that the findings and opinions presented at this report represent positions of Riinvest Institute solely and do not necessarily reflect the position of the other parties involved during the realization of this project.

3 Various attempts were made to interview the Ministry of Finance, the Ministry of Justice, and the Judical Council, but they declined our requests.

2. AN OVERVIEW OF THE BANKING SYSTEM IN KOSOVA

Financial institutions in Kosova are licensed and supervised by the Central Bank of Kosova (CBK). The country's financial sector covers the banking industry, insurance industry, pension funds and other financial institutions composed mainly by micro-credit schemes. In terms of the number of financial institutions operating in Kosovo, the structure of financial system in Kosovo has remained almost unchanged for several years, with the exception of three new financial auxiliaries added in the market in 2011 (Table 1). The total number of financial sector institutions as seen in Table 1, reached 70 at the end of November 2011 with the largest number comprised by financial auxiliaries (32) and microfinance institutions (17) making it 49 altogether, the latter managed the smallest part of the total financial sector assets (4.25 percent).

Table 1. Number of Financial Institutions in Kosovo

Description	Nov 2008	Nov 2009	Nov 2010	Nov 2011
Commercial Banks	8	8	8	8
Insurance Companies	12	11	11	11
Pension Funds	2	2	2	2
Financial Auxulliaries	29	28	29	32
Microfinance Institutions	16	19	17	17

Source: CBK Financial stability report (2011)

Despite the fact that these industries are quite profitable and have continuously expanded their activities, which represent important factors for attracting new financial institutions to enter the market, during the last three years, the number of commercial banks, insurance companies and pension funds has remained unchanged.

2.1 Commercial Banks

Banking sector in Kosovo has been developed successfully and it is seen by many (IMF 2012) as a success story. The value of the banking sector assets/liabilities in Kosova in November 2011 was 2.63 billion euros which is higher for more than 11.91 % compared to the same period of last year (see Table 2). Since the end of 2000, when the first bank was established after the war, the value of total banking sector assets as seen in Table 1 has increased by about 26 times.

Table 2: Bank data in billion euros

Years	2000	2005	2006	2007	2008	2009	2010	2011
Assets/Liabilities	0.1	0.98	1.16	1.43	1.79	2.07	2.35	2.66
Deposits	0.1	0.84	0.92	1.14	1.42	1.55	1.71	2.10
Loans	0.02	0.51	0.64	0.89	1.19	1.28	1.42	1.69

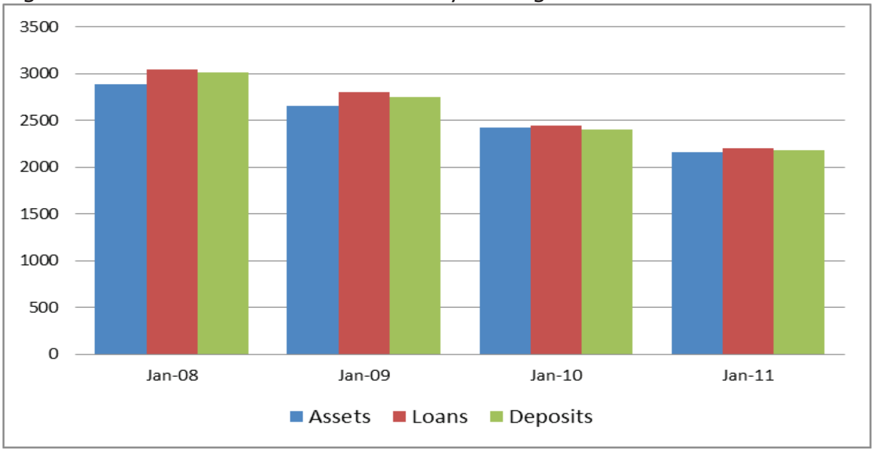
Source: CBK Annual Reports 2001-2010, and CBK's monthly periodicals

The banking sector in Kosovo is characterized with a large presence of foreign capital, where 89.2 % of total assets are managed by foreign banks. The presence of foreign financial institutions in Kosovo has contributed in the modernization of the financial system by bringing more advanced practices in financing and management of banking operations. At the moment there are eight banks operating in Kosova, six of them with complete or majority foreign capital.

The Kosovo banking sector remains highly concentrated with the market share of the three largest banks accounting for about 74% of total banking sector assets, 74 % of deposits and 71.7 % of loans at the end of November 2011, the level of concentration is much lower as compared to 2008, when the share of concentration of deposits and assets in only three banks stood at 90 %. The high concentration in the banking sector is shown also by the Herfindahl-Hirschman Index (HHI)[4] as seen in Figure 1. In 2008 the HHI for assets recorded 2,887 points compared to 2,896 points in the same period of the previous year, while HHI for loans and deposits recorded 3,014 and 3,016 points, respectively. Nevertheless, in November 2011, according to the HHI for total assets, the banking system was characterized with a concentration rate of 2,157 points, which compared to the same period of the last year, indicates a decline of the concentration rate by 265.2 HHI points. The concentration rate of the banking system is noticed to have recorded a continuous decline since 2008 also based on the HHI for total deposits and loans.

4 The Herfindahl-Hirschman Index (HHI) considers a market with a result of less than 1,000 to be a competitive marketplace; a result of 1,000-1,800 to be a moderately concentrated marketplace; and a result of 1,800 or greater to be a highly concentrated marketplace. As a general rule, mergers that increase the HHI by more than 100 points in concentrated markets raise antitrust concerns.

Figure 1. Concentration of bank activity through HHI



Source: CBK (2011)

In order to bring bank services closer to clients, commercial banks continued to expand their infrastructure, although in the last two years the pace has slowed down. This might be due to the fact that banks that have been operating in Kosovo have managed to consolidate well their presence in the market in terms of their banking units in the territory of Kosovo, and thus the slow expansion pace might be due to the measures taken by banks to reduce their expenditure.

3. CURRENT STATE OF THE BANKING SECTOR

The banking sector as presented in Table 3 until the end of 2008 has constantly increased its net profit (34 milion euros), followed by a sharp decline in 2009, where bank profits decreased to 27.4 milion euros, attributing this profit decline (24.1 %) to banks conservatism and risk averse approach (mostly due to the Eurozone debt crises), by strengthening their credit standards in granting credits to SMEs. Nevertheless, we see from Table 3 that bank's net profit has trended upward again in 2010, and it continued in 2011 as well, where by the end of 2011 the amount of total banking sector net profit was about 37 million euros, an annual increase of 13 %. Banking sector income is mainly derived from interest on loans, where the share of the banking sector interest income (in December 2011 was 195 million euros) to the total banking income at the end of 2011 (240 million euros) was 81.3 %, almost the same as it was at the end of 2010 (80.9 %), as well as in the last few years.

Table 3: Banks' income and net profit (values in millions of euros)

	2005	2006	2007	2008	2009	2010	2011
Total banking sector income	94.3	113.9	157.4	195.0	201.5	217.2	240
Banking sector interest income	74.6	88.8	117.9	155.7	163.2	175.8	195
Net profit	13.5	20.1	33.5	34	27.4	32.8	37
Return on Total Assets (ROA), in %	1.4	1.74	2.33	1.9	1.24	1.34	1.4
Return on Average Assets (ROAA), in %	1.52	1.88	2.62	2.1	1.39	1.44	1.46
Return on Equity (ROE), in %	18.24	19.46	21.94	18.65	13.33	14.23	14.50
Return on Average Equity (ROAE), in %	18.87	22.67	26.17	20.30	14.13	15.04	15.23

Source: CBK Annual reports

Return on Total Assets (ROA)[5] – ROA shows how well a company controls its costs and utilizes its resources. The higher the ROA number, the better, because the banking sector is earning more money on less investment. The highest return on assets (Table 3) that the banking sector experienced was in 2007, when return on assets stood at 2.33 %, followed by an immediate fall during 2008 and 2009. During 2010 and 2011, ROA started to increase again, where by the end of 2011 it reached 1.4 %, well above the regional average (0.4 %).

5 ROA indicate the amount of earnings generated from every unit of employed assests. The ROA is one of the most widely used profitability ratios because it is related to both profit margin and asset turnover, and shows the rate of return for both creditors and investors of the company.

Return on Average Assets (ROAA)[6] – As return on average assets (ROAA) is calculated at period ends (months, quarters, years, etc.), it does not reflect all of the highs/lows but is merely an average of the period. Thus looking at Table 3, we see that the ROAA indicator compared to ROA is slightly higher in every year, giving us a better picture of the average profitability of the banking sector.

Return on Equity (ROE)[7] - Looking at Table 3, we notice that ROE has steadily increased all the way up to 2007, reaching its peak of 21.94 %. Whereas again, due to global financial crises, as well as the new bank's presence in the market, ROE suffered a dramatic decline in 2008 and 2009 reaching its bottom at 13.33 %. However, despite the European debt crises and the increased bank competition, in 2010 and 2011 the return on equity started to increase again, where at the end of 2011 ROE marked 14.5 %, over three times greater than the regional average of 4 %.

Return on Average Equity (ROAE)[8] – In situations where the shareholders' equity does not change or changes by very little during a fiscal year, the ROE and ROAE numbers should be identical, or at least similar. However, the analysis between the ROE and ROAE as depicted in Table 3, suggests that ROAE provides us with a more accurate picture of banking sector performance, because with the exception of the last three years where similar results are displayed, before that there is considerable change between them throughout the years.

3.1 Banking Services

3.1.1 Deposits and their distribution in sectors

By the end of 2011, total deposit in the banking system of Kosovo reached at 2.1 billion euros, recording an annual growth of about 8.5 percent. The slower growth trend that characterized deposits since December 2009 was evident also during this period, given that the annual growth rate of deposits in December 2011 was about 12.3 p.p. lower compared to December 2009. The slowdown of the deposits growth was mainly a consequence of the decline of government deposits in commercial banks, as well as the implications and contagious effect of the global financial crises during this period, which both contributed to a significant slowdown of deposit growth. Ever since the establishment of the banking sector in Kosovo, whenever we had an increase in deposits, this was followed by a lower increase in loans. However, in the last three years the growth of deposits has been falling continuously, whereas the growth of loans is upward trending from year to year. Thus, for the first time in 2010 loan increases have surpassed deposit increases and this has continued in 2011 as well, suggesting a slight increase in bank competition and bank activity. The main source of deposits in the Kosovo's banking system continues to be household deposits, which by the end of 2011

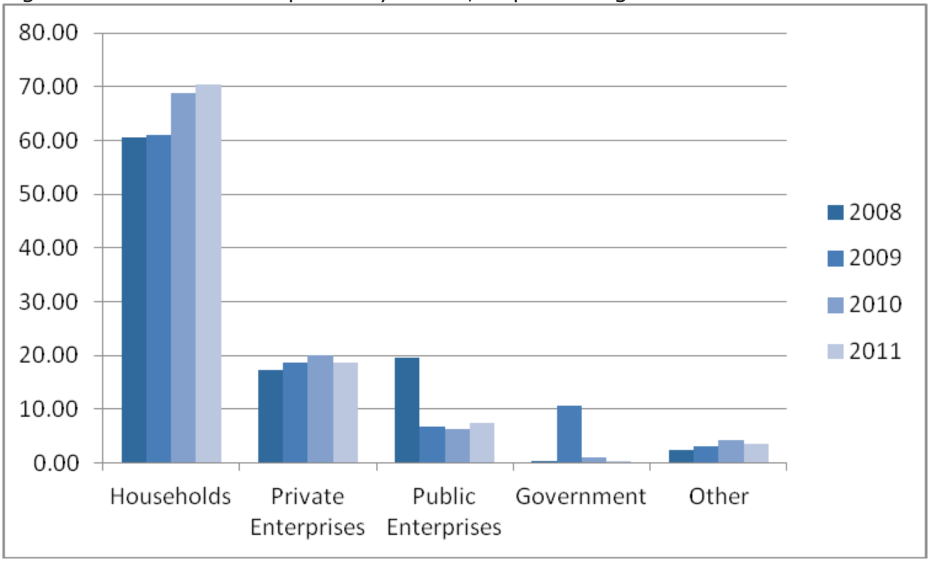
6 ROAA - An indicator used to assess the profitability of a bank's assets. It is most often used by banks and other financial institutions as a means to gauge their performance

7 ROE - Return on equity also known as return on investments (ROI), is the best measure of revealing as to how much profit a bank is generating with the money that their shareholders have invested.

