



**IMPROVING CORPORATE GOVERNANCE AND TRANSPARENCY IN  
BANKS AND INSURANCE COMPANIES IN KOSOVA**

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## EXECUTIVE SUMMARY

An effective system of corporate governance in banks and insurance companies will impose appropriate standards of conduct on managers and control and monitoring procedures on banks in order to maximize opportunities for legitimate profits subject to the best interests of depositors and shareholders. Good corporate governance regulates the relationships between banks' stakeholders, their Boards and their management. It prevents the abuse of power and self-serving conduct, as well as imprudent and high risk behavior by bank managers, and resolves conflicts of interests between managers and board members on the one hand and shareholders and depositors on the other. Indeed, the current state of the world economy is in some measure attributed to the fact that boards (and their risk management committees) have not properly discharged their duties in exercising oversight on managers engaging in high risk activities. The corporate governance of the financial sector, therefore, has important implications for the stability of the whole economy.

The banking and insurance system in Kosovo is fairly new, established only after the 1999 war (the first bank was set up in 2000). Since then, banks have year by year expanded their activities and increased their deposits, assets and also credits to businesses and households. Deposits reached an amount of 1.422 billion Euros (€) in January 2009, an increase of 23.3 per cent compared to January 2008, while loans in January 2009 reached an amount of €1.189 billion, an increase of about 31.7 per cent compared to the previous year. Measured by Return on Equity (ROE) and Return on Total Assets (ROTA), the banking system in Kosovo shows the best performance in the region with a continuous increase in profits. However, it is highly concentrated, with the three largest banks accounting for 90 per cent of assets, 88 per cent of deposits and 81.5 per cent of loans.

The banking and insurance sector has been attractive to foreign investors, with foreign capital being dominant in six of the eight banks operating in Kosovo. It is expected that enhanced corporate governance and transparency in the financial sector will influence positively the development of this sector in Kosovo and have an impact on the reduction of the informal economy through better channeling of the money in circulation and other financial transactions. Such enhanced corporate governance and transparency will also help the development of other segments of the capital market, such as the equity market.

By comparing and contrasting the rules and regulations of the banking system in Kosovo with the OECD (Organization for Economic Cooperation and Development) Principles of Corporate Governance, it can be seen that most of the regulations are concerned with financial reporting and disclosure, and correspond to the fifth OECD Principle—Disclosure and Transparency. Rules and regulations only marginally cover issues related to the first principle (ensuring a basis for an effective corporate governance framework) and the second principle (rights of shareholders). The fourth OECD principle (role of stakeholders) is vaguely addressed in Amended Rule VIII, where the rights of depositors (but not other stakeholders) are mentioned. However, rules and regulations fail to address the third OECD principle (equal treatment of all shareholders). In addition, banks seem to ignore the provision requiring at least two (out of five) board members to be non-executive (or independent) members. The absence of independent directors has a major implication for the overseeing role of the Board and enables the self-serving managers and board members to pursue their personal interests.

To sum up, the legal and regulatory framework governing the operation of banks and insurance companies in Kosovo has been in force for a relatively short period of time, and the proportion of the legislation dealing with corporate governance is relatively small. Nevertheless, it is important to note that a great deal of attention has been focused on transparency of Kosovo's financial institutions. A fit and proper criterion applied to major shareholders and senior managers in banks, and to other officers in the insurance industry, is the introduction of assurance to build confidence in the system and to ensure that the quality of the human factor is a matter of concern to regulatory authorities.

Our research findings suggest that shareholders are informed properly and in a timely manner. Also, there are indications that the rights of shareholders are being respected and that they are able to exercise their key functions. There are, however, no formal provisions for protection of minority shareholders, though at present, because of the small number of shareholders, this is not a major problem in the Kosovar financial institutions. Issues related to stakeholders within the banking and insurance industries in Kosovo are not regulated, and the banks and insurance companies address these as they see fit. This has led to a situation where stakeholders are addressed mainly for public relations purposes. The findings of the survey we have conducted reflect the fact that there is no legal requirement in place for the interests of stakeholders to be taken into account, especially those of employees and depositors. In contrast, the perceptions of one key group of stakeholders—the business community comprising banking and insurance industries—is that credit conditions are severe and inappropriate for business expansion. However, such expansion is the key for Kosovo to develop sustainable economic growth and address its major socio-economic problems: unemployment and poverty. Kosovo has the highest loan interest rates in the region, the lowest loan intensity (share of loans in GDP) and yet a very good performance of its banking system as measured by ROE and profit growth.

It is essential that government tries to encourage more competition in the financial sector and takes actions to improve the supply of credit to the private sector. A common interest of all stakeholders is higher economic growth and timely preventive measures that will ameliorate the impact of the current global crisis. In this respect there is much room for action to be taken by all stakeholders.

## RECOMMENDATIONS

1. Given the special importance of financial institutions for the functioning of a country's economy and quality of life of its citizens, Kosovo's parliament, government and central bank (CBK) should embark on completing the review of the legislation that regulates this sector, with a view to adopting a specific law on banks and insurance companies that would be suitable for the current level of development of the domestic economy. Within this legal framework, special attention should be given to advanced experiences in corporate governance of financial institutions, and OECD principles in this area. Following results of our research, we recommend that the appropriate bodies:
  - a. regulate the composition of boards of directors more effectively in order to ensure the presence of independent directors
  - b. ensure that conflicts of interest both at board and at operational level are dealt with appropriately
  - c. stipulate the role of stakeholders more clearly and take steps to ensure the involvement of the main stakeholders: i.e. depositors, borrowers, those insured, the community, and employees
  - d. explore the possibility of promulgating a Law on Deposit Insurance, following current experiences in other countries in the light of the global financial crisis.
2. We recommend that banks and insurance companies formally adopt and implement OECD Principles of Corporate Governance within their policies and procedures, and report on their compliance in their annual reports.
3. Banks and insurance companies should develop corporate governance policies for the appointment of independent board members, establish and maintain better relations with their stakeholders, and establish the unitary model of board system, in accordance with existing legal provisions.
4. Banks and insurance companies should develop training programmes for their managerial personnel, as well as for board members, aiming at improving and advancing their corporate governance practices in the light of OECD principles<sup>1</sup>.

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<sup>1</sup> There is precedence for this provision in Kosovo: the Law on Publicly Owned Enterprises (POEs) requires members of their boards of directors to undertake corporate governance training annually.

# 1. INTRODUCTION

This research report contains an analysis and assessment of the quality of corporate governance in the financial institutions (banks and insurance companies) in Kosovo within the light of the requirements and standards known as Organization for Economic Cooperation and Development (OECD) Principles.

The objectives of this report are to improve information available to relevant actors regarding both the achievements and the current situation concerning corporate governance at the banks and insurance companies and to produce policy recommendations for government, the Central Bank of Kosovo (CBK) and the financial sector companies and other stakeholders for advancing further the situation in this area.

The report is the third component of the project 'Improving the Corporate Governance Framework and Transparency in Kosovo', which is focused on the financial sector<sup>2</sup>. The first component of the project was concerned with analysis of the current state of corporate governance in Kosovo's Publicly Owned Enterprises (POEs), particularly Kosovo Electricity Corporation Joint Stock Company (KEK jsc) and Post and Telecommunications Corporation of Kosovo (PTK jsc) through undertaking a follow-up report and holding discussions on achievements made since 2006. The second component focused on a training programme on corporate governance issues and transparency conducted in two rounds for about 100 participants, including members of boards and management of banks, insurance companies, POEs, media, government, ministries and regulatory agencies.

The project was financed by the Center for International Private Enterprises (CIPE), Washington D.C., and implemented by Riinvest Institute for Development Research, with additional support provided by three Kosovar banks: Turk Ekonomi Bankasi (TEB), ProCredit Bank and Banka Ekonomike. Analysis of the corporate governance of financial institutions presented in this report was conducted from the perspective of OECD's Principles and Guidelines for Corporate Governance as well as of other international norms and codes of good corporate governance and transparency.

During report preparation the project team conducted desk research on various reports on banking and insurance companies, including those of the CBK, annual reports and other relevant literature. The main research effort was focused on a comprehensive survey of financial institutions, covering various aspects of their corporate governance practices and identifying their compliance with OECD Principles. Face-to-face interviews were conducted with board members and the management of six banks and with the six insurance companies present in Kosovo, as well as with other stakeholders, such as the Associations of Banks and Insurance Companies, Chamber of Commerce (KCC), Alliance of Kosovar Businesses (AKB). A semi-structured questionnaire containing specific questions and a number of open-ended questions were completed in each interview.

