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# Financial Environment and Small Businesses in Kosova

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# BECHELOR THESIS

# Financial Environment and Small Businesses in Kosova

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# 1. Introduction

The private sector in Kosova started to grow in early 90-s of xx sentry. After significant growth in late 80-s the private sector development started to decline because of the installation of brutal Serbian regime in Kosova. This fall of the private sector continued till late 98-where major part of small-medium enterprises faced bankruptcy.

Private sector has an important role in every national economy. In Kosova small-medium (SME) enterprises are the biggest group of businesses with 98% of total enterprises and have high potential for economical growth .After year 1999Kosova went through transition faze from Yugoslav socialist system to an open economy. From the Yugoslav system the major parte of enterprises were community enterprises were in year 1999 most of them were abandoned end left in a very bad physical condition.

Like in every other transition economies the SME- has the leading part of economical development this fact it appears the same in our economical transition. Is known that (SME)-are wary flexible organized businesses because of the size, ownership and their form of managing. In virtually all economies in the world – developed and developing alike – small- and medium sized enterprises (SMEs) are critical to the generation of economic activity and to long-term sustainability.

It is sometimes assumed that in industrialized countries large firms constitute the main drivers of economic activity. However, in a sample of developed countries drawn from the World Bank database, SMEs accounted for about three-quarters of GDP and just over 60 per cent of employment. The figures are generally much higher in the case of the developing countries, confirming the critical role of SMEs in the development process.

In addition to the contribution of SMEs to economic growth and to the creation of jobs, SMEs broaden the base of participation in society, decentralize economic power and give people a stake in the society's future. Small-business ownership encourages personal freedom and individual empowerment and contributes to social and political stability. In many developed countries, the SME sector has been the catalyst for product innovation and for productivity enhancement.
For these reasons, in virtually all successful economies, the development of small- and medium-sized enterprises is given special priority.

Improving access to finance is deemed to be the major challenge to the development of small- and medium-sized enterprises all over the world.
Because of imperfections in financial markets, small enterprises almost never have the same access to finance as do their larger more powerful counterparts.
For commercial banks, for example, small enterprises are considered to be of lower profitability and are assumed to carry greater risks than large enterprises.

Thus the availability of bank finance for SMEs is usually limited and, even when credit is available, it is usually at a higher cost and on unfavorable terms – for example, through high cost overdraft facilities rather than through term loans.
For these reasons, Governments which are committed to SME development focus on making funding available on reasonable terms.

The number of enterprises has changed continually like in all market economies. After year 1999-2002 there were 31,236 businesses after this period in 2003 the number of businesses declined in 27,920 comparing with year 2002, and in year 2004 the number of businesses increased and reached in 39,357 which are operating in 17-economical business sectors, in December 2005 the number of registered businesses was 65,051 to reach tits peak in 2007 were the number of businesses was 70,000 according the fingers give bay ministry of industry and trade (MIT).

The structure of SME according to the economical activities surveyed in year 2005 shows that 49.5% of surveyed business was indentified like trade enterprises, 32.2%of enterprises are declared like production businesses, and 18.3% are services. This fingers shows that businesses are more consecrated in trade and services comparing with production sector which is very low and according to the trend it is declining.

Seeing the importance and structure of the SMEs, like the most important economical factor in the country and discovering the difficulties that this business faces wile operating their activities which are numerous.
Finances are one of biggest problems that SMEs face in their daily operations.

*Finances for SMEs-are* vital for development of the economy and is known throughout the world that access to finance is difficult

*Many approaches*- have been tried to make finances more accessible for SMEs but none has yet been found to be totally satisfactory

*Situation Kosova* –in recent years Kosova has gone through difficult time in regard to this issue, but there are some encouraging movements that the situations is nevertheless developing positively

The financial system *1989-1999*- was destroyed together small numbered SMEs who were operating during this difficult economical period
Economical System– like in all post socialist economies Kosovo has gone through economical transition from an controlled to the market based economy.
Operating in an open economy the structure of businesses has change from public companies to small and more flexible business owned by *private individuals where financial sources and instruments have changed too.*
The growth of SMEs was an attractive priority for Kosovo in terms of job and wealth creation. SMEs required a level of capital below €100,000 and could utilize Kosovo’s entrepreneurial potential

After years of persistent banking crises, the Kosovo's financial sector has gradually revived. The entry of foreign banks, better supervision, and the creation of credible deposit-insurance schemes has all improved bank intermediation. State ownership in the banking sector is over

Over the past seven years the financial sector has been built on completely new foundations and has shown impressive growth

Kosovo banking system, now in its seventh year of operation, has undergone significant changes that justify the increase of public confidence in it. Several indicators show that Kosovo caught up with countries in the region

In 1999 the Banking and Payments Authority of Kosova (BPK) was established to license, regulate and supervise the financial sector and establish a properly functioning payments system.

## 1.1 Research Question

The thesis will be focused the financial environment conditions in Kosova and in specific for that SMEs , in order to analyze and to bring to the light the advantages and disadvantages that financial sector offers and possibilities that this sector gives his share of contributions for the SMEs development. You can find the answers in one key question and other sub questions

**I. what is the financial environment for small business development in Kosova**

- the creation development of financial institutions (1999-2008)
- what are the main investment sources that businesses use to finance their business activities
- what services-products these financial institutions offer for
  These business and how convenient are this services in terms of cost and benefits' they bring for business development
- What is the total loan amount financed from inside financial sources?
- What is the rate of interest and terms of payment for this loans and how convenient are for small-businesses?
- What is the level of non performing loans
- What is the credibility of the financial institution?
- What business sectors absorbed the major investments?
- The liquidity of financial institutions?

These are the main questions that the thesis will be based and developed in order to answer them. Financial information is used to measure performance and help make decisions about how an organization should operate.

Financial Environment shows managers how to interpret financial information and, in doing so, make better decisions. It covers important elements of finance that affect organizations large and small.

The financial environment comprises all public sector institutions, official organizations, monetary, financial, fiscal and legal authorities involved directly or indirectly with finance issues and that have a direct impact on the financial sector which is the subject of elaborations by the author.

While the author's focus in this thesis is to explain and to elaborate the financial sector and conditions that this sector is operating, later on the author will discuss about the following tasks: the author will mention and try to give an approximate information about methods of SMEs finance their activities which is very important to have an idea where this sources come from and than to see the sufficiency and the quality of this sources, and certainly analyzing the most effective way of enabling or facilitating businesses' access to finance .is there need that financial institutions and other financial service providers can improve the offer of finance for enterprises, in particular SMEs will be also another important part of work.

## 1.2 Methodology

In order to develop and to accomplish any task, it is needed from everyone to use a method of doing it. Choosing the best method of doing things is not as easy because of unknowing exactly the advantages and disadvantages of the method.

