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The performance of commercial banks and the financial soundness indicators – Evidence from Kosovo

Fadil GOVORI
Public University "Haxhi Zeka", Peja, Kosovo
govorif@gmail.com

Abstract

Financial intermediaries perform indirect financing, and in this context the commercial banks are very important participants. They carry out the bulk of indirect financing transactions. On the other hand, the implementation mechanism of monetary policy is closely linked to the functioning of the banking system.

Kosovo's Commercial Banks performance is satisfactory compared with regional. In this paper we provide some of the performance indicators. The rates of return of commercial banks are greatly and directly affected by the net interest margin, provisions for loan losses, revenues and expenses by the non-interest, taxes and the equity multiplier. In this context, liquid assets do not appear to be of high impact in determining and variability the rate of return, high liquidity with low returns.

Also, we will address the impact of the global financial crisis 2008-20012 in the commercial banks performance in Kosovo, mainly through the impact of the decline in the asset use ratio. We think that was a positive approach that banks have followed the the course of returns fall by thereduction in interest-expenditures, while the costs of provisions for loan losses to total average assets marked constant level throughout the period, despite the increasing ratio of nonperforming loans.

Drawing on these findings it is recommended that banks even further engage in reducing operational costs, diversify income sources in order not to rely exclusively on the interests of loans, and to strengthen credit risk management in order to minimize the credit risk.

Key words: Banks, banking sector, banking performance, determinants of performance, profitability, rate of return, net interest margin, non-performing loans.

JEL classification: G2, G21, G0, G01, G1, G11, G3, G32

1. Introduction

Financial intermediaries perform indirect financing helping financial system participants with asymmetric demands to provide additional funds for their needs, or to invest their savings. The main participants in the financial system are individuals, businesses, financial intermediaries, and governments. In the context of financial intermediaries that carry out indirect financing, commercial banks occupy an important place. They carry out the bulk of indirect financing transactions. On the other hand, the implementation mechanism of monetary policy is closely linked to the functioning of the banking system. The degree of efficiency of financial intermediaries influences the economic growth. For that reason we analyze the performance of commercial banks in Kosovo.

The primary purpose of the financial system is that through financial institutions mediate in the process of transferring funds by the sectors that have surplus to sectors that need additional funds. Linking between strong economic grow with the level of efficiency of banks strengthes especially in countries which have not developed financial markets and businesses use mainly bank loans as a form of financing.

The global financial crisis 2007-2009 showed the importance of the performance of banks at the national and at the international level. The importance of banks is even higher in developing and in non-developed countries, because financial markets are not developed normally, so banks are the main source of financing of the majority of firms and keep most of the savings. In this sense it is interesting to analyze the performance of banks and the banking system in general and their determinants.

Here in Kosovo banking sector dominates the financial sector including about 76.3% of total assets.[1] Banks

[1] *Other sectors of Kosovo's financial system include: Pension funds with a share of 17.0% in total assets, microfinance*

appear as the only financial intermediaries channeling funds from lenders to borrowers by generating high profitability. ROA is estimated at about 1.5%, while the ROE is estimated at 15.3% (December 2011). High profitability on the one hand enables the preservation of financial stability, but on the other hand reflects as a higher cost of intermediation since the level of profitability of commercial banks in Kosovo is built on high interest margins, that measured by the ratio of net interest income to total earning assets or net interest margin, on average is about 6.4%. High interest gap means more profits of banks and increase of stability in the banking sector, especially in the absence of functioning of capital markets where a key source of growth of basic capital appear earnings (Saunders & Schumacher, 2000).

In this paper we analyze the performance of the commercial banking sector in Kosovo based on the achieved profitability for the period 2006-2011. To get a clearer picture of the performance and development of banks in Kosovo, initially it has been compared with neighboring countries in the region in terms of participation of the banking sector loans to GDP, capital, asset quality, profitability and interest gap.

