# IMPROVING THE 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 Kosova is fairly new, established only after the 1999 war (the first bank was set up in 2000). Since then, banks have expanded their activities, increased their deposits, assets and also credit to businesses and households year by year. Deposits reached the amount of 1.422 billion euros in January 2009, an increase of 23.3 % compared to January 2008, while loans in January 2009 reached the amount of 1,189 billion euros, an increase of about 31.7% compared to the previous year. Measured by ROE and ROA, the banking system in Kosova shows the best performance in the region with a continuous increase in profits. However the banking system is highly concentrated with the three largest banks accounting for 90% of assets, 88% of deposits and 81.5% of loans. The banking and insurance sector was attractive to foreign investors with foreign capital being dominant in 6 of 8 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 Kosova and will have an impact on the reduction of informal economy through better channeling of the money in circulation and other financial transactions, and 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 banking system in Kosovo with the OECD Principles of Corporate Governance, it can bee 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 the issues related to the first principle (ensuring the basis for an effective corporate governance framework), and second principle (the rights of shareholders). The fourth OECD principle (the role of stakeholders) is vaguely addressed in Amended Rule VIII where the rights of depositors (but not other stakeholders) are mentioned. Rules and regulations fail to address the third OECD principle (equal treatment of all shareholders). 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 oversight 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 Kosova has been in force for a relatively short period of time.

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” criteria applied to major shareholders and senior managers in banks, and to other officers in the insurance industry, is an assuring step 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 shareholders are able to exercise their key functions. There are, however, no formal provisions for the protection of minority shareholders even though at present, because of the small number of shareholders, this is not a major problem in the Kosovar financial institutions. The issue of stakeholders for banking and insurance industries in Kosova is not regulated, hence it is up to the banks and insurance companies to address it as they see fit. This has led to the situation that stakeholders are addressed mainly for public relations purposes.

The survey reflects the fact that there is no legal requirement in place for the interests of the stakeholders to be taken into account – especially for employees and depositors. On the other hand the perceptions of one of key stakeholders – business community of banking and insurance industries is that credit conditions are severe and not appropriate for business expansion which is key for Kosovo to catch up with stainable economic growth and address its socio-economic severe problems - unemployment and poverty. Kosovo has the highest interest rates on loans in the region, the lowest loan intensity (share of loans to GDP), and a very good performance of Banking system measured by ROE and profit growth.

The government should try to encourage more competition in the financial sector and take actions to improve the supply of credit to the private sector. The joint interest of all stakeholders is higher economic growth and timely preventive measures which will ameliorate the impact of the current global crises. In this respect there is much room for action by all stakeholders.

**RECOMMENDATIONS**

1. Given the special importance of financial institutions for the functioning of the economy and life of citizens, the Parliament, the Government and the 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 which 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 to:

    **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: depositors, borrowers, the insured, the community, and employees;
    **d.** Explore the possibility of promulgating the 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 their corporate governance policies for the appointment of independent board members, better relations with their stakeholders, and to establish the unitary model of board system, in accordance with existing legal provisions.

4. Banks and insurance companies should develop training programs 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.[1]

[1] There is precedence for this provision in Kosovo: the Law on Publicly Owned Companies requires members of boards of directors of POEs to undertake corporate governance training annually.

## 1. INTRODUCTION

This research report contains the analysis and assessment of the quality of the corporate governance in financial institutions (banks and insurance companies) in Kosovo in the light of the requirements and standards known as OECD principles. The objective of the report is to improve information of relevant actors regarding the achievements and situation related to corporate governance at the banks and insurance companies and produce policy recommendations for the Government, 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 Kosova" that is focused on financial sector, namely banks and insurance companies[2].

The first component of the project was concerned with the analysis of the current state of corporate governance in POEs (particularly KEK JSC and PTK JSC) through follow up report and discussions on achievements since 2006, while the second component focused on a training program 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 has been financed by the Center for International Private Enterprises (CIPE), Washington D.C., and implemented by the Riinvest Institute for Development Research. In addition, the project was also supported by three Kosovar banks - TEB, Pro Credit Bank and Banka Ekonomike. The analysis of the corporate governance of financial institutions in this report is conducted from the perspective of OECD Principles and Guidelines for Corporate Governance as well as on other international norms and codes of good corporate governance and transparency.

During the preparation of this research report the project team conducted desk research on various reports on banking and insurance companies such as the reports of the Central Bank of Kosova (CBK), annual reports of banks and insurance companies, and other literature covering this area.