The methodology that the author is using to write this thesis is gathering materials and information from many different sources starting with institutions and organizations which are directly or in other forms connected with the financial sector like ministry of economy and finance(MEF), trade and industry(MTI), commercial banks and other financial intermediaries, Kosova chamber of commerce, economical and financial analysts and researches made particularly in the field of finance and SMEs developments this last ten years, books that he has used in University, information from internet, he will also will base his research on his previous experiences.

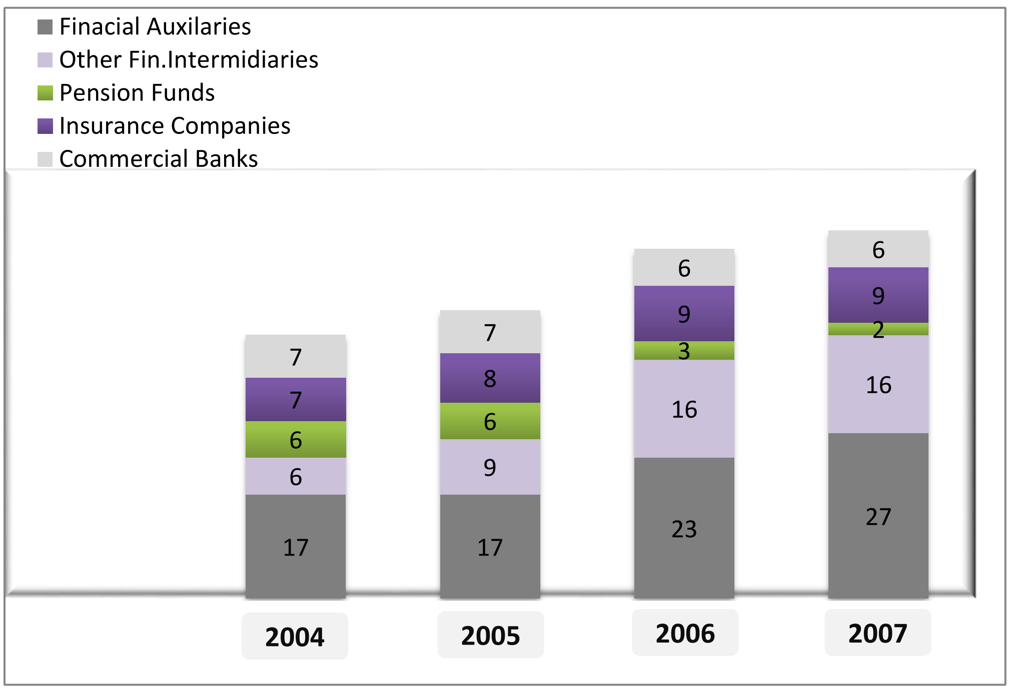
By reading and analyzing the information's collected from above motioned sources and based to his experience of private sector particularly with SMEs and the financial sector which is directly connected with this category of entrepreneurship, he will analyze the information's and find a general idea about the role of financial sector plays in helping and supporting the growth of SMEs in particular because this forms and structure of businesses make more than 98% of all businesses in country, and the support that this institutions give for macroeconomic development in generally . In other next pages it will be explained in detail everything that has to do with the financial conditions that SMEs operate, methods and channels they pursue for bring and maintaining they businesses and all other aspects connected to the financial institution and financial market.

## 2. Financial Sector in Kosova

Kosovo is a small-open economy that has lagged behind most of other TEs in financial sector development, although recent developments show that catch-up has become evident and the performance of the financial sector is now comparable with other areas in the region. Before the conflict of 1999, financial market system, in the sense of providing intermediation and payments system, was almost nonexistent. Therefore, Kosovo had to establish its financial system from scratch.

In year 2007, the Kosovo financial sector was composed of 60 financial corporations (57 in 2006). While the number of banking sector institutions remained unchanged (6) between 2006 until 2007, one International Cooperation(IC) has been licensed in November 2006 increasing the number of IC to 9 in 2007, whereas, CBAK revoked the license to a pension fund. In addition, 6 FA have been licensed since 2006, numbering 27 in total in 2007

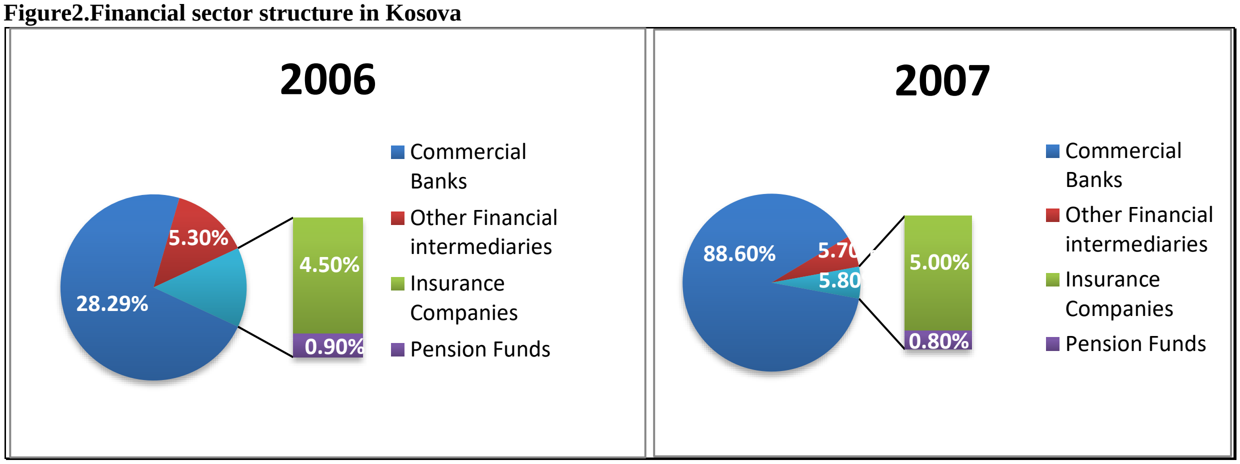
**Figure 1.Number of individual financial institutions**




*Source: Central banking authority of Kosova CBAK (2008)*

In 2007, financial sector assets amounted at euro 1.4 billion, an annual increase of 16.8%, which is lower than the annual growth recorded one year before (19.1%). Although the share of banking sector assets to total financial sector assets declined, they still represent the largest share of total financial sector assets with (88.6%). The share of other financial institutions assets to total financial sector assets increased slightly to 11.4%. The structure of other financial institutions remains almost the same, showing minor increase in the share of other financial institutions (OFI) and international corporation(IC) assets to total (OFC) assets

**Figure2.Financial sector structure in Kosova**




*Source: central banking authority of Kosova CBAK (2007)*

Recording an annual growth of 17.3%, banking sector assets amounted at euro 1.2 billion in 2007, compared to euro 1.0 billion with one year ago. OFI assets in 2007 grew annually by 8.5% amounting at euro 80.3 million. Insurance Companies assets amounted at euro 67.7 million (euro 54.7 million in 2006), while Pension Funds assets amounted at euro 10.2 million (euro 9.5 million in 2006). Amounting to euro 864.4 million in 2007, financial sector claims on real sector recorded an annual increase of 26.3%. Comprised mainly from loans, financial sector's claims on real sector accounted for 34.6% of GDP in 2007.