2. The performance of commercial banks - Literature Review

Usually when addressing the performance of commercial banks we use as a benchmark determinants of profitability of banks. Research studies on the determinants of banks' profitability focus in return on assets and on equity and the net interest margin. In this context, usually are analyzed impacts of special factors of banks in their performance such as risk, market power, administrative expenses and the cost of the reserve requirement. Many other researches of factors affecting the performance of banks include the impact of macroeconomic factors ((Angbazo, (1997), Demirgüç-Kunt and Huizinga (1999), Angbazo (1997), Athanasoglou et al. (2006)).

Demirgüç-Kunt and Huizinga (1999) using data of individual banks of 80 different countries for the period 1988-1995, analyzed how the characteristics of banks and the general environment in which they operate affect net interest margin and their profitability. Results showed that among others, well-capitalized banks have higher and interest margins and are more profitable. This is consistent with that that banks with higher capital rate have lower costs for providing funds of finance due to lower possibilities for bankruptcy; banks that have relatively high share of non-interest-earning assets are less profitable; banks that have deposits as the main source of assets are less profitable because deposits require more branches and other expenses; variations in total expenditures and other expenses are directly forwarded to the variability of the interest margin of banks.

Banks pass their operating costs to depositors and borrowers by adjusting the level of interest rates depending on the operating expenses. Also, this study found that macroeconomic factors, legal factors, and market structure affect the bank profitability. Inflation is followed by higher margins of interest. Inflation brings higher costs - more transactions and generally more extensive network of bank branches and also more income by the bank streams. Indicators of better implementation of contracts, efficiency of legal system and lack of corruption are associated with the lower margins of interest and profitability.

Angbazo (1997) in his study analyzed the U.S. banks for the period 1989-1993 and exhales as a determining factor of the net interest margin premium credit risk and macroeconomic environment. Here is proved that net interest margins are positively related to the level of the basic capital, non-interest reserves and the quality of management and negatively associated with the liquidity risk.

Saunders and Schumacher (2000) applied the model of Ho and Sanders (1981) in analyzing of determinants of net interest margin in six countries of the European Union and the United States for the period 1988-1995. The study found that macroeconomic fluctuations and regulations have significant impact in the net interest margin. Their results also showed significant inverse relation amongst strengthening the solvency of banks (defined as the highest ratio between capital and assets) and the reduction of financial costs for the services provided to customers (measured through the lowest rate of interest margin).

Athanasoglou et al. (2006) applied the dynamic model with the panel data for the study of performance of Greek banks for the period 1985-2001. The results showed that the performance of Greek banks depends on internal factors of banks - capital, credit risk (expressed as the ratio between reserves for losses on loans and loans), productivity, cost management and the size of banks; from specific factors of industry - the ownership and concentration, and the macroeconomic factors - expected inflation and production cycle.

Brock and Suarez (2000) analyzed the determinants of the interests of margins (gap) of the many Latin American countries during the mid-1990s. Analysis showed that higher operational costs and the high level of provisions for credit losses influence the higher interest gap, although the size of the impact varies by country. The required regulatory reserves also influence the higher gap.

Flamini et al. (2009) analyzed the determinants of profitability of the commercial banks in countries in Sub-Saharan Africa, including 389 banks from 41 countries in this region. The study unveiled that besides credit risk, higher returns on assets are associated with the size of the

institutions with 3.7%, Insurance companies by 3.0%, and other financial institutions.

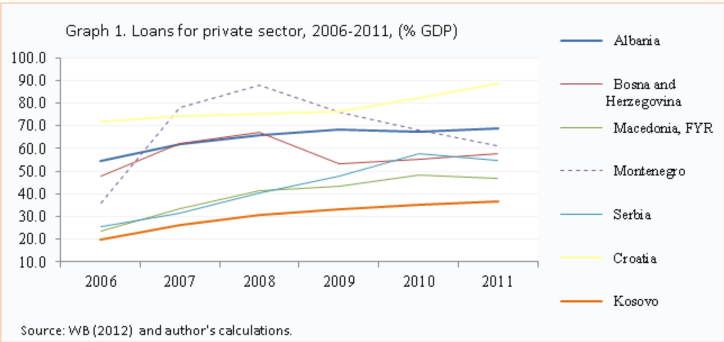
banks, variability of the activities and private ownership. Furthermore bank returns resulted to have been affected by the macroeconomic variables and the level of capital.

