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TECHNICAL ASSISTANCE REPORT—FINANCIAL SECTOR STABILITY REVIEW

July 2020

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Disclaimer:
This document was prepared before COVID-19 became a global pandemic and resulted in unprecedented economic strains. It, therefore, does not reflect the implications of these developments and related policy priorities. We direct you to the **IMF Covid-19 page** that includes staff recommendations with regard to the COVID-19 global outbreak.

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Monetary and Capital Markets Department

REPUBLIC OF KOSOVO

FINANCIAL SECTOR STABILITY REVIEW

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March 2020

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GLOSSARY

AML/CFT	Anti-Money Laundering/Combatting the Financing of Terrorism
BCP	Basel Core Principles
BSA	Balance Sheet Approach
BSD	Banking Supervision Department
CBB	Central Bank Board
CBK	Central Bank of Kosovo
CBL	Law on the Central Bank of Kosovo
CET1	Common Equity Tier 1
CR	Credit Registry
DIFK	Deposit Insurance Fund of Kosovo
DMF	Debt Management Facility
D-SIB	Domestic Systemically Important Bank
DSTI	Debt Service-to-Income
DT	Deposit Taker
DTI	Debt-to-Income
EAFSD	Economic Analysis and Financial Stability Department
EB	Executive Board
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
ELA	Emergency Liquidity Assistance
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
EUR	European Department
FinSAC	Financial Sector Advisory Center
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSC	Financial Stability and Crisis Management Committee
FSI	Financial Soundness Indicator
FSSF	Financial Sector Stability Fund
FSSR	Financial Sector Stability Review
FTE	Full-Time Equivalent
FY	Fiscal Year
GDP	Gross Domestic Product
GFS	Government Finance Statistics
GoK	Government of Kosovo
HQ	Headquarter
HQLA	High-Quality Liquid Assets
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standard

IFRS	International Financial Reporting Standards
IIP	International Investment Position
IMF	International Monetary Fund
IT	Information Technology
KAS	Kosovo Agency of Statistics
KCGF	Kosovo Credit Guarantee Fund
KFRC	Kosovo Financial Reporting Council
KPST	Kosovo Pension Savings Trust
LB	Law on Banks, Microfinancial Institutions and Nonbank Financial Institutions
LCR	Liquidity Coverage Ratio
LEG	Legal Department
LSD	Licensing and Standardization Department
LTV	Loan-to-Value
MaPP	Macroprudential Policy
MCM	Monetary and Capital Markets Department
MFI	Microfinance Institution
MFS	Monetary and Financial Statistics
MoF	Ministry of Finance
MoU	Memorandum of Understanding
MPAC	Macroprudential Policy Advisory Committee
MSME	Micro-, Small, and Medium-Sized Enterprise
MTPL	Motor Third-Party Liability
NBFI	Nonbank Financial Institution
NFC	Nonfinancial Corporation
NFSC	National Financial Stability and Crisis Management Committee
NGO	Nongovernmental Organization
NPL	Nonperforming Loan
ODC	Other Depository Corporation
OFC	Other Financial Corporation
PPP	Purchasing Power Parity
PSD	Payment System Department
RBS	Risk-Based Supervision
Repo	Repurchase Agreement
SD	Statistics Department of the CBK
SECO	Swiss State Secretariat for Economic Affairs
SRF	Standardized Report Form
STA	Statistics Department of the IMF
TA	Technical Assistance
USAID	United States Agency for International Development
WB	World Bank

PREFACE

At the request of the Central Bank of Kosovo (CBK), a technical assistance (TA) mission from the Monetary and Capital Markets Department (MCM) visited Pristina, Kosovo, from April 24 to May 7, 2019, to undertake a Financial Sector Stability Review (FSSR). The mission was led by Ann-Margret Westin (MCM) and included Richard Stobo (MCM); Zhongxia Zhang (EUR); and Michael Deasy, Keith Hall, Paula Oliveira, and Sarah Simpson (external experts). Peter Windsor (MCM) participated in the FSSR from IMF HQ. The IMF Resident Representative to Kosovo, Ruud Vermeulen, and Rosmarie Schlup from the Swiss State Secretariat for Economic Affairs (SECO), a key donor to the Financial Sector Stability Fund (FSSF), joined part of the mission. James Morsink, Deputy Director (MCM), participated in the closing meeting.

The FSSR is a new demand-led TA instrument for low- and lower-middle-income countries that provides a baseline diagnostic review of the financial sector and proposes prioritized capacity building through a country TA roadmap to deliver sound financial sector reform in support of development, financial stability, financial deepening and inclusion. The FSSR and the three-year follow-up TA based on the TA Roadmap is financed through the FSSF.

The scope of the mission was agreed with the CBK during the January 2019 scoping discussions held in Pristina and comprised central bank governance, banking supervision, insurance supervision, securities markets, macroprudential policy, and financial stability issues related to financial inclusion and deepening.

The mission met with policymakers, including the CBK board and management, staff in the Governor’s Cabinet, and with CBK staff from the following departments: Banking and Insurance Supervision, Licensing and Standardization, Asset Management, Statistics, Financial Planning and Reporting, External Relations, Legal, Risk Management, Economic Analysis and Financial Stability (EAFSD), and Internal Audit; in addition the mission met with the CBK stand-alone divisions of Anti-Money Laundering (AML), Appeals and Financial Services Users, and Credit Registry (CR). The mission also met with the Ministry of Finance (MoF), the Kosovo Credit Guarantee Fund (KCGF), the Deposit Insurance Fund of Kosovo (DIFK), the Financial Intelligence Unit, the Kosovo Financial Reporting Council (KFRC), and the Kosovo Agency of Statistics (KAS). Lastly, the mission met with representatives from the financial sector, including banks, insurance companies, pension funds, microfinance institutions (MFIs) and other nonbank financial institutions (NBFIs), and external auditors, as well as with representatives of the donor community, including the European Union (EU), SECO, the U.S. Treasury and USAID, and the World Bank (WB). The mission presented its findings and recommendations to the Executive Board (EB) of the CBK.

The mission appreciates the open and frank discussions with all counterparts. The mission team also wishes to express its appreciation to the authorities for their attention and the support provided to the mission, as well as their collaboration and hospitality during the conduct of the work. Lastly, the mission is grateful for the logistical support provided by the IMF Resident Representative Office in Pristina.

EXECUTIVE SUMMARY

The FSSR mission team conducted a diagnostic review of CBK governance and of the financial system, undertook a stocktaking of the implementation of recommendations from the 2012 Financial Sector Assessment Program (FSAP) and MCM TA, and proposed a TA Roadmap to support the efforts of the authorities to address key gaps and vulnerabilities. The IMF Statistics Department (STA) supported the mission with an assessment of the compilation of financial soundness indicators (FSIs), monetary and financial statistics, and balance sheet matrices (Annex I).

The CBK regulates the entire financial system, which is dominated by a stable banking system. Banks meet capital adequacy requirements and are reasonably profitable, with nonperforming loans (NPLs) the lowest in the region. Commercial banks' credit to the private sector has experienced double-digit growth rates over the last three years. The authorities have further strengthened the supervisory framework, including by enhancing cooperation with authorities in the region and the European Central Bank (ECB). A new draft law on banks has been prepared and legislation regulating and widening the range of activities of microfinancial institutions and other NBFIs are currently before parliament. Credit penetration is low by regional standards but continues to increase, facilitated by low interest rates, an easing of credit standards, and credit guarantee fund-backed lending. NBFIs play a small role in financial intermediation, and financial markets in Kosovo remain underdeveloped, although the CBK is working on regulation allowing for the creation of investment funds.

The mission identified some weaknesses in the current organizational structure of the CBK that may impact the effectiveness of decision-making, as well as the culture at the CBK. The Central Bank Board (CBB) is operating with fewer non-executive members than required in the Law on the Central Bank of Kosovo (CBL). Meanwhile, some CBK departments, including key areas of strategic importance, are not reporting to a deputy governor and hence are not represented at the EB. Furthermore, although allowed, neither the CBB nor the EB regularly receives direct presentations from CBK staff. The CBK should review its governance arrangements and organizational structure to ensure they are fit for purpose. This would provide a solid framework to support the CBK in moving forward with a program of improvements and a significant agenda of regulatory change.

Although the financial sector in Kosovo has been stable, the diagnostic review pointed to potential vulnerabilities in the banking and insurance sectors that need attention. The banking system may not be well prepared for a period of financial stress involving a sharp tightening of liquidity conditions. Banks' liquid assets largely consist of government securities, for which there is currently no active secondary market in Kosovo. The insurance sector is undeveloped, particularly with respect to life insurance; the powers and capacity of the CBK to undertake adequate market-conduct surveillance need to be further strengthened to address prudential solvency concerns. The liquidation of an insurance company during the mission is welcome but also points to the problems in this sector.

The CBK has taken important steps towards operationalizing the macroprudential policy framework although more remains to be done, in particular as to the institutional arrangements and the monitoring of systemic risks—differentiating between healthy financial deepening and potentially excessive credit growth is challenging in Kosovo given data limitations. Also, the CBK has yet to implement any specific macroprudential policy measures.

The mission also undertook diagnostic assessments of the preconditions for the establishment of capital markets in Kosovo, including investment companies; as well as the possible impact of financial deepening on financial stability.

Lastly, the mission conducted a stocktaking exercise on the implementation and impact of past TA. Kosovo has received extensive financial sector TA from MCM over the years, including the placement of a resident advisor in 2011. The stocktaking exercise showed that nearly all 2012 FSAP recommendations have been implemented. On the implementation of MCM TA recommendations, most progress was made on risk-based banking supervision.

Based on the diagnostic assessment, the mission made several recommendations to address the shortcomings and delivered a preliminary roadmap that prioritizes key areas of potential TA to support financial sector reforms. The main recommendations (Table 1) and the TA Roadmap (Annex II) focus on the need to review and update the organizational structure of the CBK, including of the CBB, the EB, and other decision-making structures and committees; enhance banks' crisis preparedness and monitoring of banks' liquidity risks; enhance market conduct and onsite supervision of insurance companies; review the CBK's institutional arrangements, governance, and staffing in support of financial stability and macroprudential policy, close data gaps, and consider the implementation of macroprudential policy tools; over the medium term, ensure the key building blocks for the establishment of an investment fund sector in Kosovo be put in place; establish a national strategy on financial inclusion to enable monitoring and evaluation of any risks to financial stability; and develop sectoral financial accounts and balance sheet statistics.

Table 1. FSSR Strategic Objectives, Related Key Recommendations and Priorities		
Enhance Central Bank Governance	**Priority[1]**	**Timeframe[2]**
Restart the process to appoint a fourth non-executive member to the CBB in accordance with the CBL. (**¶26)**	**H**	**ST**
Review the effectiveness of the operation of the CBB. (**¶27)**	**MH**	**MT**
Enhance the composition of the Executive Board and review its effectiveness. (**¶29–30)**	**H**	**ST**
Review and update the organizational structure of the CBK and refresh documented roles and responsibilities to ensure the structure is clear to all staff, at all levels. (**¶28)**	**H**	**ST**
Review the effectiveness of other decision-making structures and committees. (**¶24)**	**MH**	**MT**
Embed risk management within the CBK and its governance arrangements. (**¶31)**	**MH**	**MT**
Effective and Efficient Financial Supervision and Regulation		
Banking sector		
Undertake an in-depth analysis of the staffing requirements that are currently needed and will be needed in day-to-day supervision and policy. (**¶36, 53)**	**H**	**IM**
Remove any remaining doubt concerning the protection of staff against the costs of defending their actions and/or omissions made while discharging their duties in good faith. (**¶38, 54)**	**H**	**IM**
As part of the ongoing review of the list of Regulations, ensure that necessary risks and issues are dealt with (e.g., country and transfer risks, cyber risk, and certain aspects of market risk) and re-examine existing ones to ensure that they reflect the latest thinking. (**¶39, 54)**	**MH**	**ST**
In relation to the applications for banking licenses, require full details of the business and professional history of directors and senior management, as well as for principal shareholders of the proposed bank. (**¶41, 54)**	**MH**	**ST**
Intensify efforts with the ECB to participate in the Raiffeisen supervisory college and to be party to its resolution and recovery plans. (**¶42, 54)**	**H**	**IM**
Introduce a formal regime for regular meetings with the banks' external auditors. (**¶44, 54)**	**MH**	**ST**
Integrate stress tests exercises with the financial stability area and communicate the results to the banks. (**¶54, 99, 107)**	**H**	**MT**
Establish supervisory procedures that would be required during periods of stress and conduct periodic tests on the operational procedures for granting of ELA. (**¶47, 54)**	**H**	**ST**
Develop tools for a more thorough assessment of credit risk, based on granular data from the CR. (**¶48, 54)**	**MH**	**MT**

Table 1. FSSR Strategic Objectives, Related Key Recommendations and Priorities (continued)		
	Priority[1]	**Timeframe[2]**
Require banks to define scenarios forecasting disturbances to payment and settlement systems, for the purpose of operational risk management. (**¶46, 54)**	**H**	**IM**
Improve offsite monitoring tools for a better comprehension of banks' exposure to liquidity risk. (**¶50, 54)**	**H**	**IM**
Finalize the implementation of repo (repurchase agreement) facilities between the CBK and financial institutions, maturing over the intraday lag. (**¶52, 54)**	**H**	**IM**
Implement Basel III liquidity standards. (**¶49, 54)**	**H**	**ST**
Insurance sector		
Update the premium rate pricing of the mandatory motor third-party liability (MTPL) product and develop a process to regularly review the pricing as risk factors evolve. (**¶59, 71)**	**H**	**ST**
Assess the viability for the insurance industry of continuing to apply the taxes and fees, and obligations to pay for claims related to uninsured drivers. (**¶70–71)**	**H**	**ST**
Enhance the supervision of the market conduct of insurance companies by ensuring the CBK has adequate powers and resources to implement effective market-conduct supervision. (**¶62, 64, 71)**	**MH**	**MT**
Develop a framework of escalating supervisory actions for the insurance sector from preventative and corrective measures to enforcement. (**¶55)**	**H**	**ST**
Reconsider crisis management processes for the insurance industry, particularly the practice of installing CBK employees as administrators and liquidators. (**¶61, 71)**	**MH**	**MT**
Implement the risk-based supervision (RBS) manual that has been developed. (**¶68, 71)**	**MH**	**ST**
Enhance onsite supervision practices for insurance. (**¶67, 71)**	**H**	**ST**
Develop a program for the implementation of Solvency II that takes into account the circumstances of the insurance industry in Kosovo and the resources and resource needs of the CBK. (**¶75)**	**M**	**LT**
Improved Monitoring of Systemic Risks and Enhanced Financial Stability Governance		
Review the CBK's institutional arrangements and governance in support of financial stability and macroprudential policy. **(¶95, 101)**	**H**	**ST**
Amend the CBL to strengthen the legal basis for CBK's macroprudential policy powers. **(¶93, 103)**	**MH**	**LT**
Dedicate more resources to EAFSD for financial stability analysis, and "streamline" the deliverables, including the Financial Stability Report. **(¶102)**	**H**	**IM**
Complete a full review of macroprudential data gaps and develop a strategy to close them. **(¶98, 104)**	**H**	**ST**
Establish an Interagency Real Estate Working Group to close the information gaps around real estate in Kosovo. **(¶104)**	**MH**	**ST**

Table 1. FSSR Strategic Objectives, Related Key Recommendations and Priorities (concluded)		
	Priority[1]	**Timeframe[2]**
More closely monitor developments in nonfinancial sector balance sheets, including by cooperating with the KAS on the use of surveys. **(¶98, 106)**	**M**	**MT**
Explore ways to better harness Credit Registry (CR) data for macroprudential policy purposes. **(¶105)**	**MH**	**ST**
Deepen CBK's stress testing competency and network analysis. **(¶99, 107–108)**	**MH**	**MT**
Consider the use of macroprudential policies, including LTV and DSTI for consumer and mortgage lending. **(¶109)**	**H**	**IM**
Develop Securities Markets		
Ask the Government to establish a cross-agency task force on the development of capital markets in Kosovo. **(¶83)**	**M**	**MT**
Provide assistance to the MoF in drafting key pieces of capital markets legislation in order to provide a sound framework. **(¶84)**	**M**	**LT**
Increase expertise and knowledge on capital markets at CBK. **(¶85)**	**M**	**MT**
Ensure existence of pre-conditions for capital markets activity. **(¶87)**	**M**	**LT**
Financial Inclusion and Deepening (Impact on Financial Stability)		
Establish a National Strategy on Financial Inclusion. **(¶119, 126)**	**H**	**ST**
Further enhance data collection by the CR and utilize credit history data for financial stability purpose. **(¶128)**	**MH**	**MT**
Advance the regulation and technical readiness for mobile payment and electronic signature. **(¶122, 129)**	**MH**	**MT**
Reconcile the laws regarding MFIs' legal status and address the issue of Nongovernmental Organizations (NGO) MFIs' conversion. **(¶124, 131)**	**H**	**ST**
Enhanced Financial Statistics for Financial Stability Monitoring and Analysis		
Harmonize reporting of FSIs and address remaining methodological issues. (**Annex I**)	**MH**	**ST**
Ensure methodological consistencies of monetary statistics with the international standards. (**Annex I**)	**MH**	**MT**

[1] Priority: High (H); Medium High (MH); Medium (M)
[2] Timeframe: Immediate (IM) <6 months; Short-Term (ST) <12 months; Medium-Term (MT) 12–24 months; Long-Term (LT) 24–48 months.

I. INTRODUCTION

A. Scope of Work

1. **This report was prepared in the context of the FSSR mission that visited Kosovo in April–May 2019.** The mission held scoping discussions in Kosovo with the CBK in January 2019. Based on the agreed scope of work, the FSSR mission conducted a broad diagnostic of the financial system and proposed a TA Roadmap to support the efforts of the authorities to address key gaps and vulnerabilities in Kosovo's financial system. STA supported the mission with an assessment of the compilation of FSIs, monetary and financial statistics, and balance sheet matrices.