8 An indicator used to measure the return on average equity which can give us a more accurate depiction of a company's corporate profitability, especially in instances where the value of the shareholders' equity has changed considerably during a fiscal year.

amounted at euro 1.49 billion (71 percent of total deposits). Nevertheless, a tendency of slowdown in the growth of household deposits was noticed in the recent period (annual growth of 14.7 percent in December 2011 compared to 25 percent in December 2010). The slowdown of household deposits growth rate was not reflected in the share of these deposits to total deposits, given that household deposits represented 71 percent of total deposits by the end of 2011, which is for 3.8 pp higher than in December 2010 (Figure 2). The deposits of private enterprises amounted at euro 395.4 million in December 2011 (400 milion euros in December 2010), an annual decrease of 1.2 %. If we compare the growth of private enterprise deposits in the recent periods (annual growth of 18.5 % in 2009, annual growth of 17.8 % in 2010, and annual fall of 1.2% in 2011), we notice a considerable slowdown of deposit growth. Whereas deposits of public enterprises such as PTK, KEC and Prishtina International Airport, remained practically the same, reaching euro 127 million euros in December 2011 (126.6 million in December 2010). It is worth pointing out that over 200 milion euros of PTK dividends were taken by the government from commercial banks in 2009, and government in conjunction with CBK were very careful not to create shocks of massive deposit withdrawals from commercial banks.

Figure 2. Structure of deposits by sector, in percentage



Source: CBK Annual reports and CBK Bulletins

In terms of deposit maturity structure, in December 2011 time deposits continued to dominate, representing 48.2 percent of total deposits, followed by transferable deposits (deposits not subject to any kind of maturity) with around 31 percent and saving deposits with 15.1 percent of total deposits. Deposits with short-term maturity although on a decreasing trend continue to dominate the structure of time deposits. In December 2011, deposits with maturity up to one year represented 53.8 percent of total time deposits (falling from 75.7 percent of what it was in 2010), followed by 28.2

percent of deposits with maturity of over one year up to two years of total time deposits (representing an increase from 8.5 percent of what it was in 2010), and around 18 percent of time deposits of over two years (a slight increase from 15.7 percent in 2010).

Considering the trend that time deposits are pursuing, it can be noticed an increasing tendency in the share of time deposits with longer maturity, which may be related to the approval of the Law on Deposits Insurance, which has a direct impact on further increasing depositors' confidence in commercial banks. Also, higher interest rates for deposits with longer-term maturity represent an important factor that may contribute to the increase of maturity period for time deposits.

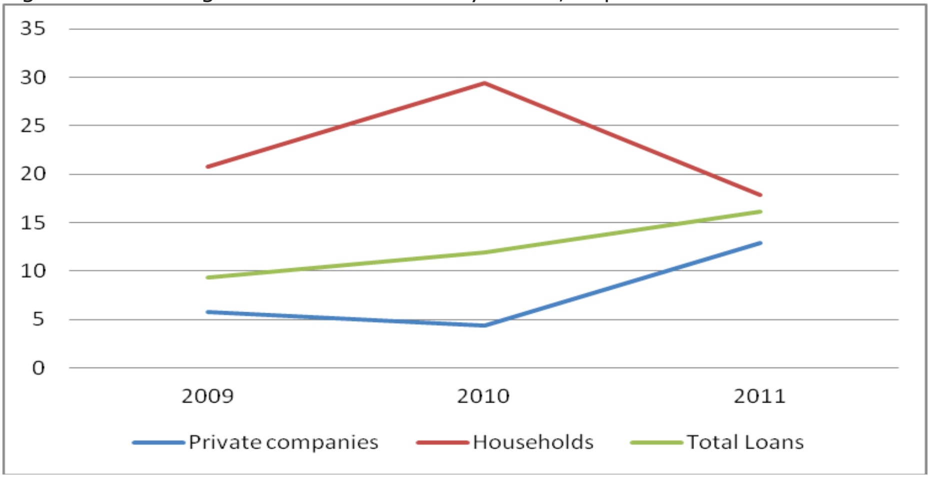
3.1.1 Loans and their distribution per sector

The banking sector's activity has expanded even further this year, and the share of total loan activity to Kosovo's GDP has increased to 38 % compared to last year (35 % share of GDP). According to the CBK data, lending activity by commercial banks was characterized with a faster growth trend. Despite the European debt crises, where European banks are struggling with consumer confidence, the bank profit indicators show that banks in Kosovo still enjoy profits above the region's average, indicating an improvement of perceptions and higher confidence of commercial banks for the overall economic environment in Kosovo. Thus after the slowdown period that emerged due to the shocks in the global economy in the last two years, in December 2011 the total value of loans issued by the banking system recorded euro 1.7 billion, marking an increase of 16.4 % compared to December 2010 (in 2010 annual credit growth was 13.2 %), showing that lending activity of banks in Kosovo is on an increasing trend.

Out of total loans, 67.4 % of these loans went to the SMEs[9], which is still considered as being lower than the regional average, and reflecting the high reliance of Kosovo's economy on trade. Although the credit market has been on an increasing trend during the last three years, growth in the past three years has shifted from companies to households, where 30.1 % of total loans by the end of 2011 went to households compared to an annual increase of 29.5 % in 2010, whereas enterprise loans started to rise again, and in 2011 they grew by 4.8 percent (Figure 3). This low credit activity of SMEs for the past couple of years as presented in Figure 3, may be associated with the global financial crises (2008-2009), as well as the European debt crises in 2010, which made banks more inclined towards the crediting of households rather than the crediting of SMEs.

9 70 % of these loans went to the trade sector in December 2011, respectively 69 % in December 2010.

Figure 3. Annual growth rates of loans by sector, in percent



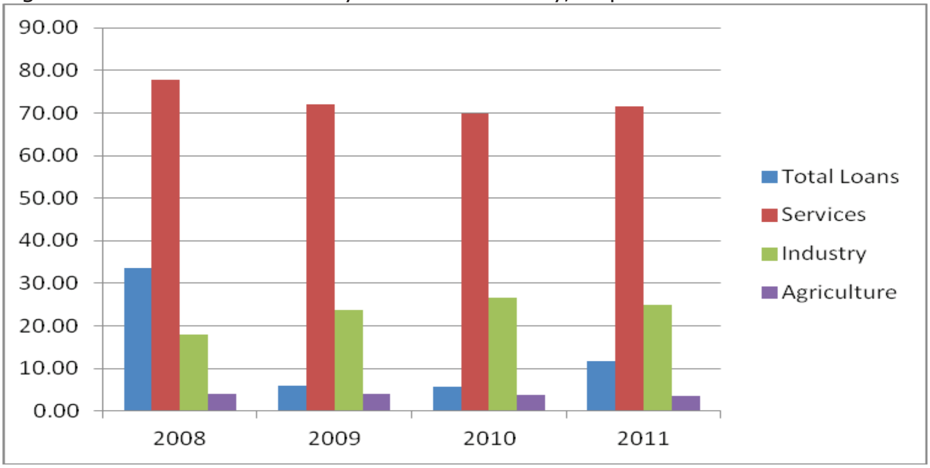
Source: CBK Annual reports and CBK Bulletins

However once the global financial crises weathered the worst, the global economic activity started to pick up its pace, leading to a slight decrease of interest rates for loans to private enterprises, which, in turn, may have also encouraged the credit demand by this sector. As a result, by the end of December 2011, private enterprise loans grew by 12.9 percent, marking an increase of 8.1 pp compared to 2010. Whereas the growth of household loans in 2011 slowed down to only 18 percent, marking a fall of 11.5 pp compared to 2010, and this slowdown of household loans to some extent may have been driven by the greater orientation of the banking system towards the crediting of enterprises during this period, due to the fact that they are able to charge businesses higher interest rates than households, and thus generate higher profit.

Figure 4 shows us that the loan structure to enterprises in terms of economic activity continues to be similar to the previous periods. Loans in the service sector still continue to dominate the structure of total loans to enterprises with a share of 71.6 percent. In December 2011, out of the total loans to the service sector, the trade sector absorbed the largest share marking 73.4 percent of total loans to enterprises as shown in Figure 4. The industry sector (including mines, manufacturing, industry and construction) in December 2011 marked 24.9 percent of total loans to enterprises, with manufacturing and construction marking 90 percent of total loans in the industry sector, an increase of 3 pp comared to the same previous period.

However, the agriculture sector with only 3.5 percent of total loans until December 2011 (3.72 percent in November 2010) continues to hold the lowest share to total loans, suggesting that the conservative lending approach of banking system towards the agriculture sector is also characterized by high interest rates, reflecting the perceived uncertainty by banks with regard to this sector, hence representing an additional factor contributing to the current low level of loans for agriculture. The agriculture sector is mainly unregistered, and the presence of asymmetric information has made many banks to view this sector as extremely risky, and thus majority of banks do not lend at all to the agriculture sector.

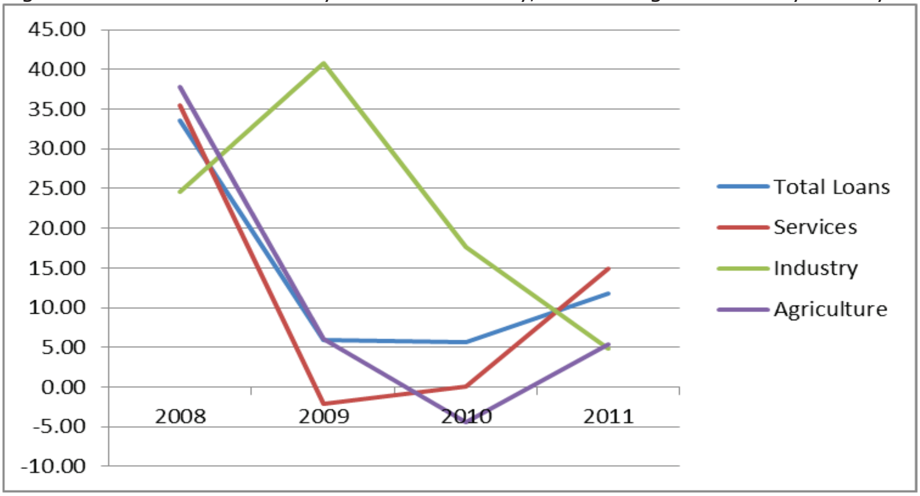
Figure 4. Structure of loans by economic activity, in percent



Source: CBK Annual reports and CBK Bulletins

The lending activity for most of the sectors of the economy slowed down until 2010 (see Figure 5), then started to improve, especially in the trade sector and other services (including hotel and restaurant services) experienced a relatively faster growth trend and continued to do so until the end of December 2011.

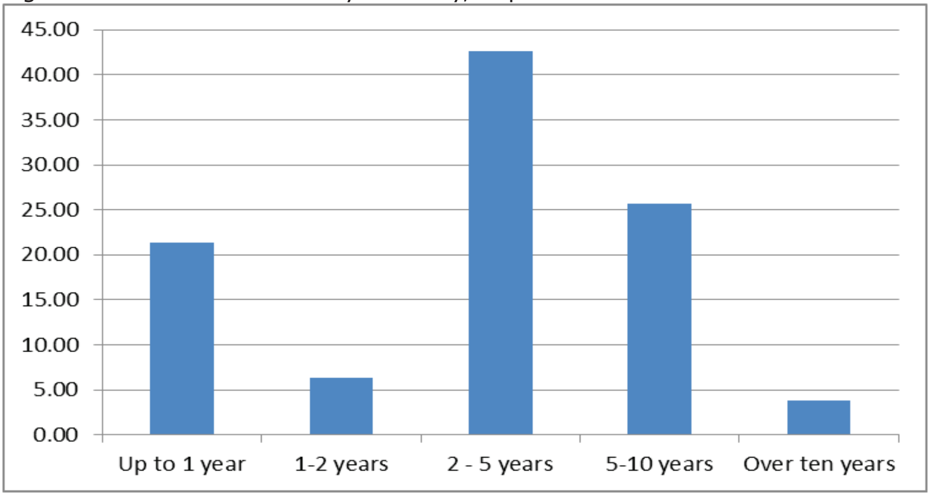
Figure 5. Structure of loans by economic activity, and their growth from year to year (in %)



Source: CBK Annual reports and CBK Bulletins

Thus, while loans to other sectors of the economy have experienced a rather slower growth trend, the accelerated growth of loans to enterprises in 2011 may be considered as a result of the faster growth of loans to trade sector and other services. Lending to the trade sector by the end of December 2011 amounted at euro 630 million, recording an annual growth of 16.6 percent. The industry sector was characterized by a slower growth trend during this period. In fact, in December 2011, loans to the industry sector recorded an annual growth of only 5.7 percent compared to 13.8 percent annual growth in December 2010 (see Figure 5).