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 members of boards and the management of six banks and for the six insurance companies (six) in Kosova as well as with other stakeholders, such as the Associations of Banks and Insurance Companies, the Chamber of Commerce, the Alliance of Kosovar Businesses. A semi-structured questionnaire containing specific questions and a number of open ended questions were completed for each interviewee.

The structure of the research report is designed as follows. In the first part the report presents the executive summary and recommendations, followed by the introduction.

[2] This project represents in facts second phase of CIPE and Riinvest cooperation in this area. It follows the first phase of project which was focused on the corporate governance issues of public enterprises (POE), namely KEK jsc and PTK jsc, implemented during 2006.

Section 2 discusses the importance of the corporate governance of financial institutions and their specific features. Section 3 continues with the analysis of the legal and regulatory framework in Kosova, Section 4 is presenting survey findings related to the current state of corporate governance in banks and insurance industries.

We would like to thank CIPE for funding this project and also for the continuous support during its implementation. Our thanks go also to TEB, Pro-Credit Bank and Banka Ekonomike for their participation at supporting certain activities of the project. We thank especially Professor Hashi, for his great cooperation with our project team.

The findings and opinions presented at this report represent positions 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. Recent Evidence on Corporate Governance Issues in Financial Institutions (FIs)

The complex nature of finance means that the concepts and daily activities of financial institutions (FIs) are not easily grasped by the majority of population, therefore they need to rely on others (the bankers) for information, and thus a key element for well functioning of the financial systems is trust which sets apart financial and non-financial institutions (Trayler, 2007).

If trust is regarded as the first reason, then the importance of financial institutions for the overall stability of a country can be considered as the second reason which sets FIs apart from other firms. This has led most governments to regulate[3] the financial sectors and it is hard to find a country that has an unregulated financial industry.[4]

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

These are the main reasons some researchers argue that there is a large enough distinction between corporate governance of financial institutions and other firms, to have corporate governance of financial institutions studied separately.[5]

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 which makes them different from other firms. First, banks are more opaque, a characteristic that amplifies the agency problem. The 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 maximize value,[6] (iii) unlikely for potential outside bidders to generate an effective takeover threat, and (iv) more likely that a more monopolistic sector will ensue, and this will lessen the impact of corporate governance mechanisms through competition.[7]

Second, banks are heavily regulated and this more often than not, imposes a natural hindrance to corporate governance mechanisms. Measures like, deposit insurance, regulatory restrictions on concentration of ownership, regulatory restrictions on entry,

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[3] The Regulation is perceived as interference since as some argue, there has been some overlap of bank regulation with corporate governance since the earliest days of modern banking (Shull, 2007).
[4] The extent of regulation is mainly country specific even within EU countries.
[5] There are researchers who argue that there are important distinctions between banks and other financial institutions (i.e. money market mutual funds, nonblank credit card companies etc.) hence advocating for separately studying bank corporate governance (see Macey and O'Hara 2003).
[6] Large investors and managers may manipulate the firm to act in their own interests instead of the board interests of the corporation and other stakeholders.
[7] Information asymmetry accompanying banking makes it very expensive for outside bidders to gather the necessary information to generate a sufficient takeover threat, which gives bank managers more discretion in pursuing their own interests without worrying too much that they are going to be replaced following a hostile takeover.

takeovers, bank activities etc., all have adverse effects on mechanisms designed to control the management by shareholders. Limitation of stock ownership by a single owner in many countries and hostile takeovers, are diminished as corporate governance mechanisms, because of regulation and the opaqueness of banks, argues Levine (2003). Third, as Caprio and Levine suggest (2002), the Government ownership makes corporate governance of banking industry very different from other industries. State ownership of banks remains large in many countries, and this is a problem for corporate governance since it creates the situation of conflict of interest between the state as a 'monitoring authority' and a 'regulatory authority'. State ownership of banks 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 groups.

Macey and O'Hara (2003) identify four elements which distinguish banks from other firms. First, it is the liquidity production role of banks that is explained through the capital structure of banks which is unique in two aspects. i) banks usually have very little equity compared to other firms, and ii), bank's liabilities are in form of deposits, which are available to their creditors/depositors on demand, while the bank 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.[8] Theoretically, bank runs can happen to solvent banks as well. In order to mitigate this problem, the deposit insurance fund was devised which according to Macey and O'Hara is the second point of distinction between corporate governance of banks and other firms. The deposit insurance fund (FDIC)[9] 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. The moral hazard is likely to occur because the bank shareholders are able to pass some of their losses onto the healthy banks whose contributions to 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.[10] 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 incentives that insured depositors control excessive risk-taking since their funds are safe regardless of the investment strategies selected by banks.

