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Republic of Kosovo: Financial System Stability Assessment

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REPUBLIC OF KOSOVO

Financial System Stability Assessment

Prepared by the Monetary and Capital Markets and European Departments

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December 10, 2012

This report is based on the work of a joint IMF-World Bank Financial Sector Assessment Program (FSAP) mission to Kosovo during September 19–October 2, 2012. The team comprised Liliana Schumacher (head of mission, IMF), Aurora Ferrari (head of mission, World Bank), Bostjan Jazbec, Diane Mendoza, David Parker, Scott Roger, Kalin Tintchev (all MCM), Pablo Druck (EUR), Eugene Gurenko, Leyla Castillo, Valeria Salomao Garcia, Blerta Qerimi, and Martin Vazquez Suarez (all World Bank), Penelope Hawkins and Alma Qamo (World Bank consultants); and was assisted by Jose Sulemane, IMF resident representative, and Jan-Peter Olters, World Bank resident representative.

- Kosovo banks are exposed to macro-financial risks due to the openness of the economy, limited possibilities to diversify and the authorities' limited tools for macroeconomic stability. The development of a macroprudential policy framework could help mitigate these risks. Stress tests suggest that the financial sector is resilient to a wide range of shocks. However there are pockets of vulnerabilities among small and medium-sized banks and in one large foreign subsidiary. Vulnerabilities are exacerbated by name concentration.
- The Central Bank of Kosovo (CBK) has made significant progress in promoting the growth and stability of the banking sector. However, banking supervision still confronts challenges due to resource constraints and because supervisory activity is conducted under difficult circumstances resulting from the political and security context of the country. Supervisors conduct sound credit risk monitoring practices, and corrective actions have also been taken in case of violation of banking laws.
- Going forward, CBK needs to adopt a risk-based supervisory approach and incorporate the supervision of operational and interest rate risks and those related to subsidiaries of foreign banks and their relations with their parents. Legal protection for banking supervisors and other CBK employees needs to be strengthened. The new AML law has significant gaps that could affect the effectiveness of AML activities in the banking sector. The regulatory framework for insurance needs to be completely overhauled to ensure the sector solvency and remove obstacles to its development.
- The authorities have made good progress in the development of a comprehensive safety net and a legal framework for crisis management; but there is room to introduce refinements so that incentives for excessive risk taking can be minimized, the size of the safety net remains adequate, and the authorities can have sufficient powers to identify a crisis scenario and take actions if necessary.

The main author of this report is Liliana Schumacher, with contributions from the FSAP team members.

FSAP assessments are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAP assessments do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.

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GLOSSARY

ACBF	Assembly Committee on Budget and Finance
AML	Anti Money Laundering
Assembly	Assembly of the Republic of Kosovo
ATM	Automated Teller Machine
Basel I	Basel Capital Accord
BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principles for Effective Banking Supervision
BL	Law No. 04/L-093 on Banks, Microfinance Institutions and Non Bank Financial Institutions
BSD	Bank Supervision Department
CAMELS	Rating System for banks, assessing Capital-Assets-Management-Earnings Liquidity-Sensitivity to market risk
CAR	Capital adequacy ratio
CBK	Central Bank of the Republic of Kosovo
CBK Law	Law No. 03/L-209 on Central Bank of the Republic of Kosovo
CMEC	Crisis Management Executive Committee
DEPO/X	Brand name for a module in the securities settlement system
DI	Deposit insurance
DIA	Deposit Insurance Agency
DIFK	Deposit Insurance Fund of Kosovo
DIL	Law on the Establishment of a Deposit Insurance System for Financial Institutions in Kosovo
DIS	Deposit Insurance Scheme
DTI	Debt to income ratio
EBA	European Banking Authority
EBRD	European Bank for Reconstruction and Development
EICS	Electronic Interbank Clearing System
ELA	Emergency liquidity assistance
EU	European Union
EULEX	European Union Rule of Law Mission
FIU	Financial Intelligence Unit
IFRS	International financial reporting standards
IL	Insurance law
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
GWP	Gross written premium
HHI	Herfindahl Index
IAIS	International Association of Insurance Supervisors
IBNR	Incurred but not reported
ICP	Insurance Core Principles

IFRS	International financial reporting standards
JSC	Joint Stock Company
IL	Insurance law
KfW	KfW Bankengruppe
KPST	Kosovo Pension Savings Trust
LITS	Life in Transition Survey
LLC	Limited Liability Company
LTV	Loan-to-value ratio
MaPaC	Macroprudential Policy Advisory Committee
MCF	Motor compensation fund
MFIs	Microfinance Institutions
MoF	Ministry of Finance
MoPA	Ministry of Public Administration
NBFI	Non Bank Financial Institution
MoU	Memorandum of Understanding
MTPL	Motor third party liability
NGO	Non-government Organization
NPC	National Payment Council
NPL	Nonperforming loan
P&A	Purchase and Assumption
POS	Point of Sale
ROE	Return on Equity
RTGS	Real time gross settlement system
RWA	Risk-Weighted Assets
SMEs	Small and Medium Enterprises
SRF	Special Reserve Fund
UNMIK	UN Interim Administration Mission in Kosovo
USAID	United States Agency for International Development
VAT	Value Added Tax

EXECUTIVE SUMMARY

Although systemic risks appear to be manageable in Kosovo, there are pockets of vulnerability. Kosovo banks are exposed to macro-financial risks due to the openness of the economy, limited scope to diversify, and modest range of tools available to the authorities to promote macroeconomic stability. Vulnerabilities are exacerbated because of excessive name concentration.

Commendable progress has been made by the Central Bank of the Republic of Kosovo (CBK) in promoting the growth and stability of the banking sector. This progress was achieved thanks to the professionalism and integrity of CBK's authorities and in spite of difficult circumstances, including legal uncertainty and a challenging security context. The fact that Kosovo's independence has not been universally recognized has posed another challenge as CBK's authority can be limited in certain areas of the country. The high standards that have characterized CBK work so far need to guide CBK's actions in the future too.

Looking forward, there are a number of steps the authorities could make to promote financial stability. Supervisors should monitor credit growth and strengthen provisions in the more vulnerable banks, including for exposures to the parent company when necessary. They should also ensure that the new regulation on large exposures is enforced in the planned schedule and avoid granting exceptions to the new limits. Since there are indications that large depositors represent a sizable proportion of total deposits in some banks, steps are needed to ensure quick access to lender of last resort facilities.

There is also a need to address inconsistencies in the regulatory framework and ensure coherence. Kosovo's legal system has been developed afresh since 2000. To quickly build the necessary institutional capacity, many public institutions have received intensive international technical assistance and that has sometimes not been fully consistent.

Thus far, the CBK has focused on credit risk, the key risk of a nascent market; going forward the focus has to be on a comprehensive risk-based approach that should include the monitoring of other forms of risk. Supervisors conduct sound credit risk monitoring practices and corrective actions have been put in place when necessary. CBK has also taken clear actions in case of violation of banking laws. Going forward, CBK needs to adopt a risk-based supervisory approach and incorporate the supervision of operational and interest rate risks and those related to subsidiaries of foreign banks and their relations with their parents.

In order to mitigate banks' exposure to macro-financial risks, the mission recommends the development of a macroprudential policy framework. Kosovo is a very open economy and exposed to external shocks. In the absence of monetary and exchange rate policies, macroprudential policy measures may be especially useful in countering cyclical risks to which the financial system is exposed. The framework should include both institutional and operational elements. Operational aspects should include setting targets for limiting excessive liquidity and leveraging risks, and could use instruments such as time-varying reserve requirements, restrictions on loan-to-income or revenue ratios, and adding a countercyclical component to capital requirements.

The mission commends the authorities for the development of a comprehensive financial safety net. Going forward, the current legal and regulatory framework should be refined to ensure that the size of the Special Reserve Fund (SRF) will remain adequate, and to minimize incentives for excessive risk taking. The banking law should be amended to ensure that banks are resolved at the least cost to taxpayers. With regard to deposit insurance, the Government should ensure that the current deposit coverage of €2,000 is only increased as the fund size increases, that banks continue to contribute, and that all past and future contributions are available to be used to repay insured deposits.

Recognizing that the banking sector is concentrated and that risks may also arise from outside the country, the authorities should introduce key tools of crisis management to minimize costs in the event that risks materialize. These include among others: the scope for the CBK to obtain appropriate government back stopping when emergency liquidity assistance (ELA) is extended to systemic banks that may be insolvent; the use of a bridge bank only in the case of systemically important banks; clear and sufficient powers to identify a crisis scenario and take actions if necessary; and contingency plans.

The authorities should ensure that the supervisory approach to microfinance institutions (MFIs) is commensurate with the risks they pose. Microfinance is a key source of lending to households, small business, and agriculture, and can offer healthy competition to banks. The current legal framework should allow the sound growth of the strongest MFIs so that they could play an important role in reaching underserved segments and increase much needed competition in the banking sector.

The regulatory framework for insurance needs to be completely overhauled. In order to make the sector safer and promote development, the CBK should reinstate the EU Solvency I framework as the main legal basis for monitoring, supervising, and enforcing minimum solvency margin requirements.

The key recommendations of the mission are prioritized in Table 1.

Table 1. Key Recommendations[1]

Short term (implementation within 12 months)

1. Ensure that costs associated with the legal defense of CBK employees sued while carrying out their official responsibilities are covered ex-ante (¶39 CBK).
2. Subject ELA granted to potentially insolvent systemically important institutions to very strict conditions (¶55, CBK).
3. DIL should raise the DIFK target level to 8–9 percent of insured deposits and should only introduce higher deposit coverage as the fund increases. It should also clarify that all past and future contributions made by the Government and KfW can be used to repay insured deposits. Banks' premiums should not be reduced or discontinued except as defined in ¶71 (¶67 and ¶69–71).
4. Amend the BL to address the identified shortcomings in the bank resolution framework (¶63) and obstacles to competition and development of the MFI sector (¶43, ¶78, and ¶79, CBK, the Government).
5. Reinstate Solvency I for all insurers; establish an investment regulation for life and non-life companies for their own surplus and reserves, as well mandatory annual actuarial audit of provisions by a certified actuary; and retain two in-house actuaries (¶42, CBK).
6. Make initial steps to establish a framework for macroprudential monitoring, analysis, and policy formulation (¶47, CBK).

Medium term (implementation in one to three years)

7. Institute a bank premium to fund ELA needs (¶58, CBK, Government).
8. Put in place extraordinary funding arrangements for the DIFK (¶68). Adopt a legal framework for crisis management, contingency plans, and perform crisis simulations (¶74–75, the Government, CBK).
9. Conduct a comprehensive review of the financial system legal and regulatory framework to remove inconsistencies, close gaps, and ensure coherence (¶33, MoF/CBK).
10. Revise the AML legislation to address its technical weakness (¶36, MoF).
11. Introduce risk-based supervision with attention to those risks resulting from systemic banks and their relation with their parent banks and groups, and enhance further the supervisory capacity of the CBK (¶38, CBK).
12. Enact and implement a regulation to introduce an out-of-court insurance dispute resolution mechanism (e.g., private arbitration with binding decision powers), in order to address the growing volume of consumer complaints against insurers and the lack of technical capacity of local courts to properly address insurance related disputes (¶30, CBK).
13. Enhance the stress testing framework to include macro scenario analysis as well as models specifying macrofinancial linkages (¶51, CBK).
14. Develop and implement macroprudential policy using quantifiable indicators and policy instruments (¶47, CBK).

[1] In brackets: paragraph in which the recommendation is discussed and authority responsible for its implementation. Within each time frame, recommendations are ordered by priority.

I. Structure of the Financial System and Recent Macro-Financial Performance

1. **Kosovo's financial sector, which is dominated by banks, has expanded rapidly since 2000.** Financial system assets as a share of GDP more than doubled from 33 percent in 2003 to about 74 percent as of June 2012. There are presently eight commercial banks, which account for more than 75 percent of total financial system assets and around 60 percent of GDP (Table 2). Six banks are locally incorporated and two are foreign branches. The three largest locally incorporated banks are subsidiaries of European banks and together account for more than 70 percent of bank assets. One of the three medium-sized banks is also foreign-owned.

2. **The nonbank sector is represented by pension funds, micro-financial institutions and insurance companies.** After banks, pension funds are the largest financial intermediaries. Their role is to complement the pay-as-you-go government funded system and their investments represent about 20 percent of total financial assets. There are also 14 small micro-financial institutions managed by nonprofit organizations, which are not deposit-takers. The insurance sector is represented by one life and 10 non-life insurance companies that together comprise about 3 percent of total assets.

3. **Kosovo is one of the smallest insurance markets in Europe**. Gross non-life premiums, including personal accident and health, amount to about €67 million, of which about €1 million are life insurance premiums. Despite a very low market penetration rate of about €38 per capita, in 2011 the overall real growth of the market measured by gross premium written (GPW) was under 5 percent. Moreover, 70 percent of premiums come from the compulsory third party motor liability insurance (MTPL).[1]

4. **Although small, the microfinance sector is a key lender to small businesses, agriculture, and low income households.** It accounts for 4 percent of the total loan portfolio of financial institutions. The average loan size amounts to €1,400 and lending to agriculture accounts for 46 percent of total lending to the sector. Two providers dominate the MFI market, with about 50 percent of assets.

5. **The CBK is the single supervisor for all financial intermediaries.** It issues banking and insurance regulations, as well as prudential rules for the pension funds. In spite of the fact that microfinance institutions are not deposit-takers, they are also supervised by the CBK.

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[1] Kosovo does not participate in the European Green Card system. This Green Card is proof that the minimum legal requirements for third party liability insurance in any country for which the Green Card is valid are covered by the insured's own motor policy.

Table 2. Kosovo: Financial System Structure (2007–2012)

	December 2007			December 2010			June 2012		
	Number	Assets (euros mn)	Percent of total assets	Number	Assets (euros mn)	Percent of total assets	Number	Assets (euros mn)	Percent of total assets
Commercial banks	9	1,435	77	8	2,455	77	8	2,652	75
Foreign	5	1,231	66	6	2,188	69	6	2,333	66
Domestic private	4	204	11	2	267	8	2	319	9
State-owned	0	0	0	0	0	0	0	0	0
Nonbank financial institutions	26	437	23	30	715	23	33	892	25
Insurance companies	9	71	4	11	97	3	13	120	3
Life insurance	…	…	…	1	4	…	3	11	0
Non-life insurance	9	71	4	10	93	3	10	109	3
Pension funds	2	278	15	2	494	16	2	659	19
Public	1	278	15	1	489	15	1	654	18
Private	1	0	0	1	5	0	1	5	0
Micro-finance institutions	15	88	5	13	102	3	14	79	2
NBFI (lending)	…	…	…	4	23	1	4	34	1
Total financial system	35	1,872	100	38	3,170	100	41	3,544	100

Source: Central Bank of Kosovo and IMF staff estimates.

6. **Kosovo has unilaterally adopted the euro as its legal tender in 2002.** While this supports stability by providing a strong monetary anchor and has generally served the economy well, it places a premium on disciplined macroeconomic policies, makes fiscal policy the main instrument for domestic demand management, and imposes limitations on the central bank's ability to act as lender of last resort.

7. **Kosovo's economy was affected by the global financial crisis of 2008/09 through a weakening of private sector demand driven by a drop in transfers from Kosovo workers abroad**. During 2008–09, economic conditions in host countries of Kosovo's diaspora rapidly deteriorated; by 2009, the Kosovo's economic outlook turned sharply weaker. GDP growth fell to 2.9 percent, from 6.9 percent the year before, and countercyclical fiscal expansion, financed largely from one-off dividends receipts and drawing down cash buffers, mitigated the impact of the private sector contraction.

8. **While Kosovo's economy recovered somewhat after 2009, broadly in line with the host countries of Kosovo's diaspora, growth has recently faltered.** During 2010–11, real GDP grew on average by 4.5 percent, driven primarily by private sector demand. Consumer prices reversed from deflation of 2.4 percent in 2009 to inflation of 5.4 percent in 2010–11, triggered by higher prices for imported food. The trade deficit widened from 39.7 percent of GDP in 2009 to 41.1 percent of GDP in 2011, reflecting mostly higher imports. Strong current and capital inflows, primarily from the Kosovar diaspora, funded the deficit. There have been indications of a weakening in domestic demand in early 2012. Staff projects real GDP growth of 2.7 percent in 2012. Consumer price inflation is expected to average 2.5 percent in 2012, compared with 7.3 percent in 2011 (Table 3).