This research report was prepared for presentation and discussion at an international conference held on 8 April 2009, representing the final activity of this project.

The structure of the research report is laid out as follows: in the first part the report presents the executive summary and recommendations, followed by this introduction.

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<sup>2</sup> This project represents in fact the second phase of CIPE and Riinvest cooperation in this area. It follows the first phase of the project that was focused on corporate governance issues of POEs, namely KEK and PTK, and implemented during 2006.

The second part discusses the importance of the corporate governance of financial institutions and their specific features. Chapter 3 presents an analysis of the legal and regulatory framework in Kosovo, and Chapter 4 the survey findings related to the current state of corporate governance in Kosovo's banks and insurance industries.

We would like to thank CIPE for funding this project and also for the continuous support provided during its implementation. Our gratitude goes also to TEB, ProCredit Bank and Banka Ekonomike for their participation in supporting certain activities of the project. We thank especially Professor Hashi, for his excellent cooperation with our project team.

The findings and opinions presented here represent the views of Riinvest Institute and do not necessarily reflect the position of the other parties involved during the realization of this project.

## 2. CORPORATE GOVERNANCE OF FINANCIAL INSTITUTIONS

### 2.1 Current status

The complex nature of finance means that the concepts and daily activities of financial institutions (FIs) are not easily grasped by the majority of the population, who therefore need to rely on others (e.g. bankers) for information and explanation. Thus a key element for well functioning of financial systems is trust, which also sets apart financial and non-financial institutions (Trayler, 2007). If trust is regarded as the first reason, then the importance of FIs in overall stability of a country can be considered as the second reason that sets them apart from other firms. This has led most governments to regulate<sup>3</sup> their country's financial sector; it is hard to find a country that has an unregulated financial industry<sup>4</sup>.

The differences in the way financial regulation is implemented, as well as differences in risk management are considered the main elements that contributed to distinguishing performance among European banks in the light of the recent financial crisis. Whereas two major Spanish banks announced profits of €14 billion for the previous year, three Belgian banks announced losses far exceeding that figure. It seems the Spanish banking supervisor had drawn lessons from the banking crisis of 1977 and it imposed stricter capital requirements on local banks than was normal for European banks. In addition, during good years, these banks were required to put aside more provisions for bad loans. This approach appeared to have worked until the recent financial crisis (Lannoo, 2009).

These are the main reasons some researchers give for arguing a case that there is a great difference between corporate governance of financial institutions and that of firms, and having corporate governance of financial institutions studied separately<sup>5</sup>.

Caprio and Levine (2002) discuss the special characteristics of banks and other financial institutions that intensify the corporate governance problem. They identify three features of banks that make them different from other firms. First, banks are more opaque, a characteristic that amplifies the agency problem. Opacity in banking makes it (i) more difficult for equity and debt holders to monitor managers, (ii) easier for managers and large investors to exploit the benefits of control, rather than maximizing value<sup>6</sup>, (iii) unlikely for potential outside bidders to generate an effective takeover threat, and (iv) more likely that a more monopolistic sector will ensue, lessening the impact of corporate governance mechanisms through competition<sup>7</sup>. Second, banks are heavily regulated and this, more often than not, imposes a natural hindrance to corporate governance mechanisms. Measures that include deposit insurance, regulatory restrictions on concentration of ownership, entry, takeover, bank activities etc., all have adverse effects on mechanisms designed to control the management by shareholders. Limitation

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<sup>3</sup> Regulation is often perceived as interference since, some argue, there has been some overlap between banking regulation and corporate governance since the earliest days of modern banking (Shull, 2007).

<sup>4</sup> The extent of regulation is mainly country specific even within EU countries.

<sup>5</sup> There are researchers who argue that there are important distinctions between banks and other financial institutions (i.e. money market mutual funds, non-bank credit card companies etc.) hence advocating for separately studying bank corporate governance (see Macey and O'Hara, 2003).

<sup>6</sup> Large investors and managers may manipulate a firm to act in their own interests instead of the board interests of the corporation and other stakeholders.

<sup>7</sup> Information asymmetry accompanying banking makes it very expensive for outside bidders to gather the necessary information to generate a sufficient takeover threat, giving bank managers more discretion in pursuing their own interests with little concern that they might be replaced following a hostile takeover.

of stock ownership by a single owner in many countries and hostile takeovers are diminished as corporate governance mechanisms, because of lack of regulation and the opaqueness of banks argues Levine (2003). Third, as Caprio and Levine (2002) suggest, government ownership makes corporate governance of the banking industry very different from that of other industries. State ownership of banks is common in many countries, presenting a problem for corporate governance since it creates a situation of conflict of interest between the state as a monitoring authority and as a regulatory authority. State ownership also means that the managing of the bank is handed to bureaucrats who are unlikely to maximize firm value, but rather cater to the interests of specific groups.

Macey and O'Hara (2003) identify four elements that distinguish banks from other firms. First, the liquidity production role of banks is explained through their capital structure, which is unique in two aspects: i) banks usually have very little equity compared to other firms, and ii) a bank's liabilities are in form of deposits, which are available to their creditors and depositors on demand; in contrast a bank's assets are loans that on average have longer maturities than the liabilities. The mismatch between liabilities and assets can become a problem with corporate governance implications in the unusual situation of a bank run<sup>8</sup>. Theoretically, bank runs can happen to solvent banks just as much as to those in difficulty. In order to mitigate this problem, the deposit insurance fund was devised, creating, according to Macey and O'Hara, the second point of corporate governance distinction between banks and other firms. In the US, the deposit insurance fund<sup>9</sup> proved to be very successful in preventing banking panics. However, the regulatory cost of deposit insurance is that it gives the managers and shareholders of insured banks incentives for engaging in excessive risk taking. A moral hazard is now more likely to occur because the bank shareholders are able to pass on some of their losses to healthy banks, whose contributions to the Federal Deposit Insurance Corporation (FDIC) pay the depositors of the failed banks, or consequently the taxpayers who refill the federal insurance funds if they are drained.

The third distinction pointed out by Macey and O'Hara is the conflict between fixed claimants and shareholders<sup>10</sup>. What makes banks different from other types of firms is the lack of significant discipline imposed by other fixed claimants. The existence of FDIC insurance removes the incentive for insured depositors to control excessive risk-taking since their funds are safe regardless of the investment strategies selected by banks.

The fourth distinction is asset structure and loyalty problems. Since the existence of a federal insurance fund decreases the incentives for monitoring, it naturally increases the risk of fraud and self-dealing. Depositors do not have the incentives to monitor the management due to free-rider issues, and they rarely organize themselves because of the

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<sup>8</sup> Bank runs are a collective action problem among depositors. If for any reason large withdrawals begin, individual depositors, fearing they will be left with nothing if a bank's reserves drain out, start withdrawing their deposits also (Diamond and Dybvig, 1983). This is a classical prisoner's dilemma, where depositors would be better off if they would refrain from withdrawing. However, in their inability to coordinate their actions they end up causing a bank run. One of the recent examples is Northern Rock Bank, which was the subject of a bank run during the summer of 2008.

<sup>9</sup> In the US, a Banking Act was passed by Congress in 1933 establishing the Federal Deposit Insurance Corporation (FDIC) and gave the federal government the power to insure deposits in qualified banks.

<sup>10</sup> In the view of a corporation as a set of explicit and implicit contracts there are different claimants to its cash flow. The claimants include not only shareholders but also creditors, employees, managers, the local communities in which the firm operates suppliers, and customers. Claimants also include the regulators in their roles as insurers of deposits and lenders of last resort and in their capacity as agents of other claimants.

collective action problems. Thus, under the FDIC Improvement Act, regulatory agencies were required to issue guidelines or regulations that would create standards for safety and soundness in several areas, including internal controls, loan documentation, credit underwriting, interest rate exposure, asset growth, compensation, asset quality, etc.

To sum up, a review of the literature shows that there are strong arguments in favor of distinguishing corporate governance of financial institutions (mainly banks) from that of other firms. The distinctions derive from the sensitive and opaque nature of the business of these institutions where 'trust' is a vital factor for their overall functioning. There is also the systemic effect on the economy in case things go wrong for one of these institutions. This has been the justification for the stricter regulation of these institutions by governments. Other differences such as a larger board size, more frequent board meetings, and the higher level of accountability for directors and officers confirm that there is indeed a difference in the corporate governance of financial institutions compared to other firms.