The fourth distinction is the asset structure and loyalty problems. Since the existence of 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

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[8] Bank runs are a collective action problem among the depositors. If for any reason, large withdrawals begin at a bank, the individual depositors, in fear that they will be left without anything if the 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 the bank run. One of the recent examples is The Northern Rock Bank which was nearly the subject of a bank run during the summer of 2008.

[9] The Banking Act was passed by the Congress in 1933 establishing Federal Deposit Insurance Corporation (FDIC) and gave the federal government the power to insure deposits in qualified banks.

[10] In the view of corporation as a set of explicit and implicit contracts there are different claimants to corporation's 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.

because of the collective action problems. Thus, under the Federal Deposit Insurance Corporation Improvement Act, regulatory agencies were required to issue guidelines or regulations which would create standards for safety and soundness in several areas such as: 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: the larger board size, more frequent board meetings, and the higher level of accountability for directors and officer confirm that there is indeed a difference in the corporate governance of financial institutions compared to other firms.

## 2.2. Corporate governance in financial institutions and its specific features

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

The stability and sustained growth of the economy is closely linked to the stability of the financial sector (especially the banking system) and any shock to the financial system is capable of creating serious instability in the whole economy. This is especially true when it comes to the latest world economic crisis. The financial sector suffers from particular information asymmetries (e.g., between bank managers and their depositors; between risk taking managers and the board; between managers and shareholders; and between banks and regulators) which may be accentuated by insufficient transparency and disclosure – a problem which is very common in Kosova.

Under a weak system of corporate governance, these asymmetries are capable of undermining the stability of the banking system, lead to a loss of confidence, possible runs on banks, or a credit crunch adversely affecting the enterprise and household sectors of the economy. 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 financial sector will influence positively the development of financial sector in Kosova which will also have an impact in the reduction of informal economy through better channeling of money circulation and other financial transactions, as well as it will help develop other segments of capital markets such as equity capital markets.

An effective system of corporate governance in banks will impose standards of conduct for managers and appropriate procedures for control within banks 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 banks' shareholders and depositors, their Boards and their management, prevents abuses of power and self-serving conduct as well as imprudent and high risk behavior by bank managers, and resolves conflicts between private interests and official duties.

### 2.3. A Short overview of banking and insurance industries in Kosova

Financial institutions in Kosova are licensed and supervised by the Central Bank of Kosova (CBK). The CBK reports to the Parliament and advises the Government. The financial sector covers the banking industry, insurance industry, pension funds and other financial institutions mainly micro- credit schemes. The total number of financial sector institutions reached 66 at the end of 2008, from which eight are banks, 10 are insurance companies and other represent mainly microfinance institutions and intermediaries.

#### *2.3.1. Commercial Banks*

Banking sector in Kosovo has been developed successfully and it is seen as an success story. The value of the banking sector assets/liabilities in Kosova in January 2009 was 1.791 billion euros which is higher for more than 23.6 % compared to the same period of last year. Since the end of 2000, when was established first bank after the conflict, the value of total banking sector assets has increased about 18 times.

Financial sector in Kosovo is characterized with a large presence of foreign capital. This is mainly prevalent in the banking and insurance market where 91.0% and 72.1% of total assets are managed by foreign companies, respectively. The presence of foreign financial institutions in Kosovo has contributed in the modernization of the financial system by bringing more advanced practices in finance in managing banking and insurance operations. At the moment there are eight banks operating in Kosova, six of them with complete or majority foreign capital. The Kosovo banking sector remains highly concentrated with the market share of the three largest banks accounting for about 90% of total banking sector assets, 88% of deposits and 81.5% of loans at the end of 2008.[11]

The level of deposits in the banking sector has increased year by year. The value of deposits reached the amount of 1.422 billion euros in January 2009, an increase of 23.3% compared to January 2008. The value of deposits in 2000 was 93 million euros, meaning that the level of deposits increased by more than 15 times from 2000 to January 2009. The largest share of deposits (60%) consists of household deposits. As deposits increased, there increased also lending activities on continuous basis from 2000 to 2009.

The amount of loans extended to economy in January 2009 was 1,189 billion euros, an increase of loans by about 31.7% compared to the previous year. The largest share of banking sector loans is extended to the trade sector (76 % of total loans in January 2009, respectively 77.7 % in January 2008), while about 24 % in January 2009 is 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.