II. Financial Institutions Resilience to Risks

A. Banks

9. **Kosovo banks are exposed to external and domestic sources of macro-financial risks.** Kosovo banks are exposed to shocks from abroad because of the openness of the economy and financial cross border exposures:

- Growth is significantly influenced by external factors. Domestic demand is mainly funded with transfers from Kosovars living abroad equivalent to about 40 percent of GDP. Moreover, these transfers are direct determinants of bank credit quality and liquidity since they are used to service loans and fund deposits.[2]

[2] These transfers include remittances, FDI, and other non-debt generating inflows that can be associated with Kosovars working abroad.

Table 3. Kosovo: Selected Economic Indicators

(in percent, unless otherwise indicated)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
					Projections					
Real growth rates										
GDP	6.9	2.9	3.9	5.0	2.7	3.2	4.3	5.0	5.0	4.6
GDP per capita	5.6	1.4	2.4	3.4	1.1	1.7	2.8	3.4	3.4	3.1
Consumption	4.3	1.0	2.9	2.9	2.0	2.6	3.1	3.3	3.1	3.0
Investment	18.1	11.7	8.8	7.6	4.4	4.3	1.5	8.3	7.1	7.0
Exports	4.7	7.8	24.2	13.6	-1.4	4.5	12.8	10.8	11.5	9.2
Imports	5.9	5.3	11.9	5.6	0.8	3.3	3.5	6.3	5.8	5.4
Official unemployment (percent of workforce)	47.5	45.4	45.1	...	...	...	...	...	...	...
Price changes										
CPI, period average	9.4	-2.4	3.5	7.3	2.5	2.2	1.6	1.5	1.5	1.5
CPI, end of period	0.5	0.1	6.6	3.6	3.8	1.7	1.4	1.6	1.4	1.5
Import prices	11.8	-4.9	3.2	7.7	1.8	-0.1	0.0	-0.8	-0.3	-0.1
GDP deflator	6.2	-1.3	3.7	4.8	2.6	2.5	2.0	2.0	2.0	2.0
Real effective exch. rate (average; -=depreciation)	3.2	-1.0	-0.7	3.5	...	...	...	...	...	...
Real effective exch. rate (end of period; -=depreciation)	0.2	-1.0	0.8	0.7	...	...	...	...	...	...
General government budget (percent of GDP)										
Revenues, incl. interest income	24.5	29.3	27.6	28.1	27.8	27.6	27.7	28.0	28.2	28.5
Primary expenditures	24.7	29.9	30.0	29.8	30.3	30.7	29.1	29.4	29.7	29.8
Of which										
Wages and salaries	5.9	6.8	7.4	8.3	8.4	8.4	8.4	8.4	8.4	8.4
Subsidies and transfers	7.1	7.3	6.4	5.8	6.1	6.1	6.1	6.1	6.1	6.1
Capital and net lending, incl. highways	7.6	11.6	11.9	11.9	11.9	11.6	10.2	10.4	10.7	10.9
Capital expenditures on highways	...	...	2.9	5.6	6.0	5.5	4.4	4.1	3.5	0.0
Overall balance	-0.2	-0.7	-2.6	-1.9	-2.7	-3.5	-1.8	-1.9	-2.0	-2.0
Debt financing, net	0.0	-0.2	0.3	-0.1	3.0	1.4	1.9	2.1	2.0	2.1
Privatization	0.0	0.0	0.0	0.0	1.2	6.3	0.2	0.2	0.2	0.3
Stock of government bank balances	10.8	8.7	5.8	3.5	4.7	8.6	8.4	8.3	7.5	7.2
Recommended minimum bank balances 1/	...	...	5.7	5.8	6.2	6.8	7.0	7.3	7.3	7.2
Financing gap	0.0	0.0	0.0	0.0	0.9	0.0	0.0	0.0	0.0	0.0
Savings-investment balances (percent of GDP)										
Domestic savings	-12.6	-7.4	-6.7	-7.9	-7.5	-6.9	-5.2	-2.9	-0.6	1.5
Transfers excluding general government (net)	14.0	11.9	12.5	12.2	12.0	11.9	11.9	11.6	11.2	10.8
Net factor income	4.3	2.1	2.1	2.6	2.4	2.3	2.4	2.4	2.4	2.4
National savings	5.8	6.6	8.0	7.0	6.9	7.4	9.1	11.0	12.9	14.6
Investment	28.6	32.3	33.9	33.2	33.1	32.4	31.2	31.7	32.0	32.6
Current account, excl. official transfers	-22.8	-25.7	-25.9	-26.2	-26.3	-25.0	-22.1	-20.7	-19.1	-17.9
Current account balance, incl. official transfers	-15.3	-15.4	-17.4	-20.3	-20.7	-21.1	-18.6	-17.5	-16.5	-15.6
Of which: official transfers 2/	7.5	10.3	8.6	5.9	5.6	3.9	3.5	3.1	2.6	2.4
Net foreign direct investment	8.9	7.1	8.5	8.0	6.6	13.0	8.6	7.8	7.6	7.4
Portfolio investment, net	1.7	-1.4	-5.5	-2.3	-2.7	-1.5	-2.2	-1.0	-0.3	0.0
Bank credit to the private sector	32.7	8.9	12.6	14.7	4.6	...	...	...	...	...
Deposits of the private sector	25.8	22.2	23.1	11.4	5.0	...	...	...	...	...
Non-performing loans (percent of total loans)	3.3	4.3	5.2	5.8	7.0 3/	...	...	...	...	...
GDP (millions of euros)	3,851	3,912	4,216	4,637	4,885	5,169	5,501	5,892	6,312	6,736
GDP per capita (euros)	2,323	2,325	2,468	2,674	2,776	2,894	3,034	3,202	3,379	3,553
GNDI per capita (euros)	2,749	2,650	2,829	3,071	3,175	3,306	3,469	3,649	3,836	4,020
Population (thousands) 4/	1,658	1,683	1,708	1,734	1,760	1,786	1,813	1,840	1,868	1,896

Sources: Kosovo authorities; and IMF staff estimates and projections.

1/ See Box 2 in the IMF Country Report No. 12/100, April 2012, International Monetary Fund, Washington DC.
2/ Total foreign assistance excluding capital transfers.
3/ September 2012.
4/ Series updated with the 2011 census.

- Inflation is mainly driven by the volatility of imported food items, affecting real income and real interest rates.
- Credit growth is influenced by developments in foreign countries since the three largest banks are foreign-owned. They have parent banks in Germany, Austria and Slovenia and two of these are embarking in significant deleveraging plans outside their home markets in order to restore their capital adequacy ratios.
- Liquid assets are mainly foreign assets. Banks fund themselves with local deposits and do not depend on funding from their parents but invest around 22 percent of total assets abroad, largely in the euro area. These investments include sovereign bonds and placements in parent and other (mainly European) banks. Placements in parent banks are limited to 15 percent of Tier 1 capital while there are no limits to placements in other banks. Sovereign bonds (mostly highly rated) are the equivalent of about 70 percent of Tier 1 capital while balances with other banks (including parent banks) are 100 percent of Tier 1 capital (Figure 1).

10. **Risks also come from specific economic and institutional features of the domestic environment in which banks operate:**

- Kosovo is a small and concentrated economy and this limits banks' ability to diversify their risks. Banks have limited possibilities to diversify across sectors. Kosovo's export sector has remained small (about 7 percent of GDP) and concentrated on low valued-added products, especially base metals; imports represent about 52 percent of GDP. About a third of all bank loans are to the trade sector while another third are loans to households. High levels of informality and flaws in commercial legislation and judiciary procedures limit acceptable clients to a reduced number of corporations and individuals, promoting also name concentration on banks' asset and liability sides.[3]

- There are limited cushions to compensate for potential macroeconomic instability. Due to the unilateral adoption of the euro, the authorities have limited instruments to conduct macroeconomic stabilization policies and to provide a safety net to banks. Local interbank and other financial markets are almost nonexistent.[4]

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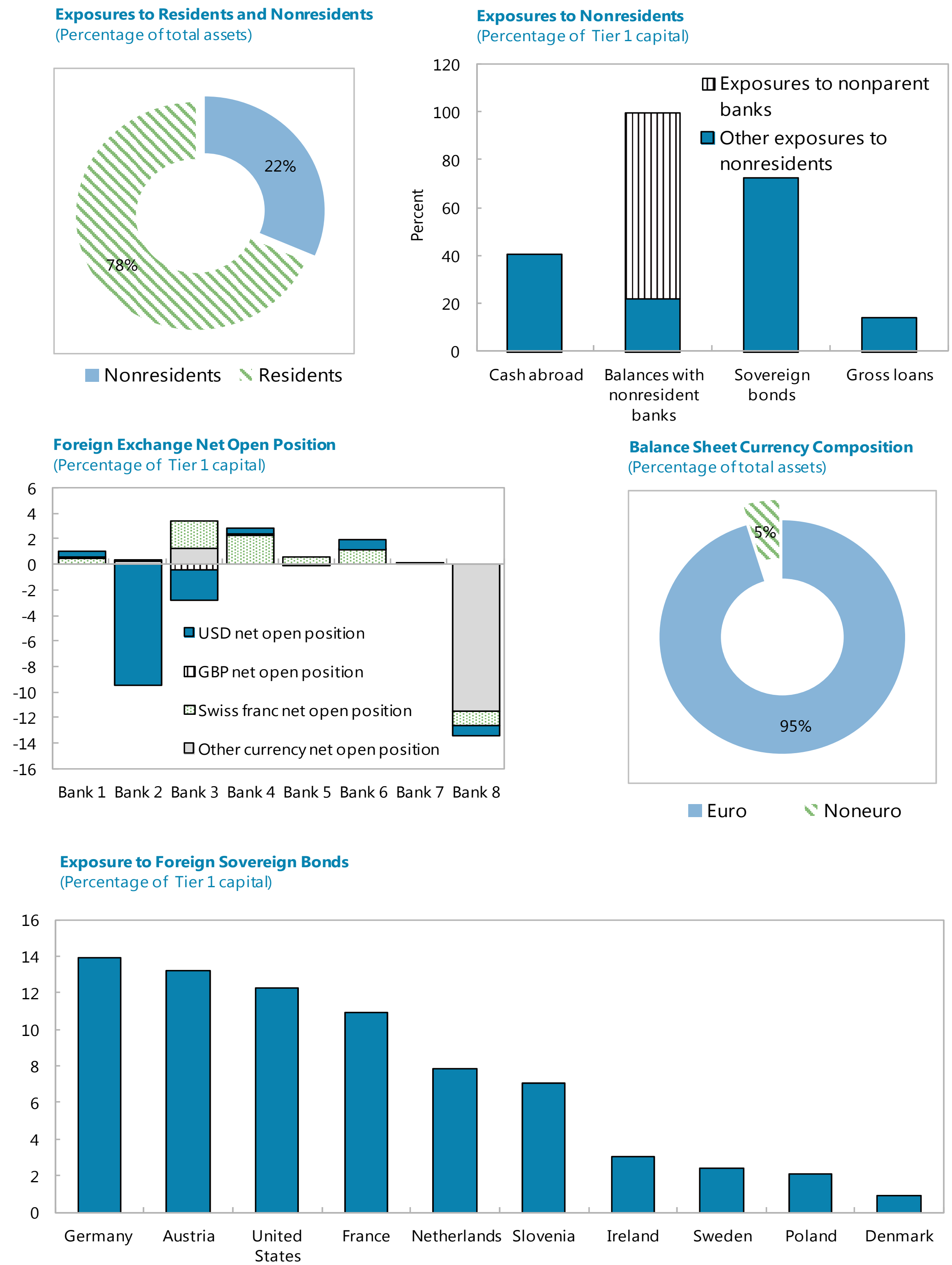
[3] An assessment of the Principles for Effective Insolvency and Creditor Rights Systems was undertaken by the World Bank in early 2012.

[4] Kosovo has successfully begun issuance of T-bills, but market development is still at an early stage**.** Monthly auctions began in January, with seven banks participating as primary dealers. To date, only three- and six-month bills have been auctioned, but there are plans to issue one-year bills in 2013. Auctions have been heavily oversubscribed. Most bills have been kept by the banks for their own account, and six-month bills have been bought by institutional investors. As a result, no secondary market trading has yet developed. After one-year bills begin to be issued, a secondary market is expected to develop and capacity development is underway to that end. Later in 2013, repo operations in government securities are expected to be introduced. Capital markets are nonexistent.

Figure 1. Kosovo: External Bank Exposures

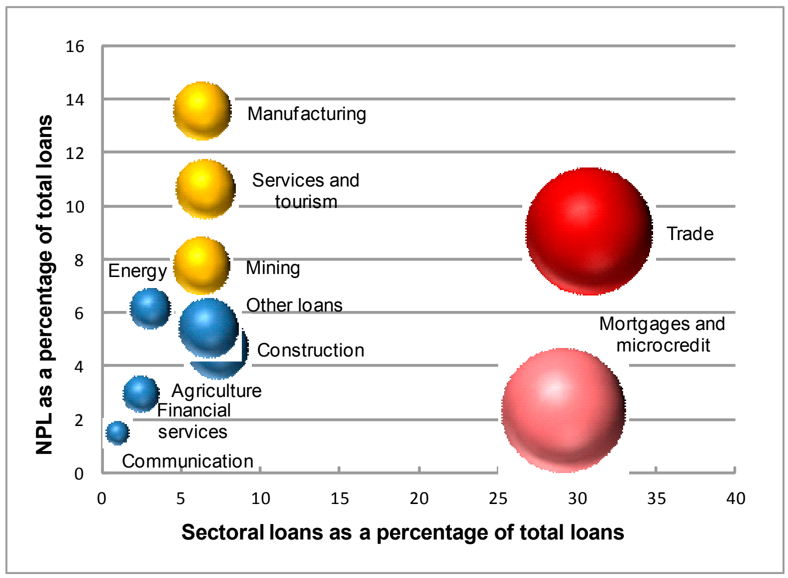


Source: National authorities and Fund staff estimates.

11. **The economic slowdown has had an impact on credit quality and bank profitability but the banking system still appears adequately capitalized and liquid** (Table 4).

- The banking system NPL ratio nearly doubled from 3.3 percent in 2008 to 6.5 percent at end June 2012. This trend is largely attributable to a large increase of NPLs in the trade sector. NPLs appear well provisioned by regional comparisons and based on relatively conservative classification requirements (Figure 2). On aggregate, banks' June 2012 return on equity was 10 percent, down from 19 percent at end-2010. Some medium-sized and small banks reported losses in the first half of 2012. As of June 2012, the banking system CAR was 17.2 percent, down from 18.8 percent at end-2010. Most banks maintained CARs above the 12 percent regulatory minimum.[5]

Kosovo: Sectoral Concentration and Nonperforming Loans 1/



1/ Size of bubble corresponds to size of the sector in total credit.

- Deposit growth remained relatively flat during the first half of 2012, which has somewhat increased banks' loan-to-deposit ratios as credit still expanded at an annualized rate of around 8 percent for the system (and higher for small and medium-sized banks). The recent deposit slowdown could be attributable to lower capital inflows associated to the Kosovar diaspora and large withdrawals of public enterprise deposits. Liquid assets however remained high (29 percent of total assets) covering about 34 percent of total deposits. The high liquidity ratio is to some extent the result of moral suasion by supervisors targeting an 80 percent loan-to-deposit ratio, which banks meet while investing the rest abroad.

12. **Stress tests were based on the potential channels of risk transmission and vulnerabilities identified in paragraphs 20–21.** Staff assessed the impact of further euro-zone deterioration on the Kosovo banking system.[6] The crisis was assumed to impact the banking

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[5] Banks are required to hold capital for credit risk following in general Basel I rules. Banks meet this requirement by holding mainly share capital and retained earnings.