## **2.2 Specific features of FI corporate governance**

Advancement of corporate governance principles in the financial sector is critical to fostering improvement in a business climate. In an emerging market economy such as Kosovo's the financial sector plays a particular role, channeling its society's savings into investments and providing necessary credits to the private sector (both enterprises and households).

Stability and sustained growth of an economy is closely linked to stability of the financial sector (especially the banking system) and any shock to the latter is capable of creating serious instability in the former. This is especially true when it comes to the current global economic crisis. The financial sector suffers from particular information asymmetries (e.g. between bank managers and bank depositors, between risk taking managers and the bank's board, between managers and shareholders, and between banks and regulators), which may be accentuated by insufficient transparency and disclosure, a common problem in Kosovo.

Under a weak system of corporate governance, such asymmetries are capable of undermining stability of the banking system, leading to a loss of confidence, possible runs on banks, or a credit crunch affecting adversely the economy's enterprise and household sectors. Indeed, the current state of the world economy is, in some measure, attributed to the fact that boards (and their risk management committees) have not properly discharged their duties in exercising oversight on managers embarking on high risk activities. The corporate governance of the financial sector, therefore, has important implications for the stability of the whole economy.

It is expected that enhanced corporate governance and transparency in the financial sector will influence positively its development in Kosovo and also have an impact in reducing the informal economy through better channeling of money circulation and other financial transactions. In addition, it will help develop other segments of capital markets such as equity capital markets.

An effective system of corporate governance in banks will impose both standards of conduct for managers and appropriate procedures for internal controls in order to maximize opportunities for legitimate profits subject to the best interests of depositors and shareholders. To that end, good corporate governance regulates the relationships between bank shareholders and depositors, and bank boards and management, prevents abuses of power and self-serving conduct, as well as imprudent and high risk behavior of bank managers, and resolves conflicts between private interests and official duties.

## 2.3 Brief overview of banking and insurance industries in Kosovo

Financial institutions in Kosovo are licensed and supervised by the CBK, which reports to parliament and advises government. The financial sector covers the banking industry, insurance industry, pension funds and other financial institutions, mainly micro-credit schemes. The total numbers of financial sector institutions in Kosovo stood at 66 at the end of 2008, of which eight were banks, ten were insurance companies with the rest being mostly microfinance institutions and intermediaries.

### 2.3.1 Commercial banks

Kosovo's banking sector not only has developed successfully but also is seen as a success story. The value of its assets and liabilities in January 2009 stood at €1.791 billion, more than 23.6 per cent larger than for the same period last year. Since the end of 2000, when the first bank was established after the conflict, the value of the total banking sector assets has increased 18-fold.

The financial sector in Kosovo is characterized by a large presence of foreign capital. This is mainly prevalent in the banking and insurance market where, respectively, 91.0 per cent and 72.1 per cent of total assets are managed by foreign companies. The presence of foreign financial institutions in Kosovo has contributed to the modernization of its financial system by bringing more advanced practices in finance into managing banking and insurance operations. As mentioned above, there are currently eight banks operating in Kosovo, six of them with complete or majority foreign capital. The new state's banking sector remains highly concentrated with the market share of the three largest banks accounting for about 90 per cent of the total banking sector assets, 88 per cent of which are deposits, and 81.5 per cent of the loans at the end of 2008<sup>11</sup>.

The level of deposits has increased year-on-year, reaching an amount of €1.422 billion in January 2009 (Table 1), an increase of 23.3 per cent compared to the same period last year. Compare this figure with the value of deposits in 2000, which stood at €93 million: the level of deposits has increased by more than 15-fold in nine years. The largest share of deposits (60%) consists of household deposits. As the deposits increased over this period, the lending activities have also increased constantly.

The amount of loans extended to the general economy in January 2009 stood at €1.189 billion, an increase of about 31.7 per cent over the year. The largest share of banking sector loans is extended to the trade sector (76% of total loans in January 2009, and 77.7% in January 2008), while about 24 per cent in January 2009 was extended to the households sector, which is still considered as being lower than the regional average. This reflects the high reliance of Kosovo's economy on trade.

**Table 1.** Bank indicators (€billion)

Indicator	Year				
	2000	2005	2006	2007	2008
Assets & liabilities	0.103	0.984	1.16	1.43	1.79
Deposits	0.093	0.836	0.924	1.14	1.42
Loans	0.003	0.513	0.636	0.891	1.19

Source: CBK Annual Reports 2001–2007 and monthly periodicals

<sup>11</sup> The high concentration in the banking sector is shown also by the Herfindahl-Hirschman Index (HHI): in 2008, the HHI for assets recorded 2,887 points, and was 2,896 points for the same period of the previous year, while HHI for loans and deposits stood at 3,014 and 3,016 points, respectively.

The banking sector is constantly increasing its profit. The amount of total banking sector net profit at the end of 2008 was about €36.4 million, increasing by about 7.7 per cent from the same previous period or by 173 per cent compared to the end of 2005 (€13.5 million), and 185 per cent from 2004 (€12.9 million). Banking sector income is mainly derived from interest on loans, where the share of the banking sector interest income (€146 million) to the total banking income at the end of 2008 (€195 million) was 74.9 per cent, almost the same as it was at the end of 2007 (74.8%).

The banking sector is constantly increasing the return on its assets (Table 2). The return on total assets (ROTA) in 2008 compared to 2007 fell by 40 basis points, while in 2007 the level of return increased by 70 basis points over the figure for the previous year. In addition, it is fairly steadily increasing the return on its equity (ROE). The figure stood at 22.2 per cent in 2008, having fallen from 26.2 per cent in 2007, a decline mainly attributed to the faster increase in shareholder capital in the banking sector.

**Table 2.** Banks' income and profit (€million)

Indicator	Year				
	2004	2005	2006	2007	2008
Total banking sector income	73.4	94.3	113.9	157.4	195.0
Banking sector interest income	53.9	74.6	88.8	117.7	146.0
Net profit	12.9	13.5	20.1	33.8	36.4
Return on Total Assets (ROTA; %)	1.6	1.5	1.9	2.6	2.5
Return on Equity (ROE; %)	17.6	20.1	22.4	26.2	22.2

Source: CBK Annual reports

The liquidity position (ratio between loans and deposits; see Table 3) of Kosovo's banking sector lies on the border of regulatory requirements<sup>12</sup>, standing at about 82 per cent in 2008, violating the recommendation of the CBK and lowering its liquidity position in the process. The liquidity position in 2007 was about 78 per cent, approaching the upper limit.

The increases recorded in the amount of deposits and loans is proof that the Kosovo banking sector is constantly developing, increasing its role in the country's economic development. This is reflected also in regular increases recorded for several indicators, including GDP share of banking sector assets, deposits and loans (Table 3). In 2008, the share increased to 47.5 per cent, compared 36.5 per cent in 2005, mainly due to an increase in volume of loans extended by the banking sector, reaching 31.1 per cent of GDP in 2008.

**Table 3.** Share of loans, deposits and assets of GDP (%)

Year	Loans/GDP	Deposits/GDP	Assets/GDP	Loans/Deposit
2004	16.4	30.4	35.6	53.8
2005	16.8	27.4	32.2	61.4
2006	20.0	29.1	36.5	68.9
2007	26.1	33.4	41.8	78.1
2008	31.1	38.0	47.5	81.9

Source: CBK Annual reports and monthly periodicals

The overall average level of interest rates on loans (Table 4) in 2008 stood at about 15.1 per cent, compared to 14.6 per cent in 2007. The average level has remained approximately the same over recent years, with a slight decrease in 2006 and increase in

<sup>12</sup> The regulatory recommended margin is 70–80%.

2008. Thus, despite the interest rates remaining high, especially for long-term capital investment needs and compared to elsewhere in the region, the amount of loans has, as shown in Table 1 and discussed above, increased year-on-year.

This phenomenon is especially apparent if we look at the interest rate spread (the difference between interest rates on loans and deposits), where despite the fact that the level has been continuously falling, it still remains the highest in the region. Nevertheless, it is worth mentioning that the interest rates for both loans and deposits have risen, indicating that the increase in the number of banks has increased competition in the Kosovo banking sector, but only with respect to more favorable interest rates for deposits and not for loans.