Figure 6. Structure of loans by maturity, in percent



Source: CBK Annual reports and CBK Bulletins (2011)

Lending to the industry sector slowed down, reflecting the "access and cost to finance" obstacle that many of the SMEs have declared. Agriculture sector in general is considered as a very important part of the economy, as it contributes heavily on GDP growth, however in Kosovo is seen as a very risky sector and as a result many of the banks do not lend to this sector at all, hence the slow growth presented in Figure 5, where the value of total loans to agriculture in December 2011 amounted at euro 40 million.

Regarding loan maturity, loans with longer maturity 2-5 years continue to dominate the structure of total loans with 42.6 percent of total loans in December 2011 (see Figure 6), where compared to 2010 it remained practically the same. Nevertheless when grouping together we get total loans with maturity of over two years represented by 72.4 percent of total banking system loans in December 2011 (72.4 percent of total loans in December 2010), in contrast to time deposits of up to two years being represented by 82 percent.

3.1.2 The Liquidity Position of Banks

In terms of the liquidity position, 82 % of total deposits in 2008 were given out in loans to enterprises and households, and for the first time commercial banks exceeded their regulatory requirement of credit limit set out by the CBK. However, due to the global financial crises, bank credit activity was slowed down (as seen in Table 4), where loans to deposit ratio in 2009 and 2010 fell to around 75 %. Nevertheless, so far this year the liquidity position has been increased to 80.8 % which has again exceeded the recommended regulatory requirement, and unless precautionary measures are taken by CBK, the trend of the liquidity position is that it will continue to exceed its recommended level, thus lowering its liquidity position.

Table 4: Share of loans, deposits and assets to GDP (%)

Years	Loans/GDP	Deposits/GDP	Assets/GDP	Loans/Deposit
2004	16.4	30.4	35.6	53.8
2005	16.8	27.4	32.2	61.4
2006	20.0	29.1	36.5	69.6
2007	26.1	33.4	41.8	78.1
2008	31.1	38.0	47.5	82
2009	32.9	39.9	53.3	73.9
2010	35.1	42.3	56.8	75.3
2011	38	47	59.5	80.8

Source: CBK Annual reports and monthly periodicals, IMF data

The increase of deposit and loan outstanding balances provides evidence that the Kosova banking sector is continuing to contribute to the economic growth in Kosovo by increasing its role in financial intermediation. This is also shown from regular increase of several indicators such as the share of banking sector assets, deposits and loans to GDP. Nevertheless, these indicators as presented in Table 4, are much lower compared to the region. The share of assets to GDP in December 2011 increased to nearly 60 %, where compared to 2005 (32.2%) it almost doubled. This is mainly due to the increase in the volume of loans extended by the banking sector that reached 38 % of GDP as of December 2011, as well as an increase in deposits, where the share of deposits to GDP in December 2011 stood at 47 %.

Interest rates – The overall average interest rates on loans in 2011 were about 14.15 %, a fall of 45 basis points compared to 14.6 % in 2010. Table 5 also shows that the level of interest rates on average throughout the years has remained nearly the same with slight decrease in 2006 and a slight increase in 2008 and 2009.

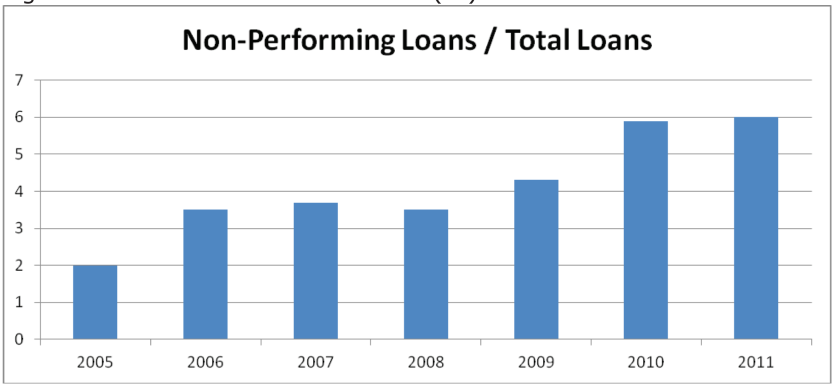
Table 5: Interest rates[10] on loans and deposits (%)

	Years	2004	2005	2006	2007	2008	2009	2010	2011
A	Deposits	2.5	3.2	3	3.3	4.2	4.3	3.7	3.5
B	Loans	14.2	14.2	13.4	14.6	14.8	14.4	14.6	14.15
C	Interest rate spread/difference (C=A-B)	11.7	11	10.4	11.3	10.6	10.1	10.9	10.65

Source: CBK Annual Reports 2004-20010, and CBK monthly periodicals

As we can see, while loan volumes have expanded annually, the interest rates compared to region have unrelentingly remained high, especially for long term capital investment needs, meaning that SMEs in order to pursue their long term investment projects, are forced to obtain investment loans from banks with very unfavourable interest rates. Nevertheless it's worth mentioning that the interest rates for both, loans and deposits alike have remained constant, showing that the increased number of banks in the market has had no effect in intensifying competition, which would then have exerted downward pressures on the interest rate spreads in the Kosovo banking sector. Loan portfolio in the Kosovo banking sector remains of good quality. Despite the fast credit growth, in September 2011, the share of non-performing loans (NPLs) to total loans (which include loans classified as 'doubtful' and 'loss') at least until now, was relatively low at 6%, remaining nearly at the same levels as in 2010 (5.9%) as shown in fig 7. The NPL to total loans ratio of 6% in 2011 ranks Kosovo below the average of 15 percent recorded in region countries, indicating that loan portfolio of banking sector in Kosovo, on average, is of a better quality than in other countries of the region. Taken by bank groups, larger banks appear to have a better quality of the loan portfolio than smaller banks.

Figure 7. Share of NPL to total loans (%)



Source: CBK Annual reports and CBK Bulletins

During 2011, three largest banks recorded a NPL to total loans ratio of 4.2%, while the rest of the banks, on average, NPL accounted for 8.1% of their loan portfolio. Regarding breakdown by sector, households have the lowest level of NPLs. Table 6

10 Taking the annual average movements of interest rates across different products and maturities.

shows that Kosovo has the lowest SME sector loan to GDP ratio in the region. Also the interest rates for loans of up to a year shows to be the highest among all the regional countries, indicating that loans are the most expensive in the region. This shows poor credit offer to SMEs and low credit intensity associated with the highest interest rates compared to neighboring countries. On the other hand profitability ratios in 2011 are foremost the best in the region.

Table 6. Credit line indicators for transitional countries in 2011 (%)

	SME sector Loans/GDP	Interest rates		Bad Loans (in total loans)
		Deposits	Loans (< 1 year)	
Kosova	28.3	3.5	14.15	5.9
Albania (in euros)	41.2	2.16	6.88	18
Bosnia	46.0	n/a	n/a	11
Serbia	47.5	4.1	11.0	19
Macedonia	49.9	5.3	9.9	8.5
Montenegro	121.2	4.8	9.2	25

Source: EBRD Transition Reports, for Kosovo IMF estimation of GDP and CBK Annual Report

Kosova's return on equity (ROE) reached 11.2% in 2011 way above the regional average (4%) and way above the other countries ROE on banking sector (see Table 7). In addition, return on assets (ROA) also performed above the regional average, where in 2011 it stood at 1%, and with the exception of Serbia, no other country performed better.

In the light of the European debt crises which was reflected mostly at the banking system, commercial banks in Kosovo seem not to have been impacted as much, and even during these periods have continued to show a good financial performance. However, it should be noted that in Kosova this has been achieved with lowest credit intensity (loan /GDP ratio), through among the highest interest rate spread margin in the region. While the positive performance of banks in Kosovo in spite of the Eurozone debt crises is to be welcomed, the downside of this is that commercial banks have continued to keep credit interest rates as the highest in the region, which is a major obstacle to SME development. Considering the fact that banks are used to these high interest rates, we think that any new entrant in the market will generate a shockwave as competition in the banking sector will be increased, and due to the comfortable position that commercial banks seem to enjoy, this might be something that banks might not like.

Table 7: Profitability ratios for 2011 (in %)

Countries	ROA	ROE
Kosova	1.4	14.5
Albania	0.2	2.5
Bosnia	0.3	3
Serbia	1.5	6
Macedonia	0.1	1
Montenegro	-0.8	-6
Regional average	**0.3**	**4**

Source: Central bank reports of respective countries

Nevertheless, when assessing the performance indicators of ROA and ROE for only the three largest banks in Kosovo, these indicators show us an even greater profit made by these banks, where 90.1 % of total net profit of the banking sector went to the three largest banks. The return on assets by the end of 2011 for only the three largest banks, marked 1.81 % which is greater than the ROA of Kosovo's banking sector, and greater than six times of the region's average (as seen in Table 7). Whereas, the return on equity (ROE) in 2011 for the three largest banks, marked a growth of 16.33 % way above the sector's average in Kosovo, and the four times the growth of the region's average.

One could argue that credit market conditions have been favourable for this, but still remain to be analyzed whether Kosovo's government, regulatory bodies, CBK, commercial banks, and other business associations have created conditions for more and free competition in a credit market, if they are undertaking necessary measures for reducing the risk, if there is enough credit supply and offer, or all banks are more than comfortable with current conditions in the credit market. The question could be raised if this is good for long term development needs of Kosovar economy, in a situation that it is difficult for businesses to finance their long term development needs. It is clear that in the end banks share the fate of their clients, businesses and households, and it seems that in this relation there should also be more common sense.

3.1.3 Mortgages

In terms of maturity, during 2011 the highest interest rates of 16.1 percent were recorded for mortgage loans with maturity of less than five years, marking an annual increase of around 2 pp (Table 8). Interest rates on mortgage loans with five to ten years maturity during 2011 stood at 11.99 %, marking an increase of 83 basis points compared to the same previous period (11.99 % during 2010). In addition to this, we also see mortgage loans with over ten years maturity registering 10.83 % marking a slight increase of 9 basis points compared to the same previous period (10.73 % during 2010).

Table 8. Interest rates for Mortgage loans

Household Loans				
Years	Consumer loans	Mortgage loans		
		<= 5 years	> 5 years and <= 10years	> 10years
2007	13.03	12.94	11.34	*
2008	13.78	11.16	11.25	10.93
2009	12.88	10.87	11.25	9.20
2010	14.56	14.15	11.16	10.74
2011	14.02	16.1	11.99	10.83

Source: CBK Annual reports and CBK Bulletins (2011)

Interest rates on mortgage loans with five to ten years maturity during 2011 stood at 11.99 %, marking an increase of 83 basis points compared to the same previous period (11.99 % during 2010). In addition to this, we also see mortgage loans with over ten years maturity registering 10.83 % marking a slight increase of 9 basis points compared to the same previous period (10.73 % during 2010). Despite that, this type of mortgage loan marked the lowest interest rates compared to other types of mortgage loans. Nevertheless, the highest demand for mortgage loans was shown for mortgage loans of less than five years. This indicates that due to an inefficient court system that seems to exist in Kosovo, when it comes to execution of loan collateral it usually takes years, thus banks are viewing the housing sector as a more risky sector, hence the higher interest rates on mortgage loans. Table 8 also shows that consumer loans in December 2011 stood at 14.02 %, marking an annual decrease of 54 basis points.

3.1.4 New banking license applications

The number of commercial banks in the financial market in Kosovo remained unchanged during the last three years, despite the fact that this industry is considered to be quite profitable and has continuously expanded its activities, which represent important factors for attracting new financial institutions to enter the market.

However, according to the CBK, the lack of new entries into the financial market in Kosovo also corresponds with the evolution of the global financial crisis since 2008, which has limited the further expansion of foreign financial institutions towards new markets. A similar impact is being caused also by the current public debt crisis in the Eurozone, which has affected a considerable number of banks in the European Union. In addition to this, there are many business obstacles in Kosovo which are considered as extremely disadvantageous, and might contribute to the lack of interest from other investors to invest in Kosovo.

3.1.5 Cadastral Issues

When commercial banks were interviewed and asked about the reasons of high interest rates, bank representatives listed a number of obstacles, and among them was also the lack of registration of apartments, and enterprises as one of the problems. This according to banks presented real obstacles due to the fact that apartment/enterprise owners did not possess the apartment or enterprise ownership certificate, making it impossible for these owners to use their apartments/enterprise as collateral when applied for bank loans. Had they been in possession of their apartment/enterprise ownership certificate, they would be able to offer their apartments/enterprise as collateral, and banks in turn would offer these owners bank loans with much lower interest rates.

