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Practical Processes of Credit Risk Management in Banks Operating in Kosovo Financial System

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Abstract:

Banks in Kosovo faces different types of risk some of them are credit risk, liquidity, solvency risk, market risk, operational risk, business risk, systemic risk and strategic risk. Credit risk is the risk of financial loss if a customer's bank or counterparties of a financial instrument fails to meet its contractual obligations, this is the most frequent risk in the nature of banks. The main activity of commercial banks in Kosovo is lending to private clients and small and medium enterprises, and it represents largest source of credit risk. Therefore, management and credit risk reduction has a special importance for a successful performance of banks in Kosovo. The purpose of this paper is to present practical processes of credit risk management in banks operating in Kosovo financial system, at a time when the financial industry intends to challenge the dynamics of the environment with appropriate rules and governance. Commercial banks in Kosovo have policies for managing credit risk, in accordance with the objectives and core mission of the bank, procedures and structure that must be appropriate to the nature, scope, and complexity of their activities.

Credit risk management policies is also conform with the rules of the Central Bank of Kosovo.

Key words: Credit Risk, Credit Management, Loan Officer, Bank, Credit Criteria

Introduction

Risk has a different concepts and is natural in all activities. Uncertain events, wrong strategies, competitive economic environment, scarcity are some of the determining factors of risk. Banks due to activity that develops, often run the risk and gains or losses are the rewards that they receive during their operation. The more risk that a bank takes over, the possibility of failure in achieving its objectives is more there.

Credit risk is the risk of financial loss if a customer's bank or counterparties of a financial instrument fails to meet its contractual obligations, this is the most frequent risk in the nature of banks.

The management of credit risk is when risk is considered understandable, measurable, controllable and when the bank has the capacity to cover the negative results brought, however the nature of risk can not be predicted with absolute certainty. Risk management has evolved to become a system of governance of risk, due to the dynamic environment in which the financial system is, and this process today has integrated directors, managers, internal auditors and other employees acting under policies and procedures adopted by this government. Risk management is not just a concept, it should be comprehensived and managed by any person within the bank.

The main activity of commercial banks in Kosovo is lending to private clients and small and medium enterprises, and it represents largest source of credit risk. Therefore, management and credit risk reduction has a special importance for a successful performance of banks in Kosovo.

The purpose of this paper is to present practical processes of credit risk management in banks operating in Kosovo financial system, at a time when the financial industry intends to challenge the dynamics of the environment with appropriate rules and governance.

The structure of the banking sector consists of ten banks of which, eight banks are foreign owned or 90.5% of total assets of the banking sector and two local ownership. Commercial banks in Kosovo have policies for managing credit risk, in accordance with the objectives and core mission of the bank, procedures and structure that must be appropriate to the nature, scope, and complexity of their activities. Credit risk management policies is also conform with the rules of the Central Bank of Kosovo.

Banks in Kosovo have an appropriate organizational structure for managing credit risk, which are clearly defined powers and responsibilities of governing bodies. Directors and management are qualified to formulate strategic and operational plans, staff training and proper quality skills and personal character, a comprehensive system of risk management and adequate access to information.

Methodology

The methodology used in the paper is based on the method of data analysis, grouping and systematization the data. The first part of the paper is covered by the definition of risk and risk management system. The second part of the paper continues with the collection of data, which is done using the poll, which was conducted by loan officers from commercial banks operating in Kosovo. The survey is representative sample, which shows the way how credit risk is manage in the banks operating in Kosovo. The results in this survey are aggregated and are presented in a form that protects the confidentiality of individual banks which are included in the survey. The survey has been enclosed and respondents were able to answer with one of the proposed options in response.

After collecting data via survey was made systematization and analysis based on the characteristics of the phenomenon being studied.

Review of the literature

Credit risk occurs due to inadequate standards, poor risk management portfolio and changes in economic circumstances. Credit risk is defined as the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with the agreed terms[1].