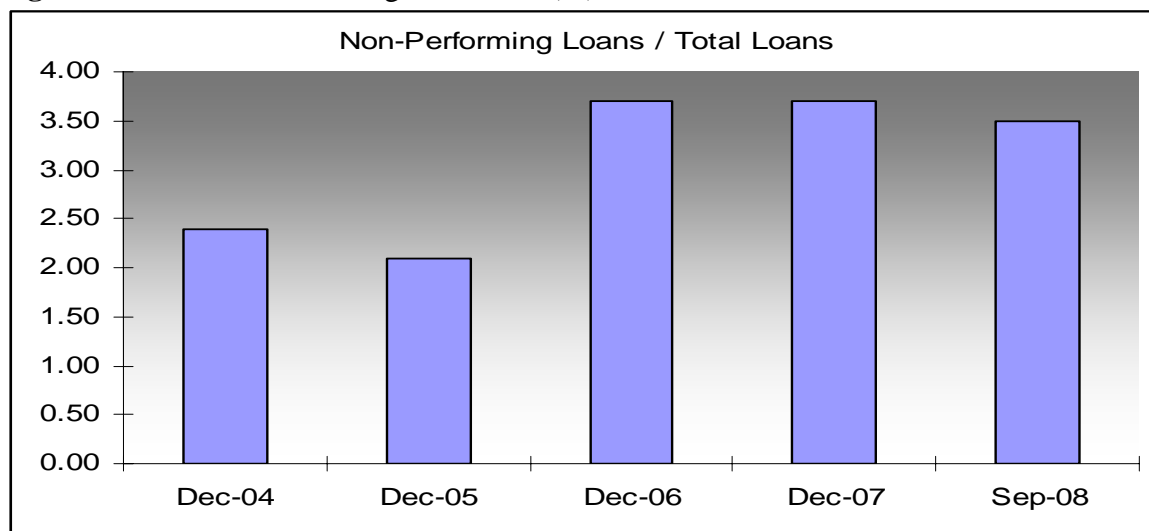
**Table 4.** Interest rates<sup>13</sup> on loans and deposits (%)

Indicator	Year				
	2004	2005	2006	2007	2008
Loans (A)	14.67	14.15	13.37	14.63	15.10
Deposits (B)	2.52	3.14	2.97	3.31	3.89
Interest rate spread/difference (A-B)	12.15	11.01	10.40	11.32	11.21

Source: CBK Annual Reports 2001–2007 and monthly periodicals

The loan portfolio in Kosovo’s banking sector remains of good quality. Despite fast credit growth, the share of non-performing loans (NPLs) among total loans (which include loans classified as ‘doubtful’ and ‘loss’) declined in September 2008 to 3.5 per cent, compared to 3.7 per cent at the end of 2007 (see Figure 1).

**Figure 1.** Share of NPL among total loans (%)



Source: CBK Bulletin 2008

The NPL to total loans ratio of 3.5 per cent in September 2008 ranks Kosovo below the average of 5.2 per cent recorded for all countries in the region, indicating that the loan portfolio of the banking sector in Kosovo is, on average, of a better quality than in the other countries. Nevertheless, caution is recommended, because compared to 2005, the NPLs have increased two and half fold, with a rise in NPLs especially in the smaller banks.

<sup>13</sup> Averaged across different products and maturities.

It appears that larger banks have a better quality of loan portfolio than the smaller ones. As of June 2008, the three largest banks recorded a NPL to total loans ratio of 3.2 per cent, while for the rest of the banks NPL accounted for, on average, 8.1 per cent of their loan portfolio. With respect to sector, households have the lowest level of NPLs.

Table 5 reports the loan to GDP ratio among countries in the region, of which Kosovo has the highest loan interest rate. This is reflected in a low level of loans being issued compared to those in these other countries. Such high interest rates mean that in Kosovo loans of one year or less are the most expensive in the region. This shows the poor credits available and is reflected in low credit intensity. Not surprisingly then, Kosovo banks' profit levels in 2007 were the highest in the region (Table 6).

**Table 5.** Credit line indicators for transitional countries in 2007 (%)

Country	Private sector loans/GDP	Interest rate		Bad loans (in total loans)
		deposits	loans (< 1 year)	
Kosovo	26.1	4.0	14.23	3.7
Albania	41.2	6.0	13.6	3.4
Bosnia	46.0	n/a	n/a	3.0
Serbia	47.5	4.1	11.0	n/a
Bulgaria	89.8	n/a	10.8	2.5
Macedonia	49.9	5.3	9.9	10.9
Croatia	117.7	2.7	9.3	4.8
Montenegro	121.2	4.8	9.2	3.2

*Source: EBRD Transition Report 2008, IMF estimates of Kosovo GDP and CBK Annual Report*

From what has been presented so far an excellent financial performance of commercial banks in Kosovo is demonstrated. This is particularly rewarding given the conditions of the current global financial crisis, which has affected banks especially. However, it should be noted that in Kosovo this has been achieved with very low credit intensity (loan/GDP ratio) and through the highest interest rates in the region and a larger margin between interest rates on deposits and loans.

**Table 6.** Profitability ratios (2007)

Country	ROTA	ROE
Kosovo	2.4	21.5
Albania	1.6	20.4
Serbia	1.7	8.5
Croatia	1.6	10.9
Macedonia	1.8	15.2

*Source: National bank of respective countries*

It could be argued that loan market conditions have been favorable for this situation, but it remains to be seen whether Kosovo's government and regulatory bodies have created conditions for more and free competition in the credit market, whether they are taking measures necessary to reduce risk and whether there is enough credit supply on offer, or whether the banks are more than comfortable with the current situation in the credit market. The question could be asked whether this situation is good for the long-term development needs of the Kosovar economy, particularly when it is difficult for businesses to finance their own development needs. Concerning corporate governance, the question could be raised in the area of the stakeholders' position (whether depositor, borrower, government, regulatory body, community). It is obvious that at some point banks will share the fate of their clients, businesses and households and it seems that in the matter elaborated here there should be more common sense applied.

### ***2.3.2 Insurance sector***

Insurance companies (ICs) in Kosovo are relatively small and few, with combined assets worth €70.8 million in 2007. Compared with the level in 2005, the value of those assets had increased by more than 53 per cent (in 2005 the figure was €46.2 million). In 2007, the share of total assets of ICs of the total financial sector assets in Kosovo was about five per cent.

Currently, there are nine insurance companies operating in Kosovo, of whom six are foreign. Their core activity is Third Party Liability (TPL), namely vehicle insurance policies. Total premiums reached a value of €50.8 million in 2007, compared to €48.7 million in 2006, and €47.2 million in 2005. The share of TPL policies among all policy premiums stood at 68.7 per cent in 2007, while the value of claims paid out by ICs that year was €12.8 million, i.e. 25.2 per cent of the premiums received. The share of TPL policy holder claims among the total claims was 84.8 per cent in 2007, compared to 90 per cent in 2006 and 96 per cent in 2005. The value of IC claims in 2006 was €10.9 million compared to €7.9 million in 2005.

### **3. LEGAL AND REGULATORY FRAMEWORK FOR BANKING AND INSURANCE SECTOR**

In this chapter the legal and regulatory framework for the banking and insurance sectors in Kosovo is investigated from the corporate governance perspective. In the absence of a specific law, the regulation of the banking and insurance industries in the country is governed by, respectively, UNMIK regulations No. 1999/21 and 2001/25. In the past, the Banking and Payment Authority of Kosovo (BPK), and its successor CBK, have issued new rules and other documents to support and amend these regulations, which remain at the core of the regulatory framework for the banking and insurance industries.

#### **3.1 Legal provisions for the banking sector in Kosovo**

Regulation No. 1999/21, ‘On Bank Licensing, Supervision and Regulation’ has been in force since 15 November 1999. It is a document comprising 53 sections covering the three areas indicated in its title. Only a few of these sections address directly or indirectly the governance of banks and other issues related to good corporate governance.

Articles 6.1(a) and 6.1(d) of ‘Section 6 – License Application’ under the heading ‘Licensing of Banks’ require from the body applying for a bank license to provide ample information regarding the qualifications and experience of administrators and persons applying to be principal shareholders or have significant interest in the bank.

Article 7.2(c) requires BPK to approve the qualifications, experience and integrity of administrators and principal shareholders before it grants a bank license. Furthermore, Section 18 demands that all persons elected or appointed as administrators of a bank must be fit and proper and of good repute and be approved by BPK prior to their assuming office. However, this Article does not impose any measurable standard for a person to fulfill in order to be appointed to these positions in a new (or existing) bank.