The Cadastral Agency of Kosovo in coordination with the World Bank has developed a project where it conducted a huge registration by including 12,000 many floor apartments and enterprises in four cities of Kosova: Prishtina, Prizren, Peja, and Gjilan. These cities were prioritized due to the fact that they contain the largest number of apartments in Kosovo. However, this represents only the first phase of the project meaning that in the next phases, the project is expected to be expanded by including other parts of Kosovo as well. The registration in other cities of Kosovo is planned to be accomplished by the end of 2013.

The certificate as a result of this project, apart from other benefits, will benefit Kosovo's banking sector as well. It will give security to the commercial banks and as such might contribute to decreasing the high interest rates. Since, the first phase of the project has finished and certificates to the 12,000 owners could be issued, the effect of registration on banking sector in terms of lower credit interest rates can be tested in the near future.

4. The Banking Sector: Survey Findings

4.1 CBK & Commercial Banks – Survey Results and Analysis from In-depth interviews

In order to provide reliable results with the objective of considering the points of views of all stakeholders, Riinvest Institute also interviewed commercial banks in Kosovo. Out of eight banks operating in Kosovo, with the exception of "Banka Ekonomike" and "Komercijalna Banka", a face – to – face interview was carried out with bank representatives by a senior researcher of the Riinvest Institute.

When commercial banks were asked about their assessment of the current state of the banking system in Kosova in relation to the other banking systems in the region, and considering the fact that the banking system in Kosova was set up in the year 2000, all the interviewed banks in general consider the banking system to be extremely healthy and stable. Also banks think that the stability of the banking system is due to advanced criterias and procedures that banks apply when assessing loan applications in general. In addition, they also point out the extremely important role of CBK in safeguarding adequate and prudent implementation of credit origination, processing and collection procedures resulting to a high-quality loan portfolio in banking sector. Another viewpoint of banks are that, initially when the banking system was set up in 2000, there was no competition in the banking system and now there are eight banks operating in Kosova, and for the moment they seem to be happy and comfortable with the level of competition in the banking sector. Also according to bank responses, the low level of bank NPLs and the high portfolio quality makes Kosovo's banking system the safest and healthiest in the region. According to commercial banks, the lack of Greek banks in Kosovo and the lack of trade that Kosovo (Kosovo commercial banks are mostly owned by Western European countries and most of the trading is done with these countries, including China and USA) has with Greece, has created an advantage for us, making us less exposed to risk, in contrast to our neighbouring countries (Macedonia, Albania, etc.) where they do a lot of trade with Greece, there are also Greek banks in the banking sector of our neighbouring countries, thus making their banking system even more exposed to bank bankruptcy risks due to the enormous debt problems faced by Greek banks.

When CBK was asked the same question, they also agree with the commercial banks assessment, and they think that despite the fact that the banking system in Kosovo is young (12 years) compared to the neighbouring countries, the banking system in terms of services and financial products that it has to offer, it has managed to consolidate itself very well. The majority of indicators, such as the level of NPLs, the level of financial products and services point out to a very healthy banking system.

Also Banks were asked why according to the perceptions of businesses, credit interest rates are extremely high and unbearable for businesses, and do not seem to have changed much since the creation of the banking system 12 years ago. The response of Banks was that businesses are misguided in thinking that credit interest rates are too high, because banks themselves do not classify them as high due to the fact that interest rates have always been on a falling trend since the setup of the banking system in Kosova. Based on the evidence presented in Table 5, these statements made by banks seem not be accurate. Nevertheless, according to Commercial Banks, a number of factors are taken into consideration when they assess a business credit application. Specifically, these factors are decisive whether a business loan will have higher or lower interest, and they are:

- The level of country risk (tradition, institutional efficiency, corruption, justice system, informal economy, country's level of relations with IMF, EBRD etc.),
- The level of risk pertaining to the company (specific or stand-alone risk), as well as the sector that it belongs to (some sectors are more riskier than others),
- The fact whether company's financial statement are audited or not; the quality of financial statements, the reputation of the auditor who has certified the Company's Financial Statements (whether is a professional auditing company). It has to be noted that many companies do not possess audited financial statements in Kosovo.
- Registering company employees with the "TAK - Tax Administration of Kosova" (which according to banks the majority of companies, either do not register its employees at all with TAK, or register them just a few of their employees, and in turn banks need to research this company at more depth making the bank decision even more costly),
- Problems encountered with the Cadastral Agency of Kosovo - CAK (owners are not able to use their properties as collateral due to lack of registration of properties by CAK, making it impossible for these owners to use their apartments/land as collateral when applied for bank loans, thus resulting in high interest rates.
- High operational bank costs (in most cases businesses do not possess all the information needed for banks to make a decision on loans, making it necessary for banks to do a lot of background checks of these companies, and in turn increase its operational costs),
- Company business plans (according to banks, very often SMEs request a loan without a business plan, or if available, the business plan is poorly developed),
- The cost of deposits (which on average is between 4-5 %) that commercial banks pay to depositors, plus the extremely low interest rates (0.5-0.6 %) that they earn on the obligatory reserves placed with the CBK, making the deposit costs even bigger as a result),
- The type of loan by client, size of business, purpose, maturity type, etc. (whether the loan is long-term, short-term, big or small, whether it is intended for investment purposes or working capital, etc.). Usually, the bigger and the more long-term the business loan is, the lower interest rates are),
- The Justice system (according to banks, the Kosovo Court system are inefficient and very slow in resolving cases),
- The type and quality of collateral used to secure the loan and collateral enforcement procedures in Kosovo (when loans are defaulted, then banks through courts try to take ownership of the collateral (house, apartment), and it takes years (about 2-4 years) for the court system to make a decision for liquidating loan collateral, and even after that, the collateral put up for public auction in most cases is not liquidated due to a culture where people are vary of buying a property possessed by banks, or perhaps owners pressure potential buyers into not buying their property),

- The level of non-performing loans (the lower the NPLs, the lower the risk that banking sector is exposed to, and the bigger the amount of deposits available to offer to SMEs for loans), which currently is the best in the region,
- The required reserve deposit ratio of 10 % (determined by CBK) to be held at all times in commercial banks,
- EURIBOR[11] rate and LIBOR[12] rate,

Thus according to commercial banks, a combination of all the factors mentioned above is taken into consideration when credit interest rates are calculated. And according to commercial banks, the reason that interest rates in Kosovo are highest in the region, are due to the fact that the neighbouring countries at each point mentioned above with the exception of NPLs, bank profitability and risk environment, stand much better than Kosova, and hence having lower riskier business environment, and lower interest rates than us. Another viewpoint of commercial banks is, that the business environment in Kosovo is mostly (96 percent) made up of small businesses, and that they seem to request mostly short-term small to medium loans, and the smaller the loan maturity the bigger the risk and the higher credit interest rates will be.

Whereas CBK on the same question as to why interest rates are perceived as being too high by businesses and households alike, they think that the banking system is very sensitive and that is heavily relied upon the effectiveness of the justice system in Kosova. According to CBK research, the Justice system in Kosova suffers from a high degree of inefficiency, meaning huge delays (2-3 years at least) in dealing with cases coming from commercial banks, as well as huge delays in the execution of collateral. Another cause for concern is the many problems that exist in the real sector of the economy, such as the lack of auditing and financial reporting of businesses, where banks are forced to refuse many business credit applications due to the fact that they do not consider these businesses trustworthy enough, or in cases where credit applications are granted, banks spend a lot of time and resources in trying to verify these financial statements offered by companies, and this is translated in higher interest rates. The lack or poor development of business plans makes the company more risky from the banks perspective, also the problems of cadastre (people not being able to get certificate of apartment, land ownership) as well contributes to higher credit interest rates. Another point is also the level of market concentration, although at a declining trend, it is still considered as being too high.

In addition to this, commercial banks also state that the biggest default credit rate is associated with SMEs, because a large number of them are bankrupted after only a short period of operation, and since according to banks the demand for short-term small and medium loans has increased considerably, this has contributed to increasing credit interest rates. Whereas the demands for long-term large loans has in fact fallen because there is only a handful of large businesses and their investment needs espe-

11 EURIBOR rate - is short for Euro Interbank Offered Rate. The Euribor rates are based on the average interest rates at which a panel of more than 50 European banks borrow funds from one another. There are different maturities, ranging from one week to one year. The interest rates do provide the basis for the price and interest rates of all kinds of financial products like saving accounts and mortgages.

12 LIBOR rate - LIBOR is an acronym for London InterBank Offered Rate. LIBOR is compiled by the British Bankers Association (BBA), and is the interest rate that banks charge each other for one-month, three-month, six-month and one-year loans. This rate is that which is charged by London banks, and is then published and used as the benchmark for bank rates all over the world.

cially in the last few years have been small. Banks also point out that when banking system was formed, there were very few products available, credit interest rates stood at 24 % and the maximum loan you could get was 100,000 DM, whereas, currently the banking system is much more advanced with many business and consumer products, and interest rates averaging about 14.3%. Nevertheless, CBK data does not agree with commercial banks declarations, because according to CBK annual reports, the loan interest rates in 2001 (there were seven commercial banks in operation) stood at 16 %, whereas deposit interest rates stood at 2.5 %, thus these high interest rates continued to fall until 2003, levelling out at 14.6%, which to this day have remained roughly the same. Whereas deposit interest rates having been increased in the last few years, now banks offer around 3.5 % for consumer and business deposits.

When banks were asked if we should expect credit interest rates to fall in the near future, or under what circumstances they would be persuaded to lower their credit interest rates, their response was that credit interest rates are on a falling trend for performing clients, because after a client finishes successfuly the first loan, the second loan is always given at a lower interest rates (1-2 %), meaning that performing clients are awarded with lower interest rates, and non-performing clients are either refused altogether or are given loans with much higher interest rates. It has to be said that we lack the necessary data to verify the above claims by banks. The court system in Kosovo also plays an extremely important part, and according to banks, the more effective and efficient become courts, the safer our investments will be and thus the lower credit interest rates will be. Another important factor for banks which might lower their operational costs and thus contribute in reducing their credit interest rates, is the lowering of informal economy through the government project of providing businesses with 'cash registers', because the bigger the number of businesses using 'fiscal checkouts' the easier it is for us to conduct our credit analysis, and the less riskier are our loans. Audited company balance sheets, and registered employees with TAK is another fact which will also contribute in making companies more believable and more sincere, and this will contribute towards lower credit interest rates. Additional impact in reducing credit interest rates will also have the registration of apartments and enterprises by the Cadastral Agency of Kosovo (CAK), in which case these owners will be in a position to obtain an ownership certificate from CAK, which in turn they would be able to offer their properties as collateral in exchange for a lower credit interest rate.

When CBK was asked, what should be done in order to have lower interest rates in the credit market, they too agree with the assessment of the commercial banks, that a general improvement of the business environment[13] will definitely attract new entrants in the Kosovo market, which banks will have to be more competitive and more efficient, and this will lower their operational costs of banks, and in turn lower their credit interest rates as well.

Considering the fact that loan to deposit ratio in Kosova as of December 2011 stood at around 80.8%, commercial banks were also asked about the quality of credit demand, and whether they have the potential for increasing their credit volume, since they have already exceeded the recommended margin limit set up by the CBK (at 80 %). Bearing in mind that credit demand is largely for short-term loans, commercial banks in general stated that up to ¼ of their loan portfolio is returned throughout the year,

13 Such as, improving the efficiency of the court system, lowering informal economy, implementing the registration of apartments at the Cadastral Agency, houses, and parcels at the Cadastre Agency, etc.

and that they have to issue loans all the time, otherwise their loan to deposit ratio at any month can fall significantly (all the way to 50 – 60 % of their loan/deposit ratio), meaning that their credit potential remains high. Nevertheless, according to banks, their ability to increase loans in the market has reached its maximum limit, however the lack of demand for long – term credit points out that SMEs do not have any long-term prospects and are only looking for short-term loans to keep them going. On top of this, the quality of credit demand although very well filtered, very often is classified as poor due to a lot of the informalities as well as the lack of business investment plans associated with these SMEs who are applying for business loans.

Whereas CBK thinks that considering the level of informality in Kosovo, it is quite challenging to assess the quality of credit demand. In terms of banks increasing their credit potential, CBK points out that all the banks in Kosova, have the potential of increasing the level of credit in the market, due to the fact that liquidity reserves held by banks have consistently exceeded their requirements. This surplus reserve can potentially be credited to the market, however according to banks, they also face a lack of adequate projects which could be credited for investment projects, and this may be one reason why banks have an excess liquidity reserves and are not willing to use it. Regarding the loan-deposit ratio, the rate of 80 % is the rate recommended by the CBK, and it is an average rate recommended which can vary from bank to bank, depending on the evaluation of the bank made by CBK. As far as loan to deposit ratio limit, this ratio can vary from bank to bank depending on their funding sources, quality of loan portfolio, etc. meaning that banks that use external sources of financing, a bigger loan-deposit ratio might be permitted. Whether a bank is small or large, CBK approach is non-discriminatory and absolutely the same to all banks, declared the CBK representative. All banks operating in Kosovo are subject to the same regulatory framework and supervisory procedures of the same. Nevertheless, foreign banks in Kosovo have the ability to obtain credit lines at all times from their mother bank if they decide to do so, and thus create additional resources which might be used to credit SMEs if there was enough credit demand in the market.