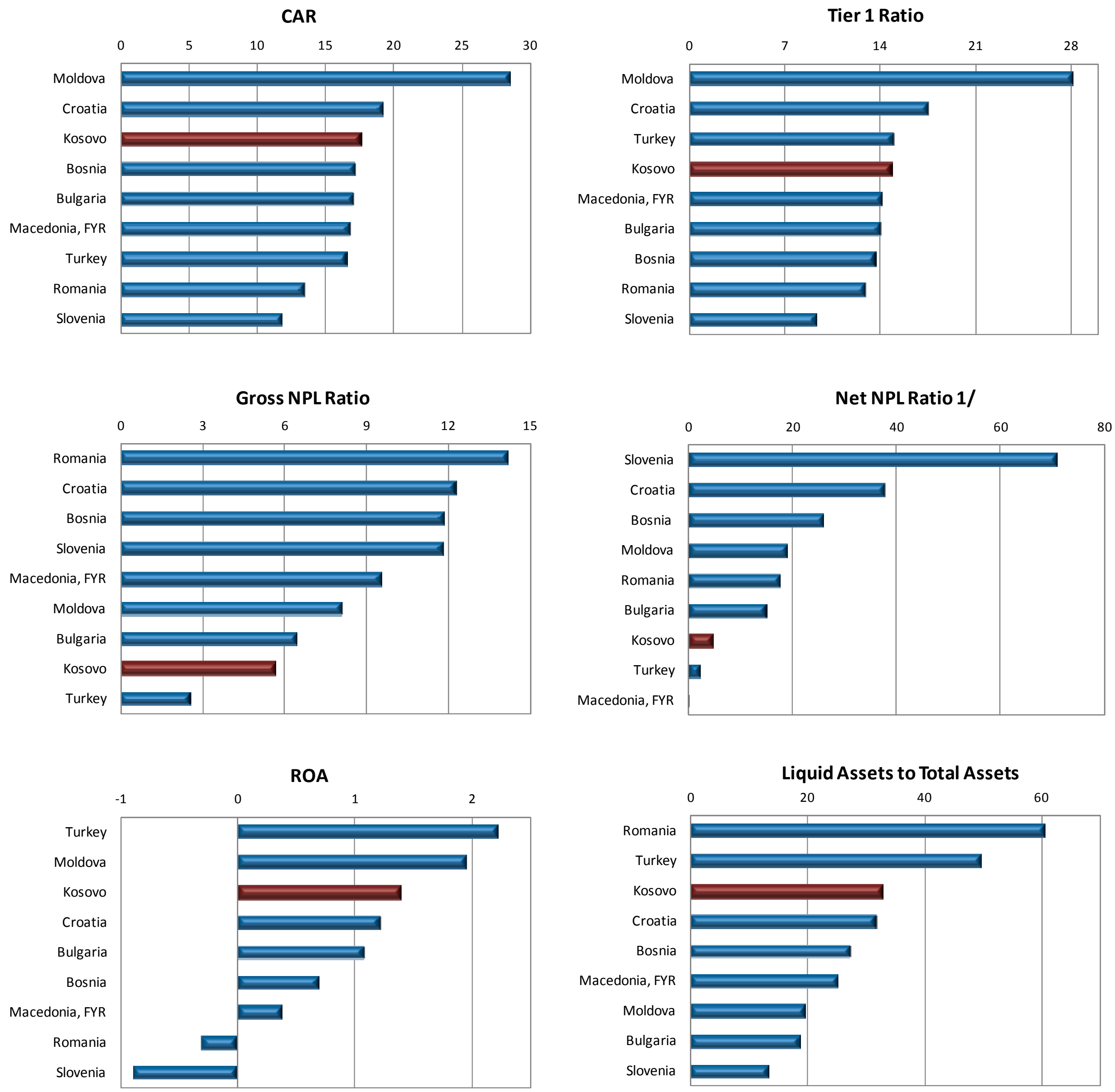
[6] The six locally incorporated banks and the two branches were included in the stress tests. However the focus of the exercise was on the locally incorporated banks. Branches are only required to maintain claims on Kosovo residents in excess of its liabilities to Kosovo residents.

Table 4. Kosovo: Financial Soundness Indicators
(in percent)

	2007	2008	2009	2010	2011	March 2012	June 2012
Capital adequacy							
Regulatory capital to risk weighted assets	17.5	16.5	18.1	18.8	17.6	18.0	17.2
Regulatory Tier I capital to risk-weighted assets	16.2	15.3	15.2	15.8	14.8	15.2	14.4
Asset quality							
Nonperforming loans to capital	2.8	3.0	2.9	5.4	4.4	4.4	5.2
Nonperforming loans to total gross loans	4.1	3.3	4.3	5.9	5.8	6.0	6.5
Distribution of loans by major segments							
Non financial corporations (% of total)	77.5	76.2	73.1	70.1	69.3	68.8	68.2
Households (% of total)	22.5	23.7	26.7	29.5	30.1	30.1	30.8
Financial institutions (% of total)	0.0	0.1	0.2	0.4	0.5	0.9	1.0
Government (% of total)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Profitability							
Return on assets	3.2	3.0	1.5	1.8	1.7	1.3	1.0
Return on equity	32.6	27.3	15.0	18.8	17.4	13.6	9.7
Net interest income to gross income	69.9	75.0	74.4	74.5	75.2	75.4	75.4
Noninterest expenses to gross income	68.2	68.7	80.2	74.3	76.8	80.9	86.6
Liquidity							
Liquid asset to total assets	26.6	28.0	37.3	36.8	31.3	30.4	28.9
Liquid asset to short-term liabilities	33.0	35.0	47.0	46.2	39.6	38.6	36.2
Foreign exchange risk							
Net open position in foreign exchange to capital		13.1	12.4	-0.1	2.5	-0.3	-2.4
Encouraged indicators							
Capital to assets	11.2	11.2	9.8	10.1	10.2	10.3	10.3
Large exposures to capital	38.3	56.5	64.6	72.4	77.8	76.7	80.9
Non-interest income to total income	25.1	20.2	19.0	19.1	18.7	18.5	18.6
Personnel expenses to noninterest expenses	35.8	36.2	39.4	39.4	38.7	38.4	38.4
Spread between domestic lending and deposit rates	10.1	9.4	10.1	10.9	10.2	10.5	9.9
Foreign currency denominated loans to total loans	…	…	…	0.2	0.4	0.4	0.4
Foreign currency denominated liabilities to total liabilities	3.9	4.7	5.4	4.9	4.9	4.9	4.6

Source: Central Bank of Kosovo and IMF staff estimates.

Figure 2. Kosovo: FSIs. Country Comparison
(In percent)



Source: IMF FSI Database

1/ NPLs net of specific provisions to capital.

system through a decline in remittances and FDI, a decline in the value of banks' holdings of European sovereign debt, higher counterparty risk from exposures to euro-zone banks, and a reduction in credit due to deleveraging by foreign-owned banks. Specifically, under this scenario GDP would decline by 2 percent, yields on European sovereign bonds held by banks would increase on average by 130 bps, and there would be an average increase in the default probability of European banks to which Kosovo banks are exposed of 140 percent (Figure 3 and Table 5).[7]

13. **The macro stress tests found the banking system to be generally resilient to further euro-zone deterioration but there are pockets of vulnerability among small and medium-sized banks and in one large foreign subsidiary** (Table 6).

- The two largest banks would remain above the regulatory minimum since the impact of higher losses on the capital ratio is partially mitigated by the projected reduction in risk-weighted assets driven by banks' deleveraging schedules to satisfy supervisory requirements abroad as well as by lower demand for credit due to the fallout from the euro-zone crisis. The remaining four locally incorporated banks are more vulnerable and their capital ratios would fall below the 12 percent minimum. The capital injection needed to restore their CARs to the minimum requirement would be about 0.2 percent of GDP.

- One large foreign bank subsidiary was viewed as more vulnerable, especially given the weaker state of its parent bank. If this subsidiary failed, other banks would not be directly affected due to limited domestic interbank linkages. However, the largest pension fund could be affected through its large deposit in the bank, which amounts to around 3 percent of its total portfolio.

- This analysis points to the need for supervisors to monitor credit growth and strengthen provisions in the more vulnerable banks, taking particular account of exposures to parent companies. Enhanced information exchange and coordination with relevant foreign supervisors may also be necessary.

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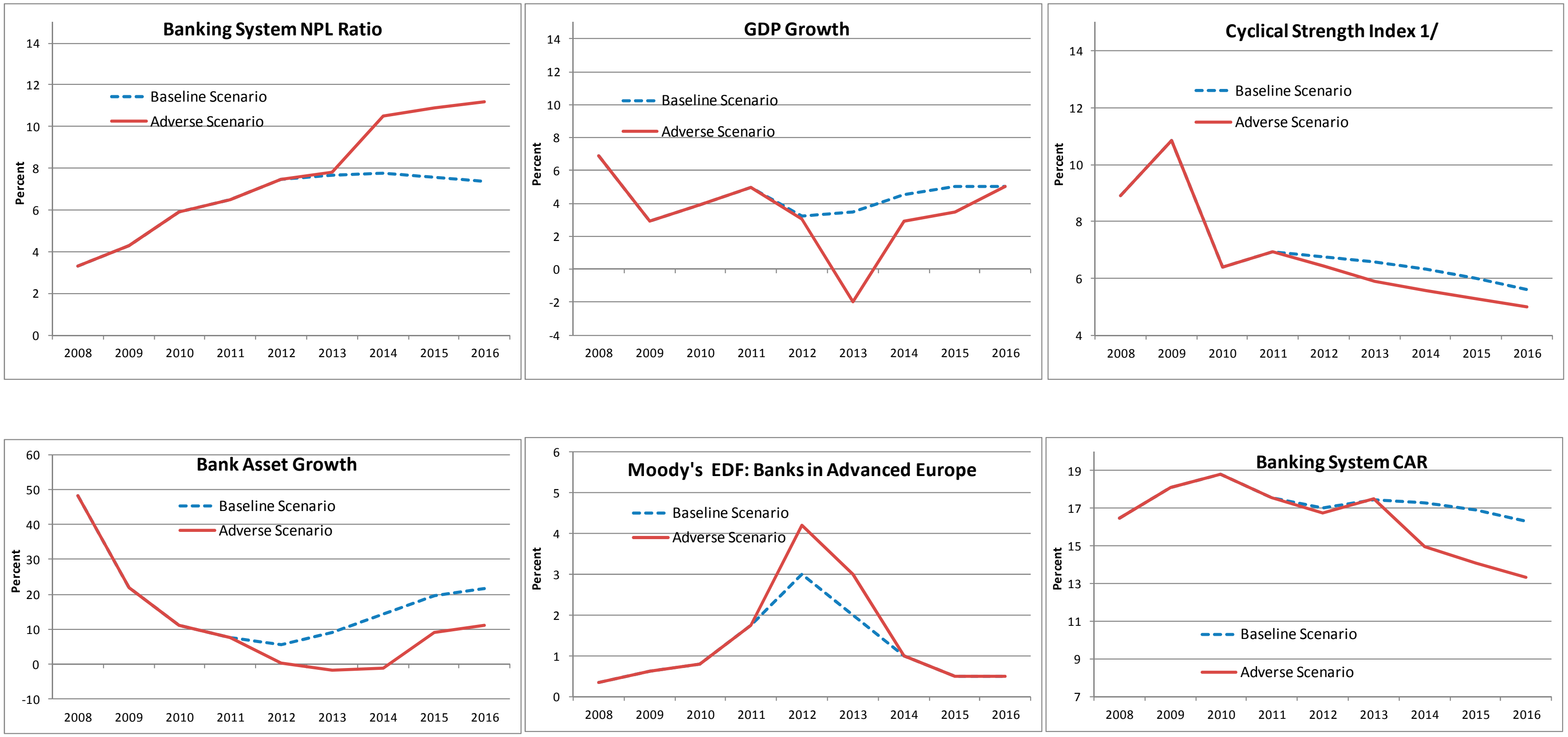
[7] Typical scenarios for FSAP stress tests include a shock to GDP of between one and two standard deviations. A 2 percent decline in GDP for Kosovo is equivalent to 3 standard deviations over Kosovo's short history. The overall impact of the scenario on banks' CAR is on average about 4.5 percentage points. Widening of sovereign spreads is consistent with the ninetieth percentile of historical daily changes in yields for a sample of European sovereign bond prices over the period 2006–2011. This in turn is equivalent to a weighted average haircut of about 5 percent. On average, European banks' default probabilities would increase from 1.8 to 4.2 percent under the adverse scenario.

Figure 3. Kosovo: Euro-Zone Recession Baseline and Alternative Scenarios



Source: Central Bank of Kosovo and IMF staff estimates.

1/ The cyclical strength index is defined as the ratio of German labor costs over Kosovo CPI, multiplied by the ratio of nominal imports to nominal exports. Higher values of the index correspond to higher remittances and lower default rates.

Table 5. Kosovo: Euro-Zone Recession Scenario—Assumptions

(In percent unless indicated otherwise)

	Actual				Projections				
	2008	2009	2010	2011	2012	2013	2014	2015	2016
Baseline									
Demand side shocks									
Real GDP growth 1/	6.9	2.9	3.9	5.0	3.2	3.5	4.5	5.0	5.0
Cyclical strength index 2/	8.9	10.8	6.4	6.9	6.8	6.6	6.3	6.0	5.6
Supply side shocks									
European banks' EDFs	0.3	0.6	0.8	1.8	3.0	2.0	1.0	0.5	0.5
NPL ratio	3.3	4.3	5.9	6.5	7.5	7.7	7.8	7.6	7.4
Bank asset growth		21.9	11.0	7.6	5.7	9.0	14.2	19.5	21.7
Banking system CAR	16.5	18.1	18.8	17.6	17.0	17.5	17.3	16.9	16.3
Adverse scenario									
Demand side shocks									
Real GDP growth 1/	6.9	2.9	3.9	5.0	3.0	-2.0	2.9	3.5	5.0
Cyclical strength index 2/	8.9	10.8	6.4	6.9	6.4	5.9	5.6	5.3	5.0
Supply side shocks									
European banks' EDFs	0.3	0.6	0.8	1.8	4.2	3.0	1.0	0.5	0.5
NPL ratio	3.3	4.3	5.9	6.5	7.5	7.8	10.5	10.9	11.2
Bank asset growth		21.9	11.0	7.6	0.4	-1.7	-1.2	9.0	11.1
Banking system CAR	16.5	18.1	18.8	17.6	16.8	17.5	14.9	14.1	13.3

Source: National authorities and IMF staff estimates.

1/ GDP growth for 2011 is an estimate.

2/ The cyclical strength index is defined as the ratio of German labor costs over Kosovo CPI, multiplied by the ratio of nominal imports to nominal exports. Higher values of the index correspond to higher remittances and lower default rates.

