Credit risk management and nonperforming loans in commercial banks in Kosovo

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Abstract

The main purpose of this research is to analyze the credit risk and the level of nonperforming loans of commercial banks in Kosovo. Risk is an internal element of banking activity, but excessive risk and poor management can lead to losses, endangering the security of a bank. Given that banks play an important financial role, they must operate safely and soundly and have sufficient capital and reserves to cope with the risks they undertake in the course of their activity. Credit risk is the main risk faced by the banking system. Banks in our country still have high interest rates on loans, but nonperforming loans are lower than in the countries of the region and beyond. This study used the tools, techniques and methods needed to analyze the credit risk and the level of nonperforming loans of the banking system in Kosovo, as well as to analyze the behavior of the consumer against the interest rate on loans of commercial banks in Kosovo. Structural (questionnaire) data are also used, as this method is more efficient and helps in collecting credible data and facilitates the achievement of the objectives of this study.

Keywords: Credit risk, risk management, loans, interest rates, risk indicators.

Introduction

Economic theory recognizes different definitions for risk, depending on the situation, viewpoint and objectives. The risk has to do with uncertainty, with the possibility to lose, but also to win, or simply deviate from the expected outcome.

For a risk business, it is possible to occur events that cause fluctuations and non-fulfillment of objectives. In today's business the risk plays a critical role. Almost every business decision requires managers and executives to balance risk and return. Effective business risk management is essential to the company's success. In the banking system, risk management takes on particular importance, where regulators are responsible for protection against failures of the banking system and the economy. Although banks have many similar risks to other businesses, the main risks that banks have particular impact on and which are dealt with in this research are: Credit risk, operational risk, liquidity risk.

Banks need to manage their risks carefully, as ineffective risk management can quickly lead to bank failure. If a bank is perceived to be in a weak financial position, depositors will withdraw their funds, other banks will not credit, on the other hand the bank itself will not be able to sell debt securities in the financial markets. All of this would further aggravate its financial situation. This paper is enriched with a case study where the credit risk of the banking system in Kosovo is presented. Banks have certain principles to manage and reduce credit risk. These principles include intensive capacity analysis for customer debts, monitoring of problematic credit exposures, implementing carefully designed and documented processes, implementing the "four eyes" principle, building a more long-term relationship with the customer by maintained regular contacts, as well as investing in well-trained and motivated workers.

Literature review

Banks are one of the most important instuctions in an economy. Usually with the bank concept are related to the creation of money, deposit collection and payment transactions. Thus, the bank is a special financial institution of the monetary-credit system that deals with obtaining and lending in a professional manner, as well as mediating in the payments flow of the clients. However, there are different terms regarding the bank's notion. There are many definitions for the word bank, (Cunderlík, 1991) says the bank is a universal name for the business (institution) specialized in currency trading, and capital intermediation (financial). (Bernard and Colli, 1992) say that the Bank is a business that professionally receives funds from the public in forms of deposits or other ways for its own account and their use in various operations such as loans and other financial operations. It is thought that the most complete definition of the bank was given by the Swiss Dr. Felix Somary in his "Bank Policy" veil (Luboteni, 2013), which was published in Thupingen in 1934. According to him, the bank is an institution or entity whose main job is the provision of credit in the form of money. In the encyclopaedia of the lexicographic agency, banks are defined as enterprises or entities which have the main activity of credit and monetary business in real estate management.

