

Analysis of Financial Performance of the Banking System in Kosovo - 2014-2019 Period

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Abstract: The banking system plays an important role in the economic development of a country. A banking institution is indispensable in a modern society. It plays a key role in the economic development of a country and focuses the essence of the money market on a developed country. The basic function of banks is to collect deposits as much as possible from customers and mobilize it in the most favorable and profitable sector such as industry, trade, agriculture and entertainment. This study mainly attempts to analyze the financial performance of commercial banks in Kosovo covering the period 2014 - 2019. There are many past studies in which researchers used different financial reports to control the financial performance of commercial banks such as: Return on Assets (ROA), Return on Equity (ROE), Return on capital (ROC), Return on Fixed Operating assets (ROFA), Report of costs on Income (C/I). Based on the accounting data, we used the key coefficients which are: ROA, ROE and NIM for estimating financial performance. The findings of the study may be useful for managing commercial banks in Kosovo.

Keywords: ROA - Return on Assets; ROE - Return on Equity; NIM - Net Interest Margin; Financial Performance; Profit

JEL Classification: G2; G21

1. Introduction

Kosovo's commercial banks have undergone major transformation since the year 2000. These changes are due to the entry of foreign banks into the financial market, changes in the regulatory environment, technological changes and increased competition. As a result of the 2008 financial crisis and the changes in the banking system, commercial banks continue to face increasing operating costs, which may affect the performance of the banking sector in Kosovo. The stability of commercial banks has contributed to the year-on-year growth of the financial sector assets in Kosovo, mainly attributable to the positive dynamics that characterize the underlying

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business, an activity that was supported by improved financing conditions on the part of banks, as well as the increase in demand for loans. The annual growth of total assets of the Kosovo financial system was 6.9% in 2018, and it is mainly a result of the growth of the banking sector assets, followed by the microfinance sector. Banking sector assets in 2018 recorded an annual growth of 8.2%, reaching a value of EUR 4.19 billion (CBK Annual Report, 2019).

The growth of the sector's assets during 2018 is related to the positive dynamics that characterized the lending activity, which was supported both by the improvement of the banks' financing conditions and the increase in demand for loans. Among other things, the credit offer was positively influenced by competition pressures, favorable liquidity position and continuous improvement of credit portfolio quality. For the third year in a row, banking sector loans were characterized by annual growth of 10.9% in 2018 and reached a value of 2.76 billion euros. During the same period, deposits in the Kosovo banking sector reached a value of euro 3.36 billion and recorded an annual growth of 8.7 percent (6.8 percent in 2017) (Annual Report - CBK). Also during 2019 (in Q3 2019), Kosovo's financial system assets recorded a year-on-year growth of 12.5%, reaching a value of EUR 7.0 billion (CBK, 2019). During this quarter, the banking sector continued to grow and perform well. The lending activity expanded as a result of the increased demand for loans and the improvement of lending terms. The expansion of lending activity was enabled by the positive dynamics in deposits, which increased significantly during Q3 of 2019.

2. Literature Review

This section presents and evaluates the literature used to measure performance of commercial banks in different countries, which have been taken as a basis for analyzing the performance of commercial banks in the Republic of Kosovo. With the emerge of the 2008 global financial crisis expressed through globally recognized financial institutions (such as Freddie Mac, Fannie Mae Merrill Lynch, Royal Bank of Scotland, Bradford & Bingley, Fortis, Hypo Real Estate, Alliance & Leicester, Bear Stearns, Lehman Brothers), research by various professors, industry analysts, freelance researchers on banking performance has greatly increased. Many famous authors, in the recent years have conducted studies on measuring the performance of banks in general and of commercial banks in particular. A large number of these studies are empirical studies on the performance of commercial banks worldwide (Grigorian & Manole, 2002; Adeusi et al., 2014; Shingjergji & Idrizi, 2014; Staikouras & Wood, 2004; Bonin *et al.*, 2005; Demirgüç-Kunt & Huizinga, 1999; Ayanda et al., 2013; Gremi, 2013).