Table 6. Summary Stress Test Results—Solvency

	Banking system	Large banks	Medium and small banks	Number of banks with CAR: <8 percent	8-12 percent	>12 percent	Percent of bank assets with CAR: <8 percent	8-12 percent	>12 percent	Recapitalization 1/ (percent of GDP)
CAR	17.2	19.4	11.9	1	0	7	6	0	94	0.0
Adj.CAR 2/	17.2	19.4	11.7	1	0	7	6	0	94	0.0
Credit Risk										
50 percent NPL increase/one-notch downgrade	15.7	18.0	10.0	1	2	5	6	11	83	0.0
80 percent NPL increase/two-notch downgrade	12.9	15.3	6.8	2	2	4	10	16	74	0.2
100 percent NPL increase/three-notch downgrade	11.1	13.6	5.1	3	3	2	17	51	33	0.5
Credit Concentration Risk										
Default of large borrowers										
Single largest borrower	15.8	18.0	10.2	1	1	6	6	6	88	0.0
Three largest borrowers	13.7	16.2	7.6	2	3	3	12	31	58	0.2
Five largest borrowers	11.9	14.6	5.4	3	2	3	17	26	58	0.5
Default of large common borrowers										
Single largest common borrower	15.9	18.4	9.8	1	0	6	6	0	94	0.0
Three largest common borrowers	15.3	17.7	9.6	1	0	6	6	0	94	0.0
Five largest common borrowers	14.7	17.0	9.1	1	1	5	6	10	84	0.0
Sectoral concentrations										
100 percent increase in NPLs in trade sector	14.1	16.5	8.2	1	3	3	6	21	72	0.1
100 percent increase in housing/construction NPLs and 20 percent decline in property prices 3/	16.3	19.0	9.9	1	0	6	6	0	93	0.0
Interest Rate Risk										
100 basis points shock	15.6	17.5	10.9	1	0	7	6	0	94	0.0
200 basis points shock	13.3	14.4	10.6	1	2	5	6	26	69	0.1
Exchange Rate Risk										
20 percent depreciation	17.1	19.3	11.7	1	0	7	6	0	94	0.0
40 percent depreciation	17.0	19.2	11.7	1	0	7	6	0	94	0.0
Systemic Risk Scenarios										
Default of two local banks 4/	15.8	18.9	8.4	2	0	6	12	0	88	0.3
Default of parent banks on:										
Maximum exposure to subsidiary by regulation 5/	15.6	17.3	11.4	1	1	6	6	10	85	0.0
Actual exposure to subsidiary 6/	15.1	16.6	11.4	1	2	5	6	26	69	0.1
Failure of a large bank:										
Impact on banking system 7/	14.9	16.1	11.9	2	0	6	22	0	78	0.7
Impact on pension fund assets (percent change in value) 8/	-3.1									
Euro Zone Recesson Scenario 9/										
Baseline										
Shock to NPLs and credit growth	16.3	18.3	11.3	1	2	5	6	11	83	0.0
Combined with shock to European bond yields 10/	16.3	18.3	11.3	1	3	4	6	27	67	0.1
And with shock to European bank placements	16.2	18.2	11.3	1	3	4	6	27	67	0.1
Impact on pension fund portfolios (percent change in value) 11/	-3.3									
Adverse scenario										
Shock to NPLs and credit growth	13.3	15.1	8.9	1	3	4	6	21	74	0.2
Combined with shock to European bond yields 10/	12.9	14.6	8.5	1	4	3	6	37	58	0.2
And with shock to European bank placements	12.7	14.4	8.4	1	4	3	6	37	58	0.2
Impact on pension fund portfolios (percent change in value) 12/	-14.2									
Adverse scenario and a default of a large bank3/	11.9	13.4	8.4	2	3	3	22	21	58	0.6

1/ The two foreign branches are excluded from the calculation of the recapitalization needs since they are not supposed to meet the minimum capital requirement. One branch's CAR is below 8 percent before the stress tests.
2/ Adjusted by the mission team to account for shortfalls in required provisioning.
3/ A shock to the default rate in the housing and construction sector, which also applies a 20 percent reduction in collateral valuations due to a decline in home values.
4/ All systemic risk scenarios do not consider banks' profits as a buffer and assume zero credit growth. The two largest net borrowers in the domestic interbank market default on exposures to other local banks. The capital of the two banks and their liabilities to other banks are written down to zero.
5/ All subsidiaries are assumed to increase their exposure to parent to the limit of 15 percent of Tier 1 capital, which is the maximum permitted by regulation.
6/ Includes a failure of a parent on its exposure to the subsidiary in Kosovo, which is equivalent to 36 percent of its capital.
7/ A parent declares bankruptcy and the capital of the subsidiary is written down to zero. The total loss to the banking system is assumed to be equivalent to the subsidiary's capital and liabilities to other institutions.
8/ The pension fund is assumed to lose its deposit in subsidiary.
9/ The year with maximum impact on CAR over the estimation period (2012-2016).
10/ Haircut corresponding to the 50th percentile of historical bond yields using a duration approximation formula and a 5-year duration assumption.
11/ Haircut corresponding to the 50th percentile of historical bond yields plus a 5 percent decline in equity valuations.
12/ Haircut corresponding to the 90th percentile of historical bond yields plus a 20 percent decline in equity valuations.
13/ In addition to the macro effects of the adverse European scenario a parent is assumed to default on its liabilities to subsidiary in Kosovo.

14. **Sensitivity tests found that banks are vulnerable to their highly concentrated portfolios and to interest rate risk while exchange rate risk is negligible.**

- Large concentrations are present despite the fact that some large corporate clients borrow from several banks. Such exposures to common borrowers could induce correlation risk in the system and the CAR of one bank with a 10 percent market share would fall below 12 percent if the five largest common borrowers in the system defaulted. Some banks would also be vulnerable to a further deterioration of loan quality in the trade sector. This assessment points to the need to ensure that the new regulation on large exposures is enforced in the planned schedule, and to avoid exceptions to the large exposure limits.[8]
- Interest rate risk is driven by maturity mismatches between interest-sensitive assets and liabilities. A parallel shift of 200 basis points in interest rates would bring two banks representing more than 25 percent of the system below the 12 percent CAR minimum. Supervisors should therefore start monitoring interest rate risk and its potential impact on earnings and asset values.[9]
- Direct and indirect exchange rate risks are low because banks on average maintain small open foreign exchange positions and loans in foreign currency are less than 2 percent of total assets.

15. **Liquidity stress tests show that current liquidity arrangements could cope with mild to medium-severity deposit runs** (Table 7).[10] Current liquidity arrangements include a targeted loan-to-deposit ratio of 80 percent imposed by supervisors by moral suasion, which most banks meet while investing most of the remaining deposits abroad, and the Emergency Liquidity Assistance (ELA) fund described in section V.

- The outcome of the systemic liquidity tests suggests that cumulative deposit outflows of 15 percent of total deposits, combined with a 10 percent haircut on liquid assets, would be enough to deplete banks' excess liquidity, bringing the liquid assets of the banking system slightly below 20 percent of total deposits.[11]
- A 30 percent outflow, combined with a 20 percent haircut on liquid assets, would nearly deplete the liquid assets of the banking system. The total liquidity assistance needed to enable the banks meet these withdrawals would be equivalent to 2.2 percent of GDP.

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[8] As of October 2012, the exposure to a single person or a group of connected persons has been lowered to 15 percent of Tier 1 capital (from 20 percent).

[9] These outcomes are based on data on contractual maturities, in which all assets with a maturity greater than one year are grouped in one bucket.

[10] The history of bank runs includes loss of customer deposits of about 30 percent in 9 months (Argentina 2001) and 57 percent in 12 months (Northern Rock). Typical stress tests in FSAPs include run off rates of about 10–50 percent. For more references see IMF Working Paper No. 12/03.

[11] Excess liquidity in this section is defined as liquid assets above 20 percent of bank deposits, which is roughly an implicit liquidity ratio targeted by supervisors.

Liquidity assistance of up to 1 percent of GDP can be covered by the ELA fund and up to 2 percent of GDP, if CBK equity and reserves are included. This outcome does not take into account the fact that some foreign-owned banks may be able to borrow from their foreign parents if needed and that haircuts to liquid assets could be much lower if the runs were triggered by local factors.

- Available ELA funds would be able to fully cover liquidity needs of the two smallest banks (which hold 2 and 5 percent of total deposits respectively) in the event of a run that would affect just these banks.
- Deposit concentration appears significant. A simultaneous withdrawal of the ten largest private deposits in each bank, which overall account for around 10 percent of total deposits, would reduce the ratio of liquid assets to total deposits of the banking system from 34 percent to around 27 percent. One small bank would run out of liquid assets and the total amount of liquidity needed to meet the withdrawals would be around 0.3 percent of GDP. Supervisors should use information on deposit composition by size to identify potential vulnerabilities arising from deposit concentration.

B. Nonbank Financial Institutions

16. **The two pension funds are still vulnerable to a sharp correction in equity markets.** The 2008–2009 crisis negatively affected the investment performance of the two pension funds: Kosovo Pension Savings Trust (KPST, a mandatory defined contribution scheme) and Slovenia-Kosovo Pension Fund (SKPF, a voluntary scheme). KPST was predominantly invested in equities and suffered a considerable decline in portfolio market valuations in 2009. Since then, it has reduced its equity holdings. However, a correction in stock market valuations of around 20 percent would result in a decline in the value of the funds' portfolios of around 14 percent. Sovereign bond holdings are also significant.[12] Market risks are born by pensioners but the funds bear liquidity risks in case redemptions exceed expectations. So far, this has not happened, as the funds have limited liabilities due the young age of the population. Interlinkages with other institutions are limited to deposits with banks, which are collateralized by pledged securities.

[12] Sovereign bonds represent about 28 percent of KPST's assets, of which about 90 percent are exposures to Germany, U.S., France, U.K. and Netherlands. Sovereign bonds represent about 70 percent of SKPF assets of which about two thirds are exposures to Slovenia, Hungary, Netherlands, U.K., Italy, U.S., and Luxembourg. SKPF is managed by a Slovenian group. SKPF's exposure to Slovenian sovereign bonds is about 14 percent of its total sovereign bond portfolio. SKPK's equity exposure is low and mainly to French and U.S. corporates.

Table 7. Summary Stress Test Results—Liquidity

	Banking system			Large banks			Medium and small banks			Domestic banks			Foreign banks		
	Liquid assets to total deposits	Number of banks with a liquidity shortfall 1/	Liquidity assistence needed (% of GDP) 2/	Liquid assets to total deposits	Number of banks with a liquidity shortfall 1/	Liquidity assistence needed (% of GDP) 2/	Liquid assets to total deposits	Number of banks with a liquidity shortfall 1/	Liquidity assistence needed (% of GDP) 2/	Liquid assets to total deposits	Number of banks with a liquidity shortfall 1/	Liquidity assistence needed (% of GDP) 2/	Liquid assets to total deposits	Number of banks with a liquidity shortfall 1/	Liquidity assistence needed (% of GDP) 2/
Initial position (June 2012)	34.0	0	0.0	36.0	0	0.0	29.4	0	0.0	36.1	0	0.0	33.8	0	0.0
Systemic deposit run															
10 percent outflow/5 percent haircut 3/	24.8	0	0.0	26.9	0	0.0	19.9	0	0.0	27.0	0	0.0	24.5	0	0.0
15 percent outflow/10 percent haircut	18.4	1	(0.1)	20.5	0	0.0	13.5	1	(0.1)	20.6	0	0.0	18.1	1	(0.1)
20 percent outflow/15 percent haircut	11.2	2	(0.5)	13.2	0	0.0	6.2	2	(0.5)	13.4	0	0.0	10.9	2	(0.5)
25 percent outflow/20 percent haircut	3.0	3	(1.2)	5.0	1	(0.3)	(2.0)	2	(0.9)	5.2	0	0.0	2.7	3	(1.2)
30 percent outflow/20 percent haircut *	(3.9)	4	(2.2)	(1.7)	1	(0.9)	(9.3)	3	(1.3)	(1.6)	1	(0.1)	(4.3)	3	(2.1)
Run on a large bank															
35 percent outflow of subsidiary's deposits/ 50 percent haircut	27.2	1	(0.5)	26.2	1	(0.5)	29.4	0	0.0	36.1	0	0.0	26.0	1	(0.5)
Deposit run contingent upon the banks'															
16.5 percent outflow/ 20 percent haircut	12.8	1	(0.1)	14.2	0	0.0	9.7	1	(0.1)	12.0	0	0.0	12.9	1	(0.1)
Deposit run contingent upon the parents'															
23 percent outflow/ 20 percent haircut	5.2	3	(1.7)	3.0	2	(1.5)	9.7	1	(0.1)	12.0	0	0.0	4.3	3	(1.7)
Withdrawal of:															
Large public deposits 4/	30.3	0	0.0	32.8	0	0.0	24.0	0	0.0	33.9	0	0.0	29.8	0	0.0
Three largest private deposits 5/	29.6	1	(0.1)	32.5	0	0.0	22.5	1	(0.1)	30.7	0	0.0	29.5	1	(0.1)
Five largest private deposits 6/	28.6	1	(0.2)	31.9	0	0.0	20.3	1	(0.2)	28.4	0	0.0	28.6	1	(0.2)
Ten largest private deposits 7/	26.7	1	(0.3)	30.7	0	0.0	16.3	1	(0.3)	24.9	0	0.0	27.0	1	(0.3)

Source: Central Bank of Kosovo and IMF staff estimates.

Note: (*) indicates approximately the maximum deposit run that could be covered by the emergency liquidity assistance fund (ELA) and the Central Bank's other available resources (e.g. capital and reserves), which together amount to around 2 percent of GDP.
1/ Number of banks with insufficient liquid assets to meet the withdrawals.
2/ Liquidity assistence needed by the banking system to meet the withdrawals.
3/ Cumulative outflow of total deposits, haircut on liquid assets.
4/ An outflow of approximately 5 percent of total deposits.
5/ An outflow of approximately 6 percent of total deposits.
6/ An outflow of approximately 8 percent of total deposits.
7/ An outflow of approximately 10 percent of total deposits.

17. **Although insurance companies do not pose systemic risks, given limit linkages to the banking sector, its financial fundamentals are very weak.** Specifically, four out of 10 nonlife companies are technically insolvent when assessed against EU Solvency I rules, and three have insufficient liquid assets to cover their current technical provisions, which in turn appear to be considerably understated. Despite the existence of a minimum Motor Third Party Liability (MTPL) premium and a maximum agents' commission rate, fierce competition often forces insurers to resort to discounts and rebates to clients and additional compensation to agents. As a result, in 2011, most companies recorded negative underwriting income from this large line of business and the average return on equity (ROE) was 2 percent. Risks also arise from the underestimation of technical provisions by many insurers, and the insufficient amount of liquid assets available in the market to support existing provisions.

18. **In case of insolvency of insurance companies, outstanding claims will have to be paid by the Motor Compensation Fund (MCF).**[13] This fund currently has about €2 million in capital. As the Fund annually collects over €10 million in premiums from the sales of "border policies," it is unlikely to experience financial difficulties from covering outstanding claims against one or even two bankrupt companies. However, in the medium term, with the disappearance of the "border policy" revenue following Kosovo's joining the Green Card system, the ability of the MCF to pay claims could be jeopardized.[14]

19. **The insurance industry is also facing growing reputational risk due to a poor record of claim payment.** This will likely hamper growth and development in the near future. CBK should enact and implement a regulation to introduce an out-of-court insurance dispute resolution mechanism (e.g., private arbitration with binding decision powers), in order to address the growing volume of consumer complaints against insurers and the lack of technical capacity of local courts to properly address insurance related disputes

20. **After almost a decade of fast growth, microfinance institutions (MFIs) have contracted in recent years.** Total MFI assets are now about 2 percent of financial system assets, down from 5 percent in 2007. The main reasons include governance concerns resulting in CBK putting the largest MFI under official administration and freezing its lending activities; reluctance of MFIs investors to increase capital due to regulatory uncertainty; fraud cases in some of the largest MFIs that resulted in credit losses; and a refocus of the MFIs on smaller loans. As of June 2012, the current level of loan impairment (loans past due 30 days or more)

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[13] The motor compensation fund established as per article 32 of the MTPL law pays the MTPL claims arising from (a) uninsured or unidentified vehicles and vehicles bearing border insurance as well as cases of the MTPL bankrupt insurers.

[14] The "border policy" is currently a prerequisite for almost all foreigners entering the country by car because Kosovo does not belong to the international Green Card system. The Green Card System is an international motor insurance card agreement between authorities and insurance organizations of multiple states by which insurers provide compensation for accidents taking place in a country different from the one in which the policyholder resides. By extending the insurance coverage territorial scope, motorists do not need to obtain a new policy in each country they visit.

was 9.2 percent while returns on assets (ROA) and on equity (ROE) were 0.6 percent and 0.4 percent respectively. As of June 2012, annualized profitability was significantly negative. MFIS have their accounts with commercial banks, and in some cases, commercial banks have granted credit lines to MFIs for onlending purposes. However, most of MFI funding comes from external sources. Given the size of MFIs, none of these transactions appears to pose systemic risk.

III. Financial Sector Oversight

A. Banking

21. **The assessment of the Basel Core Principles found an uneven level of compliance with international standards, primarily due to resource constraints.**[15] Key areas that should be addressed include: upgrades to the legal framework; development of a risk-based forward looking supervisory program; consolidated supervision and closer coordination with foreign supervisors and a continuation of the capacity building in supervision. As established in the CBK Law, the CBK is responsible for the regulation and supervision of commercial banks, microfinance companies, insurance companies and other financial service providers.

22. **Some areas of banking legislation and regulation would need to be completed or modified to ensure consistency**. The CBK was established in 2008 after the declaration of independence of Kosovo, as the successor to the Banking and Payments and the Central Banking authorities of Kosovo, which had been created in 2000. In order to build the necessary institutional capacity, many public institutions in Kosovo have been recipients of intensive and prolonged—and sometimes contradictory—international technical assistance. While this assistance has permitted the establishment of many key institutions in a very short period of time, it may have also overburdened the capacity of local officials to carry out the necessary critical analysis to make the regulatory framework fully consistent and sufficiently comprehensive.