Credit risk in commercial banks

A key function of the bank is financial intermediation, accepting deposits from those who have a surplus of funds and lending to businesses or individuals certain funds. Risk enterprise is an internal element of banking activity, but excessive risk and poor management can lead to losses, thus endangering the security of a bank. Given that banks play such an important financial role they must operate safely and soundly and hold sufficient capital and reserves to cope with the risks they undertake while exercising their business (Halili, 2012). Credit risk is the main risk faced by the banking system. The key responsibility for ensuring that a bank has strategies, policies, processes and risk management technology to adequately measure and adequately control exposure to the risks it assumes falls on the board of directors and senior bank executives (Bundo, 2012). Credit risk is the likelihood that the borrower or counterparty of a bank in a contract / agreement will not partially or fully meet his / her obligations in due time in accordance with the terms agreed upon in their contract. It can be said that this risk has to do with uncertainty in the possibility of a counterbalance to fulfill its obligations (Myers, 1976). From the fact that there are many controversial types, from individuals to government bodies, as well as many types of liabilities, the credit risk takes many forms and banks manage it in different ways.

This risk is the most important risk faced by a bank, considering that the loans constitute the largest part of a bank's assets. In order to cope with the credit risk for a stable banking activity, banks need to create sufficient financial reserves. Thus, in order to cope with unforeseen credit risk losses, the bank calculates and maintains sufficient capital depending on the size of the risk the bank undertakes, meeting the requirements of the Central Bank of Kosovo for calculation and maintenance of its level.

Data and research methodology

In this research a number of qualitative and quantitative elements were analyzed to identify and analyze the credit risk and the level of non-performing loans. The source of data used in this material is primary and secondary data. The paper will use structural data (questionnaire), as this method will show better and show the realistic situation of how satisfied customers are with lending standards by commercial banks. Population and populations participating in the sample are owners of various businesses, or people who work in businesses and who have loans in commercial banks. The number of clients interviewed in these institutions is 100 clients, where we will use the random sample to select clients.

Credit risk management and non-performing loans in Kosovo

Banks must have a credit risk management system that is appropriate to the nature, volume and complexity of their activities. The credit risk management system in banks should include the policies, procedures, rules and structure used by banks to manage credit risk. The credit risk management system should continuously and timely evaluate the quality of loans and other assets, including the determination of the adequacy of reserves for losses related to this risk. The Bank should develop strategies and policies to manage credit risk. Strategy and policy on credit risk management should be effectively communicated to the entire bank. All relevant staff should clearly understand the bank's approach to credit delivery and management and should be held responsible for compliance with the policy and procedures established[1].

Banking sector loans accelerated annual growth to 11.5 percent. Until December 2017, the total value of loans reached 2.49 miliard euros.[2] The factors that contributed to the growth of lending in 2017 were the increase in demand for loans and the improvement of credit supply by banks mainly through the reduction of the average interest rate on loans and the extension of maturity of loans. In addition to the growth of the credit portfolio, another important factor is the quality of this portfolio, ie how are the loans that are issued by the banking sector. This can be shown by the level of non-

[1] Central Bank of the Republic of Kosovo.

[2] Annual Report 2017, Central Bank of the Republic of Kosovo.

performing loans at industry level. Banks throughout the lending process and up to their maturity stage face the risk if the client has the potential to repay the loan within the terms or conditions specified in the contract. If the client fails to return the loan within the deadline specified in the contract then we say that the loan is problematic and if this problem is not resolved within 90 days, then this loan is considered non-performing. Consequences in the banking industry as a result of non-performing loans may be large if no preventive measures are taken. Non-performing loans negatively affect the performance and stability of the banking industry, increasing provisioning, lending, and in more severe cases may result in a financial institution in insolvent condition.[3]