Commercial banks were also asked as to what type of base rate they use in determining their credit interest rates in Kosovo, and if they thought that credit interest rates are affordable by businesses and households alike. When determining credit interest rates, banks in Kosovo use EURIBOR and LIBOR rate, despite the fact that these rates are very little related to the costs of bank funds in Kosovo. In terms of credit affordability, bank response was that considering the high performance of these loans, the high rate of return of these loans, and the high rate of credit demand, we think that they are affordable.

In terms of the Credit Registration Bureau which has been established and maintained by CBK since 2006, where every loan issued by commercial banks is registered in this Bureau, this is considered as a highly important step by commercial banks towards reducing credit risk due to the fact that they get the very latest information from this Credit Bureau. According to CBK and commercial banks, before approving a loan, every bank as well as other microfinance institutions, consults with the Credit Registration Bureau, whether the person applying for a loan has other loans with other banks, and this is very useful since it elaborates the history and credit worthiness of a client, thus contributing to a lower credit default risk in general.

It is also worth pointing out that government plans to issue government bonds in several phases in the amount of 74 million euros in total during 2012, with the initial phase of bonds issued already in the amount of 10 million euros in January 2012, which until now only commercial banks have had the right to invest in these securities, and through commercial banks, KPST and PAK might be interested in investing in these bonds as well. Commercial banks think that these government bonds might have an indirect impact on interest rates. With bank reserves not earning any remuneration at all, CBK and banks think that the excess reserve funds (excluding the obligatory reserve requirement by law of 10 % of deposits) of commercial banks will be used to invest in these government bonds and ensure a higher rate of return (interest rates for the January phase of government bonds is 3.51 %). This will contribute in lowering the cost of finance for banks, and this in turn might lower interest rates. Another point made by banks is that through these government bonds, Kosovan government will have increased its budget and this in turn will be used to further economic development, and if that were to happen, competition in the financial sector and economy in general would be increased with new banks and new companies willing to enter the market.

According to banks and CBK, an increase in the level of business plan writing skills of companies will also have an impact on interest rates. The reason for this is that the higher the knowledge that companies possess in business plan writing skills, the bigger the chances are that these companies will have their documentation in order (such as registering their employees with TAK, audited financial statements, regular tax payment etc.), with clear ideas of the direction of where they are taking their companies, and this in turn will enable banks to check whether the company is developing according to their business plan, as a result banks will have reduced their operational costs, meaning lower interest rates. In terms of the market concentration, with about 74 % of the market share being controlled only by three banks, many banks admit that there is a lack of competition in the banking sector, but they point out, that in order to attract new entrants, a lot of negative indicators such as corruption, informal economy, problems with the efficiency of the judiciary system (including the problems of enforcing and implementing court decisions) must be fought, because every new entrant in our economy will be faced with these problems.

4.2 SME Financing in Kosovo – Survey Results and Analysis

In order to provide reliable results with a 95 percent level confidence and 5 % confidence interval, a sample size of 600 businesses around Kosovo was taken, using the Tax Administration of Kosovo (TAK) database which has around 57,000 registered businesses. The database contains all Kosovo’s registered businesses, sorted out based on sector, size, regions and contact information. This sample was stratified according to the economic sector and Kosovo regions (six regions). This is a standard way that generates representative results.

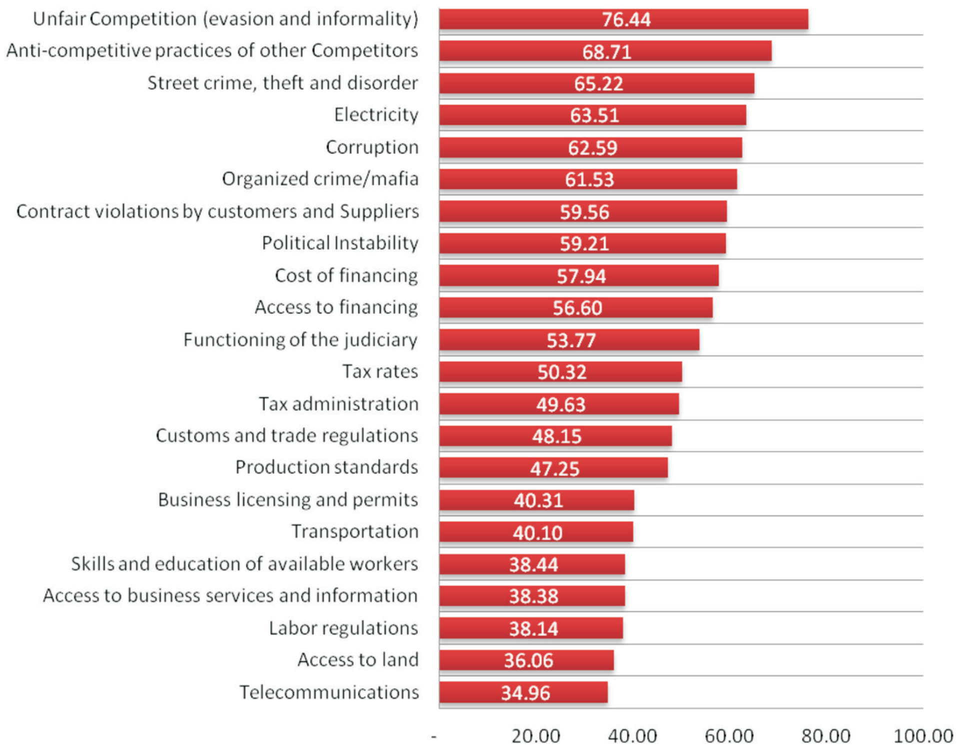
The questionnaire was designed by Riinvest institute experts. The SME survey was conducted during November and December of last year. The interviews with the representatives of chosen businesses were carried out face to face with company representatives by a team of selected surveyors who were professionally trained by the Survey Coordinator from Riinvest. The main objective of the survey was to assess the perceptions and evaluations made by SMEs regarding the access to finance conditions that SMEs deal in Kosovo. In addition to this, the survey questionnaire was designed also to evaluate the main barriers to business activities and investments faced by SMEs. Data entering has been conducted by the researchers of the statistical office in Riinvest Institute, while data processing was conducted by the same researchers using Excel and SPSS. Through these programs, different statistical results were generated which in the end were handed to researchers and finally included into the final report.

Subsequently we present the results of the survey. As expected, the majority of firms subject to our survey were micro enterprises in the range of 2-10 workers. Survey enumerators excluded all firms with 1 or less employees. Around 8 percent of respondents were small firms, while only 1.4 percent were medium sized firms. These Figures are in accordance with general structure of registered firms in Ministry of Trade and Industry; ensuring thus proper implementation of sampling of this survey. In addition to the above indicators, 95.6 percent of surveyed firms were private since the establishment, 3.5 percent were privatized companies (former socially owned enterprises) and 0.8 percent were ‘Other’. Last, around 92 percent of firms are domestic, with remaining 8 percent having foreign ownership.

Despite having a growth rate in the number of businesses operating in the country, a significant challenge to businesses, especially Small and Medium, are the procedures to start the business. Kosovo is ranked 117th out of 183 countries for the ease of doing business by the World Bank (WB, 2011).

Questionnaire surveys and targeted interviews with entrepreneurs and managers on restrictions in doing business and possible solutions conductive to their elimination became to form an important part of the study. The results shown in Figure 8 provide brief perceptions of 600 businesses on critical barriers on private sector development in Kosovo.

Fig. 8 Business Barriers in Kosovo 2011



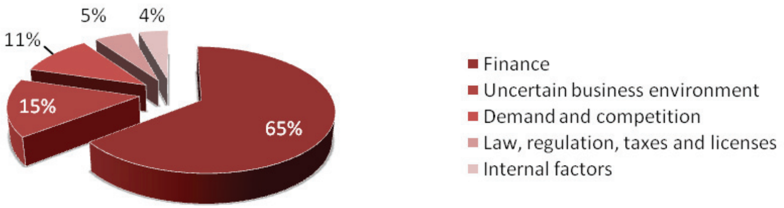
Source: UNDP HDR (2011)

Sources of finance present an important factor for the development of Kosovo enterprises which would consequently affect economic growth of the country. But, financing opportunities are not facilitating the establishment of new businesses or the increase of actual capacities of Kosovo enterprises. This assertion is derived from the fact that interest rates of commercial bank loans which are the main external financial source of enterprises are qualified as high and as an overload for the liquidity of enterprises in general. The SME survey with 600 Kosovan companies, points out that cost of finance and access to finances have both mid-ranking position with former having a score of 58 and latter 56.6 (Figure 8). These two indicators highlight the difficulties that SMEs face in trying to raise capital for their development, forcing them to obtain business loans with high interest rates, thus reducing their development potentials, or in the worst case scenario, SMEs might forego any investment project that they might have due to unaffordable credit interest rates. Based on Figure 8, we also see that many of the top business barriers are institutional barriers, which due to these barriers, our government is projecting the incapability of securing a safe and protective environment of potential foreign investors, and hence the lack of foreign investments due to such risks.
In terms of interest rates, during 2011 Kosovo's average interest rates for loans were 14.3 percent, while all regional countries have had lower rates (Albania – 12.9 percent,

Macedonia – 11.9 percent, Serbia – 10.3 percent, Croatia – 10.2 percent). In 2010 as well, Kosovo had an average interest rate of 14.3 percent. When we analyze segments of the credit market, businesses are those with the highest load of interest rates on loans because credit interest rates for businesses on average were 16.4 percent, whereas for households they were 14.3 percent. These high interest rates continue to hamper seriously business environment on our country. Evidence from our survey suggests that small firms are particularly hurt by poor access to credit, which limits their growth prospects. Improving access to finance, in addition to the reduction of its costs, especially for small firms, must be a priority in Kosovo.

Survey also focuses on business plans in starting new activities. This focus enables us to understand the restrictions existing businesses face when trying to expand. The barriers in this regard might be different to those obtained in general business environment. When asked if businesses had planned to start new activities on but could not do so, Figure 9 shows us that the majority of businesses have highlighted cost of finance as main barrier for their potential expansions, followed by uncertainty in general business environment surrounding these firms. In contrast to general business barriers presented in Figure 8, here the finance category has become the top barrier to business expansion, enhancing further the fact that access to finance has curtailed business expansion activities of SMEs.

Fig. 9 Barriers to new business activities



Source: UNDP HDR (2011)

Access and cost of finance again proves to be one of the biggest barriers in business environment. First, it is understandable that businesses in Kosovo are operating in the limits of their profitability, without having much options (that is internal funds) to expand. Second, it seems rather interesting that Unfair Competition (here covered partly under uncertain business environment), appearing as main barrier in general business activities is less relevant when measuring firms response while planning new activity.

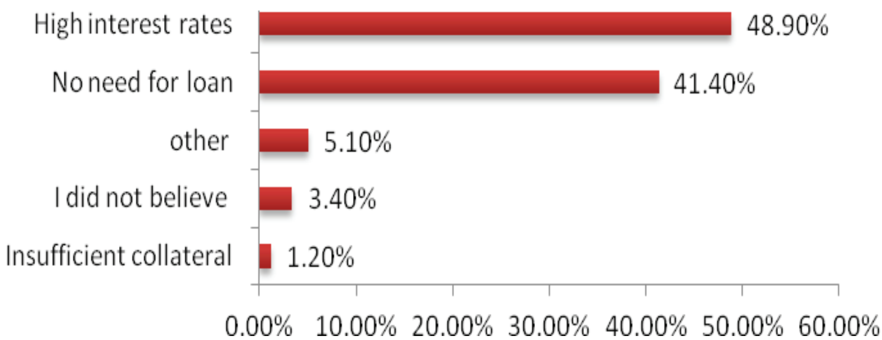
The development of a robust SME sector is essential to job creation and poverty reduction in Kosovo. SMEs in Kosovo, particularly in the manufacturing sector, remain fragile and uncompetitive. The poor level of infrastructure (particularly electricity), high level of corruption, lack of finance, political instability, and poor functioning of the judiciary contributed to an underperforming business environment. Given these factors, the contribution of SMEs to the economy has been insufficient. Understandably, access to finance and cost of finance are main barriers to sustainable business development.