Banking regulators apply financial ratios to evaluate banks' financial performance. As empirical evidence regarding the application of financial coefficients to assess

banks' performance, from above mentioned authors and others are analyzed various researches (Beaver, 1966), (Altman, 1968), (Maishanu, 2004) and (Mous, 2005). Based on the literature review of these authors, it can be concluded that there are two general approaches to measuring banks' performance. The first approach is based on accounting data, which are the main financial coefficients applied in banks and the second approach is based on econometric techniques. Numerous studies used the first approach, that of financial coefficients. Thus, Ross *et al.*, (2007) write that most scholars divide the financial reports into four groups, i.e, the ratios of profitability, solvency, liquidity, and activity for detailed analysis. Ehrhardt & Brigham (2011) stated that financial reports are designed to help evaluate financial statements and are used as a planning and control tool. Mittal & Dhade (2009) conducted a comparative study on profitability and productivity in Indian banks. A five year period is selected for performance evaluation. In their study they found that profitability improvement is the only parameter for evaluating performance from shareholder's standpoint. The study of Gremi (2013), conducted on the impact of internal factors on the profitability of banks in Albania, was based on the data of the 12 most important banks in the country for the period 2005- 2012. The variables used in this study were: ROA, bank size, bank loans, credit risk, and bank deposits. Shingjergji & Idrizi (2012) used ROA to measure profitability in their study of banks' performance in Albania during the period 2002-2013, while using capital adequacy ratio, exchange rate as independent variables between the euro and the lek, total loans and the spread of interest rates.

Another research on the determinants of bank profitability has been conducted by Adeusi *et al.* (2014), they focused their analysis on internal and macroeconomic factors, where ROA, dependent on capital adequacy, asset quality, management efficiency, liquidity, inflation and gross domestic product, were used as variables representing bank profitability. This study used data from 14 commercial banks from 2000 to 2013 as a sample. The authors (Atyeh, Yasin & Khatib 2015) investigated the performance of the Kuwaiti banking sector before and after the recent financial crisis over the period of 2006-2012. The data utilized is based on the yearly financial statements of the Kuwaiti banks that are listed on Kuwait Stock Exchange over the same period. There are several methods have been used to identify the determinants which impact the performance of the banking sector. In this research, a ratio analysis technique is considered efficient and more reliable method than other approaches. Other factors such as trend, government regulations and other economic factors are also included. Similar studies were also conducted by Saghi-Zedek (2016), Gümüş & Çelikkol (2011) Prasad & Ravinder (2012), Reddy (2012), Gupta (2014), Claeys & Vennet (2008), and Sufian & Habibullah (2009).

3. The Banking Sector in the Republic of Kosovo

The banking sector in Kosovo consists of two tiers, with the Central Bank of Kosovo operating as a tier one bank and commercial banks as a tier two bank. Kosovo's banking system consists of ten commercial banks operating their banking activities, with most of these banks being foreign-owned operating through banking units throughout Kosovo. The headquarters of all commercial banks are mainly in Prishtina and through the expanded branch network they provide banking services to clients throughout Kosovo. Deposits and loans of commercial banks in Kosovo have been steadily increasing year after year since their establishment in 2000. In recent years, growth in international financial markets has given banks the opportunity to design new products and provide a wide range of services, but on the other hand there is an associated increased risk (Ahmeti et al., 2014). If so far, the biggest risk was the risk that a bank customer or other party may fail to settle the full value liability, known as credit risk, nowadays the banking environment has changed and the market has become more complex.