2. **The mission also conducted a detailed stocktaking exercise on the implementation of the 2012 FSAP and past MCM TA recommendations since then and evaluated progress on planned financial sector reforms**. The lessons learnt from the TA stocktaking exercise (Annex III) were utilized to inform the design of a realistic and well-sequenced TA Roadmap.

3. **The diagnostic review that will guide the financial sector reforms was organized around seven thematic work streams**. These seven work streams are summarized in Annex IV. The assessment of the adequacy of financial statistics for evaluating financial stability risks and vulnerabilities conducted by the IMF's Statistics Department is contained in Annex I. The output from the evaluation of the financial statistics was utilized to inform the mission's diagnostic review of financial risks and vulnerabilities.

4. **The diagnostic review is based on existing standards and methodologies and was targeted to specific issues based on the country circumstances.** The evaluation of financial sector supervision was guided by self-assessments, where available, of the Basel Core Principles (BCP) for banks and the International Association of Insurance Supervisors (IAIS) Core Principles for Insurers. The evaluation of the financial stability and macroprudential policy frameworks was guided by the IMF's *Staff Guidance Note on Macroprudential Policies* while the authorities' stress testing capacity was evaluated using the IMF's established analytical framework and toolkits. Financial inclusion was reviewed using the Basel Committee *Guidance on the application of the Core Principles for Effective Banking Supervision to the regulation and supervision of institutions relevant to financial inclusion*. The evaluation of the compilation of FSIs was guided by the IMF's *Financial Soundness Indicators Compilation Guide*. Targeted questionnaires and market sector overviews were also provided to complement existing methodologies.

B. Macroeconomic Context and Financial System Structure

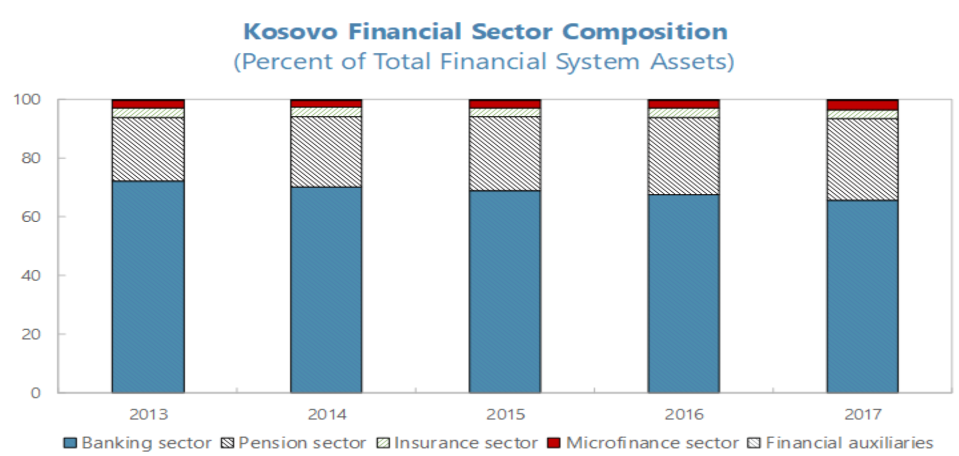
5. **Kosovo has experienced robust economic growth in recent years, although its income level is still low among European countries.** After three years of strong expansion,

the economy continued its momentum and grew at an estimated 4 percent in 2018, driven by investment, consumption, and services exports. Real gross domestic product (GDP) is forecasted to increase by 4.2 percent in 2019 due to a temporary increase in public investment, and the medium-term growth outlook remains favorable. However, with a GDP per capita at about €3,600 in 2017, Kosovo's income gap with the rest of Europe remains large (26 percent of the European Union (EU) average and 76 percent of Western Balkans average in Purchasing Power Parity (PPP) terms).

6. **While economic conditions are stable, Kosovo faces serious structural challenges.** Inflation is expected to double in 2019 to 2.2 percent from 1.1 percent in 2018, reflecting the introduction of a 100 percent tariff on imports from Serbia and Bosnia and Herzegovina in November 2018. The current account deficit is expected to remain large due to a sizable negative trade balance. In 2019, the budget deficit is projected to stay within the fiscal rule limit at about 1.9 percent of GDP, and total public debt is forecasted to rise to 19.7 percent of GDP. Meanwhile, structural issues such as low labor force participation, high unemployment, widespread informality, and weak external competitiveness constitute bottlenecks to Kosovo's growth potential.

7. **The CBK regulates the entire financial system, which is dominated by banks (Figure 1).** Given that Kosovo is a euroized economy, the primary objective of the CBK is to maintain financial stability. The CBK is the sole supervisor, in charge of regulating, supervising, and licensing all financial institutions in Kosovo. The banking sector accounts for 66 percent of total financial system assets. The banking system in turn is dominated by foreign-owned banks, accounting for 87 percent of total assets in 2018. Banks are reported to meet capital and liquidity requirements, and NPLs are the lowest in the region, at 2.6 percent. Commercial banks' credit to the private sector has experienced double-digit growth rates for the last three years.

Figure 1. Kosovo: Financial Sector



Source: Central Bank of Kosovo.

8. **Nonbank financial institutions (NBFIs) play a small role in financial intermediation, and financial markets in Kosovo remain underdeveloped.** The pension sector, the second largest sector in the financial system, has increased its share of total financial system assets from 13.6 percent in 2009 to 28 percent in 2017. The insurance sector only represents about 3 percent of total financial system assets and mainly engages in MTPL insurance. Although MFIs and NBFIs have experienced rapid growth in recent years, they only constitute 4 percent of the financial system. Kosovo does not have corporate bond or stock markets, so firms have no access to capital markets funding but are dependent on banks.

9. **Financial inclusion remains a challenge in Kosovo.** With widespread informality, the current degree of financial intermediation is low, and many households and firms are still not covered by formal financial institutions. Cash transactions are the dominant form of payment in Kosovo, while electronic payments are limited, and mobile payments are virtually nonexistent. Commercial banks have recently reduced their involvement in the small-loan market, as well as their physical financial access points; meanwhile, MFIs and NBFIs have expanded rapidly to fill the vacuum left by commercial banks.

C. Macrofinancial Vulnerabilities

10. **On first impression, there are no pressing concerns about the outlook for financial stability in Kosovo.** An overview of Kosovo's financial system provides a number of reassuring signals: banks meet capital adequacy requirements, with sufficient liquidity and low levels of NPLs. They are profitable and have been able to sustain credit growth rates in excess of 10 percent for three consecutive years. This provides much-needed support to Kosovo's economy, and is welcome from a financial deepening perspective, which is an important policy priority of the government. Credit penetration remains low by regional standards and other income-equivalent countries but has continued to increase (mainly for trade and construction), facilitated by low interest rates, an easing of credit standards, reforms to contract enforcement and the use of the KCGF to support lending to micro-, small and medium-sized enterprises (MSMEs).

11. **However, differentiating between healthy financial deepening and potentially excessive credit growth is challenging in Kosovo**. The authorities have very limited insight into nonfinancial private sector balance sheets and are unable to easily determine the debt-servicing capacity of households and companies. There is anecdotal evidence that much of the lending for consumption is finding its way into real estate in the absence of easily available mortgage finance. Real estate markets are very opaque in Kosovo and there are no price indices for residential property or readily available information on developments in commercial real estate.

12. **Kosovo is a small open economy that is vulnerable to external shocks**. Kosovo's trade deficit is high (26 percent of GDP in 2017); although there has been some welcome

diversification in exports, the country has made less progress than other West Balkan countries in growing its goods export share. The decision to impose 100 percent custom duties on goods from Serbia and Bosnia and Herzegovina in late 2018 constitutes an additional concern for Kosovo's trade relations. While the trade deficit is substantial, it is largely financed by travel services, remittances and foreign direct investment (16, 15, and 4 percent of GDP in 2017, respectively) and other non-recorded capital inflows. Remittance inflows mainly support consumption, rather than investment. This makes the domestic economy sensitive to shocks in remittance flows, which mainly come from the rest of Europe. A longer-term concern is that the current level of remittance inflows is unlikely to be sustained as the diasporas become permanent residents of their host countries.

13. **The fact that Kosovo has chosen to unilaterally euroize means that the authorities have to be very alert to capital movements and liquidity risk.** According to traditional metrics, gross international reserves—based on standard definitions—are adequate. However, a more conservative definition of reserves that excludes Privatization Agency of Kosovo and Kosovo Pensions Savings Trust (KPST) deposits suggests that reserves fall below three months of prospective imports. Furthermore, gross international reserves have declined in percent of GDP and the level is low in a regional comparison. The banking sector appears to hold ample liquidity buffers with liquid assets representing 38 percent of short-term liabilities in January 2019. However, the liquidity position may be less reassuring than at first glance. Reserve adequacy ratios are expected to decline over the medium term, which may not be sufficient to cover balance of payments needs. Banks' liquidity ratios are also gradually tightening as credit expansion outstrips deposit growth. This trend needs to be very closely monitored in Kosovo. Furthermore, liquid assets include domestic government securities (with no haircut for sovereign debt in calculating liquidity ratios according to current regulation) even though there is no active secondary market for such securities and, currently, no central bank repo facility in operation. Lastly, while the CBK has an emergency liquidity assistance (ELA) arrangement, this is limited in size due to euroization and would meet the needs of only a few smaller distressed banks. The ELA arrangement is constant in size and has never been tested.

D. Technical Assistance Stocktaking and Review

14. **Kosovo has received extensive financial sector TA from MCM over the years.** Since fiscal year (FY) 2011, Kosovo has received about 4.5 FTEs[1] of MCM TA, including the placement of a resident advisor in banking supervision and regulation in FY11. Financial sector regulation and supervision has received the lion's share of MCM TA since FY11, or 76 percent. Other important areas for MCM TA to Kosovo since FY11 have been central bank operations, and crisis preparedness and management, at 6 and 4 percent, respectively. Furthermore, TA on macroprudential policy framework was provided in 2017. Kosovo has

[1] A Full Time Equivalent (FTE) measures TA delivered in the field by one person for one year.

also received TA on property registration, the preparation of the law on MFIs, retail payment system, and MTPL pricing from the World Bank, and on insurance supervision and debt management from the U.S. Treasury; the WB Financial Sector Advisory Center (FinSAC) is currently providing TA on crisis preparedness and management.

15. **The mission conducted a stocktaking exercise on the implementation status of the 2012 FSAP recommendations, as well as MCM TA recommendations since 2012.** The stocktaking exercise showed that nearly all 2012 FSAP recommendations have been implemented. On implementing MCM TA recommendations, most progress was made on risk-based banking supervision, which has helped the CBK develop and implement a risk-based supervision manual. In addition, the CBK has followed up on the TA recommendations on the CBL by approving the risk management function, creating a risk management department and allowing financial institutions to review draft legislations. Progress was somewhat slower in the areas of contingency planning for crisis preparedness, macroprudential policy and early warning system, and insurance sector regulation and supervision. The slower implementation record in these areas may in part reflect insufficient staff resources. Nevertheless, the authorities have taken steps to address capacity constraints and promote coordination to increase the TA impact. The lessons learned from the implementation of previous TA were considered in designing a realistic FSSR TA Roadmap.

II. THE BASELINE DIAGNOSTIC REVIEW AND MAIN RECOMMENDATIONS

A. Further Enhance Central Bank Governance

16. **Good standards of corporate governance provide an invaluable backbone to a central bank, not only to ensure the bank meets its objectives through effective decision-making, but also to embed a positive culture across the organization.** While the mission recognizes that there are no specific standards of corporate governance that apply to central banks, it also notes the general importance of central bank governance. See, e.g., a recent IMF policy paper on the monetary and financial policies transparency code,[2] and selected IMF working papers[3] stressing the importance of central bank governance, including aspects of independence, decision-making, internal control and assurance, and the added value of board effectiveness (see further the Finance & Development article "Set the Tone at the

[2] IMF, 2019, *Update the Monetary and Financial Policies Code*, IMF Policy Paper 19/011, Washington, D.C.

[3] E.g., Khan, A., 2016, *Central Bank Governance and the Role of Nonfinancial Risk Management*, IMF Working Paper 16/34, Washington, D.C.; Khan, A., 2017, *Central Bank Legal Frameworks in the Aftermath of the GFC*, IMF Working Paper 17/101, Washington, D.C. The IMF has also published a video on central bank governance: https://players.brightcove.net/45228659001/default_default/index.html?videoId=6039004007001.

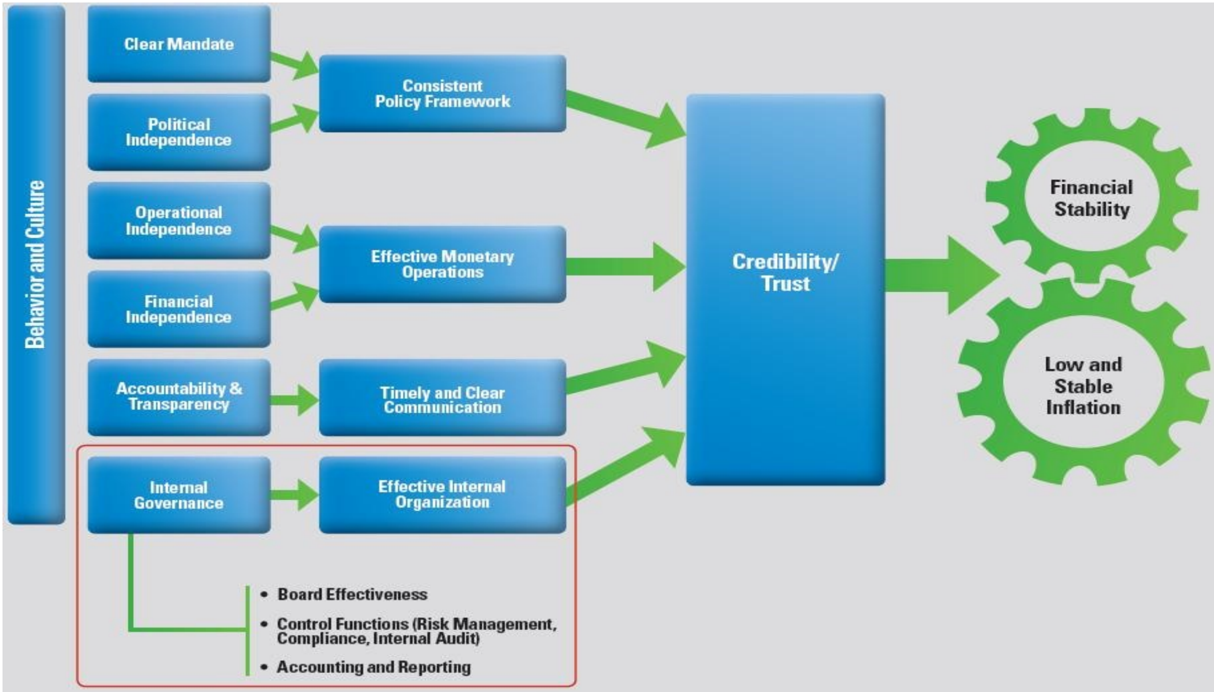
Top"[4]). Additionally, central banks should be mindful of the governance standards set by a central bank in its role as the supervisor of the financial sector. See further Figure 2.[5]

17. **The CBK has a sound legal framework in place to provide it with an excellent baseline for its operations.** Within that legal framework it is important to consider the governance that supports the CBK in achieving its objectives. The CBK's governance has evolved over time and is underpinned by clear internal rules and procedures. Maintenance of governance standards should be regularly reviewed as a central bank evolves, for example when it introduces new responsibilities or undergoes structural or management changes. It is recommended that the CBK reviews its governance arrangements and organizational structure to ensure they are fit for purpose. The culture of an organization is set top-down, but it is expressed bottom-up by working level staff. Observations made by the mission suggest that the impact of organizational arrangements warrant further consideration. Staff operate most effectively within an environment that fosters a culture of questioning, positive challenge, communication, and feedback. This is something that is on the agenda for senior management in all well-functioning organizations, including central banks. This is because a positive culture impacts recruitment, employee retention, staff morale, work performance, and reduced sickness rates. One option for CBK senior management would be to ask staff directly, for example through an anonymous staff survey (as many central banks and corporate entities adopt). Carefully targeted questions would provide the CBK senior management with a body of anecdotal evidence to consider. Many organizations conduct these surveys on an annual basis. Initial results (those in the first year of surveying) can be difficult to draw conclusions from; but over time, senior management can look for trends in the data. This can be particularly useful after key time-points, such as testing the impact of implementation of a new organizational strategy. This report highlights changes that would further strengthen the existing controls, have a positive impact on culture and provide a solid framework to support the CBK in moving forward with a program of improvements and a significant agenda of regulatory change.

[4] Finance & Development, 2016, *Set the Tone at the Top*, December 2016, Vol. 53, No. 4, Washington, D.C., IMF.

[5] All central banks do not have both key mandates. E.g., the primary mandate of the CBK is financial stability.

Figure 2. Overview of Key Internal Governance Issues of Central Banks



Source: IMF Staff.

Baseline Diagnostics

18. **The CBB is operating with fewer non-executive members than are required in accordance with the CBL.** By design (Article 34 of CBL), the CBB should contain four non-executive members plus the Governor. The CBB has been operating with only three non-executives for more than three years. Non-executive members can add significant value to board discussions, bringing different perspectives to support the CBK in meeting its objectives. The current CBK law does not contain any requirements that specify independence in relation to former employment by the CBK. Article 34(2) states "The non-executive members of the Central Bank Board shall not be members of the Central Bank's staff" but does not specify any restrictions on former staff. However, current best practice in general corporate governance standards do include recommendations that qualify standards of independence in non-executive directors. [6] This is because it is considered more difficult for non-executives to "stand apart" from an organization if they have recent working relationships with executive or other members of staff. This is particularly important for individuals who may have had roles where they directly influenced the work of a central bank or its decision-makers, such as senior advisors or key decision-makers. While the mission acknowledges that Kosovo is a small country, and therefore that unnecessary barriers should not be inserted that restrict the availability of good candidates, there is a risk that a

[6] As noted above, the mission recognizes that there is no universal standard for *central bank* governance.

lack of independence for non-executives could have unintended negative consequences. The CBK may wish to consider how to strengthen its governance in this area. For example, this could be that a former employee who is appointed to the CBB would not have worked for the CBK in a role of significant influence or proximity to senior management for a least the one year prior to appointment.[7] This observation further highlights the importance of compliance with the CBL in relation to the number of non-executives. Furthermore, in the future, the mission recommends that the CBL be reviewed to ensure that the most up-to-date practices in relation to independence of non-executives are reflected in the law.