23. **Banking supervision has to be conducted under very challenging—and sometimes even hostile—circumstances resulting from the political and security context of the country**. The fact that the declaration of independence of Kosovo has not been universally recognized internationally poses significant challenges to the CBK, as it tries to exercise its authority in certain areas of the country. For example, two commercial banks licensed in the Republic of Serbia that have operations in the northern part of Kosovo (Mitrovica, a Serbian-majority enclave) are not as intensively supervised as the banks operating in the rest of the country.[16]

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[15] The summary assessment is included as Annex I.

[16] One of these banks, the larger one, has obtained a foreign bank branch license by the CBK and regularly reports to it, but *ad-hoc* arrangements for its on-site examinations had to be put in place to accommodate for the hostile circumstances. More specifically, recognizing the social and political tensions existing in the Mitrovica area, the CBK accepted to carry out the on-site examination at a sub-branch outside of the enclave and closer to Pristina. As

(continued)

24. **The political tensions and the fact that banks operating in northern Kosovo are not regularly supervised by either banking authority have a direct bearing on the CBK's effectiveness as a bank supervisor.** Consequently, the ratings for the principles on permissible activities, ongoing supervision of banks and enforcement of corrective actions reflect the bank and supervisory standoff in Mitrovica. There is no evidence that either the Serbian or the Kosovo banking supervisory authorities are conducting the necessary supervision on these institutions. While the CBK tried to undertake an on-site examination of the bank, and reportedly even requested assistance "for security reasons" to Eulex Kosovo, in the end it had to accommodate to *ad hoc* arrangements that, while reasonable, are only second-best solutions for this situation. In this regard the assessors want to highlight the importance of the issue given its potential for escalated tensions in the region in the event a bank was to experience liquidity or other difficulties.

25. **The Anti Money Laundering (AML) law has significant gaps that could affect the effectiveness of AML activities in the banking sector.** An UN Interim Administration Mission in Kosovo (UNMIK) regulation on AML was in effect until 2010, when the Assembly of Kosovo approved the Law on the Prevention of Money Laundering and Terrorist Financing. As reported to the assessors, this Law presents several technical deficiencies, including the lack of specific provisions giving authority to the CBK or the Financial Intelligence Unit to carry out compliance inspections in several types of institutions, most notably banks. Furthermore, this Law provides insufficient protection to bank officials filing reports to the FIU in the discharge of their responsibilities.[17]

26. **Notwithstanding some progress, supervision of banks is still largely based on the review of the level of compliance with existing rules, and not on the risk profile of the entities.** The supervisors use the Capital-Assets-Management-Earnings-Liquidity-Sensitivity to market risk (CAMELS) internal rating system, and this approach has been helpful to identify problems. However, important challenges need to be addressed before a truly risk-based supervisory system is in place. Except in the assessment of the credit risk embedded in banks' loan book, which currently receives sufficient attention, especially during on-site examinations, the supervisory process does not sufficiently address some risks that are already very important to the banking sector of Kosovo.

27. **Implementing a risk-based supervisory regime in Kosovo is needed, especially for the three systemic banks.** The supervisory process has to be substantially enhanced to ensure that the risks of the foreign banks are sufficiently understood and monitored by the CBK on a

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regards the smaller institution, which is headquartered in Mitrovica, it has not even been licensed in Kosovo, as it does not recognize the authority of the CBK and still considers the National Bank of Serbia as its supervisory authority. Finally, while two branches of a small Serbian-based bank were closed by the CBK in July 2012 for not having a banking license, some other irregularities still persist, affecting the capacity of the supervisor to control all banking activity taking place in its remit.

[17] In line with FSAP policies, an AML/CFT assessment is scheduled to be conducted by the World Bank by mid-2013.

regular basis, so timely action can be initiated, to the extent possible. In addition, operational, interest rate and liquidity risks are prevalent in the system, but have not received the necessary supervisory attention yet. Market risk is currently limited; however it is likely to increase its importance in the near future as the securities market develops.

28. **Legal protection for banking supervisors and other CBK employees was found to be inadequate.** The legal framework explicitly mentions that a member of the Central Bank's decision-making bodies or its staff shall not be liable for acts or omissions performed in the course of the duties and responsibilities, unless it has been proven that such acts or omissions constitute intentional wrongful conduct or gross neglect. It additionally indicates the obligation of the CBK to indemnify them for the legal costs they have incurred in these cases. However, actual cases demonstrate that in practice employees had to cover all the costs resulting from their legal defense until being definitively cleared of any wrongdoing. Only then were staff entitled to claim the reimbursement of these legal costs from the CBK. Discussions with CBK staff indicated that these defense costs may be substantial and the process of getting definitive acquittal can take a long time. Furthermore, even if the employee is cleared of criminal acts, CBK may challenge the expenses submitted and not reimburse any costs until the claimant gets the official declaration from a Court of Justice compelling the CBK to pay for the expenses borne. The lack of proper coverage appears to be a cross-cutting issue, as it applies to bank and other financial sector supervisors, and to deposit insurance fund employees.

29. **The CBK has exercised the substantial authority that the legal framework assigns it as supervisor.** In the recent past, CBK has temporarily prohibited the payment of dividends; has required capital injections; and replaced management in banks, as well as closed the branches in Kosovo of an unlicensed bank

B. Nonbank Financial Institutions

30. **CBK main insurance regulation suffers from severe technical deficiencies and its adoption in 2007 represented a legislative setback with respect to the previous regulation**. Insurance activities are governed by UNMIK Regulation No. 2001/25 which covers licensing, supervision and regulation of insurance companies and insurance. The main regulation issued by the CBK, as the insurance market regulator, is the Regulation on Deposit of Assets as Security, Capital Adequacy, Financial Reporting, Risk Management, Investment and Liquidation, which came into effect on January 1, 2007, and replaced EU Solvency I. Another important pillar of the insurance regulatory framework is the new MTPL Law No 04/L-018 on Compulsory Motor Liability Insurance, which was passed in 2011.

31. **EU Solvency I framework should be reinstated as the main legal basis for monitoring, supervising and enforcing minimum solvency margin requirements.** When assessed against IAIS ICP principles, the existing regulatory framework is incomplete and inadequate. Despite numerous solvency and capital requirements, the current regulation falls short of establishing an adequate solvency and minimum risk capital supervision framework, which prevents the CBK from effective monitoring and supervision of the market and, at the

same time, allows companies to operate with considerably less surplus capital or solvency margin than would be required under the previous Solvency I regime. Among gaps in the existing regulations are the minimum requirements for calculating technical provisions; requirement of mandatory annual actuarial audits to be conducted by accredited and licensed actuaries; requirements for actuarial accreditation; and specification of potential liabilities for erroneous or misguided opinions. A new insurance law should also be approved to supersede all existing UNMIK regulations and provide a comprehensive legal foundation for insurance activities in Kosovo.

32. **The supervisory approach for MFIs is not related to the risks and sophistication of MFIs.** Both MFIs and NBFIs are non deposit taking institutions, regulated and supervised by CBK. The scope of permitted activities is broader for NBFIs than for MFIs, which can only lend to SMEs and low-income households. However, NBFIs do not have capital and licensing requirements, and have fewer restrictions on their activities while MFI regulations mimic that of banks. The legal framework should be amended to create a level playing field between MFIs and NBFIs. CBK should develop reporting requirements and supervisory processes appropriate to the risks posed by these institutions and ensure that regulatory requirements can promote growth in both sectors.

C. Payment System

33. **There is only one payment system in Kosovo**. It is a hybrid interbank payment system called the Electronic Interbank Clearing System (EICS), which is operated by the CBK and clears all priority payments, retail credit transfers, and retail direct debits. All commercial banks are participants in EICS, as is the CBK (both for itself and on behalf of the government). The system provides payments for large and low-value transactions. The CBK has initiated—with World Bank assistance—the implementation of a Real-Time Gross Settlement (RTGS) payment system for large-value transactions, which is expected to be completed by 2014.

34. **Non-cash payment instruments including checks are still not widely used.** The use of payment cards is still low, but their number as well as the number of transactions made by them has increased significantly over the past few years. All banks have their own networks of the Automated Teller Machines (ATM) and Point of Sale (POS) terminals. However, there is a limited cooperation among them for sharing their networks. The CBK has planned to tackle this area by initiating the establishment of a national card switch system to reduce costs and improve efficiency. Once implemented, the RTGS and the card switch system will significantly reduce settlement and systemic risks

35. **Implementation of earlier Fund technical advice on payment system oversight is mixed**. The recommendations on Legal and Regulatory Issues were taken into account by redrafting the Draft Law on the Payment Systems before sending it to the Government and the Parliament for further discussions. There are several recommendations on the organization of the oversight function that are being implemented at present by the CBK because they do not depend on the passing of the Payment System Law. For example, the oversight function has been

separated from the operation function by establishing two divisions in the Payment System Department. The hiring of an expert to head the oversight unit is proposed in the budget plan for the 2013. Other recommendations are still in the process of implementation, which mainly depends on the passing of the Law on Payment System. Detailed steps towards TA recommendations provided by the Fund to the CBK in 2011 on Payment System Oversight are presented in Appendix III.

IV. Issues in Macroprudential Oversight

36. **The CBK lacks an integrated framework for formulating and implementing policies to fulfill its primary responsibility for maintaining financial stability**. Such a framework would help counter potential macro instability that may arise from the opening of the economy and the lack of monetary policy instruments.

37. **The CBK should link a regular internal review of financial indicators to decisions on macroprudential policy, and strengthen policy transparency and accountability. To do this, it is recommended that:**

- The CBK should establish a Macroprudential Policy Advisory Committee (MaPaC), including participation of the Executive Board, the Financial Stability and Supervision Departments, and other relevant departments. The MaPaC should meet on a quarterly basis to review key indicators of macro-financial stability and evolving risks. On the basis of this assessment, the MaPaC should recommend policy measures to the Executive Board, which would then take decisions.
- Accountability and transparency arrangements should include a pre-announced schedule of meetings to decide on policy measures; press releases on decisions taken; publication of the Financial Stability Report, appearances by the Governor before the Assembly Budget and Finance Committee, as well as briefings for banks, press and analysts.

38. **To make macroprudential policy operational, the CBK will need to establish a set of primary indicators for assessing different aspects of financial stability and assign instruments to be used to manage those risks.** For these purposes it is useful to distinguish between structural vulnerabilities—structural characteristics of the financial system which may accentuate the potential for spillovers or contagion of shocks—and cyclical vulnerabilities which refer primarily to vulnerabilities which vary substantially over time, generally reflecting the state of the business cycle and risks in the real economy.

39. **Cyclical vulnerabilities include both those associated with excessive credit expansion and with liquidity risks.** To address these, the CBK will need to select a few key indicators that can be monitored on a regular and timely basis, to serve as intermediate policy guides. For leverage or credit vulnerability, the CBK could consider focusing on broad indicators for the banking system such as a bank leverage ratio or, possibly, a credit/GDP ratio. For liquidity, CBK might focus primarily on a bank loan/deposit ratio (LDR).

40. **A principal challenge is to determine indicator values, or ranges, which are judged to be consistent with financial stability, and values that should trigger policy action.**

- Stress testing may have an important role to play in such analysis. In this regard, it is recommended that stress tests be based on macroeconomic analysis.

- The CBK should also monitor a range of additional indicators in each of the main vulnerability assessment areas which will assist in interpreting developments in the primary indicators.

- The use of such ancillary indicators and stress tests should be particularly useful in distinguishing between developments affecting the financial system in general as opposed to specific institutions, and between developments which are likely to be self-correcting and more persistent trends calling for policy actions.

41. **Data limitations make the task of determining appropriate indicators particularly challenging.** The lack of timely, good quality macroeconomic data and the fact that the structure of the economy and financial system has evolved significantly over the past decade makes it difficult to distinguish between cyclical and structural movements in macroprudential indicators. Clearly, an important priority will need to be the improvement of basic macroeconomic indicators, as well as research on indicators of the business cycle in Kosovo.

42. **The CBK will also need to determine a set of instruments to be used in response to financial stability risks.** For example, for excessive leveraging or credit growth, instruments might include limits on loan-to-value or debt- or debt service-to-income ratios for households, analogous measures for firms, and adding a countercyclical element to bank capital requirements. With regard to liquidity, the CBK could consider introducing a countercyclical component to its reserve requirements for banks. A rules-based approach, in which instrument settings are adjusted systematically in response to risk indicators, facilitates policy consistency over time, helps preserve policy independence, and helps overcome inertia in policy making. Such policy rules, however, may need to be supplemented by judgment and should only serve as a starting point in decision making, which generally requires taking into account a broader range of information.

V. Financial Sector Safety Nets and Crisis Management

A. Emergency Liquidity Assistance

43. **Emergency Liquidity Assistance (ELA) was introduced in 2010 for solvent banks and insolvent but systemically important ones**. The new Central Bank Law (CBL) and a regulation on ELA enable the CBK to provide liquidity assistance for solvent but illiquid banks up to 100 percent of Tier 1 capital. The CBL also grants the CBK power to provide emergency liquidity to banks that may be insolvent, if their failure may have adverse implications for financial stability. Initially, ELA can be granted for up to 28 days. Any extension beyond three

months requires a program to be approved by the CBK's executive board specifying remedial actions to be taken by the bank.

44. **Staff does not support the use of ELA for insolvent banks, even in the case of systemic importance.** If this feature is maintained, this type of ELA should be subject to very strict conditions. These should include at least a previous declaration of systemic crisis and a guarantee issued by the Government in writing securing the repayment of the loan.

45. **Resources available for ELA operations amount to approximately €90 million.** This is equivalent to about 5 percent of bank deposits subject to reserve requirement, or 2 percent of GDP and would seem adequate to contain liquidity problems in one or two small banks.[18]

46. **Since banks are the beneficiaries of ELA, it is appropriate for them to bear at least part of the costs**. ELA serves, in effect, as a collective insurance for the industry, so that each bank does not have to fully self-insure. Currently this insurance is provided free, distorting behavior in favor of greater maturity mismatching. Introducing a premium, based on each bank's deposit base subject to reserve requirements, could both help maintain the current size of the fund relative to deposits and improve incentives for bank funding strategies.

47. **An ELA premium, equivalent to 0.3 percent annually of bank deposits subject to reserve requirements would ensure that ELA funds would remain relevant**. A premium of this size applied to the current deposit base subject to reserves, would amount to around €5.3 million and would be consistent with growth of the deposit base by about 6 percent per year. If growth of the deposit base differed significantly from this, it would be appropriate to recalibrate the premium. ELA premiums would be pooled in the SRF.[19]

48. **If a significant increase in ELA funding is judged appropriate, a reserve pooling arrangement could be considered**. Reserve pooling has been adopted by Ecuador, and is being considered in Panama and El Salvador and typically involves allocating a portion of each bank's required reserves to a pool administered by the central bank, and which could be made available for ELA purposes to other banks.

49. **Collateral requirements for ELA appear too restrictive**. Acceptable collateral for ELA include government of Kosovo securities, securities of EU countries and of banks registered in the EU, as well as liquidity reserves at CBK. These collateral requirements may

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[18] Total deposits were about €2 billion as of June 2012. Each of the largest banks holds about 10–30 percent of total deposits, while each of the remaining banks hold about 2–6 percent of total deposits. The Ministry Of Finance (MoF) used the purchase of about €46 million tied to the first program review to fund the central bank's special reserve fund (SRF) for ELA and the rest is available from the CBK's own resources. Amendments made in 2012 to the Law on Public Financial Management and Accountability state that only with the consent of the CBK may the Treasury withdraw the SRF assets; and the letter of intent and other program documents indicate that the SRF will remain available for ELA independently of the repayment of the IMF facility.

[19] It may be noted that in Ecuador, which also lacks its own currency, the ELA arrangements are entirely funded by the banks. The premium is equivalent to 0.25 percent of deposits subject to reserve requirements.

impair the scope for the CBK to respond in the event of a systemic crisis, and consideration should be given to also include certain types of loan portfolio, subject to appropriate haircuts.

50. **No operational procedures have been established for ELA yet**. In case of sudden surge in deposit withdraws, banks might need immediate access to ELA, which should be fully operational. To do so, detailed operational procedures are required, such as draft contracts, designation of tasks and responsibilities, as well as a solvency analysis. CBK should develop a remedial program when ELA is initially granted—and not just upon ELA renewal. This should be paired with enhanced monitoring by the Supervision Department.