[11] 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 compared to 2,896 points in the same period of the previous year, while HHI for loans and deposits recorded 3,014 and 3,016 points, respectively

Table 1: Bank data in billion euros

| Years | 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 CBK's monthly periodicals

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 euros, increasing by about 7.7 % from the same previous period or by 173 % compared to the end of 2005 (13.5 million euros), respectively 185 % from 2004 (12.9 million euros). Banking sector income is mainly derived from interest on loans, where the share of the banking sector interest income (146 million euros) to the total banking income at the end of 2008 (195 million euros) was 74.9 %, almost the same as it was at the end of 2007 (74.8 %).

Table 2: Banks' income and profit (values in millions of euros)

| | 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), in % | 1.6 | 1.5 | 1.9 | 2.6 | 2.5 |
| Return on Equity (ROE), in % | 17.6 | 20.1 | 22.4 | 26.2 | 22.2 |

Source: CBK Annual reports

Return on Total Assets (ROTA) **-** Banking sector is constantly increasing the return on its assets. The return on total assets (ROTA) at the end of 2008 was about 2.5 %, while in 2007 was 2.6, in 2006 has been 1.9 %, compared to 2005 which was 20.1 %. The return on total assets in 2008 compared to 2007 has fallen by 40 basis points, whereas in 2007 compared to 2006 the level of return on total assets increased by 70 basis points.

Return on Equity (ROE) **-** Banking sector is constantly increasing the return on its equity over the years. The return on equity (ROE) in 2008 was 22.2 % falling from 26.2 % in 2007. The decline of ROE is mainly attributed to the faster increase in the shareholders capital in the banking sector.

The liquidity position (the ratio between loans and deposits) of the Kosova banking sector is on the border of regulatory requirements, nearly 82 %[12] in 2008 which violates the recommended requirement set out by the Central Bank of Kosova, and thus lowering its liquidity position in the process. The liquidity position in 2007 was about 78 % where compared to previous years, it neared the upper limit of the regulatory requirement (2006 was 69% and in 2004 it was 54%).

Increasing the amount of deposits and loans shows that the Kosova banking sector is developing further and it is increasing its role in economic development. This is also shown from regular increase of several indicators such as the share of banking sector

[12] The regulatory recommended margin is 70-80%.

assets, deposits and loans to GDP. The share of assets to GDP in 2008 increased to 47.5 %, compared 36.5 % in 2005. This is mainly due to the increase in the volume of loans extended by the banking sector that reached 31.1 % of GDP in 2008.

Table 3: Share of loans, deposits and assets to GDP (%)

| Years | 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

Interest rates – The overall average interest rates on loans in 2008 were about 15.1 %, compared to 14.6 % (2007). The table below also shows that the level of interest rates on average throughout the years has remained nearly the same with slight decrease in 2006 and increase in 2008. As we can see, the amount of loans has increased every year, while the interest rates have remained high, especially for long term capital investment needs and compared to region.

This is especially true if we take into account the interest rate spread (the difference between interest rates on loans and deposits), where despite the fact that it has been continuously falling, it still remains the highest in the region. Nevertheless its worth mentioning that the interest rates for both, loans and deposits alike have risen, showing that the increase of the number of banks increased competition in the Kosovo banking sector only in more favorable interest rates for deposits, but not for loans.

Table 4: Interest rates[13] on loans and deposits (%)

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

Source: CBK Annual Reports 2004-2007

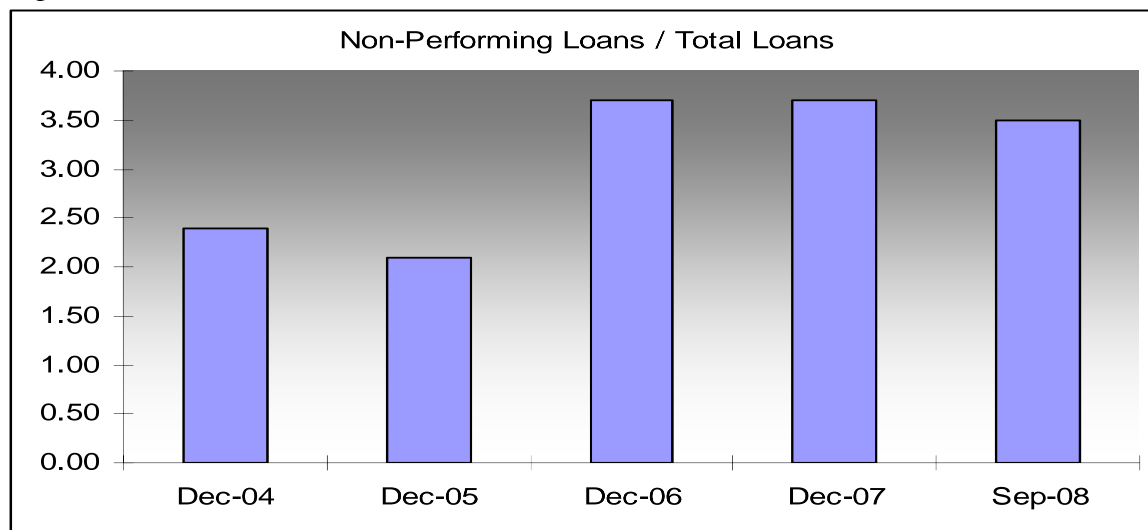
Loan portfolio in the Kosovo banking sector remains of good quality. Despite the fast credit growth, in September 2008 the share of non-performing loans (NPLs) to total loans (which include loans classified as 'doubtful' and 'loss') declined to 3.5%, compared to 3.7 % at the end of 2007 (see figure below).