The banking sector in Kosovo consists of commercial bank activities. They have different shareholding structures, most of which are foreign capital. Activities in the banking sector have been expanding year by year and the share of credit activity in Kosovo has steadily increased, despite the European debt crisis, banks in our country were not faced with a lack of credibility (International Monetary Fund, 2013). The same report states that liquid assets are mainly assets of foreign banks. During the analyzed period, the number of banks has increased substantially. While in 2014 the total number of commercial banks in Kosovo was 9, in 2019 the number of banks reached 10, which are: Bank for Business (BpB), Nova Ljublanska Banka (NLB), Banka Ekonomike, ProCredit Bank, Raiffeisen Bank Kosovo, Turkish Economy Bank (TEB), National Commercial Bank (BKT), Turkiye Cumhuriyeti Ziraat bankasi, Turkiye Is Bankasi, Komercijalna Banka AD in Mitrovica (north).

It should be noted that only two banks in Kosovo are locally owned (Banka për Biznes and Banka Ekonomike), while the other banks are foreign owned banks. Depending on the numerous services offered by commercial banks in Kosovo, lending remains their main activity, as the demand for money in a transition country is significantly greater than the money supply, so importance should be taken into account because the credit remains high (Ahmeti et al., 2014). Since the main sources of bank and deposit financing are local, this represents about 70-80% of all liabilities. This represents a great advantage for the banking sector, as they are not directly related to international financial markets, and this has contributed to reducing the impact of the global financial crisis (Ahmeti *et. al*, 2014).

4. Analysis of Key Financial Performance Coefficients

Based on the numerous works of various authors, we understand that one of the best ways to measure the performance of commercial banks' profitability analysis are the coefficients: ROA, ROE and NIM.

Return on Assets (ROA) expresses the ratio: total earnings / assets. It is used to measure how effectively a company uses its assets to make a profit. It is usually used to measure the performance of a company. High ROA implies a higher asset intensity and profitability of the company. It is the most widely used standard for bank profitability as it measures the return on investment of a company in a format that is easily comparable to other institutions. In other words, it measures how efficiently a bank can manage its assets to make profits.

Return on Equity (ROE) expresses the ratio: net profit / total capital. From a banking perspective, this ratio is the best indicator of profit flow and growth potential. Represents the level of return of the bank's shareholders, it is the percentage of profit for every € 1 invested in the bank by the shareholders.

Net Interest Margin (NIM) Ratio: Net Return on Investment - Interest Paid) / Average Assets. This ratio is used to measure the amount of operating income on average assets. The lower the NIM ratio, the lower is the quality of the management decision. The net interest margin is usually used for a bank or investment firm that invests depositors' money, allowing for an interest difference between what is paid to the bank's client and what is made by the borrower of the funds.

5. Analysis of ROA, ROE and NIM

The key profitability coefficients are provided by the financial statements published on the websites of each commercial bank in Kosovo calculated as a percentage. The coefficient values are not manipulated because any pre-published bank financial statements and are audited by audit companies and the risk of manipulation can be considered 0%. As for the concept of risk and return, they are very present in the banking industry. According to studies by audit companies, lending to higher margins and high-risk clients may increase profits (in the short term) but increase bank creditors' risk and potential future losses.

Table 3 presents the coefficients that measure the profitability of the banking sector in the period 2014-2019. The coefficients are: ROA, ROE and NIM.

Table 1. Profit Flow Trend for Period 2014-2019 (%)

Viti	2014	2015	2016	2017	2018	2019
ROA	1.26	1.11	1.68	1.63	1.57	1.76
ROE	15.07	22.12	17.17	11.58	16.41	14.23
NIM	5.70	5.79	5.56	5.18	5.11	4.94

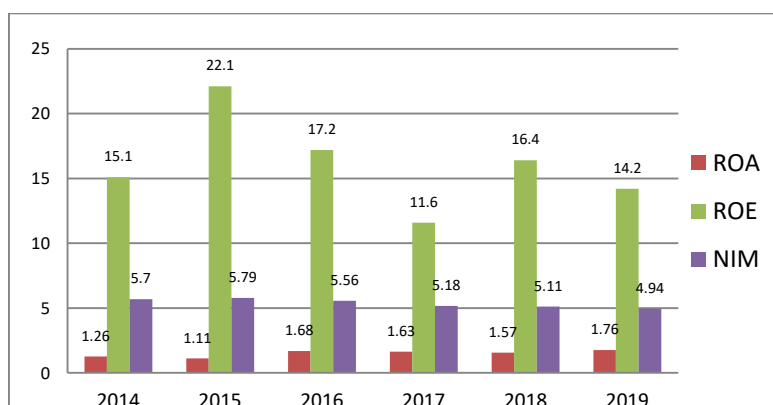
**Figure 1. Profit Flow Trend for Period 2014-2019 (Authors' Calculations)**