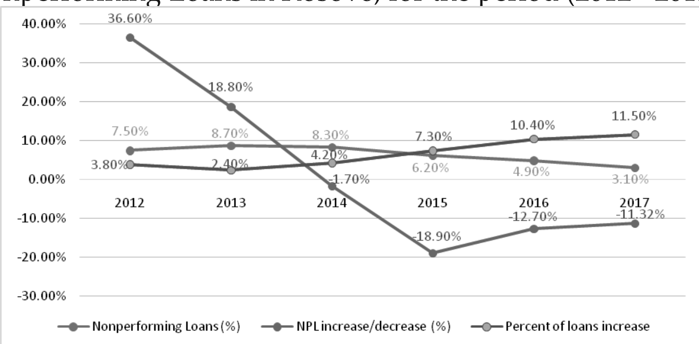
With their activities and operations, commercial banks in Kosovo realize huge profits by applying high interest rates on loans granted. For the high interest rates currently prevailing, bankers in front of clients, economic entities and others are reasoned that there are different factors and different risks that banks are following from the non-repayment of loans in a given customer period as a result of the dominance of bad credit, other factors that influence the determination of interest rates are also the interest rate on deposits, as well as the interest rate on loans issued by banks to each other. So even though banks have high interest rates on loans, Kosovo's bad loans are lower than in the countries of the region and beyond. Earlier, the European Bank for Reconstruction and Development warned that Eastern European countries could face a second wave of financial crisis, as a result of rising bad credit and business financial difficulties.

Table1. Nonperforming Loans in Kosovo, for the period (2012 - 2017)

Year	Value of nonperforming loans	Nonperforming loans in (%)	NPL increase/ decrease (%)	Percent of loans increase
2012	132.3	7.50%	36.60%	3.80%
2013	157.1	8.70%	18.80%	2.40%
2014	154.4	8.30%	-1.70%	4.20%
2015	125.2	6.20%	-18.90%	7.30%
2016	109.3	4.90%	-12.70%	10.40%
2017	96.93	3.10%	-11.32%	11.50%

Source: CBK, annual reports 2013, 2014, 2015, 2016 dhe 2017.

Graphic 1. Nonperforming Loans in Kosovo, for the period (2012 - 2017)



Source: CBK, annual reports 2013, 2014, 2015, 2016 dhe 2017.

[3] Kosovo Banking Association, Banking period 2016.

Banks in Kosovo have managed to manage a sound credit portfolio, marking the lowest level of non-performing loans at the end of 2017 of 3.1% of total credit portfolio. The banking sector had a very dynamic lending expansion during 2017, reaching a growth rate of 11.5%.

By the end of 2016, according to World Bank data, records the percentage of non-performing loans of 4.9% in relation to the total credit that the banking industry has issued to its customers. This lower level compared to all other countries presented on a comparative basis indicates the high quality of the credit portfolio that the banking industry has in Kosovo to their clients. From the data analyzed, it is seen that the banks operating in our country are sound and financially stable. The low rate of non-performing loans reflects banks' sound business development practices, prudential regulation and supervision by the Central Bank of the Republic of Kosovo, as well as a stable macroeconomic environment which has not caused any shocks on the solvency margin borrowers. Also, banks have avoided lending to those individuals or businesses who are not sure to repay their loans in time, in order to reduce the risk of non-return on the part of the borrowers. The decrease in non-performing loans has also affected the improvement of lending conditions by banks.

Table 2. Nonperforming loans in Kosovo

Nonperforming Loans in Kosovo (2012 - 2017)						
Description	2012	2013	2014	2015	2016	2017
Value of nonperforming loans	132.3	157.1	154.4	125.2	109.3	96.93
Provisions for loans losses	112.7%	110.5%	114.4%	115.1%	126.5%	149.7%

Source: CBK, annual reports 2013, 2014, 2015, 2016, 2017.

The table above shows the euro value of non-performing loans in relation to the percentage of the provision that the banking sector has allocated for loan losses. One of the preventive measures that banks undertake to hedge against credit risk, ie non-performing loans, is the provision of loans issued.[9] The table above shows that by the end of 2017 banks have allocated provisions up to 149.7% to cover possible losses from non-performing loans, 126.5 percent in 2016. This means that banks are able to cover the costs they can come from losses as a result of non-performing loans.