According to the survey conducted by Riinvest Institute, bank lending of SMEs is very low, accounting for only around 12 percent of firms. SME lending from a family or friends, accounts for about 10 percent of SME financing, which is just marginally lower than loans from banks. Nevertheless, the majority of firms (74 percent of firms) in Kosovo tend to rely heavily on retained earnings and their own funds for financing their establishment. As previously mentioned, Figure 9 shows that access and cost to finance remain within the top business barriers in Kosovo, and enhanced with the fact that over 73 % of firms in Kosovo did not take a loan in 2010, this shows the extent of problems that firms face when trying to obtain a loan. The constraint for funding seems to depend on the firm size. About 87 percent of firms that reported positive access to finance (that is, they received a loan during 2010) are micro firms, compared to around 11 percent that are small firms and around 2.5 percent that are medium size firms, where considering the fact that over 96 % of SMEs are micro firms, a positive relationship between the size of the firm and access to finance can be seen. Even though the banking system in Kosovo is progressing continuously, relatively a small number of firms are passing their business transactions and volumes through bank channels . Of all companies surveyed, about 44 percent of them are circulating their sales through banking system.

Thus a higher awareness of entrepreneurs about the importance of improving financial reporting would increase banks' trust towards businesses, and thus banks will facilitate and ease SME access to financing, as well as lower their cost of financing.

The survey also found that the majority (68 percent) of non-beneficiary firms had not applied for financing, and that only 5 percent of the surveyed SMEs that did not get a loan had applied for a loan. Figure 10 shows that almost half of respondents considered high interest rates as the main reason for non-application, while another 40 percent had no need for loan. The main reasons SMEs give for not applying for loans are: high interest rates, no need for a loan, not confident that they would be able to receive a loan from a bank, and inaccessible collateral requirements (see Figure 10).

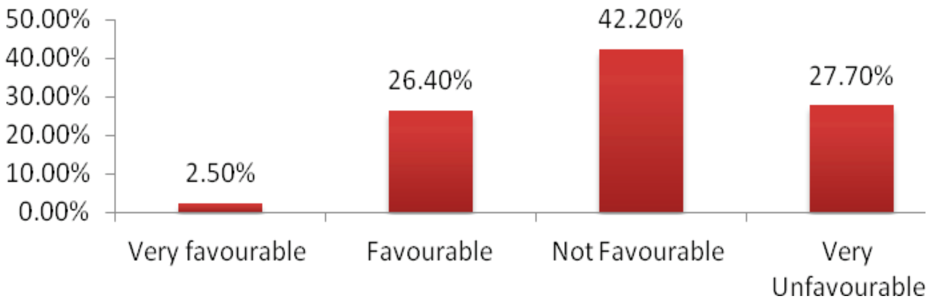
Figure 10 – Reasons for not applying for a loan



Source: UNDP HDR (2011)

In terms of firm investment plans (new business activities), the majority of firms (80 percent) have declared that they have no plans for any new business activities, while the remaining 20 percent of firms have declared that they will start a new business activity. Nevertheless, our survey also found out, that out of all the firms who received loans in 2011, about 35 percent of them plan to start a new business activity, again showing the positive relationship between access to finance and investment.

Figure 11 – Firms' perception on financing climate in Kosovo



Source: UNDP HDR (2011)

Perceptions of firms regarding the financing conditions in Kosovo are slightly different. Figures 11, shows that the perception of firms regarding their financing conditions in Kosovo are slightly different, where the majority of firms (about 70 percent) consider the financing conditions as not favourable, and very unfavourable for businesses, with only a minority (around 29 percent) of firms consider financing conditions as favourable, and very favourable for businesses. Whereas the perception of banks regarding credit interest rates for SMEs are not high at all, and in the end they merely reflect the business environment. According to the survey, no business in the primary sector thinks that the financing conditions are favourable, and only a very small number in the secondary sector thinks that financing conditions are favourable. In general, loan portfolio in the Kosovo banking sector remains of good quality. Regardless of low non-performing loans, compared to other regional countries, credit interest rates remain the highest in the region. Representatives of banking sector argue that inadequate business environment is the main cause of their conservatism, and that low rate of non-performing loans is rather due to their conservatism in providing loans.

The general consensus is that inadequate business environment is the main barrier for non-low interest rates; but beside that, firms themselves carry a part of responsibility. Tax evasion and informality disables them to provide convincing financial statements. Furthermore, unpredictability of firms' performance is contributing to high credit risk which results in higher conservatism by banks (low access to finance).

Collateral is a real restraint for applying for credit, since commercial banks require that every loan of over 10,000 euros must be collateralized with land or buildings and smaller loans generally also require some form of collateral. Additionally, not all forms of collateral are equally accepted by banks, and their preference is determined by present and anticipated transaction costs in establishing and enforcing property rights, the ease of liquidation, and the position vis-à-vis other creditors in case of insolvency. This market preference for collateral based on "administrative issues" in addition to central bank regulations is limiting access to credit to SMEs. SME loans are often guaranteed by real estate, either the company's warehouse or offices, or the home of the owners. Mortgage financing is therefore normally an important component of SME finance. All loans that are distributed in Kosovo require, additionally, at least one co-signer or guarantor. Collateral to loan ratio, respectively the coverage ratio of credit with collateral in Kosovo in 2010 was 236.1 percent which is the highest one in the region (the average ratio in the region was 126.6 percent), further enhancing the dire needs of SMEs for financing their investment, and the level of SME dependence on bank credits.

4.3 Kosovo Competition Authority & Alliance of Kosovar Businesses – Survey Results and Analysis from In-depth interviews

The Kosovo Competition Authority (KCA) as well as the Alliance of Kosovar Businesses (AKB) evaluates the banking system as being very healthy, showing the lowest NPLs and the highest net profit compared to the region. According to the KCA and AKB, the reason why the Kosovo has the highest market concentration in the region, is due to the low number of banks operating in Kosovo compared to the neighboring countries. Recent years have shown that with new banks entering the market, the concentration market has been decreased, but KCA and AKB think that the CBK and our government needs to do much more in improving the business environment, and address many of the barriers and problems faced by commercial banks. And one way to force banks in reducing their interest rates is through the licensing of other banks, which would increase competition and force banks to reduce interest rates on loans.

In terms of comparing the banking system to the region, it is difficult to make a comparison, due to the fact that all our neighboring countries (with the exception of Montenegro) have their own currency, enabling them to potentially have an effective monetary policy, whereas Kosovo has no currency of its own, and thus is somewhat limited in having an effective monetary policy. KCA also think that through their investigation, one of the reasons for having such high interest rates lies in the discrepancies that exist between the maturity of deposits and maturity loans. According to KCA and CBK, time deposits are usually short-term (less than two years), whereas loans are provided for a longer-term (average 5 years), meaning that banks have to keep excess liquidity reserves in order to meet deposit withdrawal, and in turn increasing the cost of finance for banks. Also KCA and AKB think, that the barriers mentioned above by banks, are somewhat exaggerating, and that from their viewpoint, banks have created a very comfortable position in the market, and they seem to not want to change from that.

4.4 The Kosovo Pension Savings Trust (KPST)

Considering the fact that so far the majority of KPST investment has been oriented towards international markets, with the new government plans of issuing government bonds, KPST could potentially direct a part of its investments in these government bonds, ensuring a stable higher rate of return of at least 3.51 percent, compared to the unpredictable market return coming from unstable and fluctuating stock markets that seems to be at present. This investment by KPST would enable government to support projects oriented towards economic developments, and indirectly contribute towards lowering credit interest rates.

5. CROSS – COUNTRY COMPARISON ANALYSIS

5.1 Determinants of interest rates and deposits, observation and comparative analysis for the Balkan Region

Interest rates policy is one of the most important instruments of monetary policy. The common experience in developed countries, as well as in developing ones, has shown that optimal policy of interest rates are an essential precondition to the proper orientation for economic development of a country. From the literature gathered on all countries of South-Eastern Europe (SEE), including Kosovo shows that the level of interest rate level is determined by the market. In general, experts estimate that this region has relatively high interest loan rates (nominal and real), which as a result are interpreted in high interest spreads.

Interest Rate Spread Analysis - Loan and deposit interest rates Spread is considered as an efficiency indicator of financial intermediation. This indicator appears as a difference of credit ex-post interest rates with deposit implicit interest interest rates. For a certain period, e.g. 6 months, this variable is calculated by taking the total of earned interest income from loans for the period in question, divided by the average level of loans given for the same time period and by subtracting the total expenses for interests from deposits of the period in question, divided by the average of bank deposits for the same time period. High interest rate spread percentages are a barrier for financial intermediation, since they discourage potential savers by low deposit returns, while increasing the financial cost for borrowers (individuals and mainly businesses) and thus decreasing the possibilities for investments and economical growth. This is especially disturbing for economies in transition where possibilities for alternative financial resources through capital market are almost minimal and non-existent in the case of Kosovo or Albania and a number of other countries in the South-Eastern Europe (SEE) region, and thus leaving these countries totally under the "mercy" of a banking system which is predominant in SEE financial system.

Based on the findings of Stiglitz and Weiss, 1981, high spreads come as a result of market bank inefficiencies, such as high costs of transaction and asymmetric information. The costs of intermediation that are joined with the selection, with the analysis and the monitoring of borrowers, with deposit and payment services as well as with information asymmetries that generate agency costs, create a barrier/obstacle between interest rates paid to savers on one hand, and interest rates charged to borrowers. The higher these bank inefficiencies are, the higher the bank interest rate spreads will be, thus lowering the benefits and demand for financial intermediation.

Differences in interest rate spreads - Before launching new products, each bank with the highest priority analyses the following indicators:

- Liquidity ratio
- Business aim (if the bank's aim is to be the first in the market, then it keeps the best rates in the market, regardless of interest rate spread).
- Competitiveness, to see the other banks' interest rate level, so that the

bank is competitive.

- Country risk and client risk, in order to determine the loan risk.
- Higher risks are interpreted in higher spreads.
- Collateral type has a direct impact on product spread. The better that the loan collateral is, from its quality point of view, the lower will be the spread's rates.
- Other costs involved (marketing costs, other transaction costs involved).
- The level of non-performing loans (NPLs) in country's bank system

According to many literature resources in this field (Demirgüç-Kunt and Huizinga, 1999; Dell'Arriccia and Márquez, 2004) there are many factors that have an impact on bank intermediation of a country. Thus, the cause for the high spread level could be many factors of economic, financial and legal environment of the market, starting from:

a) Low level of savings in certain countries, while the requirement for loans is presented as high and with increasing tendencies,
b) Limited resources and with relatively high financing cost,
c) Limited access in financial markets and in those of international money markets,
d) Market structure (bank ownership, bank concentration level, the level of competition, etc.),
e) The existence of a high prime risk for each country, especially for lack of financial discipline and problems with law enforcement of bank claims towards their clients related to outstanding loans (problem with recognizing, registering and executing the selling of mortgage guarantees),
f) Relatively high bank operational costs,
g) High level of NPLs in the region,
h) High level of informality and inaccuracy/manipulations with business financial statements, etc.

Besides the factors mentioned above, it has been confirmed that spreads are influenced also by other specific factors of a bank like managerial skills, operational costs of the bank, analytical and risk management skills, managing liquidity and investment portfolio, the level of capital adequacy, etc.

Many studies (Beck and Hesse, 2006) have confirmed the existence of a negative relation between the size of a bank and operational costs, as well as bank size and interest spread. This is mainly due to the fact that intercession costs comprise a fixed cost component of a bank and financial system. In the level economy conditions, namely in the case of large banks, which are able to operate in markets with a big and diversified number of clients, these costs make the difference by impacting in the decrease of interest spread. But in small countries, with relatively limited markets and for banks that are not so large, market failures like inability for diversification of loaners, bad choice, etc; condition a higher risk premium for loan interest rates. Specifically, in most countries of Balkan region, high spreads are justified by the lack of economies of scale, due to the limited size of the market and relatively low level of competitiveness in the banking and financial market in general.

From the systematic financial result analysis of bank system in general was noticed that banks with relatively high level of activities that bring income not from interests, are less profitable. Also, banks that rely mainly on client deposits for financing their activities are less profitable, since deposits require other expenses also, while costs of their funds are higher than loans or other short-term financings in monetary market.

Other factors that explain the high spread levels, especially in Albania, Serbia, Macedonia are the low appetite of commercial banks to take risks, especially when local market offers investments with very attractive interest returns on government bonds in local currency. Another factor that has an impact in keeping high interest rate spreads is the still low level of bank intermediation in the region compared with the developed European economies, which is measured through the loan to GDP ratio. This indicator, especially for Kosovo is around 38 %.