3. Development of the Banking Sector in Kosovo

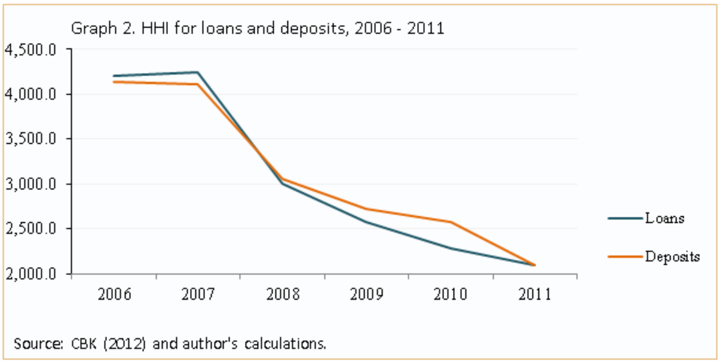
The history of the development of the Kosovo banking sector is short. Kosovo banking sector started from the beginning in 1999. Earlier there was no banking sector in terms of operating under market economy. The banking sector was part of the banking sector of the former Yugoslavia, which since the early 50's had the system of the commercial banks constituted in the National Bank and several individual commercial banks which were not owned by the state but rather collectively owned under Yugoslav autonomous system of self governing (Bonin and Wachtel, 2004). These banks were destroyed in the early 90's, with the beginning of the dissolution of former Yugoslavia. Kosovo, really, only after the liberation in 1999 had the possibility of creating financial sector from the beginning.

Kosovo's financial sector is dominated by the banking sector, with assets which include about 76.3% of the total assets. Kosovo banking sector is small in terms of his participation in the Gross Domestic Product with a share of 36.6% of the loans compared to other countries in the region, where this share reaches to 88.5% as in the case of Croatia, 69.1% in Albania, 61.0% in Montenegro etc. (Graph 1). However, the increasing trend in Kosovo banking sector is fast and appears as one of the key factors in promoting economic development. Active loans to the private sector amounted to some 1.7 billion euros at the end of 2011, while for example in late 2006, marking 636.6 million and accounted for just 20.0% of GDP.

Participation rate of the loans in the country's GDP can be taken as indicator of the level of financial sector development and the level of competition. The higher this share is much more developed and competitive banking sector is expected to be. Banks in countries with the stronger interbank competition - where the share of bank assets in the GDP is higher - have lower margins of interests and are less profitable (Demirgüç-Kunt & Huizinga, 1999). In this sense the Kosovo banking sector, in spite of rapid growth, there is room for further improvements in the order to be comparable with the the region.



Kosovo banking sector almost all the time has been characterized by the entrance of new banks and is moving towards a sustainable financial consolidation. The Kosovo banking market currently consists of nine commercial banks, of which seven are foreign owned and domestically owned two. Foreign-owned banks dominate the Kosovo banking sector, by managing 89.0% of total assets, while the remaining 11.0% of the assets are managed by two local owned banks. The market structure of the Kosovo banking sector is characterized by a high level of the concentration where about 73.0% of the banking system total assets are managed by the three largest banks (CBK, 2012).



However, the degree of concentration has been in the steady decline since 2006. Expressed through Herfindahl-Hirschman index (HHI) to total loans and total deposits, Kosovo banking sector had a large concentration by 4.210 points to total loans and 4.138 points to total deposits in 2006, while at the end of 2011 the degree of concentration was 2,090 HHI points for loans and deposits.[162] This can be translated as a performance of increased competition in the the banking sector.

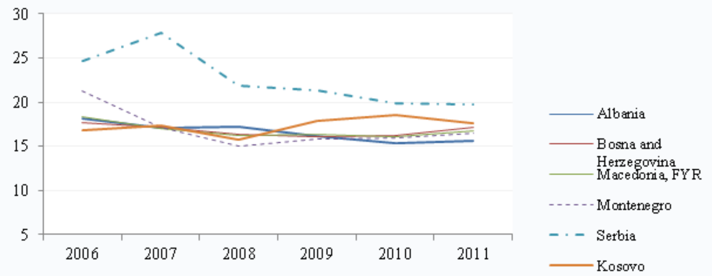
4. Financial soundness indicators

Kosovo banking sector appears with the stable financial position. All financial soundness indicators appear satisfactory and significantly stronger or comparable to the financial soundness indicators of the region. Take for example the capital, asset quality, and profitability.