On the other hand, liabilities to the real sector (composed mainly from deposits) grew by 18.5% over 2006, amounting at euro 969.1 million.

Financial sector net claims on government (fiscal sector) stood at euro -710.7 million. Government deposits grew by 59.0% in 2007, mainly as a result of the budget surplus carried forward from 2006 (euro 76.5 million), as well as the revenues from the licensing of second mobile telephony operator IPKO (euro 75 million) and the increase in revenues from privatization process.

Amounting to euro 328.9 million, privatization revenues accounted for 54.3% of total government deposits at the spectral banking authority (CBAK). The amount collected through the privatization process recorded an annual increase of 31.3%. Government deposits at the CBAK are mainly in the form of transferable deposits. However, in 2007, other deposits of the government at the CBAK amounted at euro 93.6 million. . *(Central banking authority, yearly BULLETIN 2008, page 11-12)*

## 3. Banking sector

In 1999 the Banking and Payments Authority of Kosovo (BPK) was established to license, regulate and supervise the financial sector and establish a properly functioning payments system. The basis of two tier banking system was established. With technical assistance from the international agencies, BPK has adopted banking rules and regulations in line with international standards, including regulations in accordance with the Basel Accords.

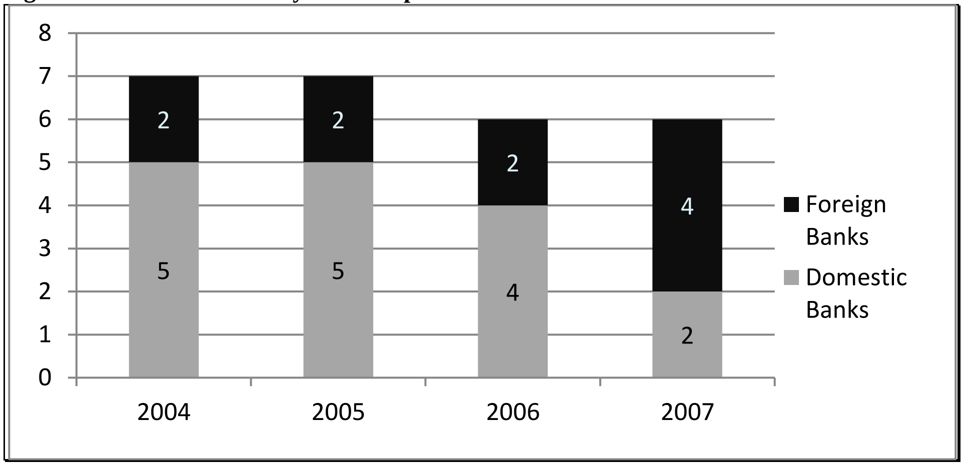
The banking sector in Kosovo, from the regulatory perspective may be labeled "liberal" as no interest rate controls, no directed credit programs and no capital account controls exist. Entry barriers and limits to branching are related only to prudential considerations applied by the BPK. It encourages banks to keep loan to deposit ratio below 70-75%, which limits rapid credit expansion and risk exposure, ensuring the liquidity position of the banking system, given that this market was developed from scratch.

Poor, although improving, legal infrastructure is an additional cause for cautious policies in the financial sector, in which there are no domestic inter-bank lending and borrowing facilities, nor deposit insurance and lender of last resort

The banking sector in Kosovo consisted of six banks (2007). However, in August 2007, the CBAK granted the license of operation to two new bank branches: Banka Kombëtare Tregtare (BKT) and Komercijalna Banka (KM). In September 2007, Turk Ekonomi Bankasi (TEB) was granted a preliminary license by central banking authority of Kosova. Expansion of the sector by new banks is expected to increase the competition in Kosovo banking sector. *(Central banking authority (CBAK), yearly BULLETIN 2008, page 13)*

Kosovo banking sector attracted new foreign investors with strong banking background in the region and wider. With respect to the banking sector regulatory framework, amendments of several existing banking rules were introduced and approved during the first half of 2007.

**Figure 3.Number of banks by ownership structure**




*Source: Central banking authority of kosova CBAK (2008)*

Regarding the change in the ownership structure, Slovenian bank Nova Ljubljanska Banka (NLB) entered in the banking market by buying more than 50% of the shares of two domestic banks in kosova, Kasabank and Banka e Re Kosovës, increasing the number of banks with foreign ownership. Thus, in 2007 from six commercial banks operating in Kosovo financial market, only two remained with full domestic ownership, managing about 8.0% of total banking sector assets. The ownership structure of the banking sector in Kosovo, in terms of the number of the foreign banks to total banks, is similar to some countries in the region, where foreign banks dominate the banking sector.

**Table 1.Number of banks in countries in the region**

| Country | Foreign Banks | Domestic Banks | Total |
|---|---|---|---|
| Albania | 15 | 2 | 17 |
| Bosnia and Herzegovina | 22 | 10 | 32 |
| FYR Macedonia | 14 | 20 | 34 |
| Montenegro | 8 | 11 | 19 |
| Serbia | 17 | 23 | 40 |
| Slovenia | 10 | 15 | 25 |
| **Kosova *** | **4** | **2** | **6** |

*Source: EBRD Transition Report (2007) and CBAK (2007)*
** Data for Kosovo are as of June 2007*

With regard to asset size, three major banks manage the largest share of total banking sector assets in country with (84.2%), while the other three are small banks with only 15.8% of total banking assets in 2007. A high market share of the three largest banks is noticed also in their portfolio of loans and deposits, which represent 86.0% of total banking sector loans, and 87.4% of total banking sector deposits. The high market share of the three largest banks indicates that Kosovo banking sector is a relatively concentrated sector because of the concentration of capital only in three banks. Moreover, the market share of the three largest banks in 2007 has further increased compared to previous periods

## 3.1 Network and activity expansion

With 17 banking units more than a year 2006, banking sector is increasing its accessibility in the different regions in country. In 2007, the total number of banking units reached 231, aiming a higher efficiency in providing their services to their customers. Banking units are mainly concentrated in the capital of Kosova, representing around 30% of total banking network, than comes other three regions where the remaining bank branches are established.