Non-performing loans in the countries of the region

This low level of non-performing loans in Kosovo shows that Kosovo has a high credit portfolio compared to all other countries presented for comparison. The quality of the credit portfolio also improved in the main eurozone economies, where on average the level of non-performing loans fell to 7.4 percent from 9.0 percent (2015). Almost all countries were characterized by declining non-performing loans. The lowest level of non-performing loans, within the countries with credit over the eurozone average, keeps Germany at about 2.3 percent and the Netherlands at a rate of 2.5 percent (2016).

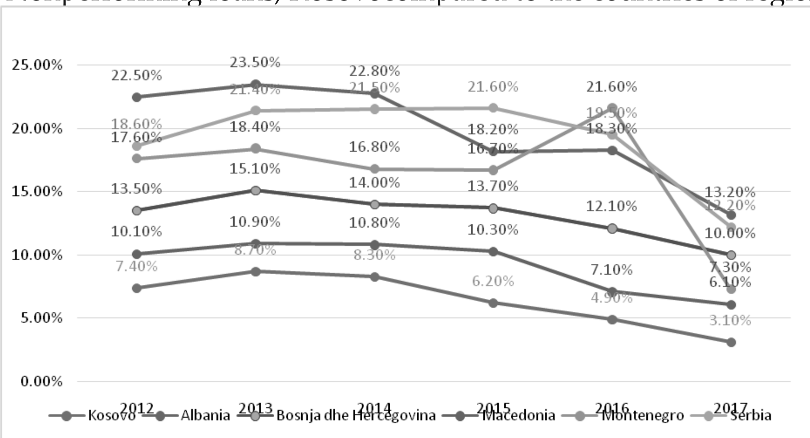
Table 3. Nonperforming loans, Kosovocompared to the countries of region (2012 - 2017)

Nonperforming loans in the countries of region						
State	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
Kosovo	7.40%	8.70%	8.30%	6.20%	4.90%	3.10%
Albania	22.50%	23.50%	22.80%	18.20%	18.30%	13.20%
Bosnja dhe Hercegovina	13.50%	15.10%	14.00%	13.70%	12.10%	10.00%
Macedonia	10.10%	10.90%	10.80%	10.30%	7.10%	6.10%
Montenegro	17.60%	18.40%	16.80%	16.70%	10.30%	7.30%
Serbia	18.60%	21.40%	21.50%	21.60%	19.50%	12.20%

Source: CBK, annual reports 2013, 2014, 2015, 2016 dhe CEIC.

Kosovo compared to the countries of the region has the lowest rates of non-performing loans, including Albania, Macedonia, Montenegro, Serbia etc. Of the countries in the region, Albania recorded the highest value of non-performing loans by 13.20%, while Serbia recorded 12.20% of the gross loan total in September 2017. Following these two countries, Bosnia and Herzegovina is ranked at 10.00% and so on.

Grphic 2. Nonperforming loans, Kosovocompared to the countries of region



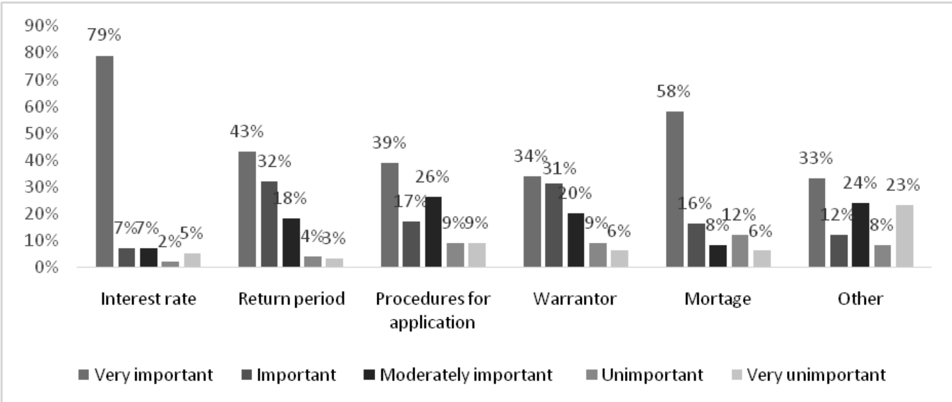
Source: CBK, annual reports 2013, 2014, 2015, 2016, 2017 dhe CEIC.

The decline in the NPL's rate reflects both the 11.5 per cent annual lending growth and the significant improvement in loan portfolio quality, where the value of non-performing loans fell 11.32 per cent year-on-year. The downward trend of the NPL rate has started since November 2014. It is worth pointing out that the non-performing loans to total loans in December 2017 were at the lowest level since the end of 2010. Also, the banking sector in Kosovo remains at the lowest level compared to the countries of the region. Kosovo continues to be the country with the best quality of the credit portfolio compared to other countries in the region.

Analysis of Results

The questionnaire is the best way to collect data from the research participants. The compilation and construction of the questionnaire has been supported and adapted to the topic of the study to obtain a score on customer feedback on commercial bank

interest rates.
Population of this survey consists of 100 persons surveyed, respondents are subjects who work or run various enterprises. Of this population, 29% of respondents are owners of enterprises, 10% are directors of enterprises, 36% of them are managers (9% of them are bank managers), 17% of respondents work as administrators in the enterprise, 6 % are credit analysts of banks and 2% have another position in the enterprise.
Graphic 3. The most important information before you decide to take the loan
(1 - is the most important factor and 5 - the least important factor).



Source: The author's data (2018).

From the chart above, we see that interest is the most important information, where 79% of respondents see interest as very important information before deciding to take the loan. Mortgages are seen as the second most important information by the respondents, where 58% of them see it as very important information. Then, as very important information is the return period of 43%, application procedures with 39%, guarantor 34% and other information with 33%, and so on.

Table 4. Banks' financing conditions

Financing conditions					
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Very favorable	5	5.0	5.0	5.0
	Favorable	36	36.0	36.0	41.0
	Unfavorable	37	37.0	37.0	78.0
	Very unfavorable	15	15.0	15.0	93.0
	I don't know	7	7.0	7.0	100.0
	Total	100	100.0	100.0	

Source: The author's data (2018).

The table above shows consumer perceptions about the terms of financing by banks. We see that only 5% of respondents think that our bank financing conditions are very favorable, 36% of respondents think that the conditions of funding are favorable, 37% think they are unfavorable, 15% think they are very unfavorable and 7% of them say they are unaware of this issue.

Table 5. How satisfied you are, with the interest rates on loans of commercial banks in Kosovo?

Rate interest on loans					
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Very satisfied	3	3.0	3.0	3.0
	Satisfied	6	6.0	6.0	9.0
	Moderately satisfied	32	32.0	32.0	41.0
	Dissatisfied	36	36.0	36.0	77.0
	Very dissatisfied	23	23.0	23.0	100.0
	Total	100	100.0	100.0	

Source: The author's data (2018).

From the table above, we see that only 3% of respondents are very satisfied with interest rates on loans, 6% of them are satisfied with interest rates on loans, 32% are on average satisfied, 36% are satisfied dissatisfied with interest rates on loans and 23% of them are very dissatisfied with interest rates on loans. It is worth noting that with lower interest rates on loans in recent years, we have a greater number of clients who are on average satisfied or fully satisfied with interest rates on loans compared to previous studies of this the type, where most of them were very dissatisfied, because the interest rates were also higher. So, banks have continued to cut interest rates on loans, but these rates continue to be considered as high by borrowers. Banks should continue to cut interest rates, as bank loans remain the main source of finance for the economy.

Table 6. Interest rates in Kosovo are reasonable, because the return risk is high

Interest_rates_reasonable					
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	I completely agree	10	10.0	10.0	10.0
	I agree	23	23.0	23.0	33.0
	I disagre	39	39.0	39.0	72.0
	Strongly disagre	25	25.0	25.0	97.0
	I don't know	3	3.0	3.0	100.0
	Total	100	100.0	100.0	

Source: The author's data (2018).

From the table above, we see that only 10% of respondents agree completely that interest rates are reasonable because the return risk is high for banks. 23% of them agree that interest rates in Kosovo are reasonable, 39% of them disagree with the assertion that interest rates in Kosovo are affordable, 25% of them do not agree with the assertion that interest rates in Kosovo are reasonable and 3% said that they are unaware of this issue. With this we can not justify the reasonableness of interest rates, as it is seen that Kosovo has the best status of bad credit, compared to the countries of the region. Analyzing the bad credit chart in the region and knowing the bad credit situation in Kosovo, we can conclude that consumers are completely right that they think that return risk is not one of the key factors that banks can are argued that it is affecting the risk of return on interest rate cut on credit, this is because Kosovo has the best status of bad credit compared to the countries of the region.

Table 7. Banks should offer lower interest rates

Interest_rates_should_decrease					
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	I completely agree	68	68.0	68.0	68.0
	I agree	28	28.0	28.0	96.0
	I disagre	2	2.0	2.0	98.0
	Strongly disagre	1	1.0	1.0	99.0
	I don't know	1	1.0	1.0	100.0
	Total	100	100.0	100.0	

Source: The author's data (2018).

From the above data, we see that the majority of respondents (68%) fully agree with the assertion that interest rates should decrease and credit procedures need to be relaxed, 28% of them agree that banks should lower interest rates, 2% of them do not agree with this assertion, 1% completely disagree, and also 1% have not been aware of this issue. Respondents agree 96% that banks have to lower interest rates because high interest rates do not allow economic entities to expand their activities, thus opening up new jobs and consequently lowering the rate unemployment and lowering the costs of citizens and businesses, these are some of the reasons that interest rates should decrease.

Conclusions

After various analyzes made in this paper, I have come to the conclusion that Banks should establish a credit risk management system, which aims to manage their credit risk well. Banks ensure that the credit risk management system, quantitatively and qualitatively, is consistent with the size of the bank, the type of activity and the level of exposure to credit risk. The basic purpose of the credit risk strategy is to determine the bank's appetite for risk. Once the risk level has been established, banks can develop a plan to optimize returns by keeping credit risk within the predetermined limits.

With their activities and operations, commercial banks realize huge profits by applying high interest rates on the loans granted. So even though banks have high interest rates on loans, Kosovo's bad loans are lower than in the countries of the region and beyond. To stay in this position and to develop even more, and to reduce the share of non-performing loans, banks need to be careful about lending to their clients and lower interest rates. In order to avoid lending to those individuals or businesses that are not sure of timely paying the loans, to avoid further growth in the level of non-recoverable loans, this can be achieved by lowering interest rates but also the repayment term is extended, then the borrowers will most easily refund the loans as their development becomes more viable.

Based on the research done for clients who have credit, we can say that the first thing that interests consumers is the interest rate as the most important information when they go to get credit. Also, we can conclude that the financing conditions have improved and that banks are paying more attention to easing the financing conditions for enterprises by reducing interest rates for this sector as the effect on economic growth is greater

Analyzing the results of the research and the bad credit table and knowing the bad credit situation in Kosovo, we can conclude that consumers are completely right that they are of the opinion that the risk of return can not be one of the main factors, that banks may reasonably be influenced by the risk of return on interest rate cut on credit, this is because Kosovo has the best status of bad credit compared to the countries of the region.

Based on the research results, we make the following recommendations:

We recommend that banks continue to lower interest rates on loans, because high interest rates do not allow economic entities to expand their activities, thereby opening up new jobs, and consequently lowering the rate unemployment and lower the costs of citizens and businesses.

We recommend lower rates of interest rates and the extension of loan repayment periods for some prospective sectors to be applied in order to rely more on them. Especially in the agricultural sector, in order to support this sector more, as it is a very important and very sensitive sector as well.

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