Article 14.1 requires prior written authorization of the BPK for the transfer of equity interest among a bank’s shareholders in order to prevent any person or interest group becoming a significant shareholder, i.e. owning more than 20 per cent of any class of voting shares of the bank.

Article 17.1 stipulates that each bank should be governed by a Governing Board consisting of an uneven number of members (not less than five), of which two shall be non-executive directors, and shall have an Audit Committee, a Credit Risk Management Committee and an Asset and Liability Management Committee. Article 17.2 stipulates that the Governing Board should be elected by shareholders and held responsible for establishing, supervising and implementation of policies, while Article 17.3 specifies that the Governing Board must be appointed by the general meeting of shareholders.

Articles 23.1–23.10 provide a wide range of advice and rules on conflict of interest for bank administrators and other employees of the bank, disclosure of information and an upper limit on the proportion of unsecured credit.

Section 30 restricts banks to enter into financial arrangements with related parties or employees in a manner which would be under less favorable terms and conditions for the bank. No bank shall extend credit to or for the benefit of a person related to the bank in excess of limits established by the BPK.

Section 32 instructs banks to prepare annual financial statements adequate to reflect their operations and financial condition in accordance with international accounting standards, reflecting the operations and financial condition of its subsidiaries and branch offices, both on an individual and consolidated basis.

Section 33 provides explicit requirements regarding the role and the obligations of the audit committee and the external auditor, and the rights and obligations of the internal auditor.

Section 34 stipulates that each bank shall within thirty days of each calendar quarter publish in a national newspaper a summary of its quarterly balance sheet, and also within the four months of the end of its financial year publish in a national newspaper a fair summary of its balance sheet and its auditor's opinion on the preceding financial year. Each bank shall also publish its annual report and provide free of charge copies to the public. This section was amended by Rule XXIV on September 2003.

By comparing and contrasting the rules and regulations of banking in Kosovo against the OECD principles of Corporate Governance it can be seen that most of the regulations address financial reporting and disclosure corresponding to the fifth OECD principle: Disclosure and Transparency. A reasonable proportion of the regulations discussed above specify the obligations and responsibilities of key executives and shareholders as well as different committees and which compares to the sixth OECD principle: the Responsibilities of the Board.

Rules and regulations touch upon the areas covered by the first OECD principle—Ensuring the Basis for an Effective Corporate Governance Framework—and the second principle—the Rights of Shareholders.

The fourth OECD principle—the Role of Stakeholders—is very vaguely addressed in Amended Rule VIII, where the rights of depositors are mentioned. However, the list of stakeholders cannot be constrained to depositors only since there are a significant number of groups that are stakeholders in a bank (e.g. employees, clients, community, etc.). What the rules and regulations of the banking industry in Kosovo fail to address is the third OECD principle—Equal Treatment of Shareholders—and perhaps this should be addressed in the near future.

Another issue for discussion is the provision by which executives directors might form a majority on the governing boards (out of five, two should be non-executive directors). Also there is no provision obliging the presence of independent board members. The current structure of governing boards in fact reflects the above provisions. This could create asymmetry in governance practices and some overweight influence of executive directors.

### **3.2 Legal provisions for the insurance sector in Kosovo**

Chapter VIII of Regulation No. 2001/25, 'On Licensing, Supervision and Regulation of Insurance' explicitly addresses the corporate governance of insurance companies, but there are sections under Chapter VI—Prudential Matters—and Chapter VII—Financial Considerations—that deal with issues related to corporate governance too.

Article 52.1 deals with the fiduciary responsibilities of directors and officers, and specifies that their violation constitutes grounds for imposition of BPK sanctions and other proceedings. Article 52.2 postulates that refusal of the board of directors to take action once there has been a clear violation of fiduciary duty subjects the insurance company to additional sanctions by BPK. According to Article 52.3, directors and officers of an insurance company, and representative officers of a branch are subject to the 'fit and proper' criterion. Directors and senior officers of an insurance company and representative officers of a branch are not allowed to hold more than one position in the company if this leads to conflict of interest (Article 52.4). This section has been amended by Rule 4 in force since January 2006. Directors and officers may, at any time, be required to provide proof that they are not under criminal investigations (Article 52.5).

Meanwhile, BPK is responsible for reviewing the curriculum vitae of proposed directors and officers, as well as representative officers of a branch (Article 52.6) and may reject any of these proposals on grounds that the best interests of the company, as well as of the insurance market, have not been served (Articles 52.7 and 52.8).

Article 53.1 stipulates that each insurance company shall be administered by a board of directors consisting of an uneven number of not less than five members. The board of directors shall be elected by the shareholders, while the general shareholders' meeting establishes the compensation for board members (Article 53.2). Responsibility of the board is to establish policies, procedures and practices for the company to follow and implement (Article 53.3), and it is its principal duty to protect the interests of policyholders (Article 53.4). Directors of an insurance company shall ensure that technical Articles are sufficient, the minimum solvency or capital margin and reserve requirement is adhered to at all times as prescribed by BPK and the company maintains sufficient liquidity (Article 53.5). This section is further elaborated in Rule 24 in force since April 2002.

Article 54.1 and 54.2 require that the senior officer of the insurance company shall be a member of the board of directors, but cannot serve as the chairperson of the board, and he or she must be a resident of Kosovo.

Article 55.1 stipulates the maintenance of adequate internal controls, encompassing the production of fully documented policies, procedures and practices for underwriting and investment activities. Article 55.2 entitles BPK to prescribe additional requirements for internal controls through rules or orders.

Article 56.1 specifies that directors, officers and employees of an insurance company shall act in a fiduciary manner to safeguard the interests of their policyholders. All related party transactions, except for those provided through BPK rules, are prohibited (Article 56.2 and 56.3). This is elaborated in greater detail in Rule 27 in force since April 2002.

Article 48.1 and 48.2 require that international accounting standards are used by insurance companies in Kosovo, and that they maintain adequate accounting systems and records, including a Premiums Register, a Premiums Ledger, Premium Reports, a Claims Register, Claims Reports, and a General Ledger. This section is amended by Rule 7 in force since April 2002.

Articles 49.1, 49.2 and 49.3 require insurance companies to have their accounts audited annually by a licensed firm approved by BPK, avoiding any conflict of interest. Article 49.4 defines the tasks for the audit firm and Article 49.5 requires this firm to express an opinion on whether the insurance company is in compliance with the present regulation and applicable rules approved by BPK. The audit firm should report directly to BPK if it becomes aware of fraudulent acts committed by the insurance company (Article 49.6). This section is amended by Rule 8 in force since January 2007.

Article 50.1 specifies the financial year-end for insurance companies to be 31 December and consolidated audited financial statements for the previous financial year should be submitted no later than 30 April. Each insurance company shall submit to BPK quarterly reports depicting its liquidity, solvency and profitability (Article 50.2).

Articles 39.1 and 39.2 specify that changes of audit firm, actuary, directors or officers require prior written approval of the BPK. Changes to the board of directors or officers require reporting and explanation to BPK.

When compared to OECD principles, the rules and regulations of the insurance market in Kosovo are in a similar situation to those of the banking sector, which is partly to be expected since the same body regulates and monitors both industries.

To sum up, the legal and regulatory framework governing the operation of banks and insurance companies in Kosovo has been in force for a relatively short period. The proportion of the legislation dealing with corporate governance, however, is relatively small. Nevertheless, it is important to note that a great deal of attention is focused on transparency of these institutions. The ‘fit and proper’ criterion applied to shareholders and senior managers in banks and to officers in the insurance industry is an assuring step to build confidence that the quality of the human factor is appreciated as key to a healthy functioning of these institutions.

Nevertheless, it cannot pass unnoticed that both the regulations and most of the rules date back to 1998 and 1999, when the Basle Committee for Bank Supervision issued its framework of internal controls and the OECD first published corporate governance principles, respectively.

## **4. CURRENT STATE OF CORPORATE GOVERNANCE IN BANKS AND INSURANCE COMPANIES – Survey Findings**

A survey of the banks and insurance companies operating in Kosovo was carried out between the last week of December 2008 and the first week of February 2009. Interviews were held with 16 persons, representing the boards or the management of six banks (out of eight) and six insurance companies (out of ten). In addition, in-depth interviews were conducted with representatives of CBK, KCC, AKB, and the Ministry of Finance. The results provide a useful insight into the state of corporate governance and compliance with OECD principles in these industries.