Figure 1 shows an increase in the profit flow trend from 2014 to 2019. ROA increased from 1.26% to 1.76%, ROE from 2014 to 2016 increased from 15.1% to 17.2%, but during 2017-2019 continued to fell and in 2019 reached 14.2%. The main reason for maintaining a steady trend of profit flow during 2014-2019 is due to the increase of total banking sector assets. NIM, from 5.70% as it was in 2014, to 2016 had a linear behavior, although in 2019 it was 4.94%.

6. Financial Performance Analysis for the Period 2014-2019

Historically, a ratio of 1% or greater has been considered very good for the banking sector, although over time this ratio has shifted depending on the prevailing economic situation. Larger banks also tend to have a lower ratio. By comparison, the average ROA of the US banking industry in Q3 2019 was 1.30%, while in some European Union countries for 2018, the ROA was: in Hungary, 2.2%, Romania, 2.1%, Croatia, 1.6%, Czech Republic, 1.2%, Slovenia, 1%, Estonia, 1.5%, Austria, 0.9% etc. (Statista, 2020). Regarding Kosovo, this ratio is averaged across different European countries but significantly higher than in the US. In 2019, ROA in commercial banks in Kosovo was 1.76% although this percentage varies from year to year, falling to 1.11% in 2014. A direct reflection of the profit made by commercial banks as a result of the increased lending activity of the banking sector

during the period 2014-2019 is given in Fig. 1. The increase of the banking sector profit presents positive implications for the level of efficiency in the banking sector.

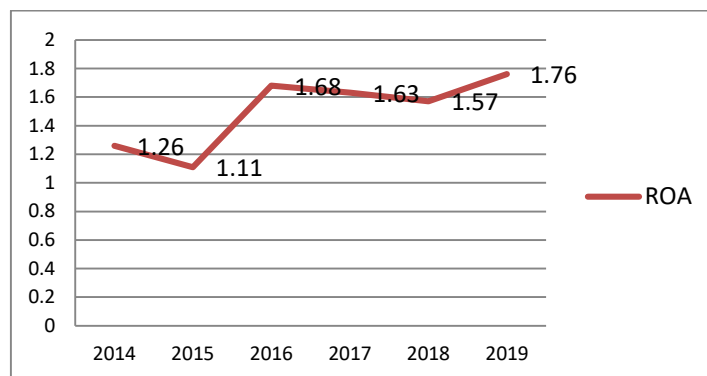


Figure 2. ROA Coefficient Trends (Authors' Calculations)

Another report worth looking at is Equity Return or ROE. This ratio is commonly used by a company's shareholders as a measure of their return on investment. The ratio measures the amount of revenue a company has returned as share capital. Unlike ROA, ROE is significantly higher in larger banks. By comparison, overall, the average ROE of the U.S. banking industry in Q2 2017 was 8.75%. On average it was 10.34% in Q2 2017 in large institutions, but only 8.51% in smaller institutions. In some European Union countries for 2018, the ROE was: in Hungary, 14.6%, Romania, 13.6%, Croatia, 8.8%, Czech Republic, 13.3%, Slovenia, 10.7%, Estonia, 9.8%, Austria, 8.6%, Germany, 2.4%, UK, - 0.3 etc. (EBF, 2020). As for Kosovo, this ratio is significantly higher than in the US but also in some different EU countries. Although it was 11.6% in 2017, which is significantly lower than in 2015, in 2019 it stands at 14.2%.