19. **The CBB is focused on meeting its accountability requirements under the CBL, but its operations suggest improvements could be made to enhance its effectiveness.** A number of potential weaknesses have been observed in the arrangements for the CBB. For example, there are no arrangements in place to provide an introduction to new non-executive members or provide ongoing training or support to the members of the CBB, either with respect to their role as a non-executive or the operations of the CBK. This reduces the ability of those members to perform effectively as non-executive members.

20. **The meetings of the CBB receive written reports supplemented by verbal explanations from the Governor and Deputy Governors.** Although it is allowed under the procedures, the CBB does not regularly receive direct presentations from CBK staff. The CBB should consider changing its agendas to have regular planned presentations of key items on its agenda, directly from the relevant staff. This would allow non-executive members the opportunity to add value through constructive challenge of issues that may not otherwise be immediately apparent. Most central bank boards have a balance of items on their agendas, including items for discussion (and potentially decision), which include relevant staff; items for decision, which may be straightforward and require no inputs; and items for information, which are not discussed.

21. **Some weaknesses have been observed in the current organizational structure of the CBK, which may impact the effectiveness of decision-making, but also the culture at the CBK.** The CBK previously had a structure with three Deputy Governors, with responsibility for the different departments of the CBK distributed between them. The vacancy left by the departure of a Deputy Governor in 2017 has not been filled, but his responsibilities have been transferred to a newly created "General Coordinator" position (not regulated in the CBL), leaving a vacuum in the composition of the EB. To escalate matters to the Executive Board, the General Coordinator reports through the Governor. This includes a number of key areas of strategic importance, including financial stability, risk management, and finance. Unlike the other areas, the departments under the General Coordinator have no independent vote at the EB, or presence at the CBB to support the CBB's oversight of those

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[7] The CBK notes that this is beyond the requirements of the CBK law (Article 34(2)).

functions. In addition to concerns regarding senior management structure, there is a lack of clarity in some parts of the CBK over roles, responsibilities, and appropriate staffing levels. For example, the mission was advised that a number of areas currently have budgeted vacancies following staff moves but have not been allowed to recruit replacement staff. This has created the impression for some staff that they are below budgeted headcount and therefore need more staff. If, in fact, senior management judges that replacements are not necessary for those roles, this should be communicated clearly, and the budgeted vacancy removed to avoid misunderstandings within the staff. A transparent review of the overall structure that seeks input from management and staff on the strengths and weaknesses of existing arrangements would allow the EB to embed any changes in a positive way.

22. **The arrangements for decision-making at the executive level allow for a concentration of power.** The CBL does not prescribe the number of Deputy Governors. The current composition of Governor plus two Deputy Governors means that in practice the EB can operate in accordance with the CBL with a quorum of two-thirds of its members. Furthermore, for a period in 2017, there were only two members of the EB.[8] Where decisions are taken with two members, the effect is that the Chair of the meeting would receive a second vote in the event of a disagreement. Structurally, this arrangement discourages constructive challenge for the other member as decisions could be taken regardless of their input. While some discretion under the law for the number of Deputy Governors can provide valuable flexibility as the CBK evolves, it would benefit from a clear minimum number (three), as well as a cap to ensure the numbers do not become excessive in the future. At this stage, the mission team is not specifically requesting changes to the CBL; however, it notes this could be an area for future consideration.[9] At that time, any review of the CBL may also wish to consider whether Deputy Governors should be appointed on staggered terms.

23. **As with the CBB, the meetings of the EB receive written reports supplemented by verbal explanations from the Governor and Deputy Governors.** Although it is allowed under the procedures, the EB does not regularly receive direct presentations from staff at the CBK. The EB should consider changing its agendas to have regular planned presentations of key items directly from the relevant staff. This would improve the transparency of decision-making at the EB and reduce the potential for disconnect between the executive and departments within the CBK. Providing relevant staff with the opportunity to see first-hand how decisions are made on their issues will help them to understand the risk appetite of decision-makers. In turn this will improve the quality of inputs that are submitted. It also has a significant positive impact on culture, as staff develop a greater understanding of how and why the CBK takes particular decisions.

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[8] CBK Annual Report for 2017.

[9] The IMF's Legal Department (LEG) would be able to provide further guidance and input.

24. **The CBK has a number of committees that operate below the level of the Executive Board, including the Macroprudential Committee and the Investment Committee.** As highlighted further below, the operations (including membership) of the Macroprudential Committee should be reviewed as a priority alongside the review of the CBB and EB. The CBK should also take the opportunity to consider the effectiveness of its other committees. As with the EB and CBB, regular effectiveness reviews for other committees can be a useful tool to allow the committee to step back and assess its performance. As part of that, the EB and CBB should consider whether the outcomes are escalated to them in a timely manner and are also cascaded to staff where relevant or appropriate.

25. **While positive progress has been made to introduce risk management processes at the CBK, at this stage the CBK, at all levels, should focus on ownership (and mitigation) of its risks.** The risk division is drawing on support from a variety of external sources to develop its risk management procedures and has a plan for further development. In particular, it recognizes the importance of embedding a culture of risk management within the CBK. This would be supported by improvements in both the organizational structure and decision-making arrangements at the CBK. Recent risk reports to the EB have only highlighted the three most significant risks (those categorized as major residual risk), but reports do not provide the opportunity to challenge those significant risks just below that reporting threshold. The risk department should also consider strategic risks, such as “effectiveness of governance arrangements,” for example. The CBK received previous recommendations on risk management from an IMF TA mission in 2012. One recommendation was to have a senior risk committee reporting to the CBB, as the Audit Committee does (some central banks adopt a joint Audit and Risk Committee). This recommendation has not yet been implemented. This remains best practice and we would encourage the CBK to revisit this recommendation.

Main Recommendations

26. **The CBK should reinstigate the process to appoint its fourth non-executive member to the CBB in accordance with the CBL.** The CBK has previously written to Parliament to request the instigation of the appointment process, but it is unclear whether the Assembly of the Republic of Kosovo discussed this item. The CBL (Article 45) states that any vacancy on the CBB should be filled within 60 calendar days. Given the significant time that has elapsed, the CBK should take the appropriate steps to restart the appointment process. The mission understands that based on the process within Parliament, it is now the responsibility of the CBK to restart the process and submit names of candidates to Parliament for approval.

27. **The CBB should review its effectiveness.** This should include (as a minimum) a review of how its meetings are structured and planned, and the inputs it receives. In line with the practice of many central bank boards, the CBB may also like to consider building

relationships with experienced non-executive members from other central bank boards in Europe. A number of central banks are developing their capabilities to review the effectiveness of their governance arrangements, which may provide a useful example for the CBK to consider.[10] The CBB should also give further consideration to the operation of its Audit Committee, the maintenance of its independence, and the effectiveness of its interaction with the CBB. The Audit committee should also encourage Internal Audit to periodically review compliance with governance arrangements as part of its audit universe.[11] Over the medium term the CBB should develop the ability within its Secretariat to review its own effectiveness on an annual basis.

28. **The CBK should review its organizational structure and refresh documented roles and responsibilities to ensure the structure is clear to all staff, at all levels.** This should clarify the appropriate staffing levels in each division/department, identify key skills within existing staff, as well as skills gaps, and seek to fill existing vacancies as a priority. The review should address key-person risk across the CBK and set out arrangements to mitigate this through training of other existing staff and introducing succession planning arrangements for key roles. As part of the review, the CBK should carefully consider how communications can be improved at all levels (between departments, and up and down the management chain) to improve transparency and support a positive culture.

29. **The Executive Board should be supplemented by an additional (fourth) voting member (a third Deputy Governor) to ensure balanced decision-making and the representation of all departments of the CBK in its deliberations.** This change is permissible under CBL and would amend the quorum from two to three members.

30. **The Executive Board should review its effectiveness.** Board effectiveness reviews can play an important role in supporting high-quality decision-making, particularly as each board evolves over time. The mission recognizes the importance of proportionality in all elements of applying governance standards to the CBK, and therefore in the first instance this effectiveness review could be conducted internally. This should include (as a minimum) a review of how its meetings are structured and planned, and the inputs it receives. In the medium term, the EB should develop the ability to review its own effectiveness on a periodic basis, in line with principles of good corporate governance.

31. **The risk division should provide the Executive Board with a more detailed view of the CBK's top risks.** This will allow the Executive Board to have regular discussions of

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[10] See, e.g., Board Secretary Report (2018) Central Bank of Seychelles: www.cbs.sc/Publications/BoardSecretaryPub.html.

[11] The CBK notes that this is outside the scope of the CBL law (Article 61(1.1-2) regarding the audit universe of Internal Audit.

its strategic and operational risks and report on its views to the CBB. Previous MCM TA recommended that the CBK seek to introduce a separate risk committee. That approach would still be considered best practice and should be introduced over the medium term. However, at this stage it may be more proportionate for the CBK to continue to use the EB while its risk management capability develops. It is vital that the EB takes ownership of its risks and actively challenges both the characterization and proposed mitigation of the risks.

B. Financial Sector Oversight

Banking Sector

Baseline Diagnostics

32. **Significant improvements have been made in the area of banking regulation and supervision since the 2012 FSAP.** Several new regulations have been issued covering almost all aspects of supervision; the CBK has introduced a risk-based, forward-looking supervisory approach; Basel III (except the liquidity standards) becomes effective in January 2020, as does International Financial Reporting Standards (IFRS) 9; and the Law on Banks, Microfinancial Institutions, and Nonbank Financial Institutions (LB) is being updated to include provisions relating to recovery and resolution of banks, consumer protection, and amendments to some existing provisions.[12] Also, the problem identified in the 2012 FSAP, whereby the CBK could not adequately supervise banks in Northern Kosovo for political and security reasons, has been partially addressed.

33. **In broad terms, regulatory structures in Kosovo coincide with international norms.** There is a strong legislative base, the CBK carries out the main functions of supervision (licensing, onsite/offsite supervision, AML/CFT surveillance, etc.) and is staffed by dedicated and knowledgeable persons, although some gaps in expertise exist, as discussed hereunder.

34. **Banks meet capital adequacy requirements and are reasonably profitable with low levels of NPLs**. The aggregate capital adequacy ratio is about 16 percent and has been at that level since 2016, at least. Almost all capital is composed of Common Equity Tier 1 (CET1).[13] The return on equity has been about 5–6 percent since 2015 and the NPL ratio is currently 2.6 percent, having fallen steadily from 5.9 percent in 2016. The reason for the favorable NPL figure is attributed to a very effective collection system, better underwriting

[12] The mission provided its views on the proposed new law on banks both before and after the mission.

[13] Currently, banks maintain an average CET1 level above 96 percent of total capital, which is sufficient to cover all Basel III buffer requirements. However, banks are not allowed to use the conservation buffer in periods of stress, which may bring difficulties for the CBK to deal with eventual breaches on capital requirements.

by banks and a strengthening of banking supervision. However, a significant part of the increase also relates to the denominator effect (rapid credit growth) and write-offs.

35. **Banking business in Kosovo is traditional in nature**. It largely comprises the acceptance of deposits and granting of loans. Virtually all banking business is conducted in euros, and there is no cross-border activity except for placements from and with foreign banks and parent bank groups of Kosovo banks. Placements from groups banks are restricted to 20 percent of total deposits, and placements with them are restricted to 10 percent of Tier l capital as such placements are regarded as related-party transactions.

36. **The CBK should review as a matter of urgency its staff complement in terms of both number and expertise.** The mission was impressed by the professionalism, knowledge, and dedication of the supervisory staff. However, they seem overstretched and will be even more so in the future. It is acknowledged that the CBK operates an effective training program with frequent attendance at relevant courses abroad. However, the burden of regulation, both in terms of policy and practical supervision, has become more complex and technical with the advent, for instance, of Basel III and IFRS 9. Accordingly, the CBK should very carefully consider the implications of these and other requirements on staffing levels and expertise. Also, there is currently no practice of seconding staff between the Banking Supervision Department (BSD) and the Licensing and Standardization Department (LSD). Such practice would be of benefit to both departments.

37. **There is no provision in law for the public disclosure of reasons for the dismissal of CBB members,** as is stipulated in the BCP.

38. **The CBK should remove any remaining doubt concerning the protection of staff against defending their actions and/or omissions made while discharging their duties in good faith.** The CBL (Article 78) provides that "The Central Bank shall indemnify a member of the Central Bank's decision-making bodies or its staff, or an agent of the Central Bank against costs incurred in the defense of a legal action brought against such person in connection with the discharge or purported discharge of official tasks within the scope of his employment or engagement under this law, provided that no such indemnification shall apply if such person has been convicted of a crime arising out of the activities that are covered by such legal action." It was noted in the 2012 FSAP, however, that then recent cases showed delays and challenges to reimbursement of legal defense costs. In response to this finding, the CBK introduced an internal rule on the indemnification of costs in legal proceedings. However, such indemnification is conditional; most notably, even where the CBK Human Resources Division recommends payment of such costs, the Governor may reject it. The CBK should consider amending the rule to more accurately reflect the provision in Essential Criteria 9 of BCP 2, namely that the supervisor and its staff are adequately protected against the costs of defending their actions and/or omissions made while discharging their duties in good faith.

39. **The CBK should review the list of regulations to ensure that all necessary risks and issues are dealt with.** The CBK has issued supervisory regulations that cover almost all relevant matters. However, there are gaps, e.g., limits on the use of capital conservation buffer, countercyclical buffer, country and transfer risks, cybercrime and certain aspects of market risk. The CBK should review the list for completeness and revisit existing regulations, many of which date from 2012–2013, to ensure that they reflect current thinking.

40. **The CBK should consider updating its list of activities that can be undertaken by banks (permitted activities)**. Article 44 of the LB sets out the list of permitted activities. However, this list was devised in 2012 when the law was enacted and takes no account of developments since then, particularly those driven by technology. During discussions with external sources concerns were raised about, for example, the absence of specific reference to digital money services and the fact that the law provides that communications with bank customers in certain circumstances must be made via letter, thereby ruling out the use of more advanced technology for such communications, e.g., the use of electronic signatures. (It is noted that permitted activities are being addressed in the current draft of the new law on banks. Inter alia, the proposed new law elaborates on existing activities, and provides for new activities, e.g., provision of insurance or reinsurance services and pension company services. It also specifically provides for the implementation of electronic money services.)

41. **In relation to the application process for a banking license, some information relating to the applicants is incomplete**. For instance, in seeking details about the professional and business history of directors and senior management of the proposed bank, the CBK requires such information only for the previous 10 years, rather than for the entire career of the applicants.

42. **The CBK has not been invited by the ECB to participate in the supervisory college of Raiffeisen.** Nor is the CBK party to its resolution and recovery plans. Raiffeisen is the largest bank in Kosovo, with a market share of almost 25 percent, and is a subsidiary of an Austrian bank. As a systemically important financial institution, it is supervised by the ECB in conjunction with the Austrian Supervisory Authority. While the local operations in Kosovo may be relatively insignificant in group terms, they are of major significance in the Kosovo financial market and economy. Accordingly, the CBK should have every opportunity to be party to group regulatory deliberations. Also, the CBK should continue its efforts to sign a memorandum of understanding (MoU) with the Austrian authorities, notwithstanding the apparent reluctance of the latter to do so.

43. **The CBK should limit the period of tenure for directors of banks.** Currently, bank directors are appointed for terms of not more than four years and may be reelected for subsequent terms. However, there is no limit to the number of times a director may be reelected. Best practice (as, for instance, set out in the joint guidelines of September 2017 on the assessment of the suitability of members of boards of banks and investment firms by the European Banking Authority and the European Securities and Markets Authority (ESMA)

(Article 91)) would suggest a maximum period of 12 years in this area; any longer could result in the independence of independent directors, in particular, being compromised. The joint guidelines do not automatically exclude such a person from being an independent director, however, it requires the bank/investment firm in question to justify to the supervisor the reasoning why the members' ability to exercise objective and balanced judgement and to take decisions independently are not affected by the situation.

44. **While the law provides for the CBK to meet the external auditors, such meetings rarely take place.** They do not seem to be regarded as necessary as generally no issues of concern to either side tend to arise. However, even in the absence of specific problems, it is regarded as good practice for the regulator and external auditor to meet on a regular basis to discuss issues of common interest. This could happen either at the planning stage of the audit or after the auditor has completed the audit, or both. Moreover, the CBK should instigate meetings with the external auditing profession as a group to discuss issues of common concern to both.

45. **The CBK banking supervisory process is well documented and comprises integrated offsite and onsite activities, while the Executive Board is the decision-making body for corrective measures against banks.** The RBS manual organizes and formalizes guidance to the CBK's bank examiners, in order to ensure a consistent application of supervisory procedures. The offsite manual, although not yet into force,[14] is very comprehensive in establishing the offsite supervision role and provides guidance on its conduction. Supervision is conducted both on a solo and consolidated basis. Onsite supervisors from banking and nonbanking areas may perform joint examinations when special expertise is needed. The Reporting and Analysis Division of BSD is responsible for offsite activities of all institutions in Kosovo's financial sector and produces micro- and macrofinancial analysis reports.

46. **The Payment System Department (PSD) is responsible for the oversight of banks' intraday liquidity procedures.** Exchange of information on banks' liquidity status between supervisors and PSD staff is adequate for each other's needs and effective in both directions, although on an informal basis. PSD is not formally responsible for reporting to BSD in the event of a bank not complying with its intraday liquidity needs. Neither the PSD nor the BSD requires banks to assess stress scenarios forecasting disturbances to payment and settlement systems.