A common characteristic of the banking systems of all South-Eastern Europe countries as well as the ones in Balkan region is an increasing presence of foreign banks during the last 15 years. Such is the case in Macedonia (93%), Bosnia and Herzegovina (92%), Albania (92%), Croatia (90.4%), Kosovo (89.2%), Montenegro (88%), and Serbia (74%). The entrance of foreign banks with new products in Kosovo's bank market, with more experience in the loan market and loan risk analysis and with the financial support from their mother banks for financing their bank branches which have been opened in these countries was accompanied with a bum of lending activity, especially with respect to individual loans or sometimes called consumer loans, including here loans for SMEs as well. Loan increase was widely stimulated by spreads 2-3 times higher that these banks were achieving in Balkan compared to other EU-17 countries or other industrialized countries. Thus, the loan to GDP ratio in most of these countries prior to entering of foreign partners in the bank market were around 20-25% of GDP, while in 2009, these levels were over 60% of GDP. This bum contributed to the economic development of these countries, by creating an increasing model based on increasing overload of personal loans as in the increased obligations of private sector towards commercial banks. Spreading of financial crisis in Europe during 2009-2010 brought deterioration on the level of non (bad) performing loans in many countries of the region, especially in countries where lending in foreign currency (Euro) occupied the main share of lending, which led further to slowdown of loan activity.

Another reason for increased loan interest rates was also the perception of high risk in these countries by foreign banks, which quite often rely on analysis or statistical models of loan risk evaluation and not direct contacts with the people who are demanding loans. In the conditions of informal economy, where businesses often work with two kinds of balance books, these models impose the setting of a higher risk premium compared to western developed financial markets. A considerable impact on the high level of loan interest rates in region, gives also the lack of support of commercial banks on income from non-interest, which is linked with the mix of bank products and services offered by banks in the region. In circumstances where large enterprises secure their financing from the market, even through private ways, the bank sector in SEE countries is supported mainly on individual loans as a profit source, while banks from these countries don't offer services of investment banking or other financial services such as retirement, insurance, investment, etc. plans, which provide high commissions from non-interests sources. It often happens that the higher the income from non-interests in income structure of a bank, the bigger the possibilities for cross compensation income that banks will have, and as a consequence more possibilities for decreasing the level of interest rate spreads. In such conditions, income from interest and high spreads remain the main resource of bank income.

A high concentration of the banking sector was observed through the HHI index, where with 2,157 points in deposit markets, as well as in the loan market, suggesting that it has considerable positive links with the interest rate spreads. Thus, the higher the bank concentration level in the market, the higher the interest rate spread will be. In the Balkan regional market, concentration of three largest banks varies from 54% in the Croatian market (minimum), to 66% in BiH (maximum), and to 74 % in Kosovo's bank market, dictating a very high level of interest rate spreads.

What are usually observed in banks throughout the region, including Kosovo, are the high levels of capital adequacy ratio (regulatory capital expressed as a ratio of risk-weighted assets). This indicator was at the level of over 16.6% for all Balkan countries at the end of 2010, which is quite high even after the crisis of 2008-2009, when as a result of decreasing bank profit, as well as the increased provisioning of NPLs, this indicator decreased significantly. These banks with such high levels of capital, they really have high possibilities in coping with unexpected shocks of the market, or in the case of crisis, however on the other hand they lose profits that ensure a high financial leverage, which at best of times amplifies bank profit as well as its high capital returns to equity (ROE). This means that many banks in the region continue to strongly rely on the strategy of a high interest rate spread, by artificially keeping loan interest rates as quite high. Banks with higher administrative expenses, are usually the ones focused on retail activity (the ones that have more SME clients and small depositors, with average low small credit surpluses and deposits for clients), such as is the case of banks in the Balkan region, where there is more probability of increasing the high interest rate spread in order to compensate high administrative costs.

According to an IMF study (E. Dabla-Norris & H. Floerkemeir, 2007) on bank efficiency and market structure it is argued that "large banks and those banks that are more liquid, that have a lower degree of exposure towards consumer loans and the ones in the agriculture sector are accompanied with lower level of ineterst rate spreads. Dominating banks in the market, with a high level of market share, also enjoy the highest interest rate spreads. Regardless of economies of scale, these banks if they became dominant in the market, they will be able to dictate high interest rates for their activities, specifically loans due to their dominant position in the market. Also banks with higher liquidity levels, as is the case of banks in our region, have fewer assets at risk and therefore provide lower profits in relation to banks that have a more substantial portfolio of their assets in the form of loans.

In the case of the deposit market being competitive, the only way these banks to maintain high profit levels is through the application of high levels of interest rates on loans that they offer and as a result high interest rate spreads. Just as important is also the bank credit portfolio structure of the economic sectors while reflecting the risk premium for the respectice sector. Banks with high concentration of loans in the sectors of manufacturing/processing and that of trade, usually due to the low level of perceived risk and collateral relatively easy to secure and execute, have lower interest rates than those that invest in agriculture sector, where uncertainty is much larger or those that deal primarily with consumer credit. According to the IMF study on bank efficiency, banks with 10% more exposure in agriculture loans or consumer loans, apply from 0.4 - 1.0 basis points more on their average interest rate spreads against similar banks.

Analysis of net margin from interests and its determining factors - Net margin from interest is another indicator for financial intercession efficiency. It is calculated as the difference of income from interest with interest costs divided by the average of bank total activities. In order to set the additional prime that banks set on interest basic rates, they are based on the bank market structure, their attitude towards risk, rate fluctuation and average size of bank transactions. A decrease of net margin from interests may be caused from a decrease of taxes or from an increase in provisioning. If a mass of this interest margin is explained from the rate fluctuation, than the policies should focus on achieving a macro-economic stability. If the impact comes from the power of banks in the market, than the focus should be oriented towards encouraging the competency increase. Differences in interest rate margins show a variety of determinants:

- Bank characteristics
- Macro-economic conditions
- Taxes and fees
- Regulation on deposit provision
- General financial structure
- Several indicators of legal and institutional basis

Also, foreign banks have a tendency to have higher interest margins in developing countries like Albania, Kosovo, Montenegro, etc, since they have advantages in technology compared to local banks, but on the other hand, as it was described above, they lack information on the local market where they operate, including the case of South-East Europe. The size of the banks tends to have impact on lower margins as a result of level economies, while the higher the operative costs, the higher are interest margins, so that the costs can be covered.

A direct impact on interest net margin has also the level of problematic loans. The higher the level of problematic loans the higher is the loan risk and thus the interest rate margins. In this case, bank needs to cover for these loss caused from these loans, by transferring its costs to clients, in the form of higher interest rates for loans. In the concrete case, this increasing rate of problematic loans in countries of our region does not help at all the decrease of loan interests, at least in the short or middle-term. Actually, according to BSCEE Review 2010, NPL rates for the region at the end of 2010 varied from 9% (lowest level in Macedonia), to 21% in Montenegro, where the NPL average for the region remained in the level of 14% but with the tendency for increase in approximately 17% during the first 6-months of 2011.

Another determining factor for the size of interest net margin is the level of required reserve. Banks are required to set their deposits in the form of required reserves with the Central Bank, and thus, the opportune cost of keeping these reserves should be compensated from setting higher interest rates for loans. Economic growth of a country is also a necessary factor for the level o interest net margins, being that the payment ability of loaners is directly linked with this factor. For example, during recession periods, this payment ability drops and as a result loaners may benefit loans from banks, but with higher rates, which increase to cover the decrease in payment ability.

- Differences in bank activity and characteristics of each bank have an impact in interest margins of different banks. Changes in operative costs and other costs from one bank to the other are reflected in changes of banking interest rate margins, since these banks transfer the burden of their operative costs to their loaners. This comes due to the lower costs of frequent received funds from main branches and the support that main branch creates for loan management risk models, procedure standardization, level economies, etc.

- International bank ownership also has an important impact over bank margins. Foreign banks, particularly, realize higher interest margins compared to local banks in developing countries (including Kosovo), and lower than developed countries.
- Macro-economic factors can explain the change in interest margin rates. Also, inflation is linked with high interest margins realized by banks, due to high costs.
- Regarding the financial structure of a bank system of a country, banks in countries with a more competitive banking sector, where there is a higher report of the total of bank sector activities towards PBB, have lower interest margins. Also, the report of bank concentration has impact on the level of interest margins, which has positive impact on bank profitability. Thus, larger banks with more dominant positions in the market tend to have higher margins in relation with countries where the bank system is distributed within different banks having a lower level of concentration.
- Lastly, differences in legal and institutional issues are very important and have a big impact in determination of interest rates. Indicators of better implementation of contracts, efficiency of legal system or lack of corruption are linked with realized low interest margins

The non-performing loan indicator in the region - An important indicator compared between countries regarding loans is linked with financial resources.

Table 9: The region's NPL indicator

The report of NPLs (in %)							
	2005	2006	2007	2008	2009	2010	2011
Albania	2.3	3.1	3.4	6.6	10.5	13.9	17
Bosnia-Herzegovina	5.3	4.0	3.0	3.1	5.9	9.2	11
Croatia	6.2	5.2	4.8	4.9	7.8	11.2	n.a
Macedonia	15.0	11.2	7.5	6.7	8.9	9.75	9.2
Montenegro	5.3	2.9	3.2	7.2	13.5	21.0	25
Serbia	n.a.	n.a.	n.a.	11.3	15.5	17.8	19
Kosovo	2	3.5	3.7	3.5	4.3	5.9	6.0

Source: Central Bank Annual reports of respective countries

In fact, for Albania, Macedonia, Montenegro (at least initially) and Serbia, loan extension was financed by more support on deposits in the country (in local financing resources) than in loan lines (either from meme banks or even in inter-bank market with resident and non-resident banks). While in Kosovo loans are mainly comprised from deposits. Regarding problematic loan rates for countries in the region (see Table 9), they present a somehow mixed picture, however their tendency remains increasing for all these countries. This not so low rate, especially for some of them, presents higher costs for banks in the form of provisions, higher taken risk, lower profitability, therefore as a result of all above mentioned factors also higher loan interest rates.

Interest rates in Kosovo

From Table 10, we can notice that interest rates for loans in Kosovo at the end of 2011 are 14.3 percent. With very difficult loan conditions, the main financial resources for credit activity in Kosovo are the citizen deposits. This goes to show that the high level of interest rates on loans is a huge burden on business developments.

Table 10. Interest rates for loans in local currency and foreign currency, in %

Countries	Albania	Croatia	Serbia	Mon-tenegro	Macedonia	Kosovo
Local currency	12,11	9,78	17,91	-	9,63	-
EUR	7,44	6,35	8,36	-	7,65	14,3
USD	7,56	-		-	5,07	-
CHF	-	-	5,22	-	-	-
Të tjera	-	7,45	10,03	9,67	-	-
Total Average	7,50	6,90	7,87	9,67	6,36	14,3

Source: Central Bank Annual reports of respective countries

From Table 10 we notice that Kosovo is among the countries with highest average interest rates for loans compared to the other countries in the region. Factors that had an impact in determining interest rates are external (mainly related to risks from macro-economic and political unstable situation), and internal, as listed below:

- The manner how NPLs were managed
- A judiciary and cadastral system with many problems. Therefore, property rights which is the main form for loan collateral, where in the case of solving this problem, then the offer for long-term loans would be increased, which would be offered with lower interest rates.
- The low level of competitiveness in the banking system.
- The high level of informality and inaccuracy/manipulations with financial statements of businesses.
- A high insecure environment in issuing loans and even greater risk in paying back those loans.

Loans for enterprises continue to have higher interest rates compared to household loans. One of the reasons that may have impacted the setting of higher costs by banks towards enterprises is their sensitivity towards economic shocks, as well as the higher risk profile of business projects. In December 2011, the average interest rate for enterprise investment loans was 16.4 percent, while the average for individual loans was 14.15 percent. It was noticed that SME investment loans, had the highest interest rates.

The interest rates, especially credit interest rates, depend a lot on factors that are within the control of commercial banks as well as on factors outside their control. The impact of Central Bank through instruments of monetary policy is very limited due to economy eurosation, which has eliminated the main traditional instruments of central banks which could have been used to have an effect on interest rates. The growth of efficiency in the banking sector would contribute in lowering the costs associated with this sector, and thus contribute in lowering loan interest rates. Moreover, the business environment where the banking sector operates is extremely important and has a direct impact on loan interest rates.