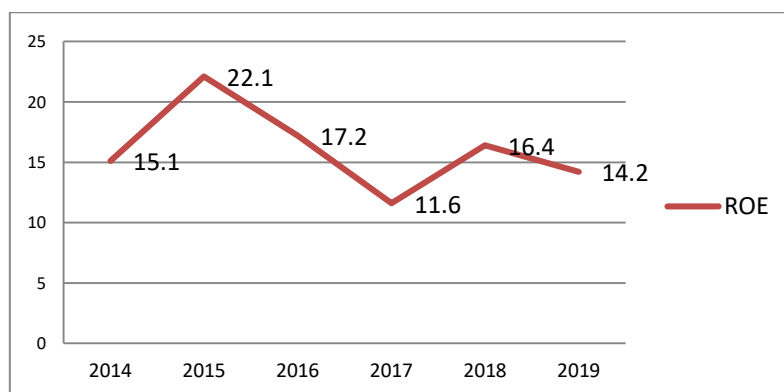


Figure 3. ROE Coefficient Trends (Authors' Calculations)

Net interest margin (NIM) as a measure of bank efficiency is a measure of the difference between the interest income generated by banks and the amount of interest paid to their lenders, relative to the amount of their assets. In our analysis, we conclude that net interest margin is positively associated with operating cost, credit risk and implicit interest payments. Based on the figure below, we can conclude that this ratio has changed from year to year, from 5.7% in 2014 to 4.94% in 2019. As shown in Figure 4, from 2014 to 2019, over time there were significant differences in the level of net interest margin which were influenced by various factors. The introduction of new banks into the financial market in Kosovo (Ziraat bank, IS bank) has been significantly influenced by the NIM movement.

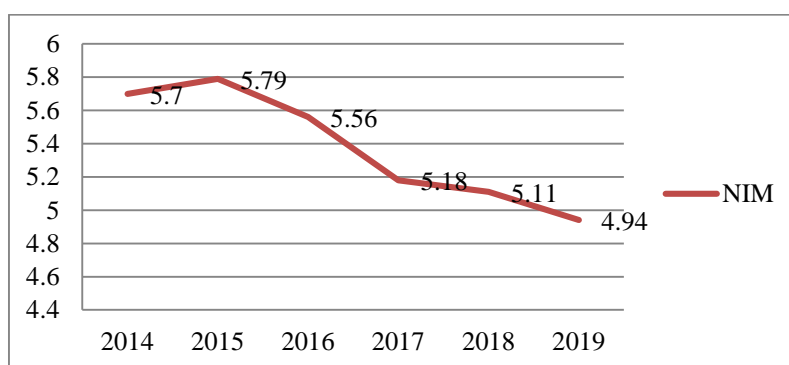


Figure 4. NIM Coefficient Trends (Authors' Calculations)

7. Conclusion

Given the nature and objective of the research, a quantitative research approach was adopted. In order to collect the necessary data, we used a structured review of the financial data during the research. Analysis of financial performance in the banking system in Kosovo includes the period from 2014 to 2019. In this study, the quality of the three financial profitability indicators of banking sector in Kosovo was measured. The results showed that overall, profit flow, liquidity and profitability have been improving steadily from 2014 onwards.

We can conclude that the banking sector has remained stable, as can be seen from the financial analysis of the banking sector indicators. Regarding capital adequacy we can say that banks are at acceptable liquidity level. Banks have continued to meet all regulatory requirements. The banking sector in terms of ROA in Kosovo shows a largely stable trend despite the decline in the last year analyzed because it is relatively better than some of the other EU countries. However, this indicates that commercial banks should pay more attention to the use of its assets more effectively.

ROE also has a similar movement as ROA and overall, it shows some stability, which can be observed even when compared to some EU countries. The net profit margin for the first time during the period under review has fallen below 5% in all likelihood, falling interest rates or even rising operating and non-operating costs. This requires banks to improve their operations. Commercial banks in Kosovo need to improve their deposits that offer cheaper funds, which can turn into strong financial performance.

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