**Table 2.Banking sector network**

| Year | No. of Banking Units |
|---|---|
| 2004 | 213 |
| 2005 | 239 |
| 2006 | 220 |
| **2007** | **232** |

*Source: Central banking authority of Kosova CBAK (2008)*
*Banking units consist of head offices, branches and sub-branches.*

The branch expansion is followed by the increase in the number of Automated Teller Machines and Point of Sales (POS). In 2007, throughout Kosovo there were 148 teller machines and 1978 POS. Consequently, there was noticed a significant increase in payments processed via POS – around 30% more than one year before. Also, clients became more familiar to **e**-banking services. The number of clients using this service almost tripled, while the number of transactions processed using **e**-banking almost tripled during the one year period. The latest events indicate the deepening of client's confidence in the **e**-banking services provided by the banking sector. By introducing loans with longer maturities (e.g. up to 10 years), banks are continuing to expand their service and product activity by identifying new products to be offered to their clients. As a result, during the year 2007 some banks introduced financial leasing service (Austrian Raiffeisen Bank), providing mainly industrial machinery and equipment. This product is expected to develop among other financial institutions and leasing companies, as well.

## 3.2 Asset Structure

Assets of the banking sector amounting at euro 1.24 billion from euro 1.05 billion in 2006. The growth of assets mostly derives from the increase in the three largest banks' assets that recorded an annual growth of 21.1%. As a share to GDP, banking sector assets reached 49.6% in 2007 from 43.8% in 2006, which indicates an increase in the intermediation of the banking sector of Kosovo. The structure of assets was not subject to significant changes between 2006 and 2007.

Representing 63.4% of total assets, loans remain the main item of the banking sector assets. Despite an annual increase of 13.8% in terms of volume, balances with commercial banks declined to 17.1% of total assets. Cash and balances with remained relatively stable at around 12.0% of total assets

# 4. Bank Loans

Loans of the banking sector reached euro 784.4 million in 2007, which is an increase of 27.1% compared to 2006. The increase in loans has mainly resulted from the expansion of the three largest banks that contributed in the overall increase of loans.

The increase of loans was mainly driven by the growth of loans to small medium enterprises (SMEs), whereas in terms of maturity, loans with maturity over 2 years (mainly to SMEs) were the main driver.

The credit expansion is financed mainly from the increase in deposits in the banking sector and potentially a shift from investments in securities towards loans.

With banking sector assets accounting for 53.5% of GDP in 2007, Kosovo ranks below the countries of the region that attained an average ratio of 72.8%. In terms of lending activity, Kosovo banking sector compares relatively well with other SEE countries. Loans granted by the banking sector of Kosovo accounted for 33.9% of GDP in 2007 compared to the average of 38.9% for other SEE countries. Loan-to-GDP ratio in Kosovo ranks higher than the ratio attained in Albania (22.3%), Serbia (28.2%) and FYROM (29.6%).

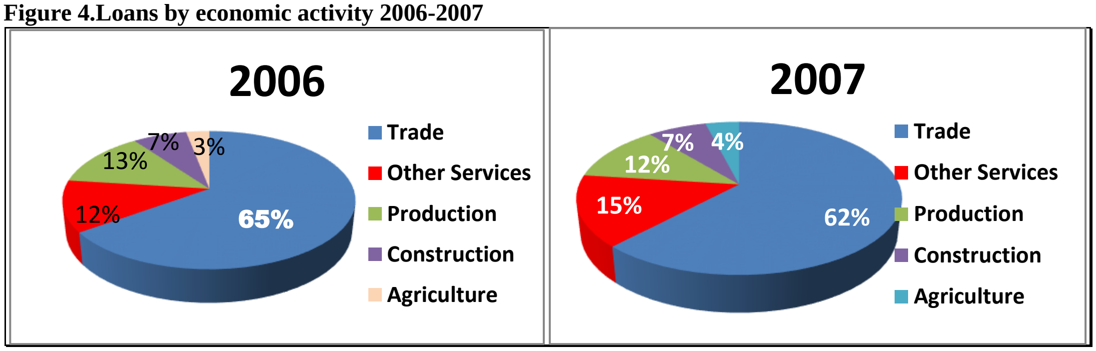
## 4.1 Loans by sector

The largest share of banking sector loans goes to SMEs that absorbed 78.3% of total loans or euro 614.5 million in 2007, an annual increase of 27.9%. The period between 2006 and 2007 marked an extension in the maturity of SMEs loans. The share of SMEs loans with maturity over 2 years to total SMEs loans recorded 56.6% in 2007 that is an increase compared to 2006. Whereas, SMEs loans of the same maturity increased share to total loans with maturity over 2 years at 72.4% in 2007 from 68.8% in 2006.

## 4.2 Loans by economic activity

Services remain the most credited sector by banks in Kosovo, with loans amounting euro 471.6 million in 2007 that is 76.8% (76.5% in 2006) of total loans to SMEs. Loans to services mainly consist of trade sector loans that compose 61.9% of total loans to SMEs. Production sector absorbed 11.7% of total loans to industry, which is euro 72.2 million. Production sector loans mainly consist of loans extended to the manufacturing sector (food, textile, leather, lumber, paper) that accounted for euro 62.9 million or 9.8% of total loans to industry. Loans extended to production sector mainly (98.1%) have over 1 year maturity. Construction sector absorbed 7.4% of total loans to the production sector in 2007 compared with 7.1% in 2006. Loans extended to the agriculture sector accounted for 4.0%, which is higher than in 2006. *(EBRD Transition Report (2006) and CBAK (2007), page 7,)*

**Figure 4.Loans by economic activity 2006-2007**

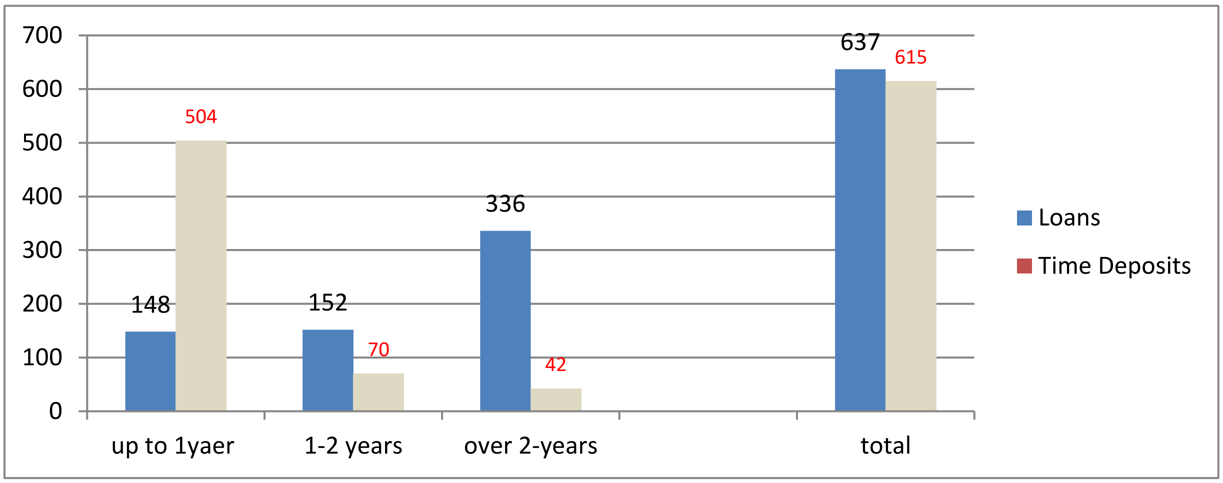



*Source: Ministry of trade and industry of kosova, SME observatory and survey of 700 SMEs*
*Central banking authority of kosova CBAK (2008)*