47. **Banking supervision in Kosovo has not yet experienced periods of financial stress.** The short history of Kosovo's banking supervision and the absence of a financial crisis during its life time have not given supervisors the practice to conduct banking

[14] The Offsite Supervision Procedures Manual for Banks was submitted to the Executive Board in October 2018; however, it is still pending approval.

supervision under stress. BSD's emergency decision-making processes and the role of supervision in the event of a bank request for ELA, for example, need to be formalized and periodically tested.

48. **The CBK keeps and administers the CR to collect and distribute credit information to financial institutions.** All credit providers are required to report to the CR of Kosovo all credit applications and credits extended to their customers, and they may assess a client's information upon his/her authorization. BSD makes use of CR information to assess whether the risk classification of a specific client is consistent among credit providers. A more thorough assessment of credit risk in banks and the credit market based on CR granular data has not yet been developed.

49. **Regulation requiring Basel III minimum standards for liquidity risk are still in an initial stage of elaboration.** The current regulation on liquidity risk management requires banks holding the ratio of liquid assets against short-term liabilities at the minimum level of 20 percent by currency, and of 25 percent in total currencies. All banks are well above these limits.

50. **The banks' liquidity risk may be underestimated by supervisors, while they rely on the current regulatory ratios for its assessment.** Liquidity buffers may be overestimated in case a bank relies on assets that could not be easily settled to cover its liquidity need, such as Government of Kosovo (GoK) securities, due to the absence of active secondary markets in Kosovo. Besides, the ratio metrics do not take into account cash outflows that may occur in stressed situations, such as the early withdrawal of term deposits. The absence of legal impediments for a customer to withdraw term deposits prior to maturity may bring unexpected outflows not considered by the current ratios. Thus, in order to cover these gaps, in particular as long as Basel III liquidity requirements are not yet in place, offsite supervision should improve monitoring tools to have a better comprehension of banks' liquidity risk exposure. Methodology should explore banks' vulnerabilities and identify whether their contingency buffers are sufficient to support the liquidity needs derived from stressed scenarios.

51. **Except for two branches, Kosovo banks would not face difficulties complying with the liquidity coverage ratio (LCR).** However, while being a minimum requirement, this ratio is also a comprehensive liquidity stress test and should be used for a more thorough assessment of banks' liquidity capacity. For example, estimations show that in a scenario where GoK securities are not included in the high-quality liquid assets (HQLA) buffer due to

the absence of a liquid market for these securities, one bank would breach the minimum LCR while two others would experience a relevant reduction in their liquidity ratio levels.[15]

52. **The CBK is experiencing delays in the implementation of repo operations longer than the intraday lag with the market.** The CBK provides intraday liquidity facilities to banks, through repo operations collateralized by government securities. However, these operations cannot exceed the intraday lag. The CBK has already drafted regulation to regulate repo operations with market participants maturing beyond the intraday term, but there is no provision for its implementation.[16] The stage of development for the facility's framework, in terms of an IT solution, at the CBK is also unclear. This facility is very relevant to improve the liquidity capacity of Kosovo's government securities and opens the door for the development of a secondary market for them. The Regulation on Liquidity Risk Management already treats these assets as liquid for the computation of the required liquidity ratios.

Main Recommendations

53. **The authorities should prioritize a review of the staffing requirements within the three supervisory Departments: Banking Supervision; Licensing and Standardization; and AML.** To this end, the authorities need to:

- Undertake an in-depth analysis of the staffing requirements that are currently needed and will be needed in day-to-day supervision and policy, particularly as a result of the upcoming implementation of new requirements such as Basel III and IFRS 9. These new requirements require highly specialist and expert staff with a detailed understanding of their subject matter. Improved IT infrastructure and greater support for data analysis should also be part of the review.

- Provide for the secondment of staff between the BSD and the LSD.

54. **Other areas that the authorities should address include:**

- Remove any remaining doubt concerning the protection of staff against the costs of defending their actions and/or omissions made while discharging their duties in good faith. Specifically, amend the CBK's internal rule on the Indemnification of Staff Costs in Legal Proceedings by providing unconditional support for staff in these circumstances.

[15] Under the Basel III LCR standard, banks must hold a stock of unencumbered HQLA to cover total net cash outflows over a 30-day period under a prescribed stress scenario.

[16] The mission provided comments on the proposed Regulation on Emergency Liquidity Assistance.

- Provide for public disclosure reasons for the dismissal of CBK's Board members.

- Review list of regulations to ensure that necessary risks and issues are dealt with (e.g., country and transfer risks, cyber risk, and certain aspects of market risk) and re-examine existing regulations to ensure that they reflect the latest thinking.

- Update list of activities and procedures that can be undertaken by banks to reflect, inter alia, technological developments in banking.

- In relation to the applications for banking licenses, require full details of the business and professional history of directors and senior management, as well as for principal shareholders of the proposed bank (rather than only for the past 10 years).

- Intensify efforts with the ECB to participate in the Raiffeisen supervisory college and to be party to its resolution and recovery plans.

- Limit the maximum period for which directors can be elected to the Boards of banks to 12 years unless the bank in question can justify to the supervisor the reasoning why the members' ability to exercise objective and balanced judgement and to take decisions independently are not affected by the situation.

- Introduce a formal regime for regular meetings with the banks' external auditors;

- Integrate stress tests exercises with the financial stability work of the CBK and communicate the results to the banks.

- Approve and implement the Offsite Supervision Procedures Manual for Banks.

- Establish supervisory procedures that would be required during periods of stress.

- Conduct periodic tests on the operational procedures for granting of ELA with participation of the banking industry.

- Periodically review the procedures and integration of onsite and offsite supervisory functions.

- Require banks to notify BSD in advance of any substantive changes in their activities, structures and overall condition, or as soon as they become aware of any material adverse developments.

- Develop tools for a more thorough assessment of credit risk based on granular data from the CR.

- Improve offsite assessment of trends in risk concentrations, risk mitigation strategies, and risk build-up across banking sectors.

- Formalize responsibilities and procedure for information exchange between BSD and the PSD.

- Require banks to define scenarios forecasting disturbances to payment and settlement systems, for the purpose of operational risk management.

- Improve offsite monitoring tools, in order to have a better comprehension of banks' exposure to liquidity risk. Methodology should explore banks' vulnerabilities and identify whether their contingency buffers are sufficient to support the liquidity needs derived from stressed scenarios. At a minimum, scenarios should take into account the absence of secondary markets in Kosovo for the estimation of the banks' liquid assets buffer, and the absence of legal impediments for early withdrawal of term deposits for the estimation of liquidity needs.

- Implement Basel III liquidity standards.

- Finalize the implementation of repo facilities between the CBK and financial institutions, maturing over the intraday lag.

Insurance Sector

Baseline Diagnostics

55. **The findings of this review of the insurance sector in Kosovo are broadly similar to those of the 2016 MCM TA mission in which concerns were expressed regarding the solvency and viability of the insurance industry, including under-provisioning.** The CBK has moved forward in one key area since then, in that it has now employed an actuary, the lack of which was a key concern of the 2016 TA mission. The 2016 TA mission resulted in a recommendation to set up a qualified and experienced actuarial function. While employing one actuary is a positive step, enhancing this function further is necessary as detailed below. The industry does not appear to have fundamentally adjusted its collective balance sheet so the concerns of the 2016 TA mission about the viability of the industry remain as detailed below. The 2016 TA mission found the new insurance legislation and regulations to be in line with Solvency I EU directives, which were superseded by Solvency II. This was a positive development but as the state of the insurance industry in 2019 shows, regulatory reform is not enough on its own. Supervision processes at all levels of intervention (not just taking extreme enforcement measures such as liquidations) should also be enhanced. It is notable that the 2016 TA mission also commented on the low loss ratios and extremely high expense ratios as detailed below.

56. **The insurance market in Kosovo is undeveloped, particularly with respect to life insurance.** There are currently 13 insurance companies in Kosovo (1 entered liquidation during the mission, at end-April 2019). The original 14 companies consisted of 12 non-life and 2 life insurance companies. At end-2018, gross non-life premiums amounted to €89.1 million, of which 67 percent was mandatory third-party liability business, while life insurance gross premiums amounted to €3 million, resulting in an insurance penetration of 1.37 percent of GDP.[17] This is reasonably in line with the average for Central and Eastern Europe (1.92 percent) but well below that of Western Europe (7.28 percent).[18]

57. **The insurance industry statistics may lack reliability and seem distorted compared with international benchmarks.** Figures provided to the IMF show combined ratios of less than 100 percent industry wide but with very high expense ratios. Loss ratios usually range between 60 and 75 percent, and expense ratios between 25 and 40 percent. However, for 2018, Kosovo insurers showed loss ratios of 46.6 percent and expense ratios of 48.1 percent for their domestic business, and 32.8 percent loss ratio for non-resident MTPL with an expense ratio of 59.6 percent. The low loss ratio may be a result of underestimating claims, particularly those going through the courts, suggesting that technical provisions are understated while the financial position is overstated. The high expense ratios may be the result of incentives provided to agents and brokers or directly to clients given the inability of insurers to compete on price as premiums are set by the CBK for the most important product, MTPL. The high expense ratios prevail even though the CBK has apparently issued a regulation limiting expenses to 35 percent of premiums, something that is only adhered to by the leading companies in the market. It is acknowledged that there are review processes in place at the CBK, as well as audits by external auditors; yet there seems to be no viable explanation for such low loss ratios and high expense ratios.

58. **Losses caused by uninsured drivers are being transferred to the insurance industry through the compensation fund run by the Kosovo Insurance Bureau.** The requirement to have MTPL is administered through the requirement for registration of motor vehicles. There is a significant prevalence of unregistered and therefore uninsured motor vehicles in Kosovo. The Insurance Association of Kosovo estimates that claims from uninsured drivers are between €3.5 million and €5 million per year, corresponding to about 10 percent of claims. This is a significant drag on the profitability of the insurance industry.

59. **Premium rates for MTPL are set by the CBK but have not been adjusted since 2011.** Current premiums are set based on previous World Bank TA. Since 2011, premiums have not been adjusted for market developments such as inflation in medical expenses, changing driver behavior due to technology, or changing risk profiles due to court awards of

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[17] CBK calculations.

[18] Swiss Re sigma No. 3/2018.

damages. It is not clear whether losses from uninsured drivers were taken into account in setting the rates. Hence, it is imperative that the MTPL premium rates be reviewed and a process established to review those rates on application of insurance companies. Since 2011, the insurance industry has twice requested increases in premiums but both applications have been rejected. In 2015, CBK regulations were changed, with some prescribed claims payment amounts increasing 10 times, yet there was no adjustment in premiums.

60. **The liquidation of an insurance company during the mission and the possible escalation of measures vis-à-vis other insurance companies are positive developments, although they also have some negative consequences.** Shutting down failing insurers provides positive signals to the remaining insurance companies that the supervisor is willing to act to prevent losses to policyholders or the industry in general through the compensation fund. It may enhance the behavior of the industry if the failing insurers were competing in unsustainable ways. However, liquidations of insurance companies are detrimental to the image of the insurance industry among the population, in particular in a country where insurance industry development is a priority. In the past, a number of insurance companies have been operating in an under-capitalized state. More recently, the CBK has been more active in taking measures against companies that do not meet solvency requirements or have only minimal buffers.

61. **The practice of installing CBK employees as administrators and liquidators compromises the independence of CBK as the supervisor of the industry.** CBK supervisors are obviously highly qualified employees and have skill sets likely to be suited to the role of administrator or liquidator. However, the CBK risks its appearance of independence and its general reputation from such appointments. While these individuals cease their formal employment relationships with the CBK once appointed, there may be informal agreements for them to return to the CBK once the administrator role is complete. The commercially determined level of remuneration for administrators is particularly a concern in terms of incentives and CBK reputation. The appointment of an ex-CBK employee in an unsuccessful administration process could become a reputational issue for the CBK.

62. **Market conduct by the insurance industry, particularly the willingness to use the court system to delay claim payments, is a concern.** Most Kosovar citizens only engage with the insurance industry through the MTPL contract. There is a culture among the insurance industry and claimants (possibly driven by the legal profession) to resolve disputes in court rather than using the CBK dispute resolution mechanisms through the complaints process. Courts have been willing to award claims that exceed prescribed amounts by the CBK. The CBK is attempting to address this by proposing legislation that will put the CBK claim payment amounts in the legislation rather than in CBK regulations, which have not been adhered to in courts. Overall, the practice of delaying claim payments through the court system may engender public distrust in the insurance industry and is a likely factor behind the low penetration of insurance in Kosovo.

63. **The lack of a range of investment opportunities and liquid secondary markets for financial instruments constitute significant concerns for the development of the insurance market.** In addition, CBK mandates limits on certain investments and requires that at least 10 percent of assets are invested with the CBK. Insurance companies predominantly invest in bank deposits, with some investments in government bonds and real property. Efficient financial markets facilitate the assessment of the financial and risk positions of insurers and the execution of their investment and risk management strategies. In the absence of efficient financial markets, the assessment of risk becomes more challenging for both insurers and supervisors, something that needs to be taken into account in the design of regulations, supervisory practices, and insurer risk management.

64. **The powers and capacity of the CBK to undertake adequate surveillance of market conduct of the insurance industry should be further strengthened.** CBK insurance supervisors do not appear to be able to obtain an understanding of how insurance companies are interacting with policyholders and potential policyholders. Apart from not being able to conduct so called "mystery shopping"[19] campaigns due to legal limitations of the CBK, there are also other conduct of business supervisory tools that do not appear to be applied by the CBK (e.g., consumer surveys).

65. **Market-conduct issues and prudential solvency concerns seem to be highly intertwined.** The behavior of insurers in attempting to delay claim payments through court processes, as well as possible incentive schemes to compete in a market with regulated premiums are concerns that have direct prudential impact. The delay of claim payments could be a sign of under-reserving and hence attempt at delaying the representation of losses. The use of incentive schemes could result in high expense ratios.

66. **The CBK has not yet adapted Solvency II.** The current prudential regulatory framework does not place as much emphasis on the risk management of insurance companies and risk-based capital requirement calculations as the current EU Solvency II framework. The CBK is beginning to look at how it can move toward implementation of Solvency II over the medium term.

67. **Onsite supervision of insurers appears to be adequately frequent but may not be delving into risks with enough intensity.** Insurance supervisors seem unaware of the basis of the high expense ratios in the industry. There are suspicions that this may be hiding the incentives used by the industry to compete in a rate-regulated environment, however these suspicions have not been verified, suggesting a need for improved onsite supervision techniques.

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[19] Whereby someone "plays the role" of customer to see how the insurer interacts with the customer, the advice provided, etc.

68. **The U.S. Treasury Financial Service Technical Assistance has helped develop an RBS manual.** This manual is currently being reviewed within the CBK. The implementation of this manual should lead to positive changes in the nature of supervision.

69. **The availability of sufficient skilled staff within the CBK to undertake supervision is an ongoing challenge, particularly with respect to actuarial expertise.** CBK has one qualified actuary, leading to significant key person risk in terms of peaks in workload, risk of unavailability due to illness, and the possibility this person may leave the CBK for more lucrative employment in the industry. It also implies a concentration of professional expertise without adequate peer challenge. The nature of the MTPL product, the need for review of the premium rates and the challenges of the Kosovo insurance industry all point to the need for enhanced actuarial expertise within the CBK. In the short term, carefully constructed outsourcing arrangements with international professional services firms may allow access to additional actuarial expertise. In the long term, sponsoring the education and professional development of students and graduates to attain actuarial qualifications and work for the CBK would be desirable.

70. **Many fees and taxes are applied to the insurance industry, threatening its viability when also combined with other regulatory requirements placed on insurers.** There is a 5 percent tax on premiums rather than the usual corporate tax applied in Kosovo. According to the Kosovo Insurance Association, the industry paid approximately €4.5 million in taxes in 2018, compared with €230,000 had the usual corporate taxation rate been applied. The CBK is aware of this issue and has taken steps with other government authorities to seek amendment to this law. The industry has been required to pay a 1 percent of premium contribution to the Red Cross, a requirement that has recently been declared unconstitutional by the Constitutional Court. The industry is also required to pay claims related to uninsured drivers. CBK applies a fee of 1.35 percent of premium. There are restrictions on investments, marketing expenses, and on overall expenses that do not appear to be enforced, and restrictions on premiums that can be charged for the major product. Overall, this does not appear to be a regulatory framework conducive to attracting new entrants to the market or ensuring the viability of current industry participants.

Main Recommendations

71. **These recommendations are framed with an awareness of other TA that is being provided, particularly by the U.S. Treasury and in the past by the World Bank.** The CBK needs to:

- Update the pricing of the mandatory MTPL product and develop a process to regularly review the pricing of this product as risk factors evolve.

- Assess the viability of continuing to apply the various taxes and fees, as well as obligations to pay for claims related to uninsured drivers.

- Enhance the supervision of market conduct of insurers.

- Reconsider crisis management processes for the insurance industry, particularly the practice of installing CBK employees as administrators and liquidators.

- Implement the RBS manual for insurance that has been developed.

- Enhance onsite supervision practices for insurance.

72. **The IMF is best placed to provide TA on the last four of those priorities.** With respect to setting MTPL premiums the CBK may seek independent professional advice or assistance from say the World Bank, which previously provided TA in this area.

73. **The transformation of the industry, its regulation and CBK's supervision of the industry is a medium- to long-term project that needs buy-in from CBK management, the insurance industry and the GoK in general.** IMF TA can only be effective with that buy-in. As a result, the observations made during the mission on CBK governance must be addressed as a precondition for the provision of IMF TA. It would be advisable to engage with other TA providers such as the U.S. Treasury and the World Bank to create a coordinated program of TA within an overall plan over an achievable timeframe and with credible milestones.

74. **The CBK along with other relevant government authorities need to develop consumer education and awareness of the benefits of insurance and seek to counter any negative public perceptions of the insurance industry due to the liquidation of one or more insurance companies.** Increased involvement in market-conduct supervision will necessarily involve more outreach to consumers in general and policyholders in particular**.** An education campaign to make the public aware of the benefits of insurance along with improved conduct by insurers should result in increased penetration of insurance in the economy. A stable and viable insurance industry that provides necessary protection and investment products can enhance economic development and financial stability.