The survey reports are here presented and discussed under five sub-headings, addressing the second, third, fourth, fifth and sixth OECD principles.

### **4.1 Shareholder rights and key ownership functions**

The OECD's second<sup>14</sup> principle of corporate governance states that 'The corporate governance framework should protect and facilitate the exercise of shareholders' rights'. The questions and results from the present survey concerning this principle are summarized in Table 7, which reports that banks in Kosovo have on average 18.5 shareholders and insurance companies 2.1. The main method used to announce shareholders' meetings is through email: two thirds of banks and the majority of insurance companies use this tool, though some use the public media and more traditional means, such as phone or written notification by post.

One third of banks surveyed announce their general meetings one month in advance, another one third two weeks in advance and one bank makes its announcement of the general meeting only one week in advance. Half of the insurance companies announce the shareholder meeting one month in advance, one a fortnight in advance and another company only one week in advance. Along with the announcement of time and place of the general meeting all banks publish the agenda and the material to be approved in the meeting. Only half of the insurance companies follow this practice.

To put an item on the agenda of the general meeting, half of the banks in the survey require 50%+1 of the shares or votes and one third require 25 per cent or fewer shares or votes (with some banks requiring as little as 10%). On the other hand, only one third of insurance companies require 50%+1 shares to put an item on the agenda of general meetings; the other two thirds of respondents did not reply to this question.

Electing or removing board members requires 50%+1 of shareholders' votes in half of the banks, with one bank requiring 100 per cent. Two banks did not respond to this question. For insurance companies half of the respondents did not reply to this question, one third require 50%+1 of shareholders' votes and one company requires 100 per cent of shareholders' votes.

For amending their statutes half of the banks and insurance companies require the approval of two thirds of shares, one third of banks require the approval of all the shareholders, while one third of insurance companies require either one third or 50%+1 of shareholders' votes. To approve mergers or takeovers, half of banks require two thirds of shareholders' votes, one requires the approval of three-quarters and one all

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<sup>14</sup> We here begin with the second OECD principle of corporate governance since the first principle is concerned with ensuring a basis for an effective corporate governance framework, which has been tackled in the Legal and Regulatory framework chapter of this report.

shareholders' votes. For insurance companies, two thirds of them require two thirds of shareholders' votes and one requires three-quarters of shareholders' votes.

**Table 7.** Rights of shareholders and key ownership functions

Question	Answer	Banks	Insurance companies
Number of shareholders	average	18.5	2.1
	max <sup>15</sup>	40	4
	min	2	1
How is the shareholders' meeting announced?	company website	-	-
	public media	1	1
	email	4	5
	post	2	-
	phone	2	1
How far in advance is the shareholder meeting announced?	no response	1	1
	one week	1	1
	two weeks	2	1
	one month	2	3
What other information, except for date and location, about the General Shareholder Meeting is announced?	no response	1	1
	agenda and materials to be approved	6	3
	other	-	-
	no response	-	3
What % of shares (or votes) is required to put an item on the agenda of general meetings?	50% +1 and more	3	2
	25% or less	2	-
	no response	1	4
What % of shareholders' votes is necessary to elect/remove members of the board?	50% +1	3	2
	other	1	1
	no response	2	3
What % of shareholders (or votes) is needed to amend the statutes?	2/3 of shareholders	3	3
	all shareholders	2	-
	other	-	2
	no response	1	1
What % of shareholders is needed to approve mergers or takeovers?	2/3 of shareholders	3	4
	all shareholders	1	-
	other	1	1
	no response	1	1

Our findings suggest that shareholders are informed properly and in a timely manner about their rights. Also, there are indications that these rights are respected, with shareholders able to exercise their key functions. These results indicate that compliance with the second OECD principle is at acceptable levels. However, this should be treated with caution as a significant proportion of questions in this section did not receive any response from representatives of banks or insurance companies, or both.

## 4.2 Equitable treatment of shareholders

The OECD third Principle of Corporate Governance, regarding the equitable treatment of shareholders, states, "The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All

<sup>15</sup> One of the banks in our sample is a subsidiary to a foreign bank, which holds 70% of the shares and is listed on its country's stock exchange; hence we think it would be safe to assume that it has hundreds or thousands of shareholders.

shareholders should have the opportunity to obtain effective redress for violation of their rights.’ Through the present survey these statements as applied in Kosovo were tested, and the results are summarized in Table 8.

**Table 8.** Equitable treatment of shareholders

Question	Answer	Banks	Insurance companies
How do you address and deal with minority shareholder concerns?	formal mechanisms	-	-
	other	3	2
	no response	3	4
Is it possible to vote <i>in absentia</i> ?	yes	5	2
	no	1	1
	other	-	3
Is there any cost to voting <i>in absentia</i> ?	yes	-	-
	no	5	2
	no response	1	4

The survey results indicate that the issue of minority shareholders in Kosovo is not of great importance. This most certainly is due to the fact that there is no stock exchange in the country, where shares can be floated and traded, with the result that it is not possible for ordinary people to buy, even just a few, shares, but rather that a limited number of people can buy substantial amounts of shares. Not surprisingly this has limited the number of shareholders, shown from our survey to be a maximum of 40 (Table 7). Such a small number of shareholders have ameliorated the problems of minority shareholders.

The way these institutions do deal with minority shareholders’ concerns depends on whether these are branches of foreign banks or local banks. The branches of foreign banks act according to the corporate culture and laws of the country of the parent bank to address and deal with such concerns, while the local banks appear not to have a formal mechanism, or at least one that we were able to identify in our survey.

One half of respondents did not reply to the question ‘How do you address and deal with minority shareholder concerns?’ The other half gave answers indicating that there was no explicit mechanism for dealing with minority shareholders’ concerns. Some answers indicate that there is an ‘agreement’ amongst large and minority shareholders conjoined by the right to delegate their votes. In the case of one bank there is a minority shareholder representative on the board, while another answered that it was possible to discuss openly all the issues at the Annual General Meeting (AGM), and for some banks all decisions taken up to now have been agreed upon by consensus.

What these answers do not provide is what happens if a minority shareholder has a concern, i.e. whether his rights are being violated. Open discussion at the AGM might provide a way to voice one’s concerns and this method gives one the opportunity to appeal to the other shareholders, but this is where the issue ends. The fact that all decisions have so far been taken by consensus is no guarantee that they will be in the future.

There are even fewer shareholders among Kosovo’s insurance companies than among its banks, with a maximum of four, and an average of 2.1, shareholders per company. The fact that one third of companies interviewed in our survey are owned by one shareholder, and another one third by two shareholders, means that the problem of minority shareholders is mitigated. This is accentuated by the fact that the companies owned by two, three or four shareholders were often one of several other businesses that these people had set up jointly in the past. Hence, there is a degree of trust and mutual understanding among them that has developed over time, even if one were to hold more shares than any other shareholder or even group of shareholders. It is important to

emphasize this situation because even if a shareholder were to hold a majority of shares in an insurance company for example, he or she might not do so in other joint businesses. Thus the incentive to abuse the minority shareholders' rights is minimized. This situation is indicated by the answers given in our survey to the question 'How do you address and deal with minority shareholder concerns?' Only two thirds answered the question, and did so along the lines of, 'Their interests are taken into consideration,' or, 'All decisions are taken by consensuses.

Voting *in absentia* is possible in the majority of banks, and there appears to be no cost for using this method, which provides shareholders with an already established alternative when exercising their voting rights. However, the insurance companies were more reserved than banks over the issue of proxy voting. Only a few of them answered that it was possible to vote *in absentia*. One reply was negative and the others did not have a view on this issue, responding that they 'have never had to deal with such situation'.

In respect of foreign shareholders, there is no indication that their rights might be violated since both in banks and in insurance companies with foreign shareholding the foreign owners are the majority shareholders.

To summarize, our survey found no indication that banks and insurance companies do not treat their shareholders equitably. Nevertheless, it is of concern that there are no mechanisms in place to protect minority shareholders. Although it is comforting to know that there have been no cases of abuse of minority shareholders' rights, absence of relevant rules or regulations might give rise to such behavior in the future.

### 4.3 Role of stakeholders in corporate governance

A stakeholder is a person or a group of people that stands to affect or be affected by the actions of a company. The OECD fourth Principle defines the role of stakeholders as follows: 'The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises'.