The NPL to total loans ratio of 3.7% in September 2008 ranks Kosovo below the average of 5.2% recorded in region countries, indicating that loan portfolio of banking sector in Kosovo, on average, is of a better quality than in other countries of the region. Nevertheless, caution is recommended, because compared to 2005, the NPLs have increased by two and half times, indicating a rise in the NPLs, especially in smaller banks.

[13] Averaged across different products and maturities.

Taken by bank groups, larger banks appear to have a better quality of the loan portfolio than smaller banks. As of June 2008, three largest banks recorded a NPL to total loans ratio of 3.2%, while the rest of the banks, on average, NPL accounted for 8.1% of their loan portfolio. Regarding breakdown by sector, households have the lowest level of NPLs.

Figure 1. Share of NPL to total loans (%)




Source: CBK Bulletin 2008.

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

| | Private sector Loans/GDP | Interest rates | | Bad Loans (in total loans) |
|---|---|---|---|---|
| | | Deposits | Loans (< 1 year) | |
| Kosova | 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 |
| Bulgaria | 89.8 | n/a | 10.8 | 2.5 |
| Serbia | 47.5 | 4.1 | 11.0 | n/a |
| Croatia | 117.7 | 2.7 | 9.3 | 4.8 |
| Macedonia | 49.9 | 5.3 | 9.9 | 10.9 |
| Montenegro | 121.2 | 4.8 | 9.2 | 3.2 |

Source: EBRD Transition Report 2008, for Kosovo IMF estimation of GDP and CBK Annual Report

The above table shows the lowest loan to GDP ratio is in Kosovo, reflecting a low level of loans being issued compared to the other countries in the region. Also the interest rates for loans of up to a year shows to be the highest among all the regional countries, indicating that loans are the most expensive in the region. This shows poor credit offer and low credit intensity associated with highest interest rates compared to neighboring countries. On the other hand profitability ratios in 2007 are foremost the best in the region.

From what has been presented above we see excellent financial performance of commercial banks in Kosovo. This is good especially in the conditions of global financial

crises especially that have been reflected especially at the banking system. However, it should be noted that in Kosova this has been achieved with lowest credit intensity (loan /GDP ratio) and though highest interest rates and larger margin between interest rates in deposits and loans.

Table 6: Profitability ratios

| | 2007 | |
|---|---|---|
| Countries | ROA | ROE |
| Kosova | 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 banks of respective countries

One could argue that loan market conditions have been favorable for this, but still remain to be analyzed whether Kosovo government and regulatory bodies have created conditions for more and free competition in a credit market, if they are undertaking necessary measures for reducing the risk, if there enough credit supply and offer, or all banks are more then comfortable with current conditions in the credit market. The question could be raised if this is good for long term development needs of Kosovar economy, in a situation that it is difficult for businesses to finance their long term development needs. On the terms of corporate governance the question could be raised in the area of the stakeholders' position (depositors, borrowers, government, regulatory bodies, community). It is clear that at the end banks share the fate of their clients, businesses and households and it seems that in this relation should be also more common sense.

### *2.3.2. The insurance sector*

Insurance companies in Kosovo are relatively small, with assets worth 70.8 million euros in 2007. If we analyze the value of insurance industry assets in 2005, we see that insurance sector total assets in 2007 have increased for more than 53% from 2005 (the value of insurance sector assets in 2005 were 46.2 million euros). In 2007, the share of total assets of ICs in the value of total financial sector assets in Kosovo was around 5%.