Risk is a concept that is used to express uncertainty about events that bring results with a material effect on the goals and objectives in a company (Selim and McNamee, 1999a)[2]. The primary purpose in approaching credit risk, is identification and assessment of risk. The objectives of a company will be achieved only when the credit risk management continual done.

When banks increase lending in the country, also increase the opportunity for greater profits but also the credit risk. Therefore the country's macroeconomic factors will cause additional risk taking. (ALBERTAZZI, Gambacorta 2009). Low interest rates result in increases in credit in the country, while higher interest rates lead to difficulties in shrine of debt.

Creating an enabling environment to credit risk procedures followed by convenient credit administration and

1. Basel Committee on Banking Supervision "Principles for the Management of Credit Risk", Basel,September 2000

[2] Theofanis Karagiorgos et al., "Efficient Risk Management and Internal Audit"

continuous checks on credit risk will were some of the practices of credit risk management. However, banks may vary depending on the nature and complexity of their credit activities.

The Bank is exposed to credit risk, which poses the risk that a homologous pair will not be able to pay all amounts (loan installments and payment plan under the credit contract) when they come due. Bank structures the level of risk, in that way where they decided where are the limits it receives against a borrower, an industry or a geographical area you. These types of risk are monitored on a permanent basis and reviewed every month or more frequently. Banks put limits in the level of credit risk for borrowers approved by the management of the relevant bank.

The Basel Committee documents are in order to encourage banking supervisors globally to promote sound practices for managing credit risk, they should be applied by lending bussines and to all activities where credit risk is present.

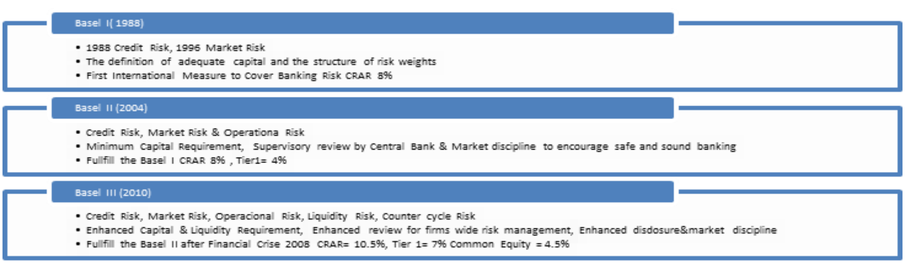


Figure.1. Basel

Since exposure to credit risk continues to be the leading source of problems in banks world-wide, banks and their supervisors should be able to draw useful lessons from past experiences[3].

[3] Abel Elizalde, "From Basel I to Basel II an analysis of the three pillars" CEMFI Working Paper No. 0704, June 2007

Definition of Risk

Risk has a different concepts and is natural in all activities. Events uncertain, wrong strategies, competitive economic environment, scarcity are some of the determining factors of risk. The more risk that a bank takes over the more there is the possibility of failure in achieving its objectives.

Banks due to activity that develops, often run the risk and gains or losses are the rewards that they receive during their operation. Some types of risk faced by banks are: credit risk, liquidity, solvency risk, market risk, operational risk, business risk, systemic risk and strategic risk. Credit risk is the risk most frequent in the nature of banks, but banks should consider the relationship between credit risk and other risks too. Credit risk is the risk of financial loss if a customer's bank or counterparties of a financial instrument fails to meet its contractual obligations (under contracts SIGNED in obtaining credit). Common types of risk are credit risk with certain commercial transactions, sectors or groups, and the risk of loan portfolio concentrated in a particular sector or lending to a large borrower.

The main activity on risk is to manage it. The management of credit risk is when risk is considered understandable , measurable, controllable and when the bank has the capacity to cover the negative results brought, however the nature of risk can not be predicted with absolute certainty[4]. Credit risk management in good way will bring benefits not only for the bank but also for the bank client who would feel more confident, to continue relation with bank.