The issue of stakeholders in the banking and insurance industries in Kosovo is not regulated, and it is up to the individual companies to address it as they see fit, which has led to a situation where stakeholders are addressed mainly for public relations purposes. The survey reflects the fact that there is no legal requirement in place, particularly for employees. Table 9 reports the survey's findings on the role of stakeholders.

**Table 9.** Role of stakeholders

Question	Answer	Banks	Insurance companies
Which of the following is considered a stakeholder by your company?	borrowers	6	-
	depositors	6	-
	the insured	-	1
	employees	5	1
	the community	6	1
	others	-	-
Does your institution have a deposit insurance system?	no response	-	5
	yes	1	-
Does your institution have a representative of employees on the board?	no	5	-
	yes	-	1
	no	6	5

When asked to identify stakeholders for their companies, all banks picked borrowers, depositors and the community, and the majority also chose employees. In contrast only one insurance company gave ‘the insured’ as a stakeholder, and one gave ‘employees’ and ‘the community’: the majority of insurance companies chose not to answer this question.

It was expected that, due to lack of regulation, the majority of banks do not have deposit insurance, and this was the case with five of them, with only one, a branch of an international bank, replying positively. Although the majority of banks selected employees as stakeholders, all responded negatively to the question of whether they have an employee representative on the board. The same answer was given by the majority of insurance companies too.

When the respondents were asked what their institutions do to cultivate relationships with stakeholders, most of the insurance companies stated that they try to improve the services offered to clients. Most banks seem to utilize service improvement as a means of cultivating their relationship with stakeholders too. All banks and most insurance companies sponsor sporting and entertainment events, and also investigative journalism and educational programmes.

In respect to functionality and quality of board of directors, the KCC representative highlighted the experiences that accompanied the setting up and functionality of banks and referred to corporate governance as the main problem at the time. Poor allocation of functions and responsibilities among governing bodies was particularly symptomatic of local banks. Nevertheless, the presence of foreign banks has introduced better corporate governance practices to the market according to this representative. The CBK representatives referred to the current regulation and emphasized the application of the ‘fit and proper’ criterion as one of the important factors impacting positively the functionality and quality of boards.

The processing of information for persons applying for board members and senior management positions involves a network of agencies outside CBK, such as the Financial Intelligence Unit (FIU), which used to operate as a UNMIK ‘agency’. For foreign banks, the information is verified with respective institutions of the ‘parent’ country. For insurance companies the criteria are stricter since mid-level management, such as unit directors, are subject to these procedures as well. The CBK representatives stated that independent board members undergo the same procedures before approval by the CBK.

Asked about their opinions regarding the relationship of FIs with their stakeholders, the KCC representative thought that communication among these actors is still at an unsatisfactory level. The CBK representatives suggested that the relationship between FIs and stakeholders was condensed to quality of reporting and disclosure. There is a reporting framework that all FIs have to follow and there are strict regulations regarding the publishing of audited reports and financial statements. In additions, all banks and insurance companies have to disclose on their websites their interest rates and premium tariffs, respectively, while for foreign banks the requirement is to publish their financial reports also for the whole group to which they belong. This increases the transparency of FIs towards stakeholders, according to CBK representatives.

Protection of shareholders’ rights and related party transactions should be regulated by law was the opinion of the KCC representative, while the CBK representatives confirmed that their institution has a clear definition of what a related party transaction is, and there are loan limits in place for bank management and employees. A crucial point in this respect is a division of the posts of CEO and Board Chairman that contributes to the independence of these two bodies.

Finally, when asked whether the OECD principles on corporate governance are being implemented the KCC representative thought that they might be partially, due to the regulation which touches upon these principles, but there is room for improvement. According to CBK representatives, all insurance companies comply with these principles since the International Association of Insurance Supervisors (IAIS) operates according to OECD principles. Banks, however, are not required to comply with OECD principles, since the regulation is based upon Basle Committee principles for corporate governance. Through advisory letters CBK has adapted the Basle principles for the Kosovar market. In future, implementation of Basle II is aspired to and this is expected to increase management standards and improve corporate governance.

To sum up, the role of stakeholders is not regulated in Kosovo, and banks and insurance companies in our survey both exhibited shortcomings. The perception of some stakeholders, namely representatives of the business community (KCC and AKB), is that within the financial system banks applying very high interest rates and short repayment periods are not fulfilling the needs of businesses for long-term capital investment. Moreover, SME surveys<sup>16</sup> undertaken over the past several years have constantly found that in Kosovo access to finance, and loan conditions, are listed among the key barriers to doing business. As discussed above, in section 2.3.1 (Table 3), the credit depth and intensity expressed by the private loans to GDP ratio demonstrates a poor supply of credit to Kosovar businesses and households compared to neighboring countries. This weakness is reflected in a constant high credit demand, despite high interest rates. It should be noted also that such high interest rates are explained in part by perceived risk due to an inefficient judiciary. The combined effect of all of this is for not enough attention to be paid to issues of common concerns among key stakeholders, i.e. banks, businesses, government and institutions.

#### **4.4 Disclosure and transparency**

The OECD fifth principle on transparency and disclosure states the following: ‘The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.’

In the present survey, all banks and insurance companies replied positively to the question about the publication of financial statements and operating results (Table 10). This was to be expected as such publication is required by the rules and regulations governing these industries<sup>17</sup>. However, a different response was given when the question concerned the publication of strategic objectives. About one third of the banks and most (more than two thirds) of the insurance companies do not publish their strategic objectives.

The survey findings emphasized that publication of names of major shareholders is an unregulated matter and it is up to individual institutions to decide whether to publish the names or not. Nevertheless, all respondents replied positively to the question, ‘Do you publish the names of your large shareowners?’ However, there were differences among the banks in terms of the threshold before declaring a shareholder. The majority of respondents either did not provide an answer or were unsure whether there is a set limit

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<sup>16</sup> SME Surveys, Riinvest 2004, 2005, 2008

<sup>17</sup> For the banking industry it is UNMIK Regulation No. 1999/21, sections 28, 32, 35, 36 and Amended Rules XI and XXIV, while for the insurance industry it is UNMIK Regulation No. 2001/25 provisions 50.1, 50.2, Rule 7 and Rule 8.

of ownership before an owner have to be declared. However, while one responded that all shareholders are listed on their web page, another replied that they declared only the eight largest shareholders; the third respondent's answer was that seven per cent ownership is necessary for an owner to be declared. Of all insurance companies interviewed, only one gave an answer, replying negatively to having a threshold for declaring a shareholder. The low level of response from the insurance industry may again be explained by the small number of shareholders (from one to four) and perhaps the respondents assumed that it is obvious that all shareholders are disclosed.

**Table 10.** Disclosure and transparency

Question	Answer	Banks	Insurance companies
Do you publish your financial statements and operating results?	yes	6	6
	no	-	-
Do you publish the company's strategic objectives?	yes	4	2
	no	2	4
Do you publish the names of your large shareowners?	yes	6	6
	no	-	-
Is there a limit of ownership set for a shareowner to be declared?	yes	3	-
	no	1	1
	no response	2	5
Do you publish information about board members?	yes	6	4
	no	-	2
Do you have any independent member on the board of directors?	yes	-	4
	no	6	2
Do you disclose remuneration for managers and board members?	yes	-	1
	no	3	3
	other (yes, to CBK)	3	2
Does your institution have a policy on conducting business with companies in which board members are important shareholders or employees?	yes	4	5
	no	2	1
Does your institution have a policy on conducting business with companies in which members of management have 'significant' shares?	yes	5	-
	no	1	1
	no response	-	5
Do you publish your audited reports?	yes	6	6 <sup>18</sup>
	no	-	-
How often do you appoint a new (different from the current or previous) external auditor?	every third year	2	-
	every fifth year	4	2
	annual basis or less	-	4

According to the survey results, banks are quite transparent when it comes to publishing information<sup>19</sup> about their board members. Two thirds of the banks responded positively to the question about publishing such information, and one third publish full CVs and the qualifications of their board members. In addition, one half of banks publish information on the qualifications of their board members. Some banks publish a short biography in addition to the qualifications of their board members. However, the fact

<sup>18</sup> One insurance company did not reply to this question since it was the first quarter of its functioning and there were as yet no audited reports.