There operate currently nine insurance companies, from which six foreign companies and three domestic companies. The core activity of insurance companies in Kosovo is the Third Party Liability (TPL) product, namely vehicles insurance policies. Total premiums reached the value of 50.8 million euros in 2007, compared to 48.7 million euros in 2006, and 47.2 million euros in 2005. The share of Third Party Liabilities (TPL) policies in total premiums reached the level of 68.7% in 2007. 12.8 million euros is the value of claims paid by ICs in 2007, or 25.2% of the ratio claims paid to premiums received. The share of TPL policy holders in total claims is 84.8% in 2007, compared to 90% in 2006 and 96% in 2005. The value of claims by ICs in 2006 was 10.9 million euros compared to 7.9 million euros in 2005.

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

This section will investigate the legal and regulatory framework for banking and insurance from the corporate governance perspective. In the absence of a specific law, the regulation of the banking and insurance industries in Kosova is governed by UNMIK regulations No. 1999/21 and 2001/25 respectively. Over time BPK (and its successor CBK) have issued new rules and other documents to support and amend these regulations which remain at the core of regulatory framework for banking and insurance industries.

### 3.1 Legal Provisions for the banking sector in Kosova

Regulation No. 1999/21 on Bank Licensing, Supervision and Regulation has been in force since 15 November 1999. It is a document comprising of 53 sections covering all the areas indicated in its title. Only a few of these 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 followed by article 7.2(c) which requires BPK to approve the qualifications, experience and integrity of administrators, principal shareholders before granting 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 the BPK prior to their assuming the 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 bank's shareholders in order to prevent any person or interest group to become a significant shareholder owning more than 20% 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 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, the 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 for the preceding financial year. Each bank shall also publish its annual report and provide free of charge copies to public. This section has been amended by Rule XXIV on September 2003.

Finally, by comparing and contrasting the rules and regulations of banking in Kosovo against the OECD principles of Corporate Governance, it can bee seen that most of the regulation addresses 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 which compares to the sixth OECD principle The Responsibilities of the board. Rules and regulations touch upon the areas covered by the first (Ensuring the basis for an effective corporate governance framework) and second (the rights of shareholders) OECD principles.

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 which are stakeholders to a bank (groups such as: employees, clients, community etc.). What the rules and regulations of banking industry in Kosovo fail to address is the third OECD principle (Equal Treatment of Shareholders) and perhaps should address this in the future.

Another issue for discussion is the provision according to which at the governing boards executives directors could be a majority (out of five, two should be non executive directors). Also there is not any provision that obliges for independent board members. The current structure of governing boards in fact reflects these provisions. This could create asymmetry in governance practices and some overweight at the influence of executive directors.

### 3.2 Legal provisions for the insurance sector in Kosova

Chapter VIII of Regulation No. 2001/25 on Licensing, Supervision and Regulation of Insurance addresses the corporate governance of insurance companies explicitly, 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 subjected to the "fit and proper" criteria. Directors and senior officer 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). 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 interest of the company as well as the insurance market has 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/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 Kosova. Article 55.1 stipulates maintaining 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 to a greater detail in Rule 27 in force since April 2002.

Article 48.1 and 48.2 require that the international accounting standards are used by insurance companies and 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 from insurance companies to have their accounts audited annually by a licensed firm approved by BPK, avoiding any conflict of interests. Article 49.4 defines the tasks for the audit firm and Article 49.5 requires the audit 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 in the board of director or officers, require reporting and explanation to the.

When compared to OECD principles, rules and regulations of insurance market in Kosova are in a similar situation as the banking rules and regulations, which is to be expected to an extent since it is the same body which regulates and monitors both industries.

To sum up, the legal and regulatory framework governing the operation of banks and insurance companies in Kosova 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” criteria applied to shareholders and senior managers in banks, and to other officers in the insurance industry, is an assuring step to build confidence that the quality of the human factor is being appreciated as a key to a healthy function of these institutions.

The fact that cannot pass unnoticed is that both regulations and most of these rules date back to 1999 and 2001, which is the time that Basle Committee for bank supervision has issued its framework of internal controls (1998) and the OECD has published for the first time the corporate governance principles (1999).

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

The survey of the banks and insurance companies in Kosova was carried out between the last week of December 2008 until the first week of February 2009. Interviews were held with 16 persons, representing the boards or the management of six banks (out of 8) and six insurance companies (out of ten companies) operating in Kosova. In addition to this, in-depth interviews were conducted with representatives of Kosovo's Central Bank, Kosovo's Chamber of Commerce (KCC), the Alliance of Kosovar Businesses (AKB), and the Ministry of Finance's office. The results have provided us with a better view of the state of corporate governance and compliance with OECD Principles in these industries.