B. Resolution of Problem Banks

51. **The CBK is the resolution authority and the recently approved Banking Law provided it with new resolution tools, which include**:

- The appointment of an official administrator, following specific triggers, who takes over the powers of the bank's shareholders and management.
- The official administrator must prepare a resolution plan within 60 days of appointment. The official administrator can propose that assets and/or liabilities be transferred to another bank under a Purchase and Assumption (P&A) transaction before the bank license is revoked; or liquidation can be initiated. If the bank is not rehabilitated within one year, the bank's license will be revoked (Article 61). CBK can also revoke a license directly and transfer assets and/or liabilities by initiating receivership. The liquidator is appointed by the CBK. Payment of insured deposits takes place after the bank license is revoked and receivership is initiated.
- The possibility of creating a bridge bank.

52. **The Government should amend the banking law to address shortcomings in the bank resolution framework.** The legal definition of P&A should include the transfer of liabilities and assets (articles 68.4 and 73.22 of the Banking Law). To minimize litigation risk, P&A should only be performed after the license is revoked. To reduce resolution costs the option of creating a bridge bank should be limited to systemic banks. A clearly formulated least-cost test should be introduced to guide the choice among resolution options, including between liquidation and P&A. CBK should be tasked with performing this test. CBK should also formalize existing policies and procedures in a bank intervention and resolution manual.

53. **CBK decisions can be challenged in court, but cannot be overturned.** Decisions by CBK or its agents cannot be overturned in court but can warrant compensation in case actions are found to be unlawfully, arbitrary or capricious. This is a good feature since it ensures prompt resolution of problem banks. However, there are consequences for the protection of CBK staff that are discussed in paragraph 39.

C. Deposit Insurance

54. **The DIFK was created by Law in 2010 and became operational in 2011.** Several amendments to the Deposit Insurance Law (DIL) are currently before Parliament (expected to be passed by end-2012) to improve and clarify the DIL structure and operations.

55. **DIFK is an independent agency with legislated objectives to protect small depositors and contribute to financial stability.** It is governed by a Management Board appointed by CBK and comprises of (i) the CBK Governor; (ii) one representative from the Ministry of Economy and Finance; (iii) the DIFK Managing Director; (iv) a deposit insurance expert; and (v) an expert certified auditor. The Law is silent on the term of the Managing Director.

56. **DIFK is an ex-ante scheme with initial funding provided by the government (which, in part, from a World Bank loan), and the German donor agency KfW**. The current fund size is a little over €13 million (including initial disbursements and bank premiums already collected). This represents approximately 4.6 percent of insured deposits in the banking sector. DIL should clarify whether the initial contribution from the Government and KfW and funds raised through bonds can be used for insured deposit payouts since the current drafting is unclear on this matter.

57. **As a narrow mandate ("paybox") scheme, DIFK is responsible for collecting periodic premiums from banks, accumulating and investing these premiums, and reimbursing insured depositors in the event of a bank failure.** DIFK has no supervisory or resolution powers; although it is permitted to (and does) assess risk-based premiums, which, in conjunction with CBK's supervisory regime, helps mitigate moral hazard. Amendments to Article 12.1 require DIFK to begin repayment of insured depositors "…as soon as possible…but not later than 30 days of the insured event" (reduced from 60). Given Kosovo's special bank insolvency regime, and assuming advance preparation by both DIFK and CBK, repayment could easily start within three to seven days.[20] Although the law permits DIFK to borrow in the market (but not from member institutions), with Government guarantee, and to issue bonds, there is no formalized emergency back-up funding arrangement in place. The Government should put in place a "fast track" limited line of credit in case of need to reimburse insured depositors when the reserve fund is depleted. Replenishment of the fund should be made through premiums paid by the banks, using the emergency premium power to the extent permitted.

58. **Staff calculations indicate that the current target reserve level of 5 percent of total insured deposits should be raised to a range of 8–9 percent.** Typical rules of thumb suggest that for a banking sector comprising 20 to 40 banks, the reserve fund should be adequate to cover 4 to 6 small, or 2 to 3 medium-sized bank failures. However, this benchmark is inadequate for Kosovo, given its relatively small banking sector and composition. Therefore, in this case it is

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[20] The special bank insolvency regime permits CBK to take resolution actions, including license revocation, without the risk that a bankruptcy court can reverse the action (any successful challenges are limited to monetary compensation), ¶64.

recommended a fund size that could compensate insured depositors in the event of two small or one medium-sized bank failures.

59. **Deposit coverage should grow in line with the growth of the DIFK.** A basic tenet of deposit insurance is that the level should cover fully a great number of depositors, but a relatively low amount of deposits by value The DIFK estimates that the €2,000 level fully covers approximately 90 percent of depositors and around 14 percent of the total value of insured deposits in the banking sector; therefore meeting this best practice. Accompanying the DIL amendments is a proposal to increase the deposit insurance coverage level from €2,000 to €5,000. Given that the current target is considered too low and there is no legitimate back-up funding arrangement in place, it would not be appropriate to introduce such expansion of coverage now. DIFK staff estimates that the proposed €5,000 level would fully cover approximately 93 percent of depositors, i.e., coverage of depositors would increase by only 3 percent; but it would increase DIFK's exposure by about 80 percent (from approximately €300 million to around €529 million). A higher fund size could support higher coverage and help to gradually close the gap with deposit insurance coverage in the euro area.[21]

60. **Banks' premium should not be reduced or discontinued even if the fund's current target size has been reached, except in cases in which a bank becomes less risky, justifying an adjustment to its risk-based premium**. The amendments that are currently before Parliament are silent on the issue of whether banks should stop contributing to the fund once the target is reached, while the current law gives power to the DIFK to do so. The core principles for deposit insurance establishes that the cost of bank failures be borne by the banking industry. This requires a deposit insurance fund to be funded primarily with bank contributions while at present most contributions to DIFK have been made by the government. At some point in the future, when the target reserve fund achieves a significant buffer above its exposure, DIFK should consider repaying government contributions.

D. Institutional Framework and Coordination Arrangements for Systemic Risk Monitoring and Crisis Management

61. **Albeit incipient, the existing coordination mechanism between the CBK, MoF, and DIFK provides the foundation for a comprehensive crisis management framework.** A tri-party MoU on financial stability cooperation was signed at end-2011 between the CBK, the MoF and the Assembly Committee on Budget and Finance (ACBF). The MoU determines the role of each authority, as well as basis for cooperation to protect financial stability. The MoU also established the Financial Stability and Crisis Management Committee (FSCMC), which is a

[21] Staff argued that it was inappropriate to increase coverage since the €2,000 level met established deposit insurance objectives. The authorities were reluctant to abandon the planned increase and a compromise was reached by EUR, after the FSAP mission left and in the context of program negotiations, whereby the coverage would increase in line with growth of the target reserve fund (including future planned contributions by donors and the government). The agreement was that coverage would increase to €3,000 on January 1, 2014, €4,000 on January 1, 2016, €5,000 on January 1, 2018.

consultative forum on financial stability issues with no decision power. Coordination between the CBK and the DIFK primarily occurs through the Governor of the CBK, within his capacity as a Board Member at the DIFK. The CBK and the DIFK recently signed a MoU for information sharing. The Government should consider creating a Crisis Management Executive Committee (CMEC) comprising the MoF, the CBK and the DIFK with decision making power regarding the declaration of a potential systemic crisis upon proposal by the CBK

62. **Kosovo has not developed a process for contingency planning**. A contingency plan ensures that all practical arrangements for actions that need to be undertaken in case of crisis are in place, so that the authorities can respond promptly. The contingency plan should be tested through simulation exercises. Large banks should also be required to prepare their own contingency plans for meeting periods of prolonged stress.

E. Legal Framework for Crisis Management

63. **The existing framework—consisting of ELA and provisions for creating bridge banks—should be completed with other legal arrangements to address potential crises**. A robust crisis framework should also include extraordinary funding arrangements for the DIFK (¶68) and an option for the CBK to avail of government guarantees to extend ELA to systemic banks that may be insolvent (¶55). Moreover, the possibility of setting up a bridge bank should be limited to cases in which a systemically important bank is involved

64. **A comprehensive framework should also name the authority responsible for the identification of systemic scenarios, provide the legal basis for the enhanced legal tools, and identify the potential source of funding**. More specifically, this framework should grant power to: (i) the CMEC to declare a potential systemic crisis upon proposal of the CBK; (ii) the DIFK to increase deposit coverage; and (iii) the Government to issue guarantees as a condition to extend ELA to systemic banks that may be insolvent as well as in these cases to lift the limit of 100 percent of Tier 1 capital. To minimize the cost of a crisis, it is crucial that the authorities have the power to undertake these actions without getting upfront Parliamentary approval or, if approval is required, this should be obtained in a single extraordinary session of Parliament to take place the same day of the crisis declaration. Whether the proposed legal provisions should be included in one law or be introduced by amending a number of laws is a matter of legal drafting. Various countries have followed different routes and such decisions really rest on the legal drafting tradition of each country.

VI. Financial Sector Development

65. **Access to financial services is mixed.** With 60 percent of all households (and 52 percent of all low-income households) having access to a bank account, the country compares well with—even above—some other countries in the region. Use of electronic payment services is limited due to high informality. ATM and branch penetration is low by regional standards. Lending activity is limited, except to salaried individuals and established businesses. Loans of less than €10,000 to small businesses account for under 7 percent of the total loan portfolio while

loans for up to €30,000 account for about 14 percent. Loans for the for agricultural activities account for only 2.4 percent of total loans provided by commercial banks**.**

66. **The interest rate spreads and margins are high when compared with the region.** The average weighted differential between deposit and lending rates in Kosovo have exceeded 1000 points since 2008. In 2011, the differential was 1060 basis points, falling to 1016 in 2012. The spread is high when compared with the region, where the average is less than 400 basis points. The net interest margin to loans ratio has remained robustly above 8 percent since 2009.

67. **Profitability and pricing resilience suggest that more competition is needed, but the new banking law reduces potential for banks and MFIs to compete.** The law effectively reduces the overlap and contestability between the lower reach of banks and the top end of the client base of MFIs. The legislative thresholds limiting MFIs to clients whose income is less than the taxable threshold, and the limit on the total annual debt servicing cost, means that most—if not all—MFIs are now in violation of the law.

68. **Regulatory uncertainty and the complexity of CBK regulatory framework constrain the MFI sector growth and development.** While it is generally understood in the sector that MFIs can operate as an NGO or as a Joint Stock Company (JSC), gaps remain for the interpretation and effective application of the Law and there is concern that MFI NGO may need to convert to MFI JSC to continue operating. MFI regulation does not seem to reflect the business reality of most MFIs. The greater part of the sector has neither the scale nor the sophistication to implement these regulations. Moreover, given that these institutions are not deposit takers, the need for such a tight regulation is not clear. CBK should create a Financial Inclusion Task Team, comprising of Ministry of Trade, Finance and Justice and businesses associations, to address obstacles to MFI growth discussed in this report.

APPENDIX I. KOSOVO: RISK ASSESSMENT MATRIX

Nature/Source of Main Threats and possible triggers	Likelihood of Severe Realization of Threat in the Next Three Years	Expected Impact on Financial Stability if Threat is Realized
A sharp domestic downturn triggered by a strong intensification of the euro area crisis.	*Medium* A strong intensification of the euro area crisis is likely to negatively affect Kosovo's near term growth prospects through a decline in remittances and FDI inflows. The Kosovar diaspora is concentrated in countries that so far have been hit less severely by the crisis.	*Medium* A sharp domestic slowdown triggered by euro-zone problems would negatively affect borrowers' debt-servicing capacity. A fall in remittances would affect bank credit and liquidity risks since remittances are used to service loans and fund deposits.
Sovereign risk from exposure to distressed euro-zone government bonds.	*Medium* Fiscal problems in the euro-zone are likely to persist and higher bond spreads are likely to have a negative impact on the value of banks' holdings of euro-zone sovereign debt.	*Small* The banking system has increased its exposure to foreign government bonds during the credit slowdown. The exposures are primarily to euro-zone countries, which account for around 8 percent of total banking system assets. Rising bond spreads would impact adversely the asset quality and capital adequacy of banks and pension funds holding such assets.
Credit quality deterioration of portfolio concentrations to trade and single borrowers.	*Medium* The lack of diversification opportunities renders banks' credit portfolios vulnerable to concentration risk. The continuing euro-zone crisis may further strain corporate balance sheets and lead to loan repayment problems for large obligors.	*High* There are significant concentrations to the trade sector and individual obligors in banks' portfolios and a shock to the quality of trade loans or defaults of the largest obligors will have a considerable impact on the system.
Contagion from parent banks	*Medium/High* The banking system is dominated by subsidiaries of European banks, which may be negatively affected by the euro-zone crisis. One foreign subsidiary's parent bank is being restructured.	*Medium/High* The banking system is funded primarily with domestic retail deposits and resilient to cross-border funding shocks. However, the banks invest a sizeable fraction of total assets abroad (about 22 percent as of June 2012). Recently adopted regulation restricts placements in parent banks to 15 percent of Tier 1 capital. Problems at a foreign parent bank may also pose reputational risks to domestic subsidiaries, whereas euroization constrains CBK's capacity to provide large-scale emergency liquidity assistance.

Nature/Source of Main Threats and possible triggers	Likelihood of Severe Realization of Threat in the Next Three Years	Expected Impact on Financial Stability if Threat is Realized
Failure of a large bank	*Low/Medium* The three largest banks report CARs well above the 12 percent benchmark. However, problems may arise at a systemically important bank due to a protracted slowdown, spillovers from the euro-zone crisis and weak supervision.	*High* The impact will be high due to high concentration of the banking system (the three largest banks account for more than two thirds of banking system assets). The preparedness of the supervisory and regulatory framework to deal with a systemic crisis is yet to be tested.

APPENDIX II. KOSOVO: STRESS TEST MATRICES

STRESS TEST MATRIX FOR SOLVENCY

Domain	Assumptions Top-down by FSAP Team
Institutions included	• All banks (eight licensed commercial banks).
Market share	• The banks included in the stress tests account for 100 percent of total banking system assets and more than 80 percent of total financial system assets.
Data and baseline date	• Balance sheet and income statement supervisory data as of June 2012.
Methodology	• Balance sheet and income statement sensitivity analysis and projections conditioned on macroeconomic scenarios that are based on a regression model estimated by the mission.
Stress test horizon	• Five year horizon for macroeconomic scenarios.
Shocks	*Scenario analysis* • Macroeconomic scenarios test the resilience of the banking system to a sharp economic downturn triggered by the euro-zone crisis and domestic fragilities. • Cross-border contagion analysis explore the scope for spillovers from parent and other foreign banks • Systemic risk scenarios (interbank exposure matrix). *Sensitivity analysis* (i) shocks to loan quality; (ii) shocks to the quality of sovereign bond holdings (haircuts); (iii) shocks to counterparty interbank exposures (iv) credit concentration/correlation risk (default of large obligors); (v) shocks to sectoral loans; (vi) failure of a large bank (vii) interest rate and exchange rate shocks.
Risks assessed	• Credit risk from domestic lending • Credit risk from holdings of foreign sovereign bonds • Counterparty risk from interbank exposures • Credit concentration/correlation risk • Macroeconomic linkages • Cross-border financial contagion risk • Interest rate and exchange rate risks • Systemic risk through interbank exposures
Calibration of risk parameters	• Regression analysis and historical experience.
Behavioral adjustments	• Credit growth projections used in macroeconomic scenarios and credit risk stress tests, profit modeled considering future lost income from NPLs and assuming constant margins and no dividend payout. Constant balance sheet allocation assumed in most stress tests.
Regulatory standards	• Hurdle rates based on national prudential requirements (12 percent minimum CAR). Basel I definitions of capital and RWA.
Results	Stress test impact measured on bank-by-bank and system CARs.

STRESS TEST MATRIX FOR LIQUIDITY RISK

Domain	Assumptions Top-down by FSAP Team
Institutions included	• All banks.
Market share	• The banks included in the stress tests account for 100 percent of total banking system assets and more than 80 percent of total financial system assets.
Data and baseline date	• Balance sheet supervisory data as of June 2012.
Stress test horizon	• Five-day horizon
Shocks *(e.g. included in scenario analysis linking solvency and liquidity, separate tests using ad hoc model/balance sheet)*	*Scenario analysis* • Scenario analysis linking solvency and liquidity risks and simulating cross-border contagion effects. Problems at parent or domestic banks trigger a systemic deposit run with run-off rates that are either uniform or contingent upon the parent/subsidiary's asset quality. *Sensitivity analysis* • Deposit concentration risk tests simulated withdrawals of large deposits (e.g., government deposits, top 3, 5,10 private deposits)
Risks assessed (e.g., funding liquidity shock, market liquidity shock, both)	• Funding liquidity shock • Market liquidity shock • Combinations of funding and market liquidity shocks • Deposit concentration risk
Calibration of risk parameters	• Historical experience/*ad hoc* simulations.
Regulatory standards	• Hurdle rates based on national prudential requirements.
Results	• Liquidity shortfalls measured as a percentage of GDP and in terms of post-shock liquid assets to total deposits ratios.