Risk management has evolved to become a system of governance of risk that due to the dynamic environment in which the financial system, and this process today has

[4] Basel Committee on Banking Supervision "Principles for the Management of Credit Risk", Basel,September 2000

integrated directors, managers, internal auditors and other employees acting under policies and procedures adopted by this government. Risk management is not just a concept, it should be comprehensive and managed by any person within the bank.
Banks must have a system for managing credit risk, which must include policies in line with the objectives and core mission of the bank, procedures and structure that must be appropriate to the nature, scope, complexity and activities .

The bank should establish an appropriate organizational structure for managing credit risk, clearly defining the powers and responsibilities of governing bodies. Directors and management must be qualified to formulate strategic and operational plans, high quality personnel with appropriate training and skills and personal character, a comprehensive system of risk management and adequate access to information.

Analysis

The structure of the banking sector in Kosovo consists of ten banks, of which eight banks are foreign owned or 90.5% of total banking sector assets while both domestically owned or 9.5%. Foreign-owned banks are from Germany, Austrua, Slovenia, Turkey, Albania. The value of the assets of the banking sector in June 2014 amounted to 3.06 billion EUR, where a significant role'll get caught gross loans amounting to EUR 1.89 billion. The growth of gross loans is a result of the easing of credit standards forgive good liquidity position of the banking sector. High interest rates has bring difficulties in payment of the loans, therefore credit growth also has been increased the credit risk which was 8.2 percent in 2014.

Loans to enterprises in June 2014 represented 67.3 percent, household loans represented 31.4 percent of total assets of the bank loan, while the remaining assets is represented by loans to non-residents and loans to non-governmental organizations.

Commercial banks in Kosovo have policies for managing credit risk, in accordance with the objectives and core mission of the bank, procedures and structure that must be appropriate to the nature, scope, and complexity of their activities. Credit risk management policies should also be conform to the Rules of the Central Bank of Kosovo.

Banks have an appropriate organizational structure for managing credit risk, clearly defining the powers and responsibilities of the management and administrative bodies.

In most commercial banks in Kosovo overall responsibility for risk management in the lending process belongs risk management department. Department for credit risk management is responsible for ensuring a healthy process of granting credit, creating a suitable environment to assess credit risk, management and monitoring of the overall quality of the loan portfolio, the bank's assessment process in credit risk management and the management of credit risk exposure. Since years ago, diversity was considered as a tool for minimize the risk. Diversity of lending, helped credit risk management in cases when one economic area has not properly productivity the other area may has properly productivity, and bank will be more sure in her operation. The diversity of banking system in Kosovo is shown in the figure below for years 2011,2012,2013 and 2014. Agriculture is representative with 5%, Mines 3%, Production 12%, Energy 1.4%, Constration 8.9%, Trade 52.2% and Other Services20.3% in June 2014[5].

[5] Report of Financial Stability From Central Bank of Kosovo, Number 06, December 2014 (http://www.bqk-kos.org)

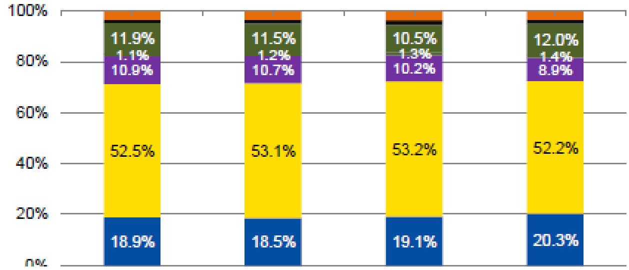


Figure.2. Diversity of lending

Loan disbursement procedures

Every commercial bank in Kosovo has procedures for disbursement of loans which must be practical and understood by its workers. Bank's internal policy regarding credit risk should always apply strictly by the staff. The first contact with the client and the bank's borrowers is through loan officer. Loan offices gathers information about the case of the loan, according to the documents required under the relevant criteria. However, the loan officer is free in his work to require additional information when it's necessary.

Loan officer has to visit client beforehand to verify the information and to gather additional information about the business, he/she is responsible for credit case all the time. On the basis of all information, loan officer performs financial analysis with appropriate methods and gives his opinion for the case.

Once completed financial analysis together with the opinion of a loan officer and relevant documentation becomes the object before the committee presentation where loan officer must defend his own opinion. Once considered the case the Commission shall take a decision on the approval or rejection of credit case. In cases where the decision of the committee is not the same as the opinion of the loan officer. Loan officer has the right to return the case back for review, and if he/she seems reasonable the case can in higher levels of bank management. On various occasions the loan officer said that a quarter of cases their loan officer remain un chosen, because of not fulfilling the criteria creditworthiness.

Credit Criteria

Credit criteria determined by the risk management department, based on the bank's business objectives and regulations of the Central Bank of Kosovo. Any allowance of credit to a borrower should be evaluated and classified on the basis of merit and criteria associated with the exposure time. Business loan criteria are: general business information, business experience, financial strength of the business, project and investment plan payment potential through business income, credit history and other credit exposures, character and reputation, clientele and competition. Each bank has a list where excludes a series of activities that are not financed by the bank.

Businesses applying for loans must comply with local legislation Kosovo Business Registry and function as legal entities. Commercial banks in Kosovo in general fund only businesses that have at least six months of operation, this is a very important criterion for the borrower. Financial strength and potential payment through business income clearly shows that a business could afford repayment. If the client has a weak credit history and other credit exposures definitely credit default risk would be potential. The weak credit history comes from not payment in regular dates or fail at all in payment of credit. If the business meets all the above criteria to satisfactorily then it shows that the business has a good reputation and character, however the competition and clients tell us possible probability of reaching financial goals. Creditworthiness criteria are interrelated and unavoidable in the evaluation of the borrower, the importance of each are shown in figure 3.

Private credit known as consumption credit are the credit for home, cars, vocational, studies, holidays, etc. Some of the most important personal credit criteria are: personal information, contract of employer, the character and history of the client and age. Due to the state's economic unstable, together with the contract of employer it's necessary by the employer required administrative stops (document which states that Company X with its signing, that the person who has applied for credit exposure until he fulfill obligations to the bank, they would not change banks, or the salary would not be given in cash, but if the borrowers is terminated the contract during that still has obligations to the bank then the company owes nothing to the bank) the worker as well as ensuring that the borrower has passed the six month probationary phase (for this period client does not have a valid contract as is under probation). Loans are allowing only for people who have character and good credit history and age 18 to 65 years. Credit criteria evaluation for private borrowers have shown in figure 4.

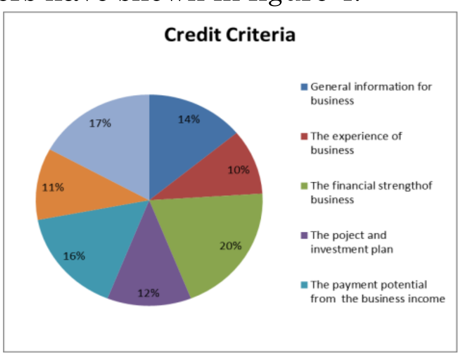


Figure.3. Credit criteria

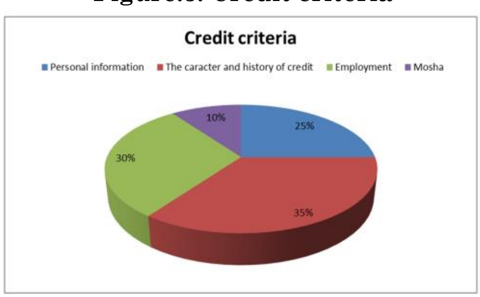


Figure.4. Credit criteria

Bank personnel should be ethics in credit exposure, according to the culture and practices of bank credit. Culture of credit at a bank built on the basis of policies, practices and strategies bank that determines behavior, belief and philosophy of credit acceptable to the bank[6]. Credit culture in the bank shows the quality of exposure and helps the bank to achieve the objectives of lending. Bank personnel should perform work under the bank credit culture strictly. In cases where the borrower is a friend, family member then credit analyst has no right to consider the case, but the case goes to one another credit analysts.

To be effective work of the bank staff should create a collaborative environment of the decision, if the staff is uncertain on any case he/she should contact the supervisor, the department's immediate superior to credit risk management. The banks staff is competent to manage and control daily operations, so the bank must always provide support to ensure an accurate information and timely on credit risk exposures. New practices of dynamic environment, changes the culture credit however banks credit should keep staff informed during every change. Methods that banks in Kosovo use in such situations are training and workshops, which have proven very fruitful. Usually banks during the recruitment of new staff organize initial training for trained personnel policies, practices and strategies of the bank.

In the case of credit analysis is especially important given credit insurance forms, it is also important criterion in granting the loan. Credit insurance forms assist the bank in managing credit risk while increasing safety and reducing risk. Some of the forms of credit insurance are: guarantor, co-debtor, collateral, mortgage and credit insurance. Co-debtors is preferable to be members of the family and the guarantor shall not be members of the family who live together in a family unit, because in cases where family incomes fall then the guarantor

[6] Reserve Bank of Malawi " Risk Management Guidelines For Banking and Institution

can cover the mortgage installments. Loan insurance can be done from insurance companies who operate in financial system. Collateral may include real estate and movable wealth where the amount classified should always be the net amount of acceptable collateral value, cash deposit and other assets. Almost any amount of loan disbursed are guaranteed by co-debtor and guarantor, collateral and insurance credit usually are made for higher values of credit.

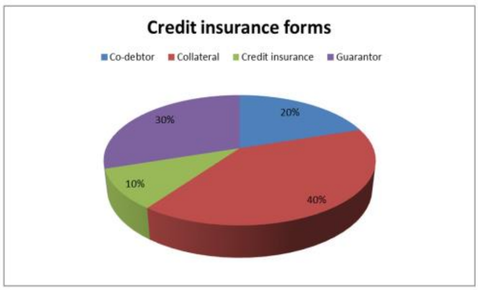


Figure.5. Credit insurance forms

Credit recovery

Loan officer and part of the administration to grant loans must be efficiency and effectiveness in administering the loan including:monitoring documentation, contractual requirements, legal agreements, collateral, accuracy and timeliness.

Importance should be given to the case of loans, which must be reviewed and ranked on the list of risk within the financial condition of the borrower. Loans valued at higher risk should have additional oversight and monitoring through more frequent visits from loan officer. In necessary cases can also be proactive negotiation and other efforts, loan restructuring, moratorium, payment arrangements, the expansion in credit limits or decrease in interest rates to help improve repayment capacity lenders. While the loan officer are doing all efforts, all the process should be reported to management and the bank is obligated for credit reports to the Central Bank of Kosovo even for the progress-payment of the loan, and financial analysis should be renewed.

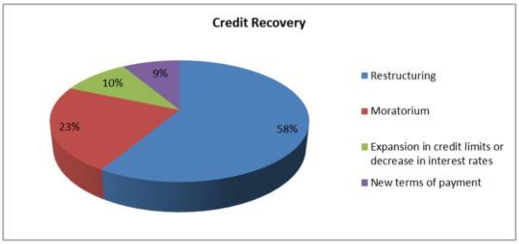
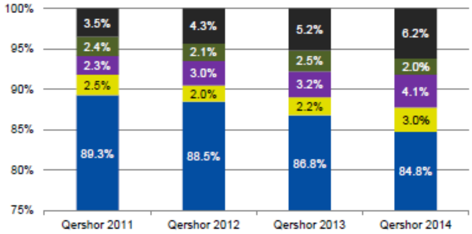


Figure 6. Credit Recovery

According to the CBK regulations for credit risk management, loans under the credit exposure classified into: standard, loans in surveillance, substandard, doubtful and loss loans[7].



Standard loans - delays up to 30 days – 84.8%
Loans Observatory - 31 to 60 day delay – 3%
Substandard loans - delays 61deri 90 days – 4.1%
Doubtful loans - 91 to 180 day delay – 2%
Credit Loss - 180 days overdue – 6.2%

In cases when the loan is classified as lost then, banks have to allocate provisions for loan losses and settle it from balance sheet after having taken reasonable action to collect credit, as determined by their policies . In such cases, the case goes to the court or private bailiffs for execution of collateral.

[7] Report of Financial Stability From Central Bank of Kosovo, Number 06, December 2014 (http://www.bqk-kos.org)

Conclusions

Banks in Kosovo faces different types of risk some of them are credit risk, liquidity, solvency risk, market risk, operational risk, business risk, systemic risk and strategic risk. Credit risk is the risk of financial loss if a customer's bank or counterparties of a financial instrument fails to meet its contractual obligations, this is the most frequent risk in the nature of banks.

The main activity of commercial banks in Kosovo is lending to private clients and small and medium enterprises, and it represents largest source of credit risk. Therefore, management and credit risk reduction has a special importance for a successful performance of banks in Kosovo.

Financial system in Kosovo develop with greater speeds since 1999, but financial system it still have simple structur. Financial system in Kosovo consist from commercial banks, insurance company, pension funds, microfinance institutions, money changers. The only source of monetary lending is the bank or microfinance institutions, microfinance institutions have higher rates of interest than banks thats why people choose the bank for lending. The structure of the banking sector consists of ten banks of which, eight banks are foreign owned or 90.5% of total assets of the banking sector and two local ownership.

Commercial banks in Kosovo have policies for managing credit risk, in accordance with the objectives and core mission of the bank, procedures and structure that must be appropriate to the nature, scope, and complexity of their activities. Credit risk management policies is also conform with the rules of the Central Bank of Kosovo.

Banks in Kosovo have an appropriate organizational structure for managing credit risk, which are clearly defined powers and responsibilities of governing bodies. Directors and management are qualified to formulate strategic and operational plans, staff training and proper quality skills and personal character, a comprehensive system of risk management and adequate access to information.

In this paper we present practical processes of credit risk management in banks operating in Kosovo financial system. The surveys done, show how a loan officer recognizes the borrowers, analyzes the case in accordance with banks credit criteria, and prepares the case to defend it before the Commission. Loan officer and part of the administration to grant loans must be efficiency and effectiveness in administering the loan including: monitoring documentation, contractual requirements, legal agreements, collateral, accuracy and timeliness.

Loan officer should kept in touch a credit case, from the date of the lending until the day when the loan is back. But even when the creditor case has finished, the loan officer should keep the relation with client to support if the client will have any other need for monetary support.

Credit criteria determined by the risk management department, based on the bank's business objectives and regulations of the Central Bank of Kosovo. Any allowance of credit to a borrower should be evaluated and classified on the basis of merit and criteria associated with the exposure time. Creditworthiness criteria are interrelated and unavoidable in the evaluation of the borrower.

Importance should be given to the case of loans, which must be reviewed and ranked on the list of risk within the financial condition of the borrower. Loans valued at higher risk should have additional oversight and monitoring through more frequent visits from loan officer. According to the Central Bank of Kosovo regulations for credit risk management, loans under the credit exposure classified into: standard, loans in surveillance, substandard, doubtful and loss loans. Credit insurance forms assist the bank in managing credit risk while increasing safety and reducing risk. Some of the forms of credit insurance are: guarantor, co-debtor, collateral, mortgage and credit insurance.

In cases when the loan is classified as lost then, banks have to allocate provisions for loan losses and settle it from balance sheet after having taken reasonable action to collect credit, as determined by their policies . In such cases, the case goes to the court or private bailiffs for execution of collateral.

Bank personnel should be ethics in credit exposure, according to the culture and practices of bank credit. Bank personnel should perform work under the bank credit culture strictly. New practices of dynamic environment, changes the culture credit however banks credit should keep staff informed during every change. Methods that banks in Kosovo use in such situations are training and workshops, which have proven very fruitful.

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