75. **Solvency II implementation is important for potential integration into the EU system but should not be seen as an immediate priority.** Solvency II has been designed for the sophisticated EU insurance market with well-resourced supervisors. The implementation of Solvency II, which was prepared over more than a decade, has improved risk management and governance of the insurance industry in the EU, but its implementation has also come at some cost. As Kosovo looks toward integration with the EU, Solvency II implementation is an important medium-term goal and can provide an excellent framework for the development of insurance regulation and supervision in Kosovo provided that the implementation sufficiently takes into account proportionality and the local circumstances of the insurance industry in Kosovo. In particular, the relative development of the industry, the resources of the CBK and the need to develop those resources, the availability of adequate investment options and the reliability of secondary markets to provide market prices of investments and

other inputs to valuation would need to be taken into account, among other considerations. The development of capital markets, as discussed below, will be important in successfully implementing a modern prudential regulatory framework such as Solvency II.

Securities Market

Baseline Diagnostics

76. **Capital markets do not currently exist in Kosovo to any meaningful extent.** There is no stock exchange. The financial sector is dominated by banks, which focus on plain-vanilla banking activity. The only securities in issuance are government bonds, for which there is no active secondary market. Neither banks nor insurance companies offer investment products. Corporates rely on bank loans for their funding needs. Aggregate credit growth is high but households' ability and willingness to consider capital markets as an alternative to banks is questionable.

77. **Auctions of government securities are typically held every two weeks by the CBK.**[20] The primary dealers consist of banks and the KPST, the state-run pillar II pension fund. Insurance companies and a few large corporates also buy government bonds through their bank. Auctions are often oversubscribed although two auctions failed in mid-2018 when the CBK signaled it would no longer buy GoK securities in the secondary market. The maturity of the issues is gradually being extended, as exemplified by the issuance of the first 10-year bond in 2018. However, the CBK believes that the limits of the domestic investor base will soon be reached.

78. **The KPST is the main domestic institutional investor but its investment portfolio is heavily weighted towards foreign assets.** The Governing Board of KPST invests the assets in line with prudent investment principles set by law. Current assets under management amounted to €1.8 billion as of end-April 2019. Currently, €1.4 billion of assets are invested in a selection of investment funds managed by major global asset managers, giving exposure to a diversified set of instruments. The remainder of the portfolio is split between Kosovo government bonds (€255 million) and cash deposits at domestic banks (€130 million). Extensive information on the performance of the portfolio is provided on the KPST website, including in the form of a Key Investor Information Document prepared in line with relevant EU legislation.

79. **All Kosovo citizens are obliged to contribute 5 percent of their salaries to the KPST, and employers must match that contribution.** Employees can choose to contribute more than 5 percent of their salary to a different pension fund. However, in practice there is only one other scheme—the Slovenian-Kosovo Pension Fund—the assets of which are a

[20] The precise auction calendar is set in line with needs and depending on when maturities fall due.

mere 0.5 percent of total pension assets. KPST is considering creating two separate portfolios within the pension fund: a default portfolio for all contributors with a balanced risk profile, and a more conservative portfolio for imminent retirees.

Main Recommendations

80. **The CBK should consider the development of capital markets as a medium-term goal.** As the CBK considers how best to implement the recommendations from the FSSR, and as it looks ahead to implementation of the substantial TA Roadmap, there are strong arguments for focusing in the first instance on other priorities. This would recognize that development of capital markets will in any case take some time and would allow scarce resources to be targeted to other areas of more pressing urgency. The recommendations below should be read in the context of this broader message.

81. **Establishing an investment fund sector in Kosovo should be subject to several other key building blocks being put in place first.** Investment funds require a diversified pool of potential investments, a sufficient number of investors who are willing and able to place their money, and the presence of key service providers. To achieve this, progress should be made in the following four areas:

- Establish a cross-agency task force for the development of capital markets in Kosovo.
- Draft key pieces of capital markets legislation in order to provide a sound framework.
- Develop expertise on capital markets at CBK.
- Ensure existence of pre-conditions for capital markets activity.

More detail on each of these recommendations is provided below.

82. **While it would be possible to allow the creation of investment funds in Kosovo in the short term through finalization and adoption of the draft investment funds law, this should rather be seen as a long-term goal that would complement the development of capital markets more generally.** Any investment funds established in the near future would lack eligible assets in which to invest. The relevant legislation could be drafted in such a way that the funds could invest in assets abroad, but this is unlikely to foster development of capital markets activity in Kosovo itself, nor would it provide financing to local companies. In addition, such an approach could risk triggering capital outflows. Moreover, it is doubtful that investors in Kosovo would be in a position to make informed investment decisions on products to which they have not had exposure thus far. Similarly, it would be imprudent to assume that Kosovars would have access to reliable advice on investment products from existing financial institutions. It is also important to note that this initiative is being taken amid a saturating market for domestic sovereign debt securities.

- ***The CBK should ask the government to establish a cross-agency task force on the development of capital markets in Kosovo.***

83. **A national task force should be created to identify the key building blocks that are needed to foster the development of capital markets.** This should involve (at least) the CBK, the MoF, the KPST (as the main institutional investor in Kosovo at present), a range of financial market participants (notably banks and insurance companies), and representatives of retail investors. The task force should indicate which aspects it considers most important. The task force should be put in place by the end of 2019 and deliver its report by mid-2020. The IMF can help guide the discussions of the task force, although this would not constitute formal TA.

- ***The CBK should provide assistance to the MoF in drafting key pieces of capital markets legislation.***

84. **Capital markets activity cannot occur without an appropriate legal framework being in place.** The CBK, working with the MoF, should prepare draft laws on capital markets that are compatible with the EU acquis. This should include legislation on primary issuance of securities, secondary market trading of securities, transparency, market abuse, and prudential/conduct of business requirements for investment services providers, as well as completion of the laws on investment funds and repos. While the EU legislation should be taken as a basis given the provisions of the Stabilization and Association Agreement, it will be important to consider both: (i) proportionality, taking into account the specific circumstances of Kosovo; and ii) international best practice. The IMF can provide TA in the form of comments and input on the draft legislation. It can be expected that the development of a comprehensive package of legislation will take about three years.

- ***Develop expertise at CBK on capital markets.***

85. **In the absence of any meaningful capital markets activity in Kosovo, it is understandable that CBK staff currently lack the appropriate knowledge or expertise to supervise such activity.** Leveraging on the existing knowledge within the Asset Management Department of the CBK, staff should be given access to training on capital markets in parallel with the development of the framework legislation. This does not preempt the eventual decision on whether a separate authority for capital markets should be created. Bodies other than the IMF are likely to be better placed to provide this training. This will be an ongoing process with no specific deadline.

86. **Kosovars' exposure to financial services is currently limited.** Many citizens (48 percent according to World Bank data) do not have bank accounts, and those that do have access only to simple banking products. Kosovo citizens do have indirect exposure to capital markets through the KPST, which provides extensive information on its investments. However, it is not clear to what extent the average citizen makes use of this information or is

able to understand it. It is therefore important that the financial literacy initiatives include a capital markets segment, which would provide basic information on financial markets and investment products.

- ***Ensure existence of preconditions for capital markets activity including improved financial reporting, corporate governance, disclosure, and external audit.***

87. **Healthy capital markets require certain preconditions to be in place if they are to function effectively and inspire confidence among potential investors.** Based on discussions with stakeholders during the FSSR mission, this is not currently the case in Kosovo. For example, evidence suggests that, while significant progress has been made, there remains room for improvement on financial reporting. Similarly, compliance with corporate governance standards is patchy, with limited separation between owners and management in many companies. As far as disclosure is concerned, the CBK should increase its focus on disclosures provided by banks to their clients with a view to enhancing the quality of such disclosures; this would act as a stepping stone towards the preparation of adequate disclosures once investment products appear on the market. Finally, standards on external audit should be tightened. Feedback from market participants suggests that external audits are only robust when provided by a small handful of providers, and that local auditors are often under pressure not to give qualified opinions. The KFRC is making significant efforts to strengthen its oversight of the audit industry, but it will take time and resources before meaningful progress is made. The IMF will liaise with the World Bank to determine how best to provide TA on these topics.

88. **Steps should be taken to develop the interbank money market and repo market and to deepen the secondary market for government bonds.** The IMF (MCM) has already provided comments on a draft law on repo, while other TA providers (the U.S. Treasury, European Bank for Reconstruction and Development (EBRD)) have also made recommendations in this context. Similarly, other TA providers are either better placed to provide input on how to deepen government bond markets or have already provided such input.

89. **It is also important to underline that the development of a healthier insurance sector based on the recommendations set out elsewhere in the FSSR will be beneficial to development of capital markets.** For example, insurers could play a larger role in providing secondary market liquidity for government securities (now) and other securities (in future), while healthier insurers would be able to offer investment products of their own (thereby providing competition for banks and other capital markets players).

C. Macroprudential Policy and Systemic Risk Monitoring

Baseline Diagnostics

90. **The CBK has already taken important steps towards operationalizing a macroprudential policy framework in Kosovo.** Because stability is not an objective that can be easily characterized as an operational target, the CBK has chosen to follow the practice pioneered by the European System Risk Board (ESRB) of rendering this high-level objective into a set of more tangible intermediate objectives. Within the ESRB framework, each of these intermediate objectives is aligned with a set of risk indicators and policy instruments that have risk mitigating potential. The CBK has completed this work for Kosovo and the framework has been published on the central bank's website. In support of this work, CBK has also made some important changes to its institutional arrangements. A macroprudential advisory committee (MPAC) was established in 2016 to assess the systemic risk outlook and provide recommendations to the CBK's Executive Board on macroprudential policy actions.

91. **Notwithstanding these important initiatives, there is still much work to be done.** The institutional arrangements in support of macroprudential policy need to be strengthened. The CBK's ability to identify appropriate macroprudential policies through its surveillance and systemic risk monitoring is impeded by important information gaps, as well as by staffing constraints. There is a risk that these issues will combine to delay timely policy actions.

Institutional Arrangements

92. **An effective macroprudential policy framework requires robust institutional arrangements**. These arrangements must incorporate important principles of good governance that ensure sound decision-making underpinned by strong mandates and powers. They must also facilitate the regular exchange of information between agencies so that a system-wide appreciation of risks can be assembled. Sufficient staff must be in place with the right expertise so that this information can be reviewed using a full range of analytical methodologies.

93. **In terms of mandates, the CBK is well-served from a broader financial stability perspective**. The CBL specifies that the *primary* objective of the central bank is to "foster and to maintain a stable financial system including a safe, sound and efficient payments system." Because Kosovo is a fully euroized economy, the objective of price stability is set as an additional, but *subordinate* objective. There is no reference to macroprudential policies in the primary legislation; but the purpose, scope, and application of macroprudential policies were approved by the Executive Board in accordance with its powers under Article 36 of the CBL. Nevertheless, CBK recognizes that there is merit in further strengthening its macroprudential policy mandate by making an explicit reference to this role within primary legislation**.**

94. **The CBK is well-equipped in terms of policy instruments.** The LB provides CBK with a full array of policy instruments for microprudential purposes. The CBK is of the view

that the LB provides sufficient flexibility for these instruments to be used also for macroprudential purposes. Nevertheless, the CBK is cognizant of the need to provide macroprudential policy with a stronger legal foundation and is proposing to do so through amendments to the LB and associated regulations. However, since the amended law will apply only to banks, and macroprudential policies must have system-wide application, it would be preferable for the CBK to derive its enabling powers by way of an amendment to the CBL.

95. **The current institutional arrangements in support of macroprudential policy should be strengthened.** The establishment of MPAC was an important step forward in terms of governance around macroprudential policy. However, decision-making itself is reserved to a small Executive Board consisting of the Governor and two Deputy Governors, neither of whom have executive responsibilities for macroprudential oversight. The mission believes there is a strong case for reviewing the governance arrangements within the CBK to ensure that they are suitably aligned with the central bank's primary mission in support of financial stability and its role as macroprudential authority. In doing so, the CBK is also encouraged to review the resourcing of the financial stability function to make sure that it is keeping pace with the expanding workload that comes from operationalizing a macroprudential policy framework. This is not only about staff numbers, but also about ensuring that staff time is used productively.

96. **An effective financial stability framework gains from a collaborative relationship between the central bank and the MoF**. In Kosovo, as the CBK regulates all financial institutions, collaboration with the MoF primarily concerns issues of crisis management. Still, it is important that the MoF is regularly briefed on the outlook for the financial sector and is not taken by surprise by unfolding events. These briefings will be formalized with the establishment of an inter-agency National Financial Stability Committee, which will meet semi-annually from late 2019 and onwards.

Systemic Risk Monitoring

97. **To fulfil its macroprudential responsibilities, the CBK must be able to monitor systemic risks in Kosovo**. This is not easy as "systemic risks" are difficult to define and quantify in practice. They most obviously exist, for example, in the shape of a broad-based breakdown in the functioning of the financial system, potentially including a large number of financial institution failures. However, an effective policy framework must function preemptively, so that systemic risks are addressed and mitigated before crystallizing in a way that damages the financial system and the real economy.

98. **Developing an early warning system in Kosovo is a challenging task.** Credit penetration remains low by regional standards and financial deepening is an important policy priority. Therefore, evidence that credit is growing at an annual rate in excess of 10 percent facilitated by low interest rates, an easing of credit standards and the use of the KCGF to

support lending to MSMEs is to be welcomed. However, differentiating between healthy financial deepening and potentially excessive credit growth is not easy. The CBK lacks the type of information on nonfinancial sector balance sheets that would allow it to form a more-forward looking assessment of systemic risks. The CBK is currently unable to assess whether the surge in credit is increasing the leverage of households and corporates and testing their debt-servicing capacities. Of particular concern is the opaqueness of property markets in Kosovo.

99. **Stress testing plays a key role in macroprudential analysis.** The CBK undertakes regular stress tests to assess the financial system's resilience in terms of solvency and liquidity in response to plausible, adverse outcomes. Currently, the EAFSD and BSD undertake their own stress tests using separate scenarios. The BSD stress test is a micro-focused exercise using individual bank data while that of EAFSD is a macro-focused exercise. While some information sharing takes place between the BSD and the EAFSD, the stress tests themselves are undertaken independently and both largely take the form of static sensitivity analysis. BSD also receives stress test results from the commercial banks but does not specify the scenarios nor validates their stress testing methodologies. Neither department undertakes any detailed network analysis to identify the potential for financial contagion in Kosovo.

Operationalizing the Macroprudential Policy Framework

100. **While the CBK has a macroprudential policy framework in place, it has yet to implement any specific policy measures.** The MPAC is briefed on a quarterly basis on systemic risks and the outlook for the financial system. So far, it has found no compelling reasons to recommend to the Executive Board that macroprudential policy actions should be taken. However, persistent credit growth and signs of a tightening in liquidity conditions suggest to the mission that it might be timely to consider the use of some of the instruments in the macroprudential policy toolkit.

Main Recommendations

Institutional Arrangements

101. **The current institutional arrangements are not well aligned with the CBK's primary objective within the CBL of fostering and maintaining financial stability**. Decision-making, which is reserved to the Executive Board, is decoupled from the process within the CBK for monitoring and assessing systemic risks and formulating an appropriate macroprudential policy response. The mission is of the view that the CBK's financial stability mandate would be strengthened by establishing a decision-making Financial Stability Committee, chaired by the Governor and composed of executives and non-executive members with relevant expertise. An alternative approach would be to broaden the composition of the existing Executive Board.

102. **More resources should be dedicated to financial stability analysis**. The CBK must be confident that it has sufficient staff with the right training and expertise to fully support the financial stability mandate. The deliverables of the EAFSD should be reviewed to ensure that they are targeted and precise. The Financial Stability Report should be further streamlined.

103. **The CBL should be amended to explicitly provide for a macroprudential policy function.** Currently, the intention is to anchor macroprudential policies within the amended law on banks, but since macroprudential policy must have system-wide application, provision within the CBL is to be preferred.

Systemic Risk Monitoring

104. **The CBK should complete a full review of macroprudential data gaps and develop a strategy to close them**. The most pressing gap relates to property where meaningful information on construction, transactions, and prices is not readily available. In order to speed up progress, the mission team recommends the formation of an *Interagency Real Estate Working Group* consisting of the CBK, the MoF, the KAS, and the Ministry of Environment and Spatial Planning. It should also involve representatives from the Real Estate Industry Association. The Working Group should review all information that is currently available on real estate, identify the information and data gaps, determine how best to address them, and—by doing so—determine what specific IMF TA might help close them.

105. **The CBK should explore ways to better harness the information collected by the CR.** There is scope to make use of the existing data for calculating default rates and loss-on-default. The CBK could use the CR data to compute loan-to-value (LTV) and debt-to-income (DTI) ratios for macroprudential policy purpose. The CBK could also use the CR information to derive aggregate borrowing statistics (loan by type of legal entity, region, and purpose and activity type, average principal amount, average interest rate, currency composition, average maturity, etc.) and make them available to the public and financial institutions.

106. **The CBK should more closely monitor developments in nonfinancial sector balance sheets.** Excessive leverage in household and corporate sector balance sheets increases the dangers of excessive credit growth. However, the large size of the informal sector in Kosovo limits the amount of information that can be drawn from the national accounts. For that reason, the CBK should explore the use of surveys in consultation with the KAS, including the current Household Budget Survey and the forthcoming Statistics on Income and Living Conditions in Households survey. STA provides TA on developing sectoral financial accounts and balance sheet statistics, including for the nonfinancial sector.

107. **The CBK needs to enhance its stress testing competencies.** Collaboration in this area between EAFSD and BSD needs to be intensified. EAFSD should take ownership of the scenario design, building on its systemic and macroeconomic perspective, with BSD contributing bank-specific knowledge to help assess the sensitivity of loan portfolios to

macroeconomic conditions. EAFSD would benefit from some assistance on the use of macrofinancial modelling to help generate and quantify adverse scenarios. Both departments would benefit from some guidance on the effective use of stress testing models, moving beyond static, single period, sensitivity analysis.

108. **The CBK is encouraged to deepen its network analysis.** While inter-linkages within the financial system are currently quite limited, this will increase over time as the nonbank sector, particularly pensions, grows in size. It is also important that the CBK deepens its analysis of the flow of funds between financial sector and nonfinancial sector balance sheets, including government.

Operationalizing the Macroprudential Policy Framework

109. **The CBK should use macroprudential policies to reinforce the quality of consumer lending**. Consumer credit has been growing strongly in recent years at an annual average rate of about 11 percent. However, the CBK has very limited insight into household sector balance sheets that would enable it to assess changes to leverage and debt-servicing capacity. There may be merit in introducing LTV, DTI or debt-service-to-income (DSTI) limits to ensure that banks' credit management systems are conservatively aligned to the opaque nature of Kosovo's credit environment.

110. **Liquidity risks need to be contained.** References to ample liquidity can be misleading given the lack of an active secondary market for domestic government securities. Any changes in liquidity conditions of the banking system need to be very carefully monitored. The CBK is to strengthen the liquidity management of banks by introducing the LCR and the net stable funding ratio as part of its planned implementation of Basel III requirements. Ultimately, the CBK needs to foster the development of an inter-bank repo market in Kosovo; a useful step in this direction will be the planned introduction of a central bank repo facility.

111. **Having taken the steps to formally identify domestic systemically important banks, the CBK should follow through with a capital surcharge.** For banks that already have capital well in excess of minimum requirements, this adjustment will have no immediate effect**.** But it will help better align regulatory requirements with CBK's assessment of the contribution made by the larger banks to overall systemic risk.

D. Financial Crisis Management

112. **The 2012 FSAP noted that Kosovo had made significant progress on financial crisis management arrangements in the preceding few years**. Provision had been made in the CBL for an ELA arrangement; the amended law on banks includes improvements in the bank resolution framework; the narrow mandate ("paybox") DIFK was in place; and a National Financial Stability and Crisis Management Committee (NFSC) had been established to push ahead on the design and implementation of a national crisis management plan.

113. **The FSAP provided a number of recommendations to further strengthen the crisis management framework**. These were supplemented in a follow-up TA Report on "Contingency Planning for Crisis Preparedness and Management" in February 2014. These recommendations focused on a number of key issues, including the limits to ELA funding, the need for improvements in the bank resolution framework, and the importance of detailed crisis preparedness and contingency planning arrangements.

114. **The limits to ELA funding arise from the euroization of Kosovo**. In that regard, the CBL limits ELA to the total reserves of the CBK (currently about €50 million), as well as a Special Reserve Fund of €46 million established by the Treasury for that purpose. Since this would likely cover the needs of only a few small banks, IMF TA on contingency planning and crisis preparedness recommended that the CBK define a larger target size and consider the use of bank premiums to raise funding.[21] It was also noted that there was still much work to be done to fully operationalize ELA. Collateral requirements were too restrictive, no pre-prepared standard contracts were in place, nor was there an established methodology for identifying the solvency and viability of illiquid banks. In response, the CBK amended and tightened the ELA regulations to incorporate IMF advice, and WB FinSAC is currently providing TA on the associated operational procedures.

115. **The IMF TA assessed Kosovo's existing problem bank resolution regime to be generally appropriate.** But potential improvements were noted around the use of purchase and assumption transactions, and the importance of promoting recovery and resolution planning— particularly for systemically important banks—was also highlighted. These improvements are to be incorporated in the amended law on banks.

116. **There was much work to be done around crisis preparedness and crisis management.** In particular, it was seen as important to ensure that the government understood its role in times of financial crisis and that measures were in place to minimize and, hopefully, avoid any calls on public funds for resolution purposes. It was hoped that the tri-partite NSFC established in 2011 would take the lead in this work. This was to be chaired by the CBK Governor and to include the Minister of Finance and the Chairman of the Parliamentary Committee on Budget and Finance. In the event, the NFSC was never operationalized.

117. **The authorities have recently revisited the NSFC and made some important changes.** The composition has been revamped. The Governor will remain as chair and the Minister of Finance a member, but there will be no representative from the legislature.

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[21] IMF MCM TA Report on "Contingency Planning for Crisis Preparedness and Management," David Parker (MCM Mission Chief), Pamela Madrid (EUR), and Javier Bolzaro (MCM External Expert), March 2014.

Instead, the other members will be the CBK Chair of MPAC and the MoF Director of Budget; in times of crisis, they will also be joined by the Managing Director of the DIFK. The committee will be rebadged as the Financial Stability and Crisis Management Committee (FSC) rather than NFSC to reflect the decoupling of the link to the Parliamentary Budget and Finance Committee. The FSC is to meet semi-annually (rather than quarterly, as was originally intended) with the first meeting scheduled for the fourth quarter 2019. The FSC will be supported by a Working Group consisting of six senior executives drawn from the CBK, MoF, and the DIFK. This will also meet twice a year. The FSC will be established by way of bilateral MoUs rather than by way of enabling legislation. A stronger legal foundation might be preferred, since the MoUs that underpinned the NSFC did not succeed in operationalizing the committee.

118. **The FSSR is not proposing IMF TA for crisis management purposes**. This is because WB FinSAC is currently providing extensive TA in this area. FinSAC's current work is focused on operationalizing the ELA framework and on the activation of the FSC. The overall objective is to raise general crisis preparedness among the authorities and to facilitate the drafting of a crisis binder that will spell out in detail the decision-making process. The FinSAC project is also expected to work with the DIFK on risk-based premiums and, possibly, on the MoU between the CBK and the DIFK.

E. Financial Stability Impact of Financial Deepening

Baseline Diagnostics

119. **Despite various policy initiatives, Kosovo lacks a comprehensive national strategy on financial inclusion.** The CBK has developed a strategy for consumer protection and financial literacy, which lead to the establishment of the Complaints Division within the central bank. The CBK's recent Financial Education Program has served the broad population and partner financial institutions. Still, there is no comprehensive financial inclusion strategy at the national level; such a strategy would allow for better monitoring and evaluation of various initiatives and their impact, including on financial stability.

120. **Data non-availability hinders the assessment of financial inclusion in Kosovo.** The authorities do not publish any financial inclusion statistics online.[22] In particular, the authorities lack data on the financial access and needs of MSMEs, as well as on the financial inclusion status of women and rural area inhabitants. Kosovo is not included in the World Bank's FinStats database, which makes structural benchmarking and international comparison difficult.

[22] Rather, so far data on financial inclusion in Kosovo can mainly be found in IMF and WB databases.

121. **Recently, banks have reduced their involvement in financial inclusion, while MFIs and NBFIs have grown rapidly to fill the gap.** In the last year, some banks have ceased to provide loans in small amounts based on cost-benefit considerations. Banks have also closed some branches and switched to online banking. Meanwhile, MFIs and NBFIs have been expanding quickly to fill the vacuum left by the commercial banks—total new MFI and NBFI loans increased by 122 percent between 2015 and 2018, while the outstanding stock grew by 114 percent.

122. **Although the authorities have made progress on the legal framework, use of electronic payments and cards are not prevalent and mobile payments are virtually nonexistent.** All central government payments are now processed electronically. The CBK has prepared a number of laws, regulations, and instructions to enhance consumer protection and regulate interest rate pricing. The authorities are working on drafting regulations on the use of electronic money.[23] However, only 24 percent of adults use electronic payments in Kosovo while less than 2 percent use mobile phones to pay bills and less than 1 percent use mobile phones to transfer money. Mobile payment and digital wallet services are not available in Kosovo, and the use of electronic signature is still not allowed.

123. **The KCGF is a focal point to address MSMEs' financing needs, but participation by MFIs and NBFIs is still limited due to legal uncertainty.** As an independent institution, KCGF issues portfolio loan guarantees to financial institutions, covering up to 50 percent of the risk for loans to MSMEs. As of February 2019, KCGF's capital reached €15.9 million, and the cumulative volume of loan portfolio approved by KCGF reached €93.8 million. Most banks are participating in the KCGF's credit guarantee scheme, which had registered 2,409 loans as of February 2019. However, only one NBFI has joined the KCGF's credit guarantee scheme so far, reflecting uncertainty regarding the future legal status of MFIs.

124. **A proposal to convert nongovernmental MFIs into joint-stock companies has not been successful.** Due to legacy reasons, 10 out of the 12 MFIs, and 3 out of the top 4 MFIs (comprising 90 percent of the market share) in Kosovo are NGOs. While the NGO status may have been a necessity in the early days, it is increasingly becoming a constraint on the development of the microfinance sector. The CBK, the MFI industry, and the World Bank have advocated for converting NGO MFIs into joint-stock companies to allow for new investment and growth. However, the provisions of the 2012 LB (which envisaged that conversion) have been ruled incompatible with the constitution by the Constitutional Court (as it would have transferred the NGO capital, once provided by donors, to the new private joint-stock companies). The new draft law on MFIs and NBFIs does not address the issues raised by the Constitutional Court. Furthermore, the draft law on MFIs and NBFIs is not

[23] With support from SECO and the World Bank under the Remittances and Payments Program.

compatible with the law on business organizations and the law governing NGOs—the law on business organizations still prohibits NGOs from owning shares in joint-stock companies or limited liability companies, while the law on NGOs has been amended to allow for transfer of assets among NGOs but it has not addressed the Constitutional Court ruling. This long-pending issue on the legal status of NGO MFIs generates uncertainty and risks.

125. **While overall developments in financial inclusion pose limited systemic risk, the authorities need to closely monitor payday loan providers.** The recent lending boom by MFIs seems to reflect the decision by commercial banks to withdraw from the small-loan market. The NPL ratio for the microfinance sector was at a record low of 2.4 percent in 2018,[24] and no claims have been submitted to KCGF so far. As the microfinance sector constitutes only 4 percent of total financial system assets in Kosovo, the financial stability impact on the entire financial system is small. Nevertheless, in the last year one new MFI and one new NBFI have started to offer small, quick, short-term payday loans at high interest rates.[25] Recent onsite examinations by the CBK found that the two institutions have been charging significantly higher interest rates than those stated in the original business plan, which have led to penalties and written warnings.[26] Even though the total combined loan amount from the two institutions is small (less than €5 million), rising NPLs could cause social unrest given the client base.[27] The CBK needs to closely watch the developments in this area, promote financial literacy on payday loans, and strengthen consumer financial protection.

Main Recommendations

126. **Establish a National Strategy on Financial Inclusion that would allow for monitoring and evaluation of financial stability risks associated with financial deepening.** Such a Financial Inclusion Strategy should comprise several institutions in addition to the CBK, including the Ministries of Finance, Trade, and Justice, as well as business associations, and would enable establishing mechanisms to monitor progress and evaluate performance of financial inclusion policy initiatives. The CBK's current initiatives on financial literacy could in turn be embedded in a national financial inclusion strategy. Improvement in financial literacy could also lay the foundation for developing securities markets in the future.

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[24] This may in part reflect significant evergreening, with NPLs rolled over as new loans.

[25] A typical loan is €200 over seven days at an annualized interest rate of 100–200 percent. The only documentation needed is an ID card, and the loan approval process takes less than half a day.

[26] In the CBK, MFI and NBFI supervision is located within the BSD. The head of the MFI and NBFI Supervision Division works closely with the director of BSD on supervising MFIs and NBFIs.

[27] For example, the new NBFI currently has 3,000 clients.

127. **Fill data gaps related to financial access and needs and provide all relevant financial inclusion data on a dedicated webpage.** Constructing financial inclusion variables would provide a more comprehensive picture of the status of financial inclusion and contribute to a future national financial inclusion strategy in terms of design, monitoring, and evaluation. In particular, there is currently no data on access to finance and financing needs of MSMEs, women, and rural area inhabitants. The authorities could take stock of all available financial inclusion data, including the information provided by international institutions, and publish them on a one-stop webpage.

128. **As financial deepening continues, further enhance data collection by the CR in the CBK and utilize credit history data for financial stability purposes.** The highly functional public CR captures the credit exposures of both legal entities and individuals. The CR could benefit from adding more inclusive credit history data, such as utility bills, as well as credit scoring as a value-added service to help banks and other financial institutions assess the creditworthiness of borrowers.

129. **Advance the regulation and technical readiness for mobile payment and electronic signature.** Mobile payment and digital wallet services promote financial inclusion and reduce the cost of access to finance, while also help the regulator monitor flow of funds and detect illicit activities. Reliance on electronic signature would enhance efficiency, as well as the security of contract enforcement.

130. **Pass the draft law on MFIs and NBFIs and clarify the services that MFIs can provide.** Passing the law will eliminate legal uncertainty and encourage MFIs and NBFIs to participate in the KCGF's credit guarantee scheme. It is important to clarify the services in which MFIs are allowed to engage; in particular, the new law could respond to MFIs' requests for offering transfer services (similar to Western Union services) and digital payment services to merchants.

131. **Reconcile the laws regarding MFIs' legal status and promptly address the issue of NGO MFIs' conversion by coordinating with all stakeholders.** The authorities need to work with other shareholders to harmonize the relevant laws and address the issues raised by the Constitutional Court to ensure conversion of NGO MFIs to private sector entities without delay.

III. TECHNICAL ASSISTANCE ROADMAP

132. **The TA Roadmap proposes TA to address risks and vulnerabilities in the financial system.** Based on the analysis of the risks and vulnerabilities and existing gaps, the TA Roadmap develops a prioritized set of actions that need to be taken by the authorities to address these vulnerabilities and strengthen the financial system. It presents, in one integrated table, the main strategic recommendations and the supporting TA to address the main risks and vulnerabilities identified by the baseline diagnostic review. The main table addresses:

- **Topical Area**: areas covered by the scope of the mission.

- **Key Risks and Vulnerabilities**: those identified by the FSSR diagnostic with high probability to affect the well-functioning of the financial system if left unaddressed, and which will benefit from targeted TA.

- **Strategic Objectives:** those goals that are necessary to attenuate the aforementioned key vulnerabilities.

- **TA Activities**: those activities undertaken to achieve the strategic objective within a proposed timeframe. Most of these activities are foreseen to be provided by IMF (mainly MCM but also STA and LEG); in some instances, other organization that may be better able at providing the support, such as the WB, have been identified.

- **Responsible Agency**: those departments/institutions that are primarily responsible to implement TA.

The focus of the TA Roadmap has benefited greatly from discussions with the CBK and from comments of various MCM functional divisions, EUR, LEG, STA, and the World Bank. A summary of the TA Roadmap is presented below; the comprehensive TA Roadmap is presented in Annex II.

Table 2. Kosovo: Summary of Main Activities for TA Roadmap

Key Vulnerability Gap	Strategic Objectives & Recommendation	Main Activities	Priority	Time Frame
Weaknesses in Central Bank Governance	Enhance governance structures & effectiveness of decision-making	Review CBK structure of management and responsibilities Review effectiveness of CBK decision-making bodies	H	ST
Supervisory and Regulatory Weaknesses in the Banking Sector	Strengthen regulatory framework with respect to CRDIV/Basel III	Oversee implementation of CRDIV/Basel III Provide necessary training to CBK staff	H	MT
	Improve assessment of banks' liquidity risk	Develop more adequate liquidity indicators and stress test model Train staff on full model	H	IM
	Improve assessment of banks' credit risk	Develop tools and indicators for more thorough assessment of credit risk and credit market based on granular CR data Train staff on tools and indicators	MH	MT
Supervisory and Regulatory Weaknesses in the Insurance Sector	Improve market conduct supervision	Develop revised regulatory framework and supervisory toolkit Provide necessary training to CBK staff	MH	MT
	Improve supervisory intervention	Develop escalating supervisory measures Train staff on supervision practices	H	ST
	Cease relying on CBK staff in failing companies	Assist with further development of crisis management practices Train staff on crisis management in the insurance sector	MH	MT
	Move toward risk-based supervision	Train staff on onsite supervision techniques Provide on-the-job-training on onsite inspection	H	ST
Underdeveloped Capital Markets	Identify priorities	Establish cross-agency task force, provide ongoing guidance	M	MT
	Ensure sound regulatory framework	Draft key pieces of capital markets legislation	M	LT
	Prepare supervisory authority for oversight	Train staff to increase capacity at the CBK	M	MT
	Create sound basis for capital markets activity	Ensure existence of preconditions for capital markets activity	M	LT
Weaknesses in Financial Stability Governance and Systemic Risk Monitoring	Provide CBK with explicit MaPP mandate	Amend the CBL to include explicit mandate for the use of prudential instruments for MaPP purposes	MH	LT
	Ensure financial stability staff sufficiently skilled	Develop HR strategy to meet staff training needs, including in the areas of stress testing and network	H	IM
	Identify source data for real estate price indices	Establish an Interagency Real Estate Working Group to develop strategy to take stock of real estate information and close data gaps	MH	ST
	Improve network analysis and stress testing skills	Enhance stress-testing methodologies and develop network analysis	MH	MT
Insufficient Overview of Financial Inclusion Initiatives	Effectively monitor risks to financial stability due to financial deepening	Establish national financial inclusion strategy	H	ST
Inadequate Financial Statistics for Assessing Financial Stability Risks and Vulnerabilities	Strengthen monetary and financial statistics	Ensure methodological consistency with international standards	MH	MT
		Developing sectoral financial accounts and balance sheet statistics	MH	LT
	Start closing information gaps around real estate market	Subject to data availability, develop statistical series on construction activity and real estate transactions	MH	LT

Timeframe: **IM:** < 6 months; **ST:** < 12 months; **MT:** 12 to 24 months; **LT:** 24 months to 48 months.

Legend			
Timeframe	**Timeframe**	**Priority**	
Immediate (IM)		**High**	
Short-Term (ST)		**Medium High**	
Medium-Term (MT)		**Medium**	
Long-Term (LT)			

ANNEX I. ASSESSMENT OF FINANCIAL SECTOR STATISTICS

Monetary and Financial Statistics (MFS) and Financial Soundness Indicators (FSI) are the two key sets of statistics collected and disseminated by the IMF through its Statistics Department (STA), that are useful for an analysis of financial sector stability. In addition, the IMF developed the Balance Sheet Approach (BSA) compiling the key sectoral balance sheets in member countries' economies as a starting point to diagnose risks and potential transmission channels of shocks, setting the stage for deeper analysis.[1]

This note, prepared at IMF Headquarters (HQs) by STA, aims to present the status of Kosovo's MFS, FSIs as well the underlying datasets for the construction of the BSA matrix.

A. Financial Soundness Indicators

FSIs are indicators of the current financial health and soundness of the entire sector of financial institutions in a country, and of the corporate and household sectors that are the financial institutions' clients. In support of macroprudential analysis, the methodology proposed in the IMF *FSI Compilation Guide*[2] covers both aggregated individual institution data and indicators that are representative of the markets in which the financial institutions operate.

The BSD of the CBK reports FSIs monthly to STA via the National Summary Data Page.[3] FSIs including all 12 core indicators and 8 encouraged indicators for deposit takers (DTs) are published through IMF's FSI webpage. See Table AI.1 for the list of currently reported FSIs for DTs published by the CBK.

FSI definitions are broadly in line with IMF guidelines but some shortcomings have been identified. For the calculation of nonperforming loans to total loans, an important indicator of credit quality, Kosovo uses the 90-day criterion that is in line with the *FSI Guide's* recommendation. One of major issues pertains to the liquidity measure (liquidity assets), which currently include government debt securities. However, as the secondary market for such securities does not exist in Kosovo and government debt securities are not considered as liquid, liquidity assets should exclude government debt securities for the calculation of FSIs. This change would affect two FSIs, liquid assets to total assets (liquid asset ratio) and liquid assets to short-term liabilities.

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[1] See IMF Policy Paper, June 2015, "Balance Sheet Analysis in Fund Surveillance," https://www.imf.org/external/np/pp/eng/2015/061215.pdf.

[2] See IMF Financial Soundness Indicators Compilation Guide, March 2006, http://www.imf.org/external/pubs/ft/fsi/guide/2006/index.htm.

[3] See National Summary Data Page for Kosovo, https://bqk-kos.org/nsdp/.

Annex I Table 1. Financial Soundness Indicators for Deposit Takers
(in percent)

	Consolidation Basis	2015	2016	2017	2018Q1	2018Q2	2018Q3
Core Indicators							
Regulatory Capital to Risk-Weighted Assets	DC	19.0	17.9	18.1	18.1	17.4	16.1
Regulatory Tier 1 Capital to Risk-Weighted Assets	DC	16.7	15.9	16.2	16.2	15.7	14.6
Non-performing Loans Net of Provisions to Capital	DC	3.0	2.0	1.1	1.2	1.4	1.6
Non-performing Loans to Total Gross Loans	DC	6.2	4.9	3.1	2.9	2.8	2.8
Sectoral Distribution of Total Loans: Residents	DC	...	...	...	...	...	...
Sectoral Distribution of Total Loans: Deposit-takers	DC	-	-	-	-	0.1	0.0
Sectoral Distribution of Total Loans: Central bank	DC	-	-	-	-	0.0	-
Sectoral Distribution of Total Loans: Other financial corporations	DC	0.4	0.4	0.2	0.2	0.3	0.2
Sectoral Distribution of Total Loans: General government	DC	-	-	-	-	0.0	-
Sectoral Distribution of Total Loans: Nonfinancial corporations	DC	65.7	63.8	63.6	63.5	63.6	63.3
Sectoral Distribution of Total Loans: Other domestic sectors	DC	33.9	35.8	36.2	36.3	36.1	36.4
Sectoral Distribution of Total Loans: Nonresidents	DC	0.0	0.0	0.0	0.0	2.2	2.6
Return on Assets	DC	2.6	2.5	2.8	2.4	2.5	67.2
Return on Equity	DC	23.7	20.5	22.1	18.6	19.0	48.0
Interest Margin to Gross Income	DC	75.8	75.3	71.2	74.5	79.5	78.8
Non-interest Expenses to Gross Income	DC	51.6	46.7	46.5	48.0	49.4	47.9
Liquid Assets to Total Assets (Liquid Asset Ratio)	DC	29.2	31.7	28.9	27.2	24.8	36.3
Liquid Assets to Short Term Liabilities	DC	37.3	41.5	38.2	35.9	33.2	12.1
Net Open Position in Foreign Exchange to Capital	DC	1.8	4.4	1.2	1.7	1.7	1.0
Encouraged Indicators							
Capital to Assets	DC	12.2	12.1	12.6	13.1	13.0	12.1
Large Exposures to Capital	DC	63.5	65.6	81.7	77.3	77.3	83.6
Gross Asset Position in Financial Derivatives to Capital	DC	-	-	-	-	-	-
Gross Liability Position in Financial Derivatives to Capital	DC	-	-	-	-	-	-
Trading Income to Total Income	DC	2.4	2.3	4.0	1.4	3.1	3.0
Personnel Expenses to Non-interest Expenses	DC	40.9	42.7	43.0	43.7	44.3	43.9
Spread Betw een Reference Lending and Deposit Rates	DC	7.7	6.0	5.5	5.6	5.3	5.6
Spread Betw een Highest and Low est Interbank Rate	NA	-	-	-	-	-	-
Customer Deposits to Total (Non-interbank) Loans	DC	130.3	130.4	124.4	121.3	113.8	117.5
Foreign-Currency-Denominated Loans to Total Loans	DC	0.3	-	-	-	0.2	0.1
Foreign-Currency-Denominated Liabilities to Total Liabilities	DC	3.7	3.6	4.6	4.8	4.9	4.7
Net Open Position in Equities to Capital	DC	-	-	-	-	-	-

Source: IMF staff estimates

Note: "…" and "-"indicate n.a.

Another major issue is to revise historical data. The BSD recently changed data sources to compile FSIs from a combination of statistical data and supervisory data to a data set solely based on supervisory data, due mainly to more detailed information on the balance sheet in line with the IFRS. The change in a data set resulted in a gap in historical data albeit relatively small in magnitude prior to September 2018. STA recommends that the CBK revise the historical data prior to September 2018 based all on the supervisory data to ensure consistency in the time-series data. Other minor issues have been addressed by the BSD—albeit pending to verification—under STA's HQ-based remote TA.[4]

[4] Those issues include the measure of total gross loans which should include interbank loans as well as non-interbank loans; and the measure of net NPLs, which should subtract only specific provisions but not general provisions.

The regulatory and accounting practices of the DTs are broadly in line with the *FSI Guide*, which defers to Basel principles and International Accounting Standards (IASs). Kosovo's FSI metadata as of July 2010 indicate that the two indicators of capital adequacy (regulatory capital, and regulatory tier 1 capital, respectively, to risk- weighted assets are compiled based on Basel I and II regulatory framework. The valuation methods used to value underlying data are based on IAS 39. STA recommends that the CBK provides up to date and complete metadata for publication on the IMF website when major changes take place; in particular, following the planned introduction of Basel III regulatory framework and IFRS 9 in 2020.

The CBK currently compiles FSIs using a "domestic consolidation" basis, which consolidates flows and positions of the resident deposit takers with those of their resident branches and deposit-taking subsidiaries. Although the *FSI Guide* recommends either a "cross-border, cross-sector, domestically incorporated" or a "domestic controlled, cross-border, cross-sector" basis as a preferred consolidation basis, it also provides the domestic consolidation basis as an alternative when resident DTs have no nonresident subsidiaries and few or no domestically controlled non-DT subsidiaries. That is the case of Kosovo; according to the metadata which depict institutional coverage of FSIs for DTs and other financial corporations (OFCs) as of 2018, DTs have no branches or subsidiaries operating abroad or non-DT subsidiaries included in the reporting of the FSIs. However, if those institutions are increasingly becoming relevant, albeit unlikely in the short to medium term, the CBK should consider using a "cross-border, cross-sector, domestically incorporated" or a "domestic controlled, cross-border, cross-sector" consolidation basis.

In addition to FSIs reported by the BSD to STA, the EAFSD of the CBK publishes selected FSIs as part of its *Monthly Information of Financial System* on its webpage.[5] As some discrepancies albeit relatively small between those two sets of FSIs have been identified, the BSD has been reviewing and addressing methodological issues under STA HQ-based remote TA. One major source of discrepancies appears to arise from different sets of source data used to compile FSIs: the BSD uses only supervisory data reported by commercial banks, while the EAFSD uses the combination of supervisory data and statistical data provided by the Statistics Department (SD) of the CBK. Differences of two sets of source data include the exclusion of interbank loans from total gross loans (supervisory data) and the exclusion of banks in liquidation from the population of FSI calculation for DTs (supervisory data). Further details on sources of discrepancies need to be provided for ongoing HQ-based remote TA. In addition, addressing those issues require cooperation and collaboration between the BSD and the EAFSD.

[5] See CBK, April 2019, "Monthly Information of Financial System," https://bqk-kos.org/?id=271.

B. Monetary and Financial Statistics

The CBK reports monetary data using standardized report forms (SRFs) for the central bank (SRF 1SR) and other depository corporations (ODCs) (SRF 2SR) monthly, and OFCs (SRF 4SR) quarterly. These broadly accord with the concepts and definitions of the *Monetary and Financial Statistics Manual and Compilation Guide 2016*. The institutional coverage of 2SR currently includes commercial banks, the only *other depository corporations* existing in Kosovo. The institutional coverage of 4SR currently includes: microfinancial institutions (accounting for 12.0 percent of total assets in the sector as of June 2019); insurance companies (8.6 percent); pension funds (78.7 percent); and money transfer agencies (0.8 percent).[6] Table AI.2 shows the structure of the financial corporation sector in Kosovo and the relative importance of subsectors as of June 2019.

Annex I Table 2. The Structure of the Financial Corporations Sector
(As of June 2019)

Subsector/Institutions	Total Assets (In Millions of euros)	Percent of Subsector	Percent of Financial System
Central Bank			
Central Bank of Kosovo	1,691		20.2
Other Depository Corporations			
Commercial Banks	4,303		51.4
Other Financial Corporations	2,378	100.0	28.4
Microfinancial Institutions	285	12.0	3.4
Insurance Companies	205	8.6	2.4
Pension Funds	1,871	78.7	22.3
Money Transfer Agencies	17	0.7	0.2
Total	8,372	n.a.	100.0

Source: Central Bank of Kosovo.

STA conducted an MFS TA mission in August 2019 to assist the CBK in improving monetary data. Main data issues identified by the mission include the following:

- **Correcting misclassification:** the mission recommended that the CBK address classification shortcomings in terms of financial instruments, sectors, and currencies—

[6] Two other subsectors exist in Kosovo: an asset management company and foreign exchange bureaus. However, they are not included in the coverage of 4SR due to their insignificant size with total assets of less than €1 million each.

mainly for 2SR and 4SR, albeit insignificant magnitude relative to total assets. Major issues include: reclassification between other accounts receivable/payable and nonfinancial assets; breakdown of insurance technical reserves among insurance subsectors (life, non-life, and reinsurance); and reclassification of foreign currency to national currency for some financial instruments.

- **Increasing periodicity of 4SR to monthly:** the CBK reports 4SR on a quarterly basis while the SD already receives monthly source data for major subsectors: insurance corporations directly from financial institutions; and pension funds indirectly from the BSD. The mission suggested that the SD make an institutional arrangement with the BSD to share source data for pension funds for timely compilation and reporting of monthly 4SR.

- **Recording revaluation for 1SR:** the CBK reports current year result (i.e., net profit/loss for the reporting period) as inclusive of valuation adjustment (i.e., revaluation). As revaluation, which is net changes in the value of assets and liabilities on its balance sheet could widely fluctuate—often only temporarily—due to changes in foreign exchange rate or price of debt securities and equities, the mission recommended that the CBK separately record revaluation for better assessment of the central bank balance sheet.

- **Estimating and reporting euro currency in circulation:** the CBK does not issue national currency, and the euro is used as legal tender and the unit of account in Kosovo. Due to difficulties with obtaining adequate source data needed for estimation, the CBK ceased compiling and reporting to STA euro currency in circulation in 2006, under-reporting broad money. While currently not reporting in MFS, the CBK internally estimates currency in circulation using information based on nominal GDP growth rate with an initial stock level in 2002 adjusted for cashless transactions in the payment system. While having cross-checked the current estimate with cash-deposit ratios for neighbor countries, the CBK views that further investigation of the estimate is needed before their reporting and dissemination. The mission team recommended that the CBK investigate other estimation methods and assess the adequacy of estimates with a view to start regularly reporting broad money, including euro currency in circulation to STA.

- **Developing financial statistics:** the CBK is developing a comprehensive database sourced from the financial sectors based on SRFs with a view to compile financial statistics to assess intersectoral linkages in the context of macroprudential policy analysis. The next steps envisioned by the CBK would be to incorporate into the database source data for the other sectors including external, government, and nonfinancial corporations (NFCs) sectors. As obtaining data for NFCs poses a significant challenge in terms of time and resources without an easy access to their source data, the mission suggested that the CBK prioritize project tasks by assessing the importance and magnitude of interlinkages between NFCs and household sectors. In the meantime, the priority should be given to using the existing data to identify vulnerability and risks in sectoral interlinkages which would guide policy analysis.

C. Balance Sheet Approach

STA compiles BSA matrices to complement the FSIs for an analysis of the financial sector stability. The BSA can be used to analyze vulnerabilities arising from balance sheet positions and mismatches at a point in time, as well as of the buildup of such vulnerabilities over time. Simulations can be conducted to analyze the spillover of possible shocks from one sector into another, such as a sudden withdrawal of bank deposits or an inability to "rollover" maturing external debt.

The BSA framework[7] considers four main types of balance sheet mismatches that can point to vulnerabilities for all sectors of the economy: (1) currency mismatches; (2) remaining maturity mismatches between liabilities and assets, such as short-term liabilities versus longer-term assets that create funding and interest rate risks; (3) capital structure problems, including an excessive reliance on debt rather than on equity (or high leverage); and (4) solvency or counterpart risk. Thus, the BSA identifies inter-sector linkages and possible balance sheet mismatches by instrument, counterpart sector, currency, and possibly maturity. The BSA may also include memorandum items to allow the calculation of control totals (e.g., nonfinancial assets and other assets/liabilities for which counterpart sectors are not identified).

The BSA represents an extension of traditional macroeconomic analysis from flows to stocks. It compiles balance sheets of each sector of the economy: namely, the government; the financial sector, broken down where possible into the central bank, ODCs, and OFCs; the nonfinancial private sector, broken down where possible into corporations and households; and the external sector (rest of the world). These balance sheets can be represented in a single table in matrix form. The BSA matrix, adapting the traditional flow-of-funds matrix, goes beyond aggregating sectoral assets, liabilities and net positions, to estimate also intersectoral assets and liabilities—that is, each sector's position vis-à-vis that of other domestic sectors as well as nonresidents.

The usefulness of BSA to enhance the mapping of risks and spillovers, and to identify the corresponding vulnerabilities for a more in-depth macro financial analysis was also emphasized in the IMF's 2014 Triennial Surveillance Review, in particular the importance of national balance sheet analysis in detecting risks and understanding how shocks are

[7] See IMF Policy Paper "Balance Sheet Approach in Fund Surveillance," June 2015. https://www.imf.org/external/np/pp/eng/2015/061215.pdf

propagated and the need for much more progress from the IMF member countries to enhance data provision.[8]

The main data source for the BSA matrix is monetary statistics (SRFs) owing to the financial intermediation role of financial corporations in an economy and the information on counterpart sector. The SRFs enable developing from-whom-to-whom tables for stocks for inclusion in the BSA. Other data sources include the international investment position (IIP), which provides information on stocks of resident sectors with the rest of the world by instrument, and the government financial balance sheet information presenting assets and liabilities of the general government or its subsectors by instrument and counterpart.

A BSA matrix for Kosovo for end–2017 is provided below using MFS and IIP (see Table AI.3)—although Kosovo provides government balance sheet data, information on sectoral breakdown is not disaggregated enough for use in the BSA. This version of from-whom-to-whom framework presents total assets and liabilities for all the sectors by counterpart sector and by currency, enabling to trace who finances whom, by how much, and in what currency. Note that by disaggregating total assets and liabilities, other BSA matrices can be produced for each financial instrument and for different maturity where data are available.

Further improvements to underlying data would increase the completeness of the matrix as well as its usefulness as an analytical tool. For the financial sector, the needed improvements such as potential reclassification of pension funds are identified above in the MFS.

For the external sector, Kosovo compiles and reports quarterly IIP data based on the sixth edition of the *Balance of Payments and International Investment Position Manual* by functional categories, instruments, sectors, and original maturity. For some components of the IIP, Kosovo provides separate data on NFCs, households and nonprofit institutions serving households. As information on currency breakdown is unavailable, assets and liabilities held by the residents vis-à-vis the rest of the world are assumed to be all in foreign currency. Developing data on the currency breakdown would improve the quality of the BSA matrix.

For the government sector, Kosovo compiles and reports annual balance sheet data in line with *Government Finance Statistics Manual 2014* (*GFSM 2014*), albeit on a cash basis. However, regular compilation and reporting of balance sheet data is not fully established as the data for 2017 has not been reported (the data only for 2015 and 2016 are available) and all instruments are not covered. Ongoing TA on Government Finance Statistics (GFS) continues to assist with those issues.