General improvement of the business environment in a country is a key factor for lowering the risks associated with loans in general, which represents one of the key factors for determining loan interest rates. On the other hand, by increasing the efficiency of the judiciary system, the execution of collateral would be easier, thus affecting the efficiency of banks and reducing credit risk. Also, an improvement on the financial reporting from businesses would have a positive impact as it would increase bank trust in businesses, and thus lower the monitoring costs. Another important factor for reducing credit risks is by promoting the corporate governance in businesses, including an increase of capacities on planning, development of concrete and feasible business plans, etc.

Challenges for the future of the region - The expansion of the internal consumer requirement in the Balkans, with conditions where the flux of sufficient funds from the main branches until now, will be decreased significantly due to the problems with liquidity and sufficient regulatory capital that they are experiencing at present, is considered as the main instrument that will keep the economy alive and the country's economic growth. This is due to the reason that opening new businesses or the expansion of existing ones through bank loans, opens new employment opportunities, it increases income in general, which has a direct impact on improving the poverty level. Expansion of domestic demand is associated more with the granting of more loans from banks. But if interest rates do not decline, future credit expansion is not expected to happen.

Continuous efforts to overcome the barriers/unfavourable conditions on interest rates (high) on the first instance, it means primary improvement of performance and basic macro-economic indicators of a country, mainly with impact oriented towards the policies of interest rates. It is understood that here, first of all as a determining factor will be ranked the demand-supply ratio for funds (in a national level the savings/investments ratio). In short term or medium term there are several factors that need to be identified with the characteristics for each country and can be taken some measures that have a positive impact on interest rates, without threatening/affecting the most fundamental principles of the market. Thus some measures of overcoming some of these problems can be listed:

A review of tax policies that seems to have a negative impact on savings in Kosovo and Albania for wider participation of public, could perceive as an incentive policy, to remove taxes on income for 2-3 years for investments in government bonds. The increase of the remuneration degree of the required reserves from Central Bank based on the different measures according to the characteristics that every country has. Maybe there is room to begin to gradually lower the required reserve level set out by CBK in all countries of the region.

The establishing of effective and efficient policies, and procedures for internal quality standards in banks regarding credit approvals and the quality management of bank credit portfolios. Bank association could look at the possibility of unifying / standardizing / harmonization of loan giving procedures. In particular for Kosovo, the focus of actors and improvement measures should be aimed in the main directions addressed at the section of policy recommendation section:

CONCLUSIONS

Literature studies collected for all Southeastern Europe (SEE) countries including Kosovo also show that the level of interest rates is determined by the market. Generally this region is estimated by experts to have rates (nominal and real) of relatively high interest rates on credit (for individual loans 14.2 %, and for SME business loans 16.65 % in December 2011), which is translated into higher spread of interest rates.

The high interest rate spread (which in Kosovo in December 2011 marked 10.8 percentage points), are considered to be a huge obstacle to financial intermediation, as they discourage potential savers with low returns from deposits, while increasing the cost of financing for borrowers (individuals and businesses primarily), thus reducing opportunities for investment and economic growth.

This is particularly worrisome for economies in transition where opportunities for alternative funding sources through the capital market are minimal or almost non-existent in the case of Kosovo and several other countries in the region of Southeast Europe (SEE), leaving these places completely under the “mercy” of the banking system that is prevalent in the financial system of the SEE. These higher spreads are justified especially in the Balkan by the lack of economies of scale due to a limited market size and relatively low level of competition in the banking and financial market as a whole.

The banking sector until the end of 2008 has constantly increased its net profit (34 million euros), followed by a sharp decline in 2009, where bank profits decreased to 27.4 million euros, attributing this profit decline (24.1 %) to banks conservatism and risk averse approach (mostly due to the Eurozone debt crises), by strengthening their credit standards in granting credits to SMEs. Nevertheless, results tell us that bank’s net profit has trended upward again in 2010, and it continued in 2011 as well, where by the end of 2011 the amount of total banking sector net profit was about 37 million euros, an annual increase of 13 %.

In addition, a high concentration of banking sector (measured by index Herfindahl-Hirschman’s (HHI)) with 2,157 points on both the deposit and the loan market, has significant positive relationship with interest rate spreads, where the higher the degree of banking market concentration, the higher the interest rate spread. Our research found out that the banking system in Kosovo remains highly concentrated with the market share of the three largest banks accounting for about 74% of total banking sector assets. This means that banks in Kosovo continue to rely heavily on a strategy of high interest rate spreads, thus keeping artificially high interest rates on loans.

Additionally we conclude that there is an increasing tendency in the share of time deposits with longer maturity, which may be related to the approval of the Law on Deposits Insurance, which has a direct impact on further increasing depositors’ confidence in commercial banks. Also, higher interest rates for deposits with longer-term maturity represent an important factor that may contribute to the increase of maturity period for time deposits.

Our research shows that performance indicators such as ROA (1.4%), and ROE (14.5 %), as well as the level of non-performing loans (6 %), make Kosovo’s banking sector the safest and most profitable as well when comparing it to the region.

Nevertheless, when assessing the performance indicators of ROA and ROE for only the three largest banks in Kosovo, these indicators lead us to a conclusion of an even greater profit made by these banks, where 90.1 % of total net profit of the banking sector went to the three largest banks. The return on assets by the end of 2011 for only the three largest banks, marked 1.81 % which is greater than the ROA of Kosovo's banking sector, and greater than six times of the region's average. Whereas, the return on equity (ROE) in 2011 for the three largest banks, marked a growth of 16.33 % way above the sector's average in Kosovo, and the four times the growth of the region's average.

According to CBK in order to have lower interest rates in the credit market, they too agree with the assessment of the commercial banks, that a general improvement of the business environment will definitely attract new entrants in the Kosovo market, which banks will have to be more competitive and more efficient, contributing to a more lower bank operational costs, and in turn lower credit interest rates as well.

In terms of banks increasing their credit potential, CBK points out that all the banks in Kosova, have the potential of increasing the level of credit in the market, due to the fact that liquidity reserves held by banks have consistently exceeded their requirements, meaning that these surplus reserve can potentially be credited to the market. However according to banks, they also face a lack of adequate projects which could be credited for investment projects, and this may be one reason why banks have an excess liquidity reserves and are not willing to use it.

In terms of the Credit Registration Bureau which has been established and maintained by CBK since 2006, where every loan issued by commercial banks is registered in this Bureau, this is considered as a highly important step by commercial banks towards reducing credit risk due to the fact that they get the very latest information from this Credit Bureau. According to CBK and commercial banks, before approving a loan, every bank as well as other microfinance institutions, consults with the Credit Registration Bureau, whether the person applying for a loan has other loans with other banks, and this is very useful since it elaborates the history and credit worthiness of a client, thus contributing to a lower credit default risk in general.

Regarding government bonds, commercial banks think that they might have an indirect impact on interest rates. With bank reserves not earning any remuneration at all, CBK and banks think that the excess reserve funds (excluding the obligatory reserve requirement by law of 10 % of deposits) of commercial banks will be used to invest in these government bonds and ensure a higher rate of return (interest rates for the January phase of government bonds is 3.51 %). This will contribute in lowering the cost of finance for banks, and this in turn might lower interest rates.

According to banks and CBK, an increase in the level of business plan writing skills of companies will also have an impact on interest rates. The reason for this is that the higher the knowledge that companies possess in business plan writing skills, the bigger the chances are that these companies will have their documentation in order (such as registering their employees with TAK, audited financial statements, regular tax payment etc.), with clear ideas of the direction of where they are taking their companies, and this in turn will enable banks to check whether the company is developing according to their business plan, as a result banks will have reduced their operational costs, meaning lower interest rates.

The general consensus is that lack of competition in financial markets, and inadequate general business environment is the main barrier for non-low interest rates; but beside that, firms themselves carry a part of responsibility. Tax evasion and informality disables them to provide convincing financial statements. Furthermore, unpredictability of firms' performance is contributing to high credit risk which results in higher conservatism by banks (low access to finance). The main business barriers in Kosovo are institutional. Driven by unfair competition, corruption, cost and access to finance, street crime (and organized crime) and political instability, these barriers risk seriously opportunities for a profound business environment in Kosovo.

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Annex 1
Interest rates in Macedonia

At the end of 2010, bank system in Macedonia comprised of 18 banks, 14 of which owned by foreign share holders, from which 9 where branches of foreign banks. Therefore, it is clear that bank system is dominated by foreign banks, but the level of financial mediation remains in very low level compared to European Union countries. Interest rates for loans, either for local currency or for the foreign one, either for businesses or individual, had a decreasing tendency since 2009. This decrease was supported by the decrease of basic interest rates, from 9% in 2009 to 4% in 2011. The loan for this period received a push from increase of deposits, especially from individuals as the main factor, thus expressing also an increase of public trust in bank sector.

Annex 2
Interest rates in Serbia

Regardless of the fact that bank sector in Serbia is considered as the most successful part of economy, interest rates for loans set by Serb banks are at very high levels. This is due to the high level of inflation and the policy followed by the Central Bank. Therefore, in order for the bank to retain the inflation rate at the desired level it applies high interest rates. On the other hand, interest rates for deposits are higher than in the countries in the region (excluding Kosovo) and thus businesses of these countries choose Serb banks to put their savings into. Retaining the interest rate at high levels has increased the difficulty of loaners during the last years to repay the received loans, impacting the increase of the problematic loans at 9.2% for individuals and 20% for corporations by the end of 2010.

Annex 3
Interest rates in Albania

Due to the number of banks, the competitiveness of the market and conditions of bank services have experienced an improvement in Albania. However, financial mediation in country is still low, which presents an obstacle for expansion of private sector, comprised mainly from small and medium enterprises. Regardless of a small decrease in relation to the previous period, interest rates in Albania are considered relatively high, since basic interest rates determined by Central Bank for re-purchasing agreements is still high (5.00%), compared with basic rates of re-financing applied by European Central Bank (1.25%) or Federal Reserve (0.25%). These rates are applied to ensure a stability of prices in the country, therefore to keep the inflation within the set levels. However, these rates have their impact on loan interest rates in local currency. In the analysis of interest rates for loans in country, it may be said that one of the reasons for relatively high interest rates in relation to the region, is annual rate of investment return on Treasury Bonds (government debt), which is presented relatively high in relation to the other part of European countries. This rate is significantly important, since most of banks in country determine the interest rate for consummator loans taking the annual rate of Treasury Bonds as a reference, by making the loan interest rates fluctuate according to the interest rate trends.

Also, the level of required reserve and its remuneration rate have impacted on the level of market interest rates. Commercial banks in Albania show the same tendency with banks of the region to fill in the "loss" from engaging their funds in required reserve, required in mandatory form from Central Bank (which is remunerated with low interests), by making the margin move after several periods in case of reserve level changes. In determining the interest rates is included also an addition in the form of risk prime. Therefore, the manner loan interest rates are built is as such: fund costs (for each coin) plus the risk prime for each segment (individual, small and medium enterprises and corporate) plus the individual profit margin of respective bank. Regarding the risk prime for each segment there are always incorporated different risks, such as the place, branch, sector, client, liquidity, maturity, etc. For a long time minimal prime for banks in Albania was 3% (thus 3 leke lost for each 100 leke). On this logic, interest rates for local currency in general are high, while they appear mitigated in the currency, although for these rates is followed the tendency of international index rates (Euribor, Libor or basic rate of Federal Reserve or European Central Bank).

Another issue that has impact on interest rates for offered loans from banks, especially for businesses, are also the problems with collateral registration and its execution in case there is a need, problems that need to be taken into consideration when we evaluate the set rates in Albanian loan market. It was noticed in Albania during the last three years an increase of provisioning costs due to the increase of activities that carry risks, making the net margin of the interest rate increase. This level at the end of the third quarter of 2011 according to the Bank of Albania reached the level of 18%.

Income from non-interests (from commissions, etc.) in Albania prove that cases when they are high, after a certain period, lead to a decrease in loan interests, serving as replacement/compensation of each-other. Also, although banks have been adding capital, as a result of requirements from supervising authority, they were more careful regarding the loan and respective interest rates, thus the higher the engaged capital the higher is also the taken risk.

On the other hand, political and economic changes that happened in Albania have impacted the bank system development, which transferred in a two-level system, recognized a privatization process, loan liberalization, indirect instruments of monetary policy, consolidation of regulatory and supervising staff, openness towards foreign financial institutions, as well as joining or merging processes of banks. All these factors have impacted on products, services, as well as interest rates offered to the public.

Finally, net margin of interest rate in Albania was positively impacted by fluctuation of interest rate (Euribor, basic rate of local currency, and somehow from Libor), from the level of bank operative expenses, which had an increasing tendency, as well as from the sum of bank reserve laid by Central Bank. Other determining factors are level of bank capitalization, net income from commissions, management affectivity, loan risk and concentration level in loaning terms.