Next, the survey reports are going to be presented and discussed under five sub-headings, addressing the second to the sixth OECD principle.

## *4.1. The Rights of Shareholders and Key Ownership Functions*

The OECD's second[14] principle of corporate governance suggests that "The corporate governance framework should protect and facilitate the exercise of shareholders' rights".

The results of the survey on this principle are summarized in table 7. The survey shows that banks in Kosova have on average 18.5 shareholders while Insurance companies have 2.1. It also shows that the main method of announcing shareholders' meetings is through email. Two-thirds of banks and majority of insurance companies use this tool although some of them use the public media and more traditional means such as phone and written notification by post.

One-third of banks in the survey announce their general meetings one month in advance, another one-third announces the meeting two weeks in advance and one makes its announcement the general meeting only one week in advance. Half of the insurance companies announce the shareholder meeting one month in advance; one of them two weeks in advance and another company only one week in advance. 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 required 50%+1 of the shares/ votes, and one-third of them require 25% or less shares respectively 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.

[14] We are starting with the second OECD principle of corporate governance since the first principle is concerned with ensuring the basis for an effective corporate governance framework, and this has been tackled in the section Legal and Regulatory framework of this report.

Electing or removing board members require 50% + 1 of shareholders' votes in half of the banks, one bank requires 100%. 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% of shareholders' votes.

Table 7: The rights of shareholders and key ownership functions

| Questionnaire/Questions | Answers | Banks | Insurance companies |
|---|---|---|---|
| Number of shareholders | Average | 18.5 | 2.1 |
| | Max[15] | 40 | 4 |
| | Min | 2 | 1 |
| How is the shareholders' meeting announced? | Co. website | - | - |
| | Public media | 1 | 1 |
| | Email | 4 | 5 |
| | Written notification by post | 2 | - |
| | Phone | 2 | 1 |
| | No response | 1 | 1 |
| How far in advance is the shareholder meeting announced? | One week | 1 | 1 |
| | Two weeks | 2 | 1 |
| | One month | 2 | 3 |
| | No response | 1 | 1 |
| What other information, except for date and location, about the General Shareholder Meeting is announced? | 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/takeovers? | 2/3 of shareholders | 3 | 4 |
| | All shareholders | 1 | - |
| | Other | 1 | 1 |
| | No response | 1 | 1 |

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

[15] One of the banks in our sample is a subsidiary to a foreign bank, which holds 70% of 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.

Our findings suggest that shareholders are informed properly and in a timely manner. Also, there are indications that the rights of shareholders are respected and shareholders are 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 and/or insurance companies.

### *4.2 The Equitable Treatment of Shareholders*

In the OECD Principles of Corporate Governance, the third principle 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 shareholders should have the opportunity to obtain effective redress for violation of their rights." Testing these statements through our survey, we got the results which are summarized in the following table.

Table 8: Equitable treatment of shareholders

| Questionnaire/Questions | Answers | Number of Banks | Number of Insurance Cos. |
|---|---|---|---|
| How do you address and deal with minority shareholder concerns? | Formal mechanisms | - | - |
| | Other | 3 | 2 |
| | No response | 3 | 4 |
| Is it possible to vote in absentia? | Yes | 5 | 2 |
| | No | 1 | 1 |
| | Other | - | 3 |
| Is there any cost to voting in absentia? | Yes | - | - |
| | No | 5 | 2 |
| | No response | 1 | 4 |

The issue of minority shareholders in Kosovo, as the survey results indicate, is not of a large impact mainly due to the fact that there is no stock exchange in Kosova where the shares of these institutions could have been floated traded. This has meant that it was not possible for ordinary people to buy only few shares but rather only few people could buy substantial amounts of shares, which limited the number of shareholders as our survey has shown, to maximum 40 (Table 7). Small number of shareholders has ameliorated the problems of minority shareholders.

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

In our overall sample of banks, one half of the respondents did not have an answer to the question: "How do you address and deal with minority shareholder concerns?". The other half of those who were interviewed returned 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; and in the case of one bank, there is a minority shareholder representative at the board; the ability to discuss openly all the issues at the

Annual General Meeting (AGM) was the answer of another bank representative; or even, all decisions so far have been taken by consensus, for some banks.

What these answers do not provide is what happens if a minority shareholder has a concern, i.e., his rights are being violated? Discussing openly at the AGM might provide a way to make ones' concerns public and it gives a chance to appeal to the humanity of other shareholders, but this is where it ends. The fact that all decisions have been taken by consensus so far, is not a guarantee that in the future will be so.