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[8] See 2014 Triennial Surveillance Review - Overview Paper
http://www.imf.org/~/media/Websites/IMF/imported-full-text-pdf/external/np/pp/eng/2014/_073014.ashx

Annex I. Table 3. Balance Sheet Matrix

Balance Sheet Approach Matrix

Kosovo

2017 - Percent of GDP (6282 millions)

	Government		Central Bank		Other Depository Corporations		Other Financial Corporations		Nonfinancial Corporations		Households		External		Total	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Government													**Source: IIP**			
Total			3%	14%	4%	0%	2%	0%	2%	1%	0%	0%	7%	0%	17%	15%
In domestic currency			0%	14%	4%	0%	2%	0%	2%	1%	0%	0%	0%	0%	8%	15%
In foreign currency			3%	0%	0%	0%	0%	0%					7%	0%	9%	0%
Central Bank													**Source: MFS**			
Total	14%	3%			5%	3%	1%	0%	1%	0%	0%	0%	5%	20%	26%	26%
In domestic currency	14%	0%			5%	3%	1%	0%	1%	0%	0%	0%	0%	0%	21%	3%
In foreign currency	0%	3%			0%	0%	0%	0%	0%	0%	0%	0%	5%	20%	5%	22%
Oth. Dep. Corporations													**Source: MFS**			
Total	0%	4%	3%	5%	0%	1%	2%	0%	10%	25%	43%	14%	4%	11%	62%	61%
In domestic currency	0%	4%	3%	5%	0%	1%	2%	0%	10%	25%	41%	14%	0%	0%	56%	50%
In foreign currency	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	2%	0%	4%	11%	6%	11%
Oth. Fin Corporations													**Source: MFS**			
Total	0%	2%	0%	1%	0%	2%	0%	0%	0%	3%	30%	0%	2%	24%	32%	31%
In domestic currency	0%	2%	0%	1%	0%	2%	0%	0%	0%	3%	3%	0%	0%	0%	4%	7%
In foreign currency	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	26%	0%	2%	24%	28%	24%
Nonfinancial Corporations																
Total	1%	2%	0%	1%	25%	10%	3%	0%					54%	21%	82%	34%
In domestic currency	1%	2%	0%	1%	25%	10%	3%	0%					0%	0%	28%	12%
In foreign currency			0%	0%	0%	0%	0%	0%					54%	21%	54%	21%
Households																
Total	0%	0%	0%	0%	14%	43%	0%	30%					0%	0%	14%	72%
In domestic currency	0%	0%	0%	0%	14%	41%	0%	3%					0%	0%	14%	44%
In foreign currency			0%	0%	0%	2%	0%	26%					0%	0%	0%	28%
External	**Source: IIP**		**Source: MFS**		**Source: MFS**		**Source: MFS**									
Total	0%	7%	20%	5%	11%	4%	24%	2%	21%	54%	0%	0%			76%	71%
In domestic currency	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%			0%	0%
In foreign currency	0%	7%	20%	5%	11%	4%	24%	2%	21%	54%	0%	0%			76%	71%
Total	15%	17%	26%	26%	60%	63%	31%	32%	34%	82%	72%	14%	71%	76%		
In domestic currency	15%	8%	3%	21%	49%	57%	7%	4%	12%	28%	44%	14%	0%	0%		
In foreign currency	0%	9%	22%	5%	11%	6%	24%	29%	21%	54%	28%	0%	71%	76%		

Source: IMF and IMF staff estimates.

GFS, based on the *GFSM* 2014, recommends compiling data series on stock positions with the sectoral breakdown of the counterparty. Until these data are developed, the from-whom-to-whom information presented in the BSA matrix need to be estimated for the counterpart sectors such as the financial and the external sector, using data available from MFS and IIP, respectively.

Most of the remaining data gaps in the BSA matrix after completed by MFS, IIP, and GFS can be filled with data on NFCs and households. Collecting data on positions between NFCs and households can be, however, challenging as they can only be obtained from national accounts related data sources, for which the CBK needs close cooperation with other statistical, supervisory, and regulatory agencies—data quality, coverage, periodicity, and timeliness are usually major issues even if source data are available.

ANNEX II. TECHNICAL ASSISTANCE ROADMAP

Topical Area	Key Vulnerability	Strategic Objective	TA Activity	Responsible Agency	Priority	Timeframe
Enhance Central Bank Governance						
Central Bank Governance	Weaknesses in central bank governance.	Strengthen structural arrangements for central bank governance and enhance effectiveness of decision-making.	1. Review the structure of management and responsibilities within the CBK. 2. Review the effectiveness of decision-making bodies at the CBK, including membership of key committees. (MCM)	CBK	**H**	**ST**
Strengthen Financial Supervision and Regulation						
Banking Sector						
CRDIV/BASEL lll	CRDIV/Basel lll is a complex and technical document, which places onerous responsibilities on supervisors to implement.	Strengthen regulatory framework.	Oversee the implementation of CRDIV/Basel lll and provide the necessary training to CBK staff to fully understand and implement it successfully. (MCM: this may involve a number of visits to the CBK on an ongoing basis)	CBK	**H**	**MT**
Banking Supervision	Underestimation of banks' liquidity risk.	Make use of more adequate liquidity monitoring indicators and a stress test model to improve the assessment of banks' liquidity risk.	1. Development of more adequate liquidity indicators for the monitoring of banks' liquidity profile. 2. Development of a liquidity stress tests model. 3. Staff training: full model: • full comprehension of the liquidity stress test model; • use of the indicators and stress test model in offsite supervision. (MCM)	CBK (BSD)	**H**	**IM**
Banking Supervision	Less sophisticated tools and indicators to assess the banks' exposure to credit risk and to monitor the credit market's performance and vulnerabilities.	Make use of more sophisticated tools and indicators for a more thorough assessment of banks' exposure to credit risk and the performance and vulnerabilities of the credit market, based on granular data from the CR.	1. Development of tools and indicators for a more thorough assessment of credit risk, based on granular data from the CR. 2. Development of tools and indicators for a more thorough assessment of credit market, based on granular data from the CR. 3. Staff training: • credit risk monitoring skills • full comprehension of the tools and indicators • use of the indicators and tools in the offsite supervision for a micro and macro perspective of the credit risk (MCM)	CBK (BSD and EAFSD)	**MH**	**MT**

Topical Area	Key Vulnerability	Strategic Objective	TA Activity	Responsible Agency	Priority	Timeframe
Insurance Sector						
Insurance Regulation and Supervision	Market-conduct issues are not adequately addressed in supervision practices. Market-conduct issues may be causing prudential issues.	Improve market conduct supervision.	1. Development of a revised regulatory framework for market conduct supervision. 2. Development of a supervisory toolkit for market conduct supervision. 3. Staff training on market-conduct supervision. (MCM)	CBK	MH	MT
Insurance Regulation and Supervision	Supervisory actions focus on enforcement and are very legalistic leading to suboptimal outcomes where issues in the industry are only addressed through enforcement.	Improve supervisory intervention through preventative and correct measures before the use of enforcement.	1. Development of escalating supervisory measures before enforcement measures. 2. Staff training on supervision practices including about the "mindset" of supervision, moving away from a detailed regulation and compliance focus and on achieving outcomes with the industry that do not involve enforcement. (MCM)	CBK	H	ST
Insurance Regulation and Supervision	Crisis management involves installing CBK employees as administrators and then liquidators if administration fails exposing the CBK to reputational risk.	Develop new approaches to crisis management that does not involve the use of CBK employees.	1. Assistance with the further development of crisis management practices building on processes already in place but removing the use of CBK employees. 2. Staff training on crisis management in insurance. (Possibly to be provided by IMF LEG)	CBK	MH	MT
Insurance Regulation and Supervision	Onsite inspections may be overlooking material risks.	Improve onsite inspection techniques by becoming risk focused rather than compliance focused.	1. Staff training on onsite supervision techniques. 2. Joining an onsite inspection to provide on-the-job training if possible. (MCM)	CBK	H	ST
Insurance Regulation and Supervision	Solvency II implemented too quickly and in a piecemeal way.	Proportionately implement Solvency II and work with the industry to prepare it for Solvency II and prepare the supervision staff.	1. Partner with EIOPA to provide assistance on designing a proportionate implementation of Solvency II. 2. Partner with EIOPA to provide staff training on Solvency II supervision techniques. (The WB may provide assistance on Solvency II under the FSAP development module.)	CBK	M	LT

Topical Area	Key Vulnerability	Strategic Objective	TA Activity	Responsible Agency	Priority	Timeframe
Securities Market						
Securities Markets	Underdeveloped capital markets.	Identify priorities for development of capital markets.	Establish a cross-agency task force on the development of capital markets in Kosovo. (MCM to provide ongoing guidance to task force)	CBK, MoF, KPST,	M	MT
Securities Markets	Underdeveloped capital markets.	Ensure sound regulatory framework for capital markets.	Provide assistance to the MoF in drafting key pieces of capital markets legislation. (MCM, together with LEG, to review and comment on drafts prepared by CBK)	CBK, MoF	M	LT
Securities Markets	Underdeveloped capital markets.	Prepare supervisory authority for oversight of capital markets.	Increase expertise and knowledge on capital markets at CBK. (MCM to identify appropriate TA/training provider by liaising with the World Bank, EBRD, and ESMA)	CBK	M	MT
Securities Markets	Underdeveloped capital markets.	Create sound basis for capital markets activity.	Ensure existence of preconditions for capital markets activity. (MCM to liaise with the WB to agree on appropriate provider of TA; DMF may have started preparatory work in this area)	CBK, MoF	M	LT
Systemic Risk, Financial Stability, and Macroprudential Policy						
Financial Stability Governance	Lack of appropriate institutional arrangements and governance for MaPP purposes.	Undertake a strategic review of CBK's institutional arrangements and practices in support of MaPP purposes.	TA on institutional arrangements around MaPP would be incorporated into a broader TA mission on central bank governance. (MCM)	CBK	H	ST
Financial Stability Governance	Lack of reference in the CBL to use of prudential instruments for MaPP purposes.	Amend the CBL to provide CBK with an explicit mandate for the use of prudential instruments for MaPP purposes.	Review and assist in drafting the CBL. (MCM together with LEG)	CBK	MH	LT
Systemic Risk Monitoring	Insufficient skilled staff to complete MaPP analysis to a high standard.	Develop an HR strategy to identify and meet the training needs of staff, including for core competencies such as stress testing and network analysis.	Train staff. (Draw on training courses available from the IMF Institute for Capacity Development)	CBK	H	IM
Systemic Risk Monitoring	Inadequate detection of key financial sector risks and vulnerabilities.	Conduct data gap analysis.	TA on developing sectoral financial accounts and balance sheet statistics, including for the nonfinancial sector. (STA)	CBK, MoF, and KAS	H	ST

Topical Area	Key Vulnerability	Strategic Objective	TA Activity	Responsible Agency	Priority	Timeframe
Systemic Risk, Financial Stability, and Macroprudential Policy						
Systemic Risk Monitoring	Inadequate detection of key financial sector risks and vulnerabilities.	Identify source data for real estate price indices.	Establish an Interagency Real Estate Working Group consisting of the CBK, MOF, KAS, the Ministry of Environment and Spatial Planning, and real estate industry representatives to undertake a stock-take of real estate information and develop a strategy for closing gaps. (Possibly supported by STA)	CBK, MoF, KAS, and the Ministry of Environment and Spatial Planning.	MH	ST
Systemic Risk Monitoring	Inadequate detection of key financial sector risks and vulnerabilities.	Improve stress testing and network analysis competencies.	Enhance stress testing methodologies and develop network analysis. (MCM)	CBK	MH	MT
Implement Robust Framework for Assessing Financial Stability Impact of Financial Inclusion						
Financial Inclusion	Lack of overview of financial inclusion initiatives, in turn hindering monitoring and evaluation of financial stability risks associated with financial deepening.	Effectively monitor risks to financial stability stemming from financial deepening.	Establish a national financial inclusion strategy. (This TA could be provided by the WB)	CBK, MoF, Ministries of Trade and Justice, and business associations	H	ST
Strengthen Financial Reporting and Statistics in the Nonbank Sector						
Financial Statistics						
Financial Statistics	Inadequate financial statistics for assessing risk.	Strengthen Monetary and Financial Statistics.	Ensure methodological consistencies with the international standards. (STA)	CBK	MH	MT
Financial Statistics	Inadequate financial statistics for assessing risk.	Strengthen Monetary and Financial Statistics.	Develop sectoral financial accounts and balance sheet statistics. (STA)	CBK, KAS	MH	LT
Real Estate Statistics	Missing information in real estate statistics.	Start closing the information gaps around real estate market.	Subject to data availability, develop statistical series on construction activity and real estate transactions. (STA)	CBK, KAS	MH	LT
Timeframe: **IM:** < 6 months; **ST:** < 12 months; **MT:** 12 to 24 months; **LT:** 24 months to 48 months.						

Legend

Timeframe	Timeframe	Priority	
Immediate (IM)	red	**High**	red
Short-Term (ST)	yellow	**Medium High**	yellow
Medium-Term (MT)	orange	**Medium**	green
Long-Term (LT)	green		

ANNEX III. IMPLEMENTATION OF PAST KEY MCM TA RECOMMENDATIONS

Recommendation	Priority	Implementation status	Implementation Progress
Central Bank Law			
A risk management framework be set up within the CBK.		Fully Implemented	A CBK Risk Management Function was established in 2014 and the Executive Board approved a Policy on Risk Management in 2015. In 2017, the Risk Management Function was transformed into a Risk Management Department, and Operational Risk Management was further enhanced.
Contingency Planning for Crisis Preparedness			
The FSC should meet at least quarterly and include the highest ranking members at least every six months. CBK, as chair, should be responsible for the agendas and minutes.	High	Partially Implemented	An MoU was signed in 2013 by the CBK, MoF, and the Committee of the Assembly on Budget and Finance, creating a National Committee for Financial Stability and Crisis Management (NCFS) to meet quarterly with head of agencies; however, the NCFS was never operationalized.
Banking Regulation & Supervision			
Develop a first baseline projection of banks' key financial soundness indicators prior to implementing top-down stress testing.		Largely Implemented	Since end-2014 banks are asked to provide three-year projections for main financial indicators, also used for banking supervision purposes.
Develop capacity within the BSD to analyze commercial banks' bottom-up stress tests prior to commencing top-down stress testing.		Fully Implemented	Reviewing banks' stress-tests is part of examination process.
Extend the supervisory approach to cover banking sector risks on a consolidated basis.		Fully Implemented	Since approval of RBS manual, examination on a consolidated basis is applied, including consolidated reporting. The Regulation on Consolidated Supervision is in place.
BSD should complete the transition to RBS and fully embed RBS into the supervisory function, including finalizing the off-site supervision manual.	High	Fully Implemented	
Ensure the BSD has appropriate resources to: (i) develop and maintain analytical tools; (ii) carry out its off-supervisory supervisory duties with absolute regularity, even while engaged in one-off strategic projects.	High	Partially Implemented	Further resources will be needed to fully implement Basel III/CRDIV
Insurance Sector Regulation & Supervision			
Foster distribution cost reduction on MTPL (CBK).	High	Fully Implemented	The CBK has prepared and made effective the regulation on the sale of motor third party liability and the management of the insurer's expenses from 29 December 2016.
Ensure the adequacy of technical provisions and implement Solvency I capital adequacy (CBK).	High	Fully Implemented	Since Q2 2017, there is a regulation, harmonized with the EU Solvency I, on the calculation of minimum solvency margin, capital adequacy and guarantee fund for all non-life insurers.
Strengthen the fit-and-proper and external audit professional requisites (CBK).	High	Fully Implemented	CBK has issued a regulation on the appointment of external auditors of insurers, insurance intermediaries, claim handlers and the Kosovo Insurance Bureau.
Enhance actuarial capabilities (CBK).	High	Fully Implemented	Since September 2017 the CBK has an actuary who is certified from the Albanian Financial Supervision Authority and the Institute and Faculty of Actuaries.
Macroprudential Policy & Early Warning System			
BSD and EAFSD should collaborate on the conduct of stress testing.	High	Largely Implemented	There is regular information exchange, including those for stress-testing purposes. However, collaboration in this area needs to be intensified.
Develop a work plan to close data gaps in non-financial sector balance sheet, particularly for household and corporate sector income.	High	Not started	
Clearly identify which instruments are currently available for use and those which are more a "work in progress" pending improvements in indicators.	High	Partially Implemented	Instruments approved as part of the Macroprudential Policy Framework are mainly in place but still need to be operationalized.
Remove Emergency Liquidity Assistance as macroprudential tool.	High	Largely Implemented	Not included in the CBK's list of main macroprudential policy instruments.
Assign more resources and invest further in EAFSD staff of to deepen the analytical competencies required to fully operationalize the macro-prudential policy framework.	High	Partially Implemented	The EAFSD will add two additional staff in 2019.

ANNEX IV. 2019 FSSR BACKGROUND NOTES

Topic/Document	Description
MCM Background Notes	
Banking Sector	*Michel Deasy and Paula Cristina Seixas de Oliveira* The purpose of the background note on banking supervision and regulation is to carry out a stability assessment of the banking regulatory system in Kosovo and develop an agenda for follow-up TA in areas where deficiencies are identified or where further analytical support may be required.
Insurance Sector	*Peter Windsor* The background note provides an analysis of the insurance industry in Kosovo and of its regulatory framework and issues identified with respect to its supervision. It adds further detail on the key recommendations covered in the Aide Memoire, and also provides additional recommendations, including regarding financial education and industry development.
Securities Markets	*Richard Stobo* This note discusses the development of capital markets in Kosovo, as a necessary precursor to the introduction of an investment funds regime. The note assesses the current regulatory and supervisory context, identifies the key steps to be taken to create a sound basis for capital markets activity, and makes suggestions on how best to organize TA to support that objective.
Macroprudential Policy	*Keith Hall and Zhongxia Zhang* This background note reviews key elements of CBK's macroprudential policy framework. These include the institutional arrangements underpinning CBK's role as a macroprudential authority, the challenges of developing a systemic monitoring capacity in Kosovo where there a significant information gaps; and the strategy adopted by CBK for operationalizing the use of macroprudential policies.
Central Bank Governance	*Sarah Simpson* The background note contains a detailed explanation of observations, recommendations, and best practice relating to central bank governance, particularly on: decision-making structures; organizational structure and design; risk management; and internal audit.
Financial Inclusion and Deepening (Impact on Financial Stability)	*Ann-Margret Westin and Zhongxia Zhang* The background note documents the state of nature of financial inclusion in Kosovo and the different initiatives currently being undertaken to enhance financial deepening. The note then proposes recommendations to mitigate any risks to financial stability from financial deepening.
Statistical Annex	
Financial Statistics	*Naoto Osawa* This statistical annex examines Kosovo's Financial Soundness Indicators and Monetary and Financial Statistics. It presents the current reporting status of these two key data sets and identifies several potential methodological issues and data gaps. Lastly, the annex attempts to map the inter-sectoral linkages for Kosovo from a stock perspective using a balance sheet approach.