## 4.3 Loans by maturity

Loans with maturity up to 1 year accounted for 22.1% of total loans in 2007, which is a decline compared to 2006. A decline is noticed also in the share of loans with maturity over 1 and up to 2 years. The largest category of loans are with maturity over 2 years and further increased their share to total loans reaching 57.8% in 2007 (49.1% in 2006).The increase in the loans maturity can partially be attributed to the increase in the banks confidence in market. Three largest banks have the highest share of loans with maturity over 2 years, composing 63.0% of their total loan portfolio compared to 26.4% in other three banks

**Figure 5.Loans and time deposits maturity structure**




*Source: Central banking authority of kosova CBAK (2007).*

Central bank CBAK (2007)

## 4.4 Loan Quality

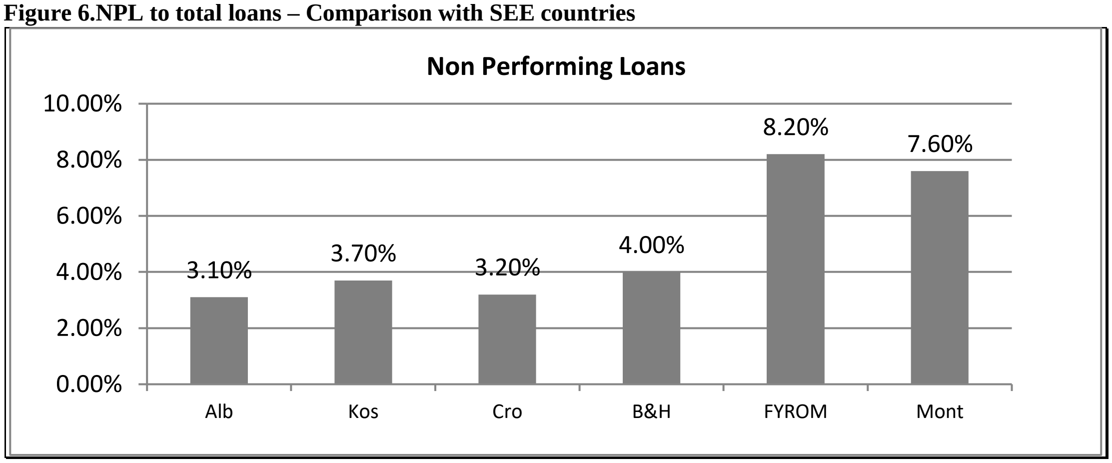
Consisting of doubtful and loss loans, Non-Performing Loans (NPL) represented 3.7% of total loans in banking sector of Kosova in 2007, indicating a slight deviation in the quality of loan portfolio compared to 2006 (1.6% of total loans). The increase in NPL was mainly recorded during the second half of 2006, where the share of NPL to total loan portfolio reached 3.7% in 2006. NPL in Kosovo banking sector mainly consist of doubtful loans that compose 63.0% of total NPL, followed by loss loans with 37.0%.

Taken by bank groups, larger banks appear to have a better quality of the loan portfolio than smaller banks. In 2007, three largest banks recorded a NPL to total loans ratio of 3.2%, while at rest of the banks, on average, NPL accounted for 8.1% of their loan portfolio. The growth of total loan portfolio was also associated by an increase in total provisioning that in 2007 covered 4.7% of total loan portfolio, which is an increase compared to 2006. However, the degree of NPL coverage by total provisions (total provisions to NPL ratio) declined to 125.6% in June 2007 from 240.6% in 2006, mainly due to a faster growth in NPL than in provisions

The NPL to total loans ratio of 3.7% ranks Kosovo below the average of 5.2% 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.

The highest NPL to total loans ratio is noticed in Macedonia, where non-performing loans accounted for 8.2% of total loan portfolio, followed by Montenegro with 7.6%. Whereas, the country that recorded the lowest share of NPL to total loans is Albania with an NPL to total loans ratio of 3.1%.

**Figure 6.NPL to total loans – Comparison with SEE countries**




*Source: Central Banks in respective countries, CBAK (2007)*
*Note: For Croatia, the share of partly recoverable and irrecoverable placements to total placements is used*
*Note: Data for Albania, Bosnia and Herzegovina, FYROM, and Montenegro are as of December 2006, whereas for Croatia as of June 2006. Data for NPL level in Serbia are not available*

Central Banks in respective countries, (2007)
EBRD Transition Report (2006) and CBAK (2007)

## 5. Interest rates

Interest rates are among the most closely watched variables in the economy.
Their movements are reported almost daily by the news media because thy directly affect our every day lives and have important consequences for the health of the economy. They effect personal decisions such as whether to consume or save, whether to by a house and whether to put money in the savings accounts. Interest rates also affect economic decisions of business and households, such as whether to use their funds to invest in new business facilities and equipment or to save money in the bank, whether to take loans from banks or to use other investment sources with better credit interest.

Interest rates for deposits in 2007 stood at 2.46%, which is an increase of Compared to 2006. In terms of sector, interest rates for business deposits reached 3.33% in 2007 (2.53% in 2006), while interest rates for household deposits increased to 2.10% (1.98% in 2006). Increase is noticed also in interest rates for loans that increased compared to June 2006, reaching 14.84% in 2007. In terms of sector, interest rates for loans to SMEs stood at 15.38% in 2007 (14.93% in 2006), while interest rates for loans to households stood at 13.14%. *(Central banking authority (CBAK), yearly BULLETIN 2008, page 26)*

The overall interest rate spread in 2007 declined. Decline of the interest rate spread is due to a higher increase in the interest rate for deposits than in the interest rate for loans. The interest rate spread for SMEs declined in 2007, while the interest rate spread for households increased in (2006).

### 5.1 Lending rates

Interest's rates on business loan vary from 14.7 % to 16.1 % depending on the maturity.
In general interest rates on longer-term loans are lower than for loans with shorter-term maturities. One possible explanation is that banks use more advanced screening technologies or apply more strict criteria for longer-term loans. Those loans are provided to the most creditworthy borrowers with longer business history or longer client relationship with particular bank. The banks may require more guarantees for longer term credits reducing the risk, and hence the interest rate. Consumer loans are less expensive than business loans, being a peculiarity, probably due to the less risky nature of those products related to lower amounts and simpler procedures. Overall, apart from significant increase in the intermediary role of banks in Kosovo the maturity structure towards longer-term loans improved as well. *(Banking and Payments Authority of Kosovo Interest Rates in Kosovo, Some Comparisons and Possible Determinants page7)*

In order to evaluate whether the lending rates and the spreads are high (around 12%), we will try to reflect on some issues that may influence costs of external finance for firms
Where capital markets are perfect, firms are indifferent between what sources they use (internal or external) to finance their investment. But when transaction costs (TC), information

asymmetries (IA) and agency problems are severe, firms may face high costs in raising external finance. The crucial dimensions of financial development in terms of reducing those imperfections are the increased efficiency of financial intermediaries accompanied by improvements in other determinants, i.e. legal framework, legal enforcement, regulations and the macroeconomic environment.

One of the remedies to these markets is well functioning institutions, be it regulatory institutions or courts. Examples of the role of institutions are manifold. Financial markets are strictly regulated. Banks are required to hold proper capital structure, liquidity and risk exposure. Otherwise, excessive risk taking behavior due to competitive pressure and/or deposit insurance will prevail (moral hazard problem). Also there are regulatory requirements for firms to disseminate information i.e., in order to be listed in the stock exchange. Without that information, company evaluation by the market participants will be hard and incomplete.

One important element in the credit market is the ability of financial intermediaries (FIs) to use non-price terms in debt contracts collateral. The use of collateral and other restrictive covenants directly depends on the efficiency and effectiveness of law. In other words, degree to which creditor rights are secured by written law and extent to which these laws are enforced properly will influence the ability of FIs to use collateral and other contractual agreements to secure the debt and overcome moral hazard behavior by borrowers.
Interest rate spreads in countries in the region (SEE) appear high compared to NMS-8. There are many possible explanations for such comparatively high rates

One element important to note is that loan interest rates are high and in many cases higher than in Kosovo (except in Bulgaria and Croatia). However, spreads are lower mainly due to higher interest rates on deposits. This may be a reflection of the currency denomination of deposits, inflation premia in some countries or market peculiarities of the particular country

**Table 3.Interest Rate in western Balkans (in %)**

| Country | Description | 2004-2006 |
|---|---|---|
| Albania | Lending rate | 10.05 |
| | Deposit rate | 7.6 |
| FYR Macedonia | Lending rate | 14.5 |
| | Deposit rate | 6.7 |
| Croatia | Lending rate | 12.0 |
| | Deposit rate | 1.7 |
| Serbia | Lending rate | 12.6 |
| | Deposit rate | 2.4 |
| Kosova | Lending rate | 14.8 |
| | Deposit rate | 2.8 |

Source: European Bank for Reconstruction and Development EBRD (2004), European Commission (2004), World Bank (2004) and BPK

EBRD (2006), European Commission (2006), World Bank (2006)

# 6. Bank Deposits

Banking sector deposits amounted at euro 981.5 million, an increase of 16.1% compared to one year ago. The increase of deposits comes mainly from the growth of deposits in three largest banks that grew by 19.2%. Banking sector deposits are held mainly in euro currency (95.3% of total deposits).

## 6.1 Deposits by sector

Deposits of the banking sector mainly consist of household deposits that compose 60.0% of total deposits (euro 589.1 million). Compared to one year before, household deposits increased their share to total deposits by 23.0%.

Companies and small medium enterprises deposits represent the second largest source of banking sector deposits. These deposits amounted at euro 316.6 million with 32.3% of total deposits this year. However, compared to one year ago, the share of companies and private sector enterprises deposits in total deposits declined. These deposits mainly consist of public Corporations deposits that account for 63.9% of total non financial deposits (20.6% of total deposits).

Government deposits in banking sector amounted at euro 4.6 million, which is an annual decline of 0.9%, where as a share to total deposits they remained constant at 0.5%. An increase is noted in deposits of other financial corporations that, considering the low base, increased by 88.3%, increasing their share to total deposits at 3.8% from 2.4% in 2006. Amounting euro 19.3 million, deposits of non-residents represented 2.0% of total deposits at banking sector. Deposits of non-residents grew by 5.3% annually, which is much lower than the annual growth of the past two years that averaged to 20.6%. *(EBRD Transition Report (2006) and CBAK (2008) page 23)*

## 6.2 Deposits by maturity

The share of transferable deposits to total deposits continues to decline as the share of other deposits is continuously growing. Transferable deposits represented 33.7% of total deposits. Transferable deposits amounted at euro 330.5 million in 2007, an annual increase of 1.1%. Other deposits, on the other hand, reached 66.3% of total deposits from 61.3% in 2006. With an annual growth of 25.6%, the outstanding amount of other deposits amounted at euro 651.0 million.

The structure of other deposits mainly comprises of deposits with maturity up to 1 year that compose 78.8% of other deposits (81.9% in 2006), followed by deposits with maturity over 1 year and up to 2 years that compose 13.9% . The smallest share of deposits is represented by deposits with maturity over 2 years that compose 7.4% of total other deposits. Taken by bank groups, there are no significant changes in the composition of other deposits between larger and smaller banks.

**Table 4.Commercial Banks Effective Interest Rates (in %)**

| Description | | Interest Rate |
|---|---|---|
| **LOANS** | | |
| | **Companies/Enterprises** | |
| **Business investment loans** | **<=year** | **16.11** |
| **Other Business loans** | **> 1year<=3years** | **14.65** |
| | **<=1month** | **15.59** |
| | **>3months and <=1year** | **15.69** |
| | **>1year** | **15.36** |
| | **Households** | |
| **Consumer Loans** | | **12.73** |
| **DEPOSITS** | | |
| | **Companies/Enterprises** | |
| **Less Than 250,000 EUR** | **<1month** | **1.66** |
| | **>1month <=3months** | **2.24** |
| | **>3months and<=1year** | **2.89** |
| | **Households** | |
| **Time Deposits** | **<=1month** | **1.69** |
| | **>1month to 3months** | **2.23** |
| | **>3months and<=1year** | **3.01** |
| | **>1year and<=2years** | **3.79** |
| | **>2years** | **4.11** |

*Source: BPK (banking and payment authority of Kosova*)

World Bank (2004-2006) and European Commission (2006)

This paper will rely on effective rates for the period from 2004 onwards.

## 7. Liquidity and Solvency

Liquidity of banking sector continued to decline over the first half of 2007 both, in terms of loans to deposits ratio, and the share of liquid assets to total assets. Due to a faster growth in loans extended by the banking sector than in deposits received, the ratio of loans to deposits reached 79.9% in 2007 from 73.0% in 2006. Loans to deposits ratio increased in 2007 despite a decline in this ratio in December 2006 when this ratio accounted for 68.9%.

A less favorable liquidity position is shown by the share of liquid assets (cash, balances with central bank, balances with banking sector, and securities) to total assets of the banking sector. This ratio declined to 33.2% in 2007, a decline compared to one year ago. The decline in the share of liquid assets to total assets can partly be explained by the decline of securities and balances with commercial banks as a share to total assets, while on the other hand, there is an increase in the share of loans to total assets of the banking sector. Moreover, within loans there is a continuous shift from shorter to longer term loans.

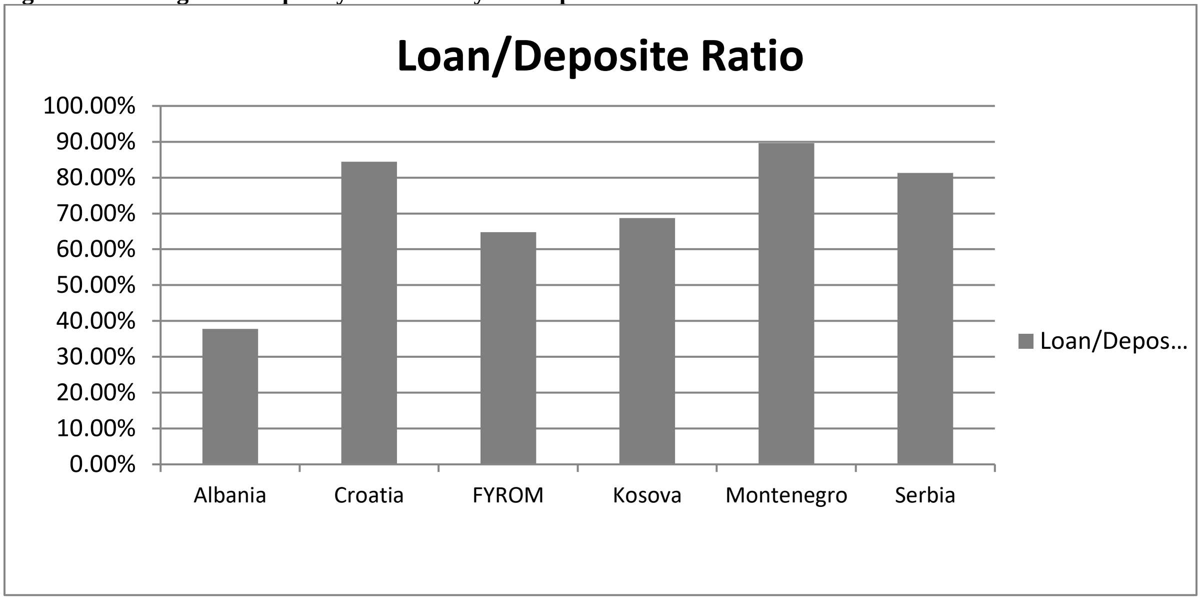
The continuous increase of longer term loans on one hand, and persisting low level of long term deposits on the other hand, may cause another liquidity risk deriving from the maturity mismatch between loans and deposits. The highest maturity mismatch stands for loans and deposits with maturity over 2 years followed by those with maturity over 1 year and less than 2 years, where loans exceed deposits by euro 405.8 million and euro 67.1 million, respectively.

The opposite situation stands for loans and deposits with maturity up to 1 year, where deposits exceed loans by euro 339.5 million, an amount that can be used to fulfill the gap in other maturities . On the other hand, core deposits composed 80.9% of total deposits, indicating a relatively favorable liquidity position in the Kosovo banking sector with regard to this indicator. The ratio of 80.9% implies that the largest share of deposits is spread to smaller depositors.

Regarding solvency, banking sector showed favorable results with a Capital Adequacy Ratio (CAR) of 17.3% (16.1% in June 2006), which is well above the minimum of 12.0% required by the banking sector regulator. CAR increased due to a faster growth in capital compared to the risk weighted assets. The level of 17.3%, recorded in June 2007 represents the highest level of CAR attained since year 2003. Taken banks individually, all banks recorded a CAR higher than the minimum required, whereas smaller banks appear to have a higher CAR than larger banks

Improvement in the solvency of the banking sector is shown also by the increase in the share of banking sector capital to total assets. Due to a faster increase in the banking sector capital than assets, capital to total assets ratio reached 11.3% in 2007, an increase compared to one year before.

**Figure 7s.Banking sector liquidity and solvency – Comparison with western Balkans countries**




*Source: Business Monitor International (2006); EBRD (2005)*
**Note: Data for south east countries (SEE) are as of 2005*

Compared to region countries, Kosovo stands in a relatively favorable position also with regard to banking sector liquidity, which in our case is measured by loan to deposit ratio. Kosovo banking sector recorded a loan to deposit ratio of 79.9% that is slightly higher than the average recorded in the region that stood at 78.0%. Taken by individual countries, the highest ratio is recorded in Bosnia and Herzegovina (105.3%), whereas the lowest is recorded in Albania (37.8%).

In terms of CAR, with 17.3%, Kosovo banking sector ranks below the average CAR recorded in the region that stood at 18.8%. The highest CAR was recorded in Serbia (24.7%), while the country with the lowest CAR

Business Monitor International (2006); EBRD (2005)

# 8. Insurance Companies

Insurance market continued to grow, while all companies are still dealing only with non-life insurance services. Compulsory insurance and third party liability (TPL) policies remain the main activities offered in the Kosovo insurance market. Foreign companies hold the largest market share in the sector, accounting for 73.0% of total insurance company's assets. Apart from the change in the number of companies, the ownership structure changed as well. With the change in ownership of Dukagjini insurance company, the number of foreign companies increased to 6, and the remaining 3 are domestic companies. The share of three largest companies' assets to total insurance company's assets declined to 51.9% in 2007. %.*( Central banking authority (CBAK), yearly BULLETIN 2007, page 16)*

**Table 5.Ownership structure of insurance sector assets, in euro thousands (2004 – 2006)**

| DISCRIPTION | 2004 | | 2005 | | 2006 | |
|---|---|---|---|---|---|---|
| | Amount | Share (%) | Amount | Share (%) | Amount | Share (%) |
| **Foreign Insurance com** | **25,916** | **59.2** | **33,279** | **61.1** | **43,795** | **69.5** |
| **Domestic Insurance com** | **17,881** | **40.8** | **21,144** | **38.9** | **19,176** | **30.5** |
| **Total Assets** | **43,797** | | **54,423** | | **62,971** | |

Source: CBAK (2007).

Central banking authority (CBAK)
Ministry of finance and economics

## 9. Micro financial Institutions

The primary purpose of micro-finance is to provide access to finance for very small, private sector entrepreneurs who otherwise have little opportunity of securing debt financing on acceptable terms. Commercial banks often view micro-lending as labor-intensive, risky and therefore unprofitable. They are more concentrate on the provision of finance to medium and large enterprises and of banking services that generate fees and commissions.
These factors make it very difficult for micro businesses to obtain access to finance at a reasonable cost and on reasonable terms. In a way this could be seen as a paradox. As a result of lack of banking finance, micro-enterprises are those with the highest equity ratio, relying predominantly on internal funds. Micro-enterprises are therefore financially strong companies. However, they are seriously affected in their attempts to access loan finance by asymmetric information problems. Being small, new and unknown, frequently in the black economy, often unable to provide tax returns or to prepare business plans, they do not manage to communicate to lenders about their creditworthiness if the lenders avail themselves of traditional credit techniques.

Currently, there are 16 micro finance institutions (MFI) operating in Kosovo, and their main funding remains the external donations. These institutions mainly lend to the micro businesses sector and partially to households.

The share of MFI loans to total financial sector loans decreased from 8.3% from one year before to 8.0% in 2007. However, in volume, MFI loans recorded an annual growth of 24.9%, reaching euro 68.4 million in 2007. The number of extended loans by OFI reached around 40 thousand in 2007 from 33 thousand with one year before. The average amount of loan granted by OFI in 2007 was euro 1.7 thousand that represents an annual decrease of 1.9%.
*(Central banking authority bulletin/2007)*

## 10.Security and stock market

Over the last decade, the financial sector has converged towards a universal bank-based system, which is largely foreign-owned with, in particular, a strong presence of EU financial institutions. Capital flows channeled through the banking sector have been fostering rapid domestic credit growth private enterprises. By contrast, the non-banking sector, security and stock markets play no role in financial intermediation in Kosova.

The lack of integration of Kosova stock exchanges with the capital markets with regional and developed countries represent a serious obstacle to attracting foreign investment leading to its redirection to more developed markets.

The initial stage of development of capital markets not only limits the ability to finance both corporate and public sectors, but also deters companies from listing their shares on the official capital market and actively trading them.

# 11.CONCLUSION

This paper has investigated the extent to which the banking system and other financial structures and instruments targeted to serve the financial needs of the local private enterprise. It has done so both by looking at the sources of finance used by the enterprise sector when making investments and by looking at the level of banking intermediation and the development of non-banking financial products.

The financial sector plays a key role in economic development because it links all markets, improving the efficiency of resource use. Progress in financial sector promises better developments for this sector in the future. However, financial intermediation levels are still low compared to the East European countries and the European Union. Therefore, deepening and strengthening the financial sector remains the priority for financial sector reform, with a special focus on the private commercial banks.
Financial sector reform in kosova have largely been driven by the international community for political and security reasons and by risks that are not attractive to private investors

International donor initiatives to reform the legal and regulatory environment, to increase the Institutional capacity of financial sector institutions, to create microfinance banks, and to provide refinancing lines for SMEs finance have all contributed to the progress that has been achieved

The banking sector in Kosovo, from the regulatory perspective is considered “liberal” as no interest rate controls, no directed credit programs and no capital account controls exist. Entry barriers and limits to branching are related only to prudential considerations applied by the central banking authority of kosova.

Nevertheless, significant bottlenecks continue to impede development of the Kosovo’s financial sectors, including:

- Such as political shocks and weak legal environments, especially regarding commercial law and financial regulation.
- Supply side factors such as banks’ risk aversion, staff that lack training and experience, and mismatched term structures that inhibit term lending.
- Demand side factors such as a large number of young micro, small and medium-sized enterprises without credit history, and their lack of familiarity with credit approval procedures

Furthermore, credit and loan interest rates (between 11 to 18 % annually), are extremely high and don’t support business development. The income reported by the Banks operating for the last seven years in Kosovo has been around 300 million euro from loans only which reflects the fact that the Banks have been making huge profits while maintaining high prices. On the other hand, access to mainstream finance for innovative ideas and business start-ups is impossible

Based on conclusions and interviews made with interested parties and detailed analyses of procedures for credit approvals, the main reasons why SMEs have difficulties in getting loans are:

**SME & Crediting**

- Procedures for credit evaluation are to long and burocratic
- Inquiries for completed documentation(Business Plan)
- Skepticism view that banks share for SMEs
- High interest rate
- Very high collateral request
- Limited amounts
- Short credit maturities

**Bank Complains**

- Continuous instability and confidence of dates and information's given from businesses
- Absence of legal and technical instruments to control and analyze business liquidity
- Difficulties in activating legal instruments for collateral sequestering
- Absence of bankable projects
  - *Local consultants are not supported from banks*
  - *Foreign consultants are to expensive*

Despite of the fact that banking sector liquidity in the past two years declined to en considerable extent because of the increase of loans with maturity more than 2-years compared to deposits with less than one year, financial sector and especially baking sector is fare to say is liquid to some extent and this is because the fact that central bank an government are interested and willing to guarantee the liquidity of banks.

When we consider the loan maturities they are far from being fordable for enterprises and especially for SME. This is major concern for businesses in kosova because loans with maturity les than two years compose more then 50%of total loan portfolio approved from banks the same situations is with the other financial intermediaries which have the same policy towards this issue.

In developed and politically stable countries companies despite the internal financial market sources they also have access in the foreign capital and markets. Kosova still after the independence can not benefit from this international institutions (like World Bank International Monetary Fund and European Bank) because the obstacles made by our neighbor Serbia for known political disputes between two countries.

Security and stock market in kosova can be described as follow:

- There is no insurance of stocks and share capital because of the absence of capital market
- The markets were companies can be listed and trade their shares is not established
- There are no Leasing companies and leasing commodities offered from banks except Raiffeisen bank (contract with Porsche)
- Agencies that can by bad credits from banks and companies are still not operating in the market

Finally we can try to answer the question of funds availability for SMEs in kosova?

According to researches conducted with 700enterprices about investments in kosova,the limiting factor that companies face in ***starting new businesses*** are lack of funds
When the ***existing firms*** were asked to define limitations that they face, cost of financing appears to be less important and the interest that they pay is rated in level seven, while access to capital is rated as $11^{th}$ important factor.

Analyzing these figures we can say that the fund insufficiency become questionable
The total sum of credits comparing with the deposits in kosova is around 60%, generally seeing t**here are enough funds in market** but how this funds are allocated among businesses and households is subject for further analyses.

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