APPENDIX III. KOSOVO: FOLLOW UP OF RECOMMENDATIONS ON PAYMENT SYSTEM OVERSIGHT

Action	Recommended Time Frame	Comments
Legal and Regulatory Issues		
1. Define the legal architecture for the Payment Systems legal provisions	Immediately	Included in the Draft Law on Payment System
2. Ensure consistency between the Payment System law and the Banking law	Immediately	Included in the Draft Law on Payment System
3. Include the list of the reasons for revoking or suspending a payment system operator in the Payment System law	Immediately	Included in the Draft Law on Payment System
4. Add the possibility for the central bank to ask for specific external audits in the Payment System law	Immediately	Included in the Draft Law on Payment System
5. Publish an oversight regulation	Once the Payment System law enters into force	Included in the Draft on Oversight of Payment System Regulation
Oversight Activities[1]		
6. Include the systems operated and payments instruments issued by the CBK in the oversight scope	Continuously	Included in the Draft on Oversight of Payment System Regulation
7. Develop a three-year annual on-site inspection plan for payment service providers, including non-banks	By end 2011	Waiting for the implementation of the Law on the Payment System.
8. Publish a policy statement on oversight	By the time the Payment System law enters into force	Will be fully implemented when the Law on Payment System is implemented.
9. Producing quarterly oversight written notes, to be communicated to the Governor	As from September 2011	Weekly and monthly reports have been presented to the CBK Executive Board since September 2011. The format of the Quarterly report is still there to be determined.

[1] Recommended activities regarding the Committee on Payment and Settlement Systems (CPSS) General Principles compliance and assessments are not included in the table.

Action	Recommended Time Frame	Comments
10. Provide a summary of the oversight activities and developments relating to the Kosovo's payment system in the Annual report	As from the next Annual report	The summary on oversight activities was published for the first time in the Annual Report for 2011.
11. Include a section on the national payment system in the Financial Stability Report	As from the next Financial Stability report	The section on payment systems is included in the Financial Stability Report No.2
Oversight Organization		
12. Implement a strict organizational separation between the oversight function and the operation function	Continuously	Two divisions in the Payment System Department has been established: (i) Payment System Operations Division and (ii) Analysis and Oversight of Payment Systems Division
13. Hire an experienced executive for the oversight unit, with a banking supervision background to be able to organize systems' assessments and payment service providers' on-site inspections	Immediately	Hiring of an expert is proposed in the budget plan for the 2013
14. Develop a range of procedures to implement the oversight policy, consistently with the banking supervision ones	Once the Payment System law and the oversight regulation are finalized	Waiting for the implementation of the Law on the Payment System.
15. Define an annual oversight working plan	Immediately	An annual oversight working plan has been prepared.
16. Submit oversight activities to internal audit	Continuously	A standard document is being prepared to be sent to the internal audit.
17. Create an internal CBK committee including all the relevant functions, to meet regularly and form a common position on oversight issues	Immediately	Not implemented.
18. Organize a close cooperation with the neighboring countries on oversight issues	To be launched as soon as possible	Participated at the conferences organized by the National Bank of Macedonia and Turkey in 2012. Plans to visit the Bank of Albania in October 2012.

APPENDIX IV. BASEL CORE PRINCIPLES—SUMMARY ASSESSMENT

SUMMARY, KEY FINDINGS, AND RECOMMENDATIONS

1. **The assessment of the Basel Core Principles for Effective Supervision (BCP) was conducted from September 18 to October 2, 2012 as part of an FSAP Assessment**. The supervisory framework was assessed against the BCP methodology issued in October 2006; and the principles were assessed on the essential criteria only. This is the first BCP assessment for Kosovo under the Financial Sector Assessment Program (FSAP). It was conducted by Diane Mendoza, (IMF, former-OCC) and Martín Vázquez Suárez (World Bank, former-Bank of Spain).

Information and methodology used for assessment

2. **The assessment is based on several sources:** (i) a preliminary self-assessment prepared by CBK; (ii) meetings with the Governor, the Deputy Governor for supervision of financial institutions, the Directors and senior staff of CBK working on supervisory, regulatory and legal matters, including insurance supervision and the market for public debt instruments, and the credit registry; (iii) meetings with the Head and senior officials of the Financial Intelligence Unit (FIU) and the Director of the Deposit Insurance Fund; (iv) review of laws, regulations, advisory letters, and other documentation regarding the current and projected supervisory framework for Kosovo, the strategic plan of CBK, and studies on the structure and recent developments in the financial sector of Kosovo; (v) reviews of CBK executive orders, inspection manuals and guidelines, offsite and onsite supervision reports, licensing documentation, fines and sanctions, and correspondence, communications and documents following-up on deficiencies noted in inspection reports and (vi) meetings with senior executives of local and international banks of different size and complexity operating in Kosovo, the Chairman and board members of the Kosovo Financial Reporting Council, the association of certified accountants and auditors, the bankers' association, and several bank auditors.

Institutional and macroeconomic setting and market structure—Overview[1]

3. **Kosovo is in the final stages of transition to full self-governance in economic and financial affairs**. Since 1999, Kosovo has been under the administration of the United Nations following the terms established in the UN Security Council resolution 1244. In February 2008 it declared its independence, which was considered to be according to international law by the UN International Court of Justice, but that was unevenly recognized by the international community. In this context, international institutions, among others the International Monetary Fund and the

[1] This section draws on several recent reports on Kosovo prepared by the International Monetary Fund, and more specifically on the IMF Country Report No. 12/100, of April 2012, and the IMF Country Report No. 12/180, of July 2012.

World Bank, have been playing a key role thereafter assisting local authorities in building economic and social institutions and promoting economic governance.

4. **Kosovo's economy has remained largely shielded from the euro-area crisis, but there are risks**. Growth appears to be slowing modestly but is still robust, as anticipated under the program baseline. Direct financial or trade linkages to crisis countries are still small. However, Kosovo is vulnerable to a deterioration of labor market conditions in countries where the *Kosovo diaspora* resides, as this could depress remittances and foreign-direct investment and have negative repercussions for growth and the banking sector.

5. **Kosovo's banks have grown rapidly: at end-2011 they held assets that represented almost 60 percent of GDP, compared to 5 percent of GDP in 2000**. While the banking system has remained stable, the legal framework for supervision and regulation, as well as the CBK's capacity to provide emergency liquidity assistance to banks, are in need of an upgrade.

6. **Most banks are foreign owned, with parent institutions in Germany,[2] Austria, Slovenia, Turkey, and Albania**. Banks in general are deposit funded and do not depend on financing from their parents, and this makes Kosovo's banking sector less vulnerable to an intensification of the euro-area crisis than those of some regional peers.

7. **The banking sector's average capital adequacy stood well above the regulatory minimum of 12 percent, and the share of nonperforming loans was 6 percent, largely unchanged since end-2011**. Prudent loan-to-deposit ratios averaging about 80 percent across the banking sector indicate that the banking sector operates with substantial liquidity buffers. A small domestic bank was recapitalized by its owners in February after its capital adequacy ratio had temporarily dropped below the regulatory minimum in 2011, as a result of the on-site supervisory work of the CBK.

Preconditions for effective banking supervision

8. **Some aspects of the financial infrastructure in Kosovo can represent a challenge to implement effective banking supervision in this country**. More specifically, the existing difficulties to enforce contracts and the insufficient definition of real estate property rights (in part as a result of the war), as well as the reported widespread inefficiency of the judiciary, present significant difficulties in taking possession of collateral and reduce its value to mobilize credit in the economy.

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[2] In the case of this local bank that belongs to a group that has its holding entity incorporated in Germany, it is important to note that until September this year this group, while officially consolidated in Germany, was not allowed to have banking operations in that country, since it did not have a banking license in that country (reportedly, banking operations are planned to start in Germany at the end of 2012 or early 2013). This feature is important because this institution represents an important part of the Kosovo banking sector, both in terms of deposits and loans, and until now it has not been subject to consolidated supervision in any jurisdiction.

9. **On the other hand, some other features of the financial infrastructure, while in need of continuous improvement, are already performing acceptably well**. The accounting framework that the CBK has imposed on banks is based on IFRS (with some differences on provisioning mainly to take account of the above mentioned difficulties to take possession of collateral and the increased costs involved in lending activity in Kosovo), and the auditing profession, while in need of modernization in some important areas, is performing well in regard to the banking sector. Finally, the public credit registry, operated within the CBK, is reported to work efficiently.

10. **As established in the CBK Law, the CBK is responsible for the regulation and supervision of commercial banks, microfinance companies, insurance companies, and other financial service providers**. The financial sector is bank-centric, with commercial banks holding about 75 percent of all financial assets as of June 2012 (pension funds held assets that represented about 19 percent of the system and the rest was held by insurance companies and microfinance institutions).

11. **Real GDP growth in 2011 is estimated to have reached 5 percent, driven principally by domestic demand, in particular investment**. Inflation moderated to 3½ percent (y-o-y), after the increase to double-digit figures that took place in early 2011 as a result of higher prices for food imports. The current account deficit is estimated to have widened to about 20 percent of GDP in 2011, from 17½ percent of GDP in 2010, reflecting mostly higher imports. Strong capital inflows, including foreign direct investment from the Kosovo diaspora, have continued to fund the deficit.

Main findings

12. **This is the first FSAP conducted in the Republic of Kosovo**; however, BCP self-assessments were conducted in 2006 and 2008. Kosovo is a very young country that faces considerable political and social challenges. Tensions arising from the absence of unanimous international acceptance as an independent country have direct impact on the ability of the CBK to fully execute its supervisory mandate. Of note is the inability of the CBK to conduct on site supervision in certain areas of Kosovo. Prior to independence, the legal framework was provided by the UNMIK regulations and, since independence in 2008, the Assembly has issued an important stream of legislation.

13. **The assessors recognize the considerable volume of legislation issued and are aware of the attendant challenges**. However, in review of the laws and discussions with the CBK staff and relevant stakeholders, it became apparent that significant weaknesses still exist and need to be addressed. Foreign-owned banks dominate Kosovo's banking sector, bringing both positive elements and risks, and in any event demanding a more robust and comprehensive oversight by the CBK, and especially the development of a risk-based, forward-looking supervisory system. The following summarizes the main findings of the detailed assessment of compliance with the BCP.

Objectives, Independence, Powers, Transparency, and Cooperation (CP 1)

14. **CBK is a public legal subject, based on Kosovo's Constitution, and has financial and managerial autonomy**. The primary objective of the CBK is to maintain a stable financial system, to achieving and maintaining price stability; and to support the policies of the government. There are two stated objectives for the CBK as supervisor of the banking sector, one is to evaluate the over-all safety and soundness of banking organizations and the second is to protect depositors' funds and maintain a stable financial system. A fairly detailed governance framework, with well-articulated responsibilities for the executive management of the CBK, provides accountability and transparency. A hiring process for the Governor, Deputy Governors and Central Bank Board members is detailed in the Law No. 03/L-209 on Central Bank of the Republic of Kosovo (CBK Law) as well as termination processes.

15. **CBK has exclusive responsibility for the supervision and regulation of commercial banks, micro finance institutions, insurance companies, and other financial service providers**, as enshrined in CBK Law and Law No. 04/L-093 on Bank Microfinance Institutions and Non Bank Financial Institutions (Banking Law). A Banking Supervision Department (BSD) conducts the on and off-site examinations of the banks and is supported by the Licensing and Regulation Department, which is responsible for licensing all financial institutions as well as providing legal support to the supervisors. Six of the eight commercial banks operating in Kosovo are controlled by foreign banks, and the CBK has formal arrangements for information sharing with four of the six home supervisors. The CBK is encouraged to initiate coordination and information sharing with the remaining foreign supervisors. Internally, the BSD is encouraged to enhance and document its institutional knowledge of the banks, their foreign parent banks and cross border affiliates, both on an individual basis and the system as a whole. Expanding the sources of information and its analysis should contribute to the CBK having a stronger understanding of the risks in banks.

16. **In general, sufficient legal powers for supervision are granted to the CBK (except for the prevention of ML/CTF), but the laws' effectiveness is impaired by technical weaknesses, inconsistencies and gaps, especially as regards the regulation of specific risks**. A fairly strong legal framework existed under the UNMIK regime, but since Kosovo's independence, those UNMIK regulations have been replaced by laws promulgated by the Assembly of the Republic of Kosovo. Perhaps it is due to the significant volume of laws that have been issued, the potential for the considerable technical assistance to overwhelm the critical analytic skills of the local staff or the possibility that too many people were involved in the revisions to the laws, but there appears to be a pattern of critical weaknesses. Also there is confusion between the laws and the regulations, possibly due to the very prescriptive nature of the laws. Supervisors have inadequate coverage of legal expenses in the event of lawsuits for actions taken and/or omissions made in good faith while discharging their duties. While the law provides for reimbursement of defense costs, the process is cumbersome and as recent experience has shown— results in delayed payment. CBK is encouraged to explore options that

would provide timely cost coverage and to develop review processes to ensure staff are operating within the CBK's mandate.

Licensing and Structure (CPs 2–5)

17. **Since 2008, the number of licensed banks has been held steady at eight, with six of them being controlled by foreign owners**. In July 2012, CBK took action to close two locations of an unlicensed bank operating in Kosovo. An unauthorized bank, albeit a small one, is still operating in a Serbian enclave in the north of Kosovo. The mission acknowledges the risks that the supervisor may encounter if efforts to conduct supervision were carried out in the bank. However, allowing such an operation to continue has unacceptable risks for the banking sector and the CBK and has the potential of sending the wrong message to the industry as well as negatively impacting the reputation of the CBK.

18. **In the years since 2008, three applications were denied, withdrawn or rejected and two were pending at the time of the assessment**. The Banking Law is very prescriptive regarding licensing, and the CBK is encouraged to consider developing a regulation to guide applicants. A licensing manual was developed through technical assistance provided in the early years, and BSD acknowledged that it is in need of update. Such updates should include in-depth assessments of the strategic plans and risks the applicant banks are expecting to take on, as well as assessments of foreign banks' ability to minimize their risk from exposures to affiliates. CBK is cautioned that supervisory resources must keep pace with the financial sector's growth and complexity.

19. **Activities that banks are allowed to engage in are adequately identified by the CBK**. Transfer of ownership or control over banks is subject to CBK approval. It is important to note that with the October 12, 2012 effective date of the Banking Law, the threshold for a significant interest in a bank or other entity will be decreased from 20 percent to 5 percent; which has the potential of expanding the number of "bank-related persons." While there appears to be adequate control if a bank merges with or makes a major acquisition in another financial institution, there is inadequate control over investments in non-financial companies. Limits for such investments are low; however, this does not minimize the potential for significant risks arising from investments. The CBK is encouraged to require a notification by banks regarding investments in non-financial companies and to have the authority to unwind such transactions if the risk is determined to be excessive for any reason.

Prudential Regulation and Requirements (CPs 6–18)

20. **A minimum paid in capital requirement for domestic banks of seven million Euros will become effective October 12, 2012, rising from five million euros**. Branches of foreign banks may be required to maintain a capital equivalency deposit with the CBK, if so directed by the CBK. Minimum risk weighted assets (RWA) to Tier I capital is 8 percent and total capital to RWA is 12 percent. However, the capital calculations do not include charges for market risk and

operational risk. The definition of capital and the weights assigned to assets are largely compliant with the Basel weighting guidelines.

21. **Thus far, CBK has used a very "light touch" on the risk management processes of banks**. Banking Law and rules address risk management very generally, such as the requirement for a risk management committee or policy. Guidance provided by the CBK to the industry has been limited to credit risk and liquidity risk, and in the latter, with insufficient level of detail. CAMELS-based review is still the foundation on which supervision is conducted, although CBK has introduced a risk matrix component into the on-site examinations of the systemic banks (those holding 10 percent or more of deposits). It is acknowledged by the CBK, and the assessors concur, that the risk matrix component is just an initial step to have a comprehensive risk based forward-looking supervisory process in place. The CBK, and the BSD therein, faces the challenge of developing both staff skills and internal processes to be able to implement a risk-based and forward-looking supervisory regime in the face of current and incipient risks.

22. **Credit risk in the loan portfolio is well-addressed by the supervisory process**. Banking Law includes an extensive set of rules and regulations to address credit risk in the loan portfolio, and much of the on-site examination is dedicated to this component. However, as the loan portfolios are only one source of credit risk, and other important risks are already present in the Kosovo banking sector, the CBK is urged to expand their supervisory processes, especially to address the risks arising from the exposures held by local banks against their parent banks abroad or their affiliated institutions. Supervisors appear well-informed of loan portfolio exposures to banks' related parties and such loans are regularly reviewed as part of the on-site examinations. Of particular concern is the insufficient monitoring by the CBK of local banks' exposures to their foreign parents and their affiliates, despite the pervasive negative media reports regarding some specific institutions and the general deterioration of the economic conditions in the Euro-zone. There is need of specific regulation regarding country risk and transfer risk. Neither of these risks is minor in Kosovo, given the important presence of foreign-owned institutions, and transfer risk could be particularly important if any of the jurisdictions that are home of the parent banks of the undertakings operating in Kosovo decided to impose restrictions on cross-border flows.

23. **The CBK places emphasis on corporate governance and internal control requirements when carrying out its supervisory role, especially during on-site examinations**. The guidance issued to banks addresses internal control, audit, and Board of Directors' responsibilities in designing and implementing risk management systems. During onsite inspections compliance with risk management requirements is reviewed and identified deficiencies are explicitly addressed in reports of inspection. The CBK makes due follow-up of significant deficiencies and acts on them if necessary.

24. **The legal framework to prevent the abuse of the banking system has to be modified to correct some important technical deficiencies, most notably the absence of specific assignment of responsibility to any public authority in Kosovo to conduct on-site**

AML/CTF compliance reviews in banks and financial institutions. Other weaknesses of the current situation refer to the insufficient degree of coordination between the CBK and the FIU and the limited performance of CBK's division specialized in AML and prevention of the abuse of the local financial system, which needs to be thoroughly reshaped and significantly reinforced. Currently, there is a vacuum in the law on AML/CTF in the assignment of responsibility to undertake compliance examinations in several institutions, most notably banks, which coupled with the limited coordination between the FIU and the CBK is resulting in an increased perception that the obligation to report suspicious activities is not fully met in all cases. In addition, the division that belongs to the BSD that is specialized in AML is not functioning as required due to the inadequacy of its head, its severe lack of resources and the inappropriateness of its supervisory approach.

Methods of Ongoing Supervision (CPs19–21)

25. **The ongoing supervision process is focused on controlling the adequacy of banks' management and the quality of internal controls, and it attaches importance to the critical revision of loan portfolios**. This approach has proved its soundness through the remarkable resilience showed by the Kosovo banking sector during the current international crisis. However, the system is in need of significant improvement in several areas in order to fully control all relevant risks of the banking sector. The current regulatory framework for liquidity and interest rate risks needs completion, as they are currently too generic to favor CBK supervisory action, and those for operational risk and the risks resulting from the relationship between the subsidiary in Kosovo and its parent bank abroad and its group are yet to be developed. The draft regulations that are in process of final approval by the CBK board will be an important step forward that will need to be complemented by the enhancement of the supervisory process of the CBK.

26. **Offsite supervision and supervisory reporting need significant improvement to include more analysis and thus be able to guide supervisory action**. Offsite supervision prepares monthly and quarterly reports, but they provide insufficient analysis to guide supervisory action. Supervisory reporting will have to be significantly improved and widen its reach, increase its depth and improve its level of detail. It will need to be based on a reliable technological platform, that currently the CBK does not have,[3] receive much more detailed information from banks, and include areas that are insufficiently covered or not covered at all as consolidated information, operations subject to country and transfer risk, etc. Currently macroprudential analysis is limited, although the Financial Stability Report issued yearly by the CBK could be a good base for these analyses, since the report is rich in information on the banking sector.

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[3]There is a project in its initial phases to provide the CBK with the necessary technological platform.

Accounting and disclosure (CP 22)

27. **The accounting framework applicable to banks is based in IFRS, while CBK has established some differences in provisioning, to make the regime more stringent to reflect the difficulties that lenders face in Kosovo to enforce contracts in case of default**. Banks are generally audited by partners belonging to one of the so-called "Big 4" accounting firms and the reliability of their accounts is not in dispute. Work is underway to upgrade the overall status of smaller, local, independent accounting firms to improve the quality of their services and the overall reliability of nonbank financial statements, but much remain to be done in this respect.

Corrective and remedial powers of supervisors (CP 23)

28. **The legal regime for corrective and remedial actions is clearly addressed in the banking law and regulations, and these powers are actively used by the CBK**. Enforcement powers are broad and clearly spelled out. The authority of the CBK to resolve problem bank situations is clearly defined from the preventive stage through resolution and liquidation. A number of cases were reviewed during the assessment to determine the extent of the CBK use of its enforcement authority. Some of the cases reviewed involved requiring a bank to restructure board and senior management and the recapitalization of the bank, the closing of the branch of a foreign bank operating unlicensed in Kosovo and the successful—and still on-going—resolution of a failed bank. However, the special circumstances that affect Kosovo as a result of the lack of unanimous international recognition as an independent state have an impact in capacity of the CBK to carry out its supervisory responsibilities, and some irregular activity is still undertaken in the northern part of the country by at least one unlicensed entity.

Consolidated and cross-border banking supervision (CPs 24–25)

29. **Domestic supervisory coordination is done on an informal basis within the CBK, as the central bank is also responsible for the supervision of insurance companies**. The department responsible for insurance supervision provides information to the BSD on the main findings of its inspections and information is exchanged between both supervisors as needed, most notably as regards mutual exposures. This system will need to be significantly improved and formalized to ensure that proper consolidated supervision is effectively undertaken.

30. **The importance in Kosovo of banks that belong to banking groups that are consolidated abroad makes especially important that the effective implementation of the current MoUs is given due priority**. Kosovo is host of several international banking groups of varying size and complexity which represent more than 70 percent of the system in both deposit and loan terms. CBK has limited capacity to monitor the risks that these institutions represent for the local banking system, most notably by means of its participation in the supervisory college of one of these banks, the establishment of memoranda of understanding with the supervisors of Slovenia, Germany, Turkey and Albania, and recently thanks to the assignment of responsibility to the German supervisor, the BaFin, to carry out the consolidated supervision of the group to

which one bank in Kosovo belongs. However, the situation has still to be significantly improved for CBK to have the necessary and timely knowledge on the condition of the parent bank and its group to be able to act—to the extent possible—to mitigate any exposures to risk that are deemed excessive.

Appendix IV. Table 1. Summary Compliance with the Basel Core Principles—ROSCs

Core Principle	Comments
1. Objectives, independence, powers, transparency, and cooperation	
1.1 Responsibilities and objectives	Except for the ability to review AML/CTF issues, responsibilities are generally clear.
1.2 Independence, accountability and transparency	Supervisor is independent, accountable and transparent; concern over management of AML supervisory function.
1.3 Legal framework	Gaps and conflicts exist in legal framework.
1.4 Legal powers	Generally supervisors have legal powers, however there is a gap regarding AML/CTF.
1.5 Legal protection	While the law provides indemnity and addresses cost coverage, recent cases have show delays and challenges to reimbursement of legal defense costs.
1.6 Cooperation	CBK is authorized to engage with foreign supervisory authorities; however there is concern about treatment of confidential information shared domestically.
2. Permissible activities	Permissible activities for banks are clearly defined: CBK needs to address unlicensed banking operations in Kosovo.
3. Licensing criteria	Licensing processes need to incorporate risk-oriented elements.
4. Transfer of significant ownership	Adequate framework exists to address changes in ownership.
5. Major acquisitions	An adequate framework for acquisition of financial institutions exists; however there is no notification requirement or opportunity to reverse investments in non-financial companies.
6. Capital adequacy	Include market and operational risks in the calculation of capital requirement.
7. Risk management process	Supervisors are not satisfied that banks have a comprehensive risk management process in place.
8. Credit risk	Credit risk in loan portfolio appears sufficiently supervised; however, other sources of credit risk are not.
9. Problem assets, provisions, and reserves	Oversight and provisioning for loan portfolio problems appear adequate, but other problem assets not adequately addressed.

10. Large exposure limits	Generous exemptions; limits are not applied on a consolidated basis.
11. Exposure to related parties	Exposures in loan portfolio appear well-supervised; however other exposures to related parties are not receiving adequate attention.
12. Country and transfer risks	Neither the regulation nor the supervisory processes address these risks specifically.
13. Market risks	Regulation and supervisory processes insufficiently address this incipient but growing risk.
14. Liquidity risk	The current regulation is too generic and supervisory practice is too heavily dependent on on-site revisions.
15. Operational risk	There is no specific regulation or supervisory processes to address this risk specifically. There are revisions on some aspects (i.e., IT-related) but overall insufficiently addressed.
16. Interest rate risk in the banking book	There is no specific regulation on this risk, and its supervision is too much dependent on on-site inspections.
17. Internal control and audit	Important emphasis on this area during on-site inspections. Some weaknesses on the compliance function and on outsourced tasks still remain.
18. Abuse of financial services	Legal framework and supervisory practices are insufficient to provide assurance that banks have in place rigorous controls to prevent the abuse of the banking system.
19. Supervisory approach	Important emphasis in the monitoring of the quality of banks' loans portfolios and quality of management and internal controls, but insufficient control of other important risks present in the system (liquidity, interest rate, operational, and risks with parent entities of Kosovo's subsidiaries).
20. Supervisory techniques	Off-site supervision insufficient to provide guidance to supervisory action, insufficient coverage of important risks (liquidity, interest rate, operational, and risks with parent entities of Kosovo's subsidiaries) and procedures to be developed to cover them.
21. Supervisory reporting	Insufficient reporting to cover of important risks (liquidity, interest rate, operational, and risks with parent entities of Kosovo's subsidiaries), and insufficient analysis of the information received.

22. Accounting and disclosure	Banking sector accounting and auditing practices, sufficiently robust, in contrast with the majority of the non-banking sector.
23. Corrective and remedial powers of supervisors	Legal regime recognizes extensive power to CBK and it actually uses it. However, there are irregularities affecting one small entity still operating without license in the northern part of the country.
24. Consolidated supervision	Regulatory framework and supervisory practices insufficient for CBK to have all potential group-wide risks duly taken into account.
25. Home-host relationships	Four MoU signed with home banking supervisors, but important deficiencies in the way these are actually translated into the timely exchange of information remain.

Appendix IV. Table 2. Recommended Action Plan to Improve Compliance with the Basel Core Principles

Reference Principle	Recommended Action
1.1 Responsibilities and objectives	CBK should clarify its responsibilities vis-à-vis AML and BSD should clarify its objectives.
1.2 Independence, accountability and transparency	CBK should consider re-assigning the manager of the AML supervisory function.
1.3 Legal Framework	CBK should undertake a comprehensive review of the legal framework to remove gaps and conflicts.
1.4 Legal Powers	CBK should clarify authority to examine in AML.
1.5 Legal Protection	CBK should explore alternatives to ensure adequate and timely coverage of defense costs and establish internal review procedures.
1.6 Cooperation	CBK should ensure that procedures to protect confidential information are in place before sharing.
2. Permissible Activities	CBK should address unlicensed banks operating in Kosovo.
3. Licensing criteria	Also, when updating the licensing manual, CBK should incorporate risk-oriented elements.
5. Major acquisitions	CBK should require notification of acquisitions in non-financial companies and have opportunity to reverse.
6. Capital adequacy	Capital calculations should include market and operational risk charges.
7. Risk management process	BSD should develop supervisory processes to satisfy that banks have comprehensive risk management processes in place.
8. Credit risk	BSD should expand credit risk reviews beyond the loan portfolio.
9. Problem assets, provisions and reserves	BSD should expand supervisory review problem assets other than those in loan portfolio.
10. Large exposure limits	CBK should reconsider exemptions available under current regulation and apply limit on consolidated basis.
11. Exposure to related parties	BSD should expand supervisory processes to exposures to related parties that are not in loan portfolio.
12. Country and transfer risks	CBK to develop regulation and supervisory practices to timely identify these risks and to promptly act.
13. Market risks	CBK to develop regulation and supervisory practices, including training of staff, to monitor the incipient market risk.

Reference Principle	Recommended Action
14. Liquidity risk	CBK to develop regulation and supervisory practices to timely identify and measure liquidity risk in an individual, group and system-wide basis, including by undertaking stress tests. Staff should be trained in assessing liquidity risk.
15. Operational risk	CBK to develop regulation and supervisory practices to have a measure of this risk in supervised entities. Train staff to be able to understand, monitor and challenge operational risk models in supervised entities that already have them in place.
16. Interest rate risk in the banking book	CBK to develop regulation and supervisory practices to timely identify and measure interest-rate risk in an individual, group and system-wide basis, including by undertaking stress tests. Staff should be trained in assessing interest rate risk.
17. Internal control and audit	CBK to complete current regulation to require that banks have a compliance function whose remit is not limited to AML but to compliance with all laws and regulations. Develop specific regulation to ensure that outsourced functions are under the same prudential standards as non-outsourced ones.
18. Abuse of financial services	CBK and MOF to upgrade relevant legislation and regulation, their information sharing and cooperation arrangements and make the necessary improvements in supervisory practices to ensure that comprehensive and timely inspections of banks are effectively undertaken.
19. Supervisory approach	CBK to develop regulation and supervisory practices to have a comprehensive vision of the risks affecting the banking sector, and specifically address liquidity, interest rate, operational risks, and the risks resulting from the relationship of Kosovo's subsidiaries with their foreign parent entities.
20. Supervisory techniques	CBK to significantly improve regulation and procedures for off-site supervision to be to be able to provide detailed information and analysis to guide supervisory action. CBK to enhance coverage of liquidity, interest rate, and operational risks, and the risks arising from the relationship of Kosovo's subsidiaries with their foreign parent entities.

Reference Principle	Recommended Action
21. Supervisory reporting	CBK to significantly improve reporting requirements to cover with detail the main components of liquidity, interest rate, and operational risks, and the risks arising from the relationship of Kosovo's subsidiaries with their foreign parent entities. Reporting on a consolidated basis to be implemented.
22. Accounting and disclosure	CBK to benefit from its participation in the Kosovo Financial Reporting Council to promote improvement in the general accounting and auditing framework in Kosovo, so financial reporting for banks' borrowers becomes more reliable.
23. Corrective and remedial powers of supervisors	CBK to keep addressing—to the extent possible—the irregularities resulting from non licensed entities operating as banks in the northern part of the country.
24. Consolidated supervision	CBK to start developing regulation and supervisory practices to identify and measure the risks affecting supervised entities and their groups, including cross-participations and cases of groups that do not have a consolidating entity in Kosovo. Train staff to be able to keep up with events.
25. Home-host relationships	CBK to improve the implementation of current MoUs with home supervisors to ensure that the exchange of information provides timely information. CBK to improve supervisory practices to ensure that the risks arising from parent banks and their groups are closely monitored so corrective action can be timely adopted.

Authorities' response to the assessment

The Central Bank of the Republic of Kosovo (CBK) welcomes the assessment of the CBK Regulatory and Supervisory framework and acknowledges the extensive work done by the IMF and the World Bank FSAP Assessment Team. The CBK wants to express its appreciation to the assessment team for their comprehensive work. The assessment of the Basel Core Principles (BCP) was a useful exercise. The assessments and suggestions were truly helpful to diagnose and prioritize the work CBK has to do to adapt its banking regulations to international standards. The recommendations are therefore well received and will be considered carefully by the CBK Authorities in their continuous efforts for strengthening banking supervision.

Notwithstanding our appreciation to the Assessment Team, it is necessary to state that the CBK expresses serious reservations about the level of evaluation regarding the Principles 2 to which the grade "Materially noncompliant" was assigned. The CBK authorities recognize this specific recommendation; however, it believes that this is a situation well beyond the control of the CBK as this situation requires a political, not a supervisory remedy. We, therefore, respectfully request that the current grade assigned be reconsidered with a view to the assignment of a grade that is more reflective of the current reality.