4.1. The capital adequacy ratio

The capital adequacy ratio expressed as the ratio between regulatory capital and total risk-weighted assets is estimated as one of the most important indicators to evaluate the viability of the banking system. Capital adequacy and appropriateness determines the scale of ability of financial institutions to withstand shocks in their balance sheets (IMF, 2011). Capital adequacy ratio in the the Kosovo banking sector is estimated about 17.6%, which is slightly above the average of the countries of the region which is estimated about 17.5%.

Graph 3. Total regulatory capital to the risk-weighted assets, (%)



Source: IMF (2012) and author's calculations.

The level of regulatory capital (CAR) in the Kosovo banking sector is significantly higher than the regulatory requirements of the CBK, which define a minimum regulatory capital ratio of 12.0% of risk-weighted assets.

The height of CAR is made possible by the performance of the rapid growth of total capital. On average during the years 2006-2011 regulatory capital is added each year to about 36.3 million euros or 20.9%, far exceeding the average growth rate of RWA estimated at 20.0%. The increase of total capital is made possible by the entry of foreign capital and by the continued capitalization of profits. During this period in the Kosovo banking market entered NLB Prishtina bank through the purchase of Kasa Bank and New Bank of the Kosovo (BRK), and began to operate TEB Bank. The average net profit realized during this period was around 29.5 million euros and and provides a strong growth of total equity or regulatory capital.

Table 1. Capital adequacy ratio, 2006 -2011

	2006	2007	2008	2009	2010	2011
Capital adequacy ratio	16.8	17.4	15.7	18	18.6	17.6
First class capital to the risk-weighted assets (%)	14.7	16.1	14.6	15	15.6	1,261.7
Total regulatory capital (million euros)	118.0	164.6	196.9	241.3	271.3	299.7
Total first class capital (million euros)	103.1	152.3	182.5	201.7	227.3	252.3
Total risk-weighted assets (RWA) (million euros)	702.9	943.7	1,253.0	1,340.8	1,455.1	1,710.0
Net income (million euro)	20.2	33.4	26.0	27.4	32.8	37.0
Dividend paid (million euros)	0.6	9.2	10.0	21.3	15.7	20.0

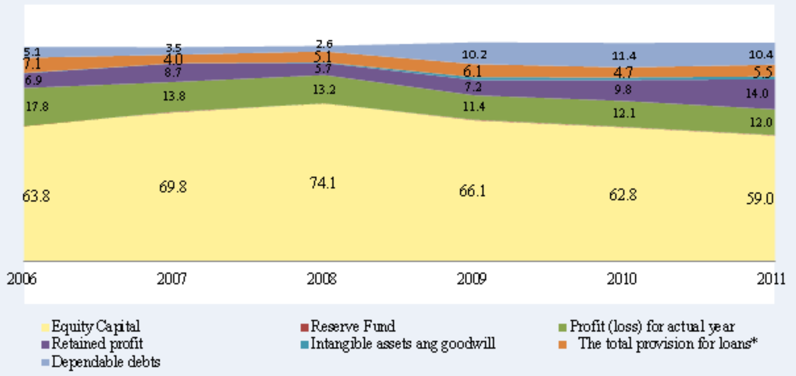
Source: CBK (2012)

[162] *The U.S. Department of Justice, as a non-concentrated markets considers those in which the HHI ranges amongst 1000 and 1800 points, and as a concentrated markets those over 1,800 HHI points.*

In the last six years (2006-2011) in the Kosovo banking sector, the total value of dividends paid reaches to 76.7 million euros, which constitutes about 43.4% of the total value of earnings or said differently in the period 2006-2011 on average about 12.8 million euros per year, or about 41.3% of the level of the annual profits went to dividend payments, while the rest of profits on average 16.7 million euros per year or 58.7% was directed in increasing the capital or kept the status of retained earnings from the previous years.

In the structure of regulatory capital, share capital appears as the main source of financing, on average in the period 2006 -2011 by 65.9%, followed by earnings realized during the current year and retained earnings on average of 15.2%. Subordinated debts on average in the period we are analyzing finance the equity with about 7.2% by increasing especially in 2009 (Graph 4).

Graph 4. Constituent elements of the regulatory capital, 2006 - 2011, (%)

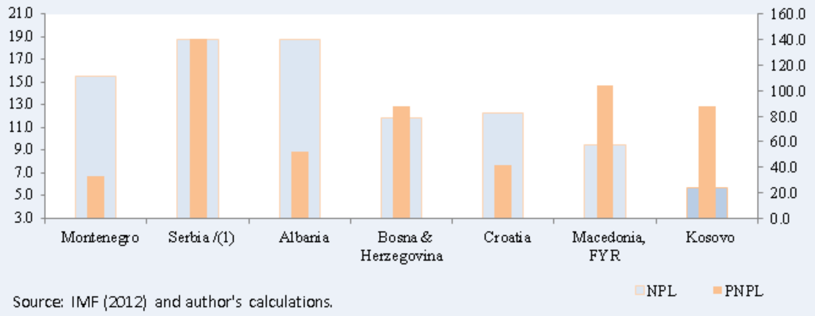


Source: CBK (2012) and author's calculations.

4.2. The quality of bank assets

The quality of bank assets affects earnings, capital and liquidity. Non-performing loans (NPL) ratio expressed as the ratio between total loans and non-performing loan portfolio can be assessed as one of the most important indicators to evaluate the quality of a particular bank's loan portfolio or of the banking sector in general. NPL ratio in the Kosovo banking sector is estimated at about 5.7% and can be evaluated as a moderate level compared with countries in the region. Specific provisions for NPL cover about 87.8% of nonperforming loans in 2011. Such a coverage ratio can be considered as satisfactory.

Graph 5. The ratio of nonperforming loans and their coverage by provisions, 2011, (%)

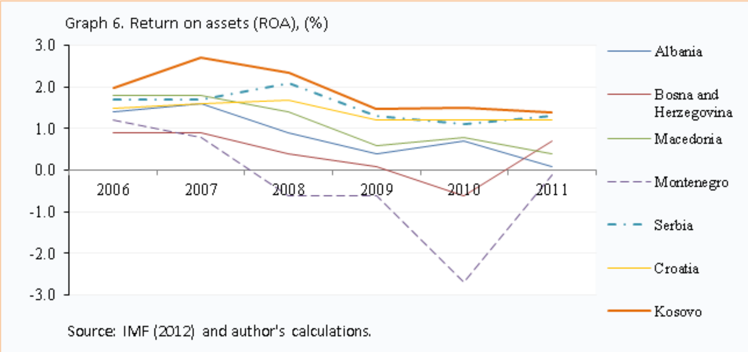


Source: IMF (2012) and author's calculations.

However, the NPL ratio has shown growth performance in the recent years by 3.3% in 2008 to 4.4% in 2009 and 5.9% in 2010, 5.7% in 2011. This according to CBK at least for 2010 to some extent can be attributed to the "base effect" caused by the tightening of lending by commercial banks in response to increased uncertainty over the performance of the real sector of the economy.

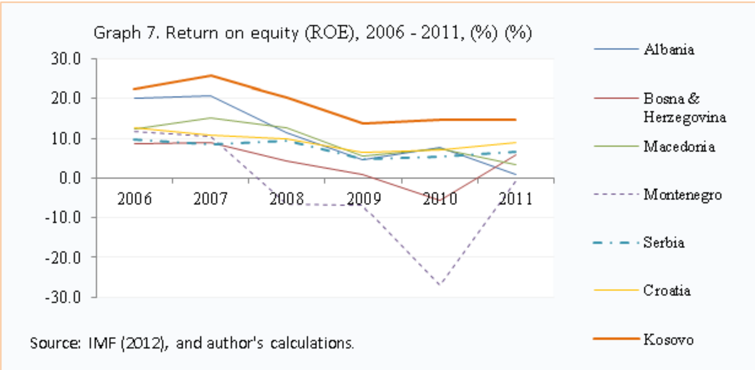
4.3. Indicators of profitability

Kosovo banking sector is among the countries with the highest indicators of the profitability in the region. ROE for the Kosovo banking sector at the end of 2011 is estimated for 14.5%, while ROA 1.4% (Graphs 6 and 7).

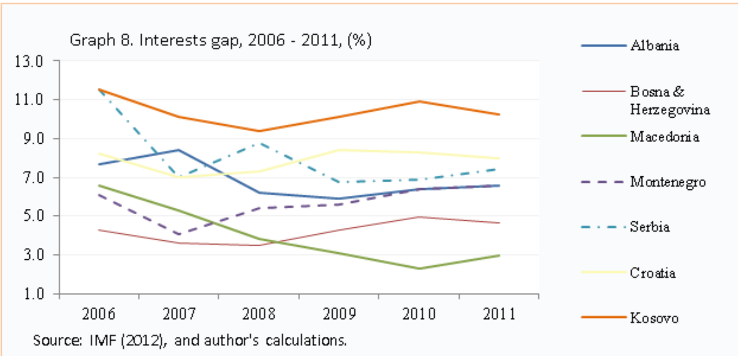


The basis of the high level of profits in the Kosovo banking sector derives from generating high revenues from interests. Income from interests in the period 2006-2011 on average accounted for 79.3% of the total revenues of Kosovo Banking Sector.

The remaining 20.7% of revenues consist of revenues by non-interest which mainly consists of revenues from commissions.



The gap between interest rates in loans and interest rates in deposits reaches to 10.2 percentage points (pp) in December 2011, while in the region ranges from 3.0 pp as in the case of Macedonia, or even up to 8.0 pp as is the case with the Croatian banking sector (Graph 8). The average interest rate in loans is estimated around 13.9%, while the average interest rate in deposits around 3.6% (CBK, 2012). Among the reasons for the high interest gap may be the small size of the banking sector, reflecting non realization of economies of scale, the requirements of rapid return on investment and high perception of the credit risk, despite that according to data asset quality problems appear not so high.



Furthermore interbank competition appears limited by allowing banks to operate with higher interest margins.

High interest gap represents an obstacle to financial intermediation, by discouraging potential savers who realize lower returns in deposits and increase the cost of financing the debtors. That impacts reducing of the investments and economic growth opportunities.

General and administrative expenses (personnel expenses, administrative expenses and depreciation and other non-interest expenses) represent the majority of the total costs in Kosovo banking sector averaging 53.6% in the period 2006-2011. Provisions for loan losses are other determinant of financial performance of the banking sector with a share of 15.5% in total expenditures.

Therefore, based on the level of capitalization and regulatory capital structure of the Kosovo banking sector, quality of assets and the amount of aggregate indicators of the profitability, it is estimated that Kosovo banking sector in the period 2006-2011 had a financial performance and stable condition.

5. Conclusions

In this paper has been analyzed performance of commercial banks in Kosovo, which generally regarded generate high rates from return on equity and assets. Generating high income, powered by higher interest gap, caused the Kosovo banking sector to be fairly stable during the 2007-2009 global financial crisis. The impact of the latter in 2008 was reflected in higher interest expenses of deposits by banks to 3.2% from 2.8% in 2007, reflecting the fear of the withdrawal of deposits and the decline in revenues from securities as a result of adverse developments in international financial markets, and reducing their weight in total assets to 2.5% from 6.1% (as a measure of reducing the exposure of abroad).

The effects of the global financial crisis in the Kosovo banking sector appear more in 2009 in terms of growth of nonperforming loans and consequently lower level of the revenue generation from the use of assets. The new situation banks responded with reducing costs, especially reducing administrative costs. During 2010 and 2011, Kosovo banking sector exceeded pressures and returned to performance of returns growth. In 2011 ROA was 1.5% and ROE was 15.3%.

In an attempt to maximize earnings Kosovo banks should focus on increasing efficiency through improved internal factors, respectively it is recommended that banks continue to increase their operating efficiency by reducing operational costs and further diversify their revenues. Maintaining and further improvement of lending practices is a key element in the sustainability of commercial banks in Kosovo.

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