<sup>19</sup> The question was asked whether any (or all) of the following information is published:

- full CV
- qualifications
- other company directorships
- selection process
- remuneration, or other (not mentioned in the list)

remains that one third of banks in our survey do not publish any information on their board members, while none publish any information on remuneration of the bank managers or board members.

A similar situation applied to the insurance companies: although two thirds publish information on their board members, they publish only the names and percentage of ownership. One company responded that only a short profile of the board member is published<sup>20</sup>. Nevertheless, our survey also shows that neither banks nor insurance companies publish information regarding the process of selecting their board members, or information regarding other directorships.

Perhaps, the most controversial result from the survey was the fact that all banks responded negatively to the question of the presence of independent board members<sup>21</sup>. In this respect, insurance companies were different from banks with two-thirds having independent directors on their board, though this still leaves one-third that responded negatively to this question. Half of the banks and insurance companies in our survey disclose to the regulatory authority the remuneration of both board members and managers, with the other half considering this information confidential.

In respect to related party transactions, all banks but one replied positively to having policies on dealing with companies in which board members or managers are important shareholders or employees. The response from insurance companies to the question on related party transactions was similar to the one from banks since all but one responded positively to having policies in place when dealing with companies in which board members are important shareholders. Interestingly, only one responded negatively to the question of whether there are procedures in place addressing related party transactions with companies in which managers are important shareholders or employees; the rest of the respondents did not reply at all to this question. In contrast, two or three years ago, this issue appeared to be a serious problem. The failure to implement sound standards in corporate governance has led to serious problems in at least two Kosovar banks, one of which, Credit Bank of Prishtina, went bankrupt in 2004. The main problem appeared to be the conflict of interest of certain BoD members in these banks through the issuing of credits for their own or related businesses and subsequent failure to repay these debts.

Regarding disclosure and publication of financial information, all banks use a combination of international and local accounting standards, while insurance companies use only international accounting standards. The frequency of disclosure of information is regulated for both banks and insurance companies, and it is also required by the regulations to publish audited reports in a timely manner in national newspapers<sup>22</sup>. All banks in our survey publish their financial statements and operating results on their own website, though some publish in national newspapers only their balance sheet. One-third of banks in our survey responded that they contract a different independent auditor every third year with the other two-thirds doing so every fifth year. The (independent) auditor in all banks reports to shareholders (AGM) and for half of banks in our survey it also reports to the BoD. Publishing of audited reports is different for insurance companies since this is not regulated as it is for banks. All insurance companies in our survey

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<sup>20</sup> We have found that one insurance company publishes the list of names of the board members while another company publishes the name and ownership percentage of its two shareholders (which are two of five board members). Once again, we were unable to find any further information in respect of board members of insurance companies.

<sup>21</sup> Regulation 1999/21 section 17 states that two of the board members should be non-executive directors.

<sup>22</sup> UNMIK Regulation No. 1999/21, Section 34.

publish their reports only on their web sites and only a few also publish this information in their annual report. When appointing a new independent audit, one-third replied 'every six months', another third replied 'every year', and the remaining one-third replied 'every five years'. In the case of insurance companies, the survey found that the independent audit reports to the BoD in approximately 85 per cent of cases, with approximately 15 per cent additionally reporting to the CBK and another 15 per cent additionally reporting to the shareholders.

To summarize, from the results of our survey it appears banks and insurance companies are very diligent about issues related to transparency and disclosure, though in general banks publish more information than do insurance companies. Perhaps the fact that the regulatory bodies have paid attention to this issue has resulted in better compliance with the OECD principle.

#### **4.5 Responsibilities of the board**

Principles of corporate governance place a heavy responsibility on company boards, even if in practice many boards do not take this responsibility seriously. The quality of a company can often be judged by the quality of its board. The sixth OECD Principle highlights the role of the board: 'The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.'

Table 11 summarizes the findings of the present survey in terms of board functioning. Participation of board members in board meetings was very good for banks (100%) and relatively good for insurance companies (two thirds have between 80% and 100% participation inclusive). Although half of the banks did not have a system of penalties for non-attendance, the rest had quite severe measures in place: e.g. if a board member fails to attend three meetings (in one bank's case it is two meetings), the board chairperson may request his or her replacement. For insurance companies, the situation was slightly different, with only one applying penalties for non-attendance and three not doing so, with the other companies not responding. (The penalty mentioned by the insurance company for non-attendance at a board meeting was the per diem payment would not be paid.)

Bank BoDs seem to have met more often during 2008 than did those of insurance companies. Three banks had twelve or more board meetings, with the rest meeting on a quarterly or bimonthly basis. The majority (5) of insurance companies met on a monthly basis during 2008, with only one meeting more than once a month.

All banks replied to the survey questions of whether their boards deal with corporate strategy, major action plans, risk policy, annual budget, and a business plan. All insurance companies responded that their boards deal with corporate strategy, major action plans, and risk policy, with two replying that their boards also deal with an annual budget and a business plan. Half of the banks have their corporate strategy approved by the board for a three-year period and five years for the other half. One third of insurance companies approve their corporate strategy for a period of three years and the other two thirds do so for five years.

All banks and insurance companies declared that their boards set performance objectives for management. The performance objective most frequently used by the boards was the 'market share', but quite often 'number of clients' was used as a performance target too. Boards of banks also use qualitative and quantitative performance criteria such as the quality of the portfolio; the proportion of projects implemented successfully, the achievement of set goals (such as increase in deposits), development of

certain lines of business, etc. Other objectives used by boards of insurance companies are not as elaborate as those used in the banking industry. Only one insurance company mentioned ‘development and training of staff’ and ‘creativity’ as performance objectives for managers.

**Table 11.** Responsibilities of the board

Question	Answer	Banks	Insurance companies
Average participation in board meetings?	100%	6	2
	> 80%	-	2
	no response	-	2
Does the institution have a system of penalties for members who fail to attend the board meetings?	yes	2	1
	no	3	3
	no response	1	2
How many times did the board meet in 2008?	average	12	11.1
	max. number of meetings	24	14
For what period is the corporate strategy approved by the board?	three years	3	2
	five years	3	4
Does the board set performance objectives for management?	yes	6	6
	no	-	-
Does the company have performance objectives for board members?	yes	3	1
	no	2	4
	no response	1	1
Who monitors the implementation of strategic plans and corporate performance and oversees major capital expenditures?	board of directors	-	4
	board of directors and management	5	2
	other	1	-
Does the board have any of the following committees?	audit	6	5
	remuneration	1	-
	appointment	2	-
	risk	6	2
Does the board decide on a ‘corporate governance policy’?	yes	5	5
	no	1	1

The situation proved to be different when we asked whether there were performance objectives for board members. Only half of banks in our survey responded positively to this question while two thirds of insurance companies responded negatively. Performance objectives for board members included finishing projects on time, increase in the bank’s overall profit, increase in the number of clients, achievement of objectives as set in the short- and medium-term plan, etc. For insurance companies the target was the fulfillment of plans on time.

For the majority of banks in our survey (5), monitoring of implementation of strategic plans and corporate performance and overseeing of major capital expenditures is conducted jointly by the BoD and management. In the remaining bank this is done by the internal audit committee<sup>23</sup>. For two thirds of insurance companies it is the BoD alone that deals with these issues and for the remaining one third of companies the BoD and management jointly monitor implementation of strategic plans and corporate performance, and oversee major capital expenditures.

Banks in our survey appear to have more and better quality committees than do insurance companies. All banks have audit committees, in contrast to only five insurance companies; some banks have remuneration and appointment committees while insurance

<sup>23</sup> One bank, in addition to an internal audit committee has an internal audit council too.

companies have neither of these; all banks have a risk committee in contrast to one third of insurance companies having one. Some banks have other committees such as Asset/Liability Management Committee (ALCO) while some insurance companies have committees such as claims evaluation committee, underwriting committee, committee for evaluation of training needs, etc.

Finally, the boards decide on corporate governance practices of the majority of banks and insurance companies. Our survey found the implementation and monitoring of these practices is very similar for both industries. Reports from different levels of management, as well as from the internal audit person or committee are used to monitor and implement corporate governance practices.

However, from at least part of the interviews the impression was given that board members need more insight about advanced standards of corporate governance and OECD principles, especially concerning relationships along shareholders, BoD and management.

To sum up, according to our survey the functioning of boards appears to be in good order, though there are slight differences in how bank boards and insurance company boards work. The main failure in complying with the sixth OECD principle is a lack of attention on stakeholders. This is symptomatic of both industries.

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