In contrast to banks, insurance companies have a maximum of 4 shareholders (on average, 2.1 shareholders per company). The fact that one third of companies in our survey are owned by one shareholder, and another one third by two shareholders, means that the minority shareholder problem is mitigated. This is further strengthened by the fact that companies owned by two, three or four shareholders, usually are one of several other businesses that these people have set up jointly in the past. Hence, there is a degree of mutual trust among the shareholders developed over time – even if one holds more shares than the other shareholder/s.

This is an important fact to emphasize because, if one of the shareholders holds the majority of shares in the insurance company, it might not be so in other joint businesses, hence the incentive to abuse the minority shareholders' rights is minimized. This is confirmed by the answers provided in our survey. Only two thirds responded to the question "How do you address and deal with minority shareholder concerns?" along the lines of: their interests are taken into consideration, or, all decisions are taken by consensus which is quite possible when there are one, two or three shareholders.

Voting in absentia is possible in the majority of banks, and there is no cost for such method of voting according to our survey results. This provides bank shareholders with additional already established methods of exercising their voting rights. Insurance companies in our survey, however, are slightly more reserved than banks when proxy voting is concerned. Only few of them answered positively to the "voting in absentia" option. One insurance company's reply was negative to this option and few others did not have a view on this issue and responded "we have never had to deal with such situation".
In respect of foreign shareholders, there is no indication that their rights might be violated since, in both banks and insurance companies with foreign shareholding, the foreign owners are the majority shareholders.

To summarize, our survey has not been able to pick up any indications that banks and insurance companies do not treat equitably their shareholders. We do, however, find worrying the fact that there are no mechanisms in place to protect minority shareholders, and while it is comforting to know that there has not been a case of abusing minority shareholders' rights so far, the absence of rules or regulations in this area might give rise to such behavior in future.

### *4.3 The Role of Stakeholders in Corporate Governance*

A stakeholder is a person or a group which stands to affect the actions or be affected by the actions of a company. The OECD's fourth principle of corporate governance 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 for banking and insurance industries in Kosova is not regulated, hence it is up to the banks and insurance companies to address it as they see fit.

This has lead to the situation that stakeholders mainly are addressed for public relations purposes. The survey reflects the fact that there is no legal requirement in place – especially for the representative of employees. In the following table, findings from our survey are summarized:

Table 9: The role of stakeholders

| Questionnaire/Questions | Answers | Number of Banks | Number of Insurance Cos. |
|---|---|---|---|
| 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 | - | - |
| | No response | - | 5 |
| Does your institution have a deposit insurance system? | Yes | 1 | - |
| | No | 5 | - |
| Does your institution have a representative of employees on the board? | Yes | - | 1 |
| | No | 6 | 5 |

When they were asked to identify the stakeholders for their companies, all banks in our survey listed: borrowers, depositors, and community, and the majority of banks also listed employees as their stakeholders. The interesting finding for insurance companies was that only a minority (1) listed 'the insured' as their stakeholder, and it was a similar minority (1) that listed 'employees' and 'community' as their stakeholders. The majority of insurance companies (5) chose not to respond to the question regarding stakeholders.

When the respondents were asked what their institutions do to cultivate the relationships with stakeholders, most of the insurance companies stated that they try to improve the services offered to clients. Most banks seem to utilize the improving of services approach as a means of cultivating their relationship with stakeholders too. However, all banks and most of insurance companies resort to the sponsorship of sporting, entertainment events and also investigative journalism and educational programs.

The expected result due to lack of regulation, is that majority of banks do not have deposit insurance (5) and a minority (1, which is a branch of an international bank) replied positively. Although the majority of banks in our survey have listed employees as their stakeholders, all of them responded negatively to the question of whether they have an employee representative on the board. The same answer was reported by the majority of insurance companies too.

In respect to functionality and quality of board of directors, the KCC representative focused more on experiences that accompanied the setting up and functionality of banks and referred to corporate governance as the main problem at the time. Poor division of functions and responsibilities among governing bodies was particularly symptomatic to local banks. The presence of foreign banks has introduced better corporate governance practices to the market according to the KCC representative. The CBK representatives referred to the current regulation and stretched the application

of "fit and proper" criteria 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 like Financial Intelligence Unit (FIU) that 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 the mid-level management such as unit directors, are subjected to these procedures too. The CBK representatives stated that independent board members undergo same procedures before approved by the CBK.

Asked about their opinