THE PROFITABILITY OF BANKING SECTOR IN KOSOVO

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Abstract: *This paper focuses on the trends of the profitability of banking sector. The Kosovo belongs to the economies in transition process toward open market economy. The establishment of new financial system in Kosovo started at the end of 1999 from scratch and new banking institutions were established by the private capital investment. This paper examines the evolution of banking profitability over period of 6 years from 2010 until 2015. The survey examines banking sector (10 banks) which experienced continuously good profitability and analysis how profitability has been fluctuated using profitability indicators as return on assets, return on equity and net interest margin. The results will express how high profitability returns in 2010 have been followed by a slight decrease of profitability during 2012-2013; and ending in 2015 with the highest profitability indicators since the establishment of banking sector. The ROA indicator has been doubled while ROE productivity indicator has been close to the double figure comparing banking performance in period from 2010 to 2015. The Kosovo banking industry except very good liquidity and capital adequacy ratios has continued to have very qualitative loan portfolio expressed with the lowest level of non-performing loans (NPL) in region which at the end impacted very high profitability in banking industry.*

Key words: *banks, profitability, ROA, ROE, net interest margin*

1. INTRODUCTION

Commercial banks established by the private capital who operate in the market as the intermediary financial institutions are oriented toward maximization of profits, considering the regulatory objective of the safety of depositor's interests. Over the last two decades, the banking system has been facing a lot of changes in Europe and other countries that are under a process of transition. In the process of transition, banking industry must carry out its operations in compliance with domestic and international regulatory (credit, capital, liquidity) requirements. The profitability of banking industry is influenced by the internal or bank-specific factors and other external factors. The internal factors have an impact on external factors and vice versa; meaning that factors such as liquidity risk, capital adequacy, credit risk, etc. directly or indirectly will impact the profitability of banking industry and influence the economic growth of a country.

The interest of both the country and business is to maintain a good profitability of banking industry and keep high reciprocity confidence. The inability of achieving expected profitability would have negative consequences for banking institutions and for country's development and economic growth. Kosovo banking industry permanently has had good asset quality and consequently, it was expressed in good performance and stability of banking system.

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2. LITERATURE REVIEW

There are conducted a great assorted literature, approaching bank profitability and many other studies which examine bank performance factors, some of them being focused specifically in some countries while others on their panels.

Various analyzes towards bank profitability are performed on particular states such as Switzerland (Dietrich and Wanzenried, 2009), US (Berger, 1995; Angbazo, 1997), Japan (Lui and Wilson, 2010), Greece (Mamatzakis, 2003; Kosmidou, 2008; Alexiou and Sofoklis, 2009), Malaysia (Guru et al., 1999), Turkey (Alper and Anbar, 2011; Kaya, 2002; Tunay and Silpar, 2006), Brazil (Afanasieff et al., 2002), China (Heffernan and Fu, 2008), India (Badola and Verma, 2006),Pakistan (Javaid, 2011; Burki, 2006),Turkey (Alper and Anbar, 2011; Kaya, 2002; Tunay and Silpar, 2006; Philippines (Sufian and Chong, 2008),Sayilgan and Yildirim, 2009),Croatia (Kundid et al., 2011), Korea (Sufian, 2011), Czech Republic (Horvath, 2009), Romania (Andries and Cocris, 2010) and Taiwan (Ramlall, 2009; Chen and Yeh, 1998).

On the other hand, some additional important studies appraise bank profitability through groups of countries (Molyneux and Thorton, 1992; Molyneux and Forbes, 1995; Demerguç-Kunt and Huizinga, 2001, 1999; Goddard et al., 2004; Bashir, 2000; Hassan and Bashir, 2003; Athanasoglou et al., 2005; Athanasoglou et al., 2006). Consequently, some of these studies examined the determinants of bank profitability in regard to European banks. Furthermore, Molyneux and Thornton (1992) observe the profitability of banks in a total of 18 European nations during the period from 1986 to 1989, concluding that there is an important positive connotation among the level of interest rates and the return on equity, government ownership, and bank concentration. Based on his analysis, Goddard et.al (2004) states that between bank profitability and risk endures a positive and constructive rapport, while bank size has an irrelevant influence on profitability. Their findings have been obtained by evaluating the profitability of 6 different countries of European banks throughout 1992 to 1998. Concentration is completely correlated with bank profitability, and inflation has a robust effect on profitability, whereas the real GDP per capita variations do not alter significantly the profits in banks. The study was conducted on South Eastern European area over the period from 1998 to 2002 (Athanasoglou et al, 2005).

Further studies have attempted to recognize the banks' profitability determinants due to their role and importance in today's economy. Moreover, fluctuations in the banks' profitability affect their ability to issue new equity due to the presence of agency costs and tax disadvantages negatively (Cornett and Tehranian, 1994). Thus, beginning with Short (1979) and Bourke (1989) efforts, analyzes and works, many other researchers are concerned with finding the factors of the banks' profitability. The empirical literature emphases on diverse categories of determinants. Consequently, a plethora of studies measures the impact of the macroeconomic habitat on the banks' profitability. Though some researches (Demirgüç-Kunt and Huizinga, 1999; Pasiouras and Kosmidou, 2007; Athanasoglou et al., 2008) correlate the individual banks' profitability to various macro-indicators, other researches apply collective bank data to assess the economic framework impact (Albertazzi and Gambacorta, 2009).

However, some other literature concentrates on the features of the banking sector. Determinants such as the concentration level, competition, ownership or the presence of foreign banks, reforms, are observed by Berger and Humphrey (1997), Iannotta et al. (2007), Short (1979), García-Herrero et al. (2009). Lastly, a final category of researches discusses the role of internal factors, for example: capital (Berger, 1995), non-performing loans, loan loss provisioning

(Bikker and Metzemakers, 2005), or interest rate risk (Hmweck and Kilcollin, 1984). Additionally, there are studies that search various categories of factors and their role, such as banking industry, macroeconomic and financial soundness factors (i.e. Pasiouras and Kosmidou, 2007; Athanasoglou et al., 2008). Simultaneously, a category of studies Berger, 1995; Pasiouras and Kosmidou, 2007; Kosmidou, 2008; Athanasoglou et al., 2008; Dietrich and Wanzenried, 2011) approaches the situation of a single country, whilst other studies observe the viability factors in a panel of countries (Molyneux and Thorton, 1992; DemirgüçKunt and Huizinga, 1999; Albertazzi and Gambacorta, 2009). Nevertheless, the majority of the studies have been concentrated on individual banks and developed countries. Less studies were on the transition and the emerging banking sector with insufficient omission (Andrieş et al., 2012; Lee and Hsieh, 2013)

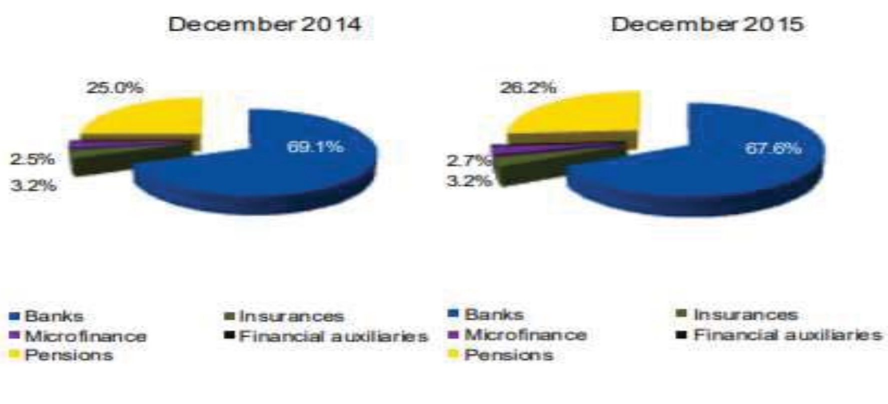
3. METHODOLOGY AND DATA

Analyzing efficiency is of high importance for the evaluation of banks' performance. Therefore, banks' shareholders, bank partners, and customers use financial indicators as an important analytical instrument to compare and evaluate the performance of banking institutions. Financial indicators could be divided into four categories: profitability rates, margin rates, weighted result rates and employment efficiency rates. To analyze and evaluate the efficiency indicators the most frequent banking financial reports used are balance sheets, profit and loss accounts. Within the first category of the indicators are profitability rates, where the most used are: return on assets (ROA), computed as a ratio of the net profit to the average total bank assets; return on equity (ROE), computed as a ratio of the net profit to average equity; return on sale (ROS); costs ratio (C/I). In the second category of efficiency, indicators include margin rates counting two basic rates: net interest margin and interest spread. In this study, are used three profitability indicators as the following: return on assets, return on equity and net interest margin.

The yearly data for the ten banking institutions are extracted from the official web page of the Central Bank of Kosovo and other bank institutions.

The figure below shows the structure of the financial system in Kosovo in last two years of study reflecting that the banks are remaining the most important institutions participating with 67.6% in the financial market, followed by pensions with 26.2% and other institutions which comprise rest of 6% of share.

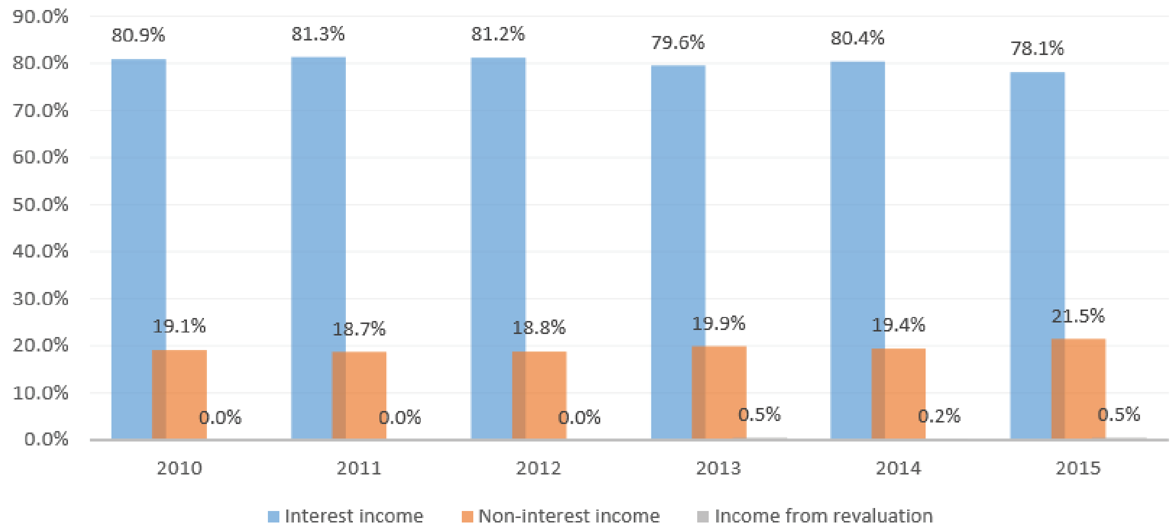
Figure 1: Structure of financial system assets



Source: CBK (2016)

Additionally, it is revealed the structure of revenues of the banking industry in Kosovo, from 2010 to 2015. Consequently, it provides with the information that the main source of banking revenues is interest income, with participation in 2010 with 80.8%, while facing a slight decrease in 2015 at 78.1%. The second source of revenue is non-interest income ranging from 19.1% in 2010 to 21.5% in 2015. The decrease in revenues from interest income is a result of a continuous decrease of loan interest rates in domestic market, dropping from two-digit number interest rate in 2010 to one-digit number interest rate. Within the interest income category, main income source is loan interest rate. Fees and commissions are the main sources of revenue falling within non-interest income category.

Figure 2: Interest income, non-interest income, income from revaluations (2010-2015)



Source: CBK – Income statement of other depository corporations (April 2016)

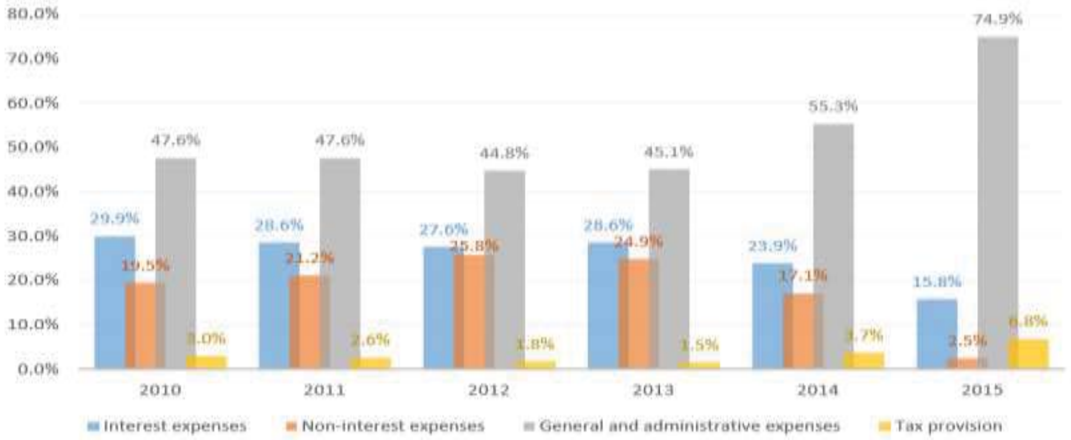
In addition, Table 1. shows the level of non-performing loans in relation to total loans for 7 regional countries. It shows that Kosovo is standing in top of the list of countries with the lowest level of non-performing loans, having a direct impact in a high level of interest income in banking and high bank profitability in general. The level of non-performing loans in Kosovo is too far from other regional countries, seeing that some countries have the level of NPL for two or three times higher. The good credit risk management of banks has resulted with healthy loan portfolio, is the most important factor in generating income, and less problematic loans which at the end affected the very high profitability of banking industry.

Table 1: Non-performing loans in relation to total loans (2010-2015)

NON-PERFORMING LOANS IN RELATION TO TOTAL LOANS (2010-2015)						
Country	2010	2011	2012	2013	2014	2015
Albania	14.0%	18.8%	22.5%	23.5%	22.8%	20.9%
Bosnia and Herzegovina	11.4%	11.8%	13.5%	15.1%	14.0%	14.1%
Croatia	11.1%	12.3%	13.8%	15.4%	16.7%	17.1%
Kosovo	5.8%	5.7%	7.4%	8.5%	8.3%	7.1%
Macedonia	9.0%	9.5%	10.1%	10.9%	10.8%	11.0%
Montenegro	21.0%	15.5%	17.6%	18.4%	16.8%	16.7%
Serbia	16.9%	20.0%	18.6%	21.4%	21.5%	22.8%

The structure of expenses in the banking industry is shown in Figure 3, reflecting a high decrease in interest expenses form 29.9% in 2010 to 15.8% in 2015. The high decreasing effect has faced non-interest expenses from 19.6% in 2010 to 2.5% in 2015. On the other side, we could notice a very high increase of general and administrative expenses from 47.8% in 2010 to 74.9% in 2015 and similar impact on tax provisions from 2.7% in 2010 to 6.8% in 2015. The decrease of interest expenses is a consequence of the decrease in interest rates in international financial markets.

Figure 3. Expenses of the banking industry (2010-2015)



Source: CBK – Income statement of other depository corporations (April 2016)

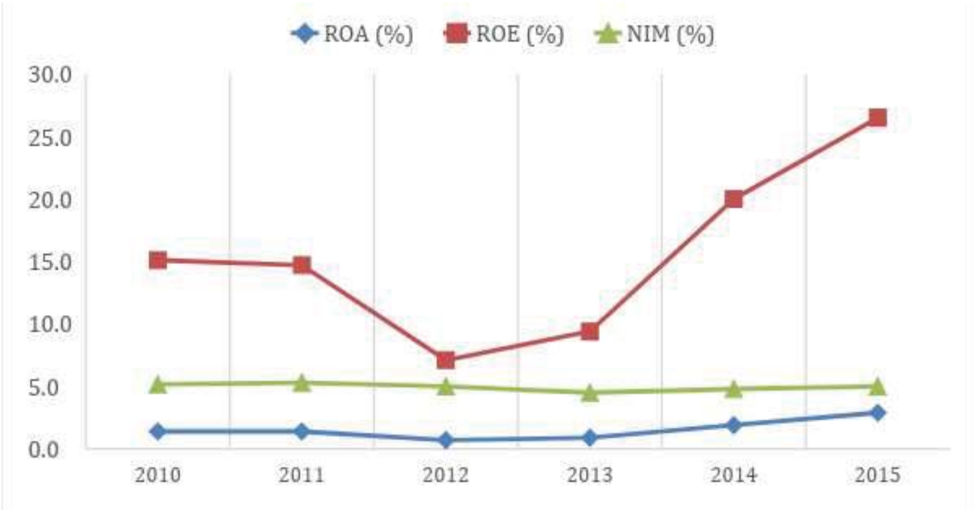
Moreover, Table 2 presents a summary of total assets, total capital, total liabilities, net profit, interest income, interest expenses and particularly three financial indicators ROA, ROE and NIM for the banking industry in Kosovo. Data are shown on yearly basis and cover examined period from 2010 - 2015. Calculation results show the very high profitability of banking industry measured by profitability rates and margin rates. The table represents high performance in all three indicators measured and analyzed by the study.

Table 2: Main-banking indicators 2010-2015

	2010	**2011**	**2012**	**2013**	**2014**	**2015**
Total Assets (000€)	2,455.10	2,649.70	2,829.30	3,059.30	3,186.60	3,385.30
Total Liabilities (000€)	2,455.10	2,649.70	2,829.30	3,059.30	3,186.60	3,385.30
Total Capital (000€)	230.4	252.8	270.7	277.8	323.1	392.7
Profit (000€)	32.8	35.5	18.5	25.9	60	94.7
Income (000€)	217.1	239.6	247.1	249	244.2	238.2
Expenses (000€)	184.3	204.1	228.6	223	184.2	143.5
ROA (%)	1.4	1.4	0.7	0.9	1.9	2.9
ROE (%)	15.1	14.7	7.1	9.4	20.0	26.5
NIM (%)	5.2	5.3	5.0	4.5	4.8	5.0
Interest Income (000€)	175.4	194.6	199.2	196.2	193.5	186
Interest Expenses (000€)	55.2	58.4	63.1	63.8	44	22.6

Figure 4 analyses separately movement of profitability rates. ROA indicator reflects the same rate of 1.4% in 2010 and 2011, while there is decreasing effect in 2012 and 2013 reaching 0.7% and 0.9%. The last two years examined by study reflects high increase which has been doubled in 2015 compared to 2010 reaching from 1.4% to 2.9% of ROA. ROE indicator of the banking industry in Kosovo similar to ROA has very high and stable profitability trend in 2010 and 2011 with around 15%, while in 2012 and 2013 has experienced decreasing result between 7 - 9.4%. Similarity trend with ROA has been noticed during 2014 and 2015 which has been reflected by a high increase and in 2015 was doubled reaching 26.5 % of ROE.

Figure 4. Movement of ROA/ROE/NIM profitability rates



On the other side, margin rate has shown different and more stable profitability results compare to profitability rates. The net interest margin (NIM) has resulted in 2010 with a ratio of 5.2% reflecting a slight decrease in 2013 and 2014 of 4.5% and 4.8%. In last year covered by study 2015 net interest margin has returned to a high marginal rate of 5.0%.

Overall profitability of banking industry has proven to be very high in all three used rates.

4. CONCLUSION

To conclude with, most of the papers focus on the individual banks and on the developed markets, fewer papers have dealt with the banking industry profitability in transition markets. This study gives a contribution to the evidence and profitability trends in transition markets taking into consideration Kosovo as an individual country. The study uses the financial indicators, focusing on profitability rates and margin rate of the banks' profitability in Kosovo. The findings are significant independently analyzing the ROA, the ROE or NIM for measuring the profitability.

The results achieved to show an increase in the efficiency of banks' performance in the period from 2010 to 2015. The total balance sheet of the banking sector has increased from 2.5 billion in 2010 to nearly 3.5 billion in 2015. The primary factor for the development of the banking sector in Kosovo was a very dynamic and permanent increase of loan activity. The increasing trend of loan portfolio resulted from the high demand for loans for households and enterprises.

Financial indicators can be used by all those interested in evaluating a bank's performance – regulators and supervisors, shareholders, management and/or customers.

Reliable and good official indicators regarding the bank capitalization and liquidity have been supported with the lowest level of the non-performing loans of Kosovo in the region. The continuous increase of banking income and at the same time continuous decrease of banking expenses have had an impact on bank profitability maintaining very sound loan portfolio and banking institutions. The profitability indicators shown through ROA and ROE reflects very high performance and efficiency not only in the region but if we compare even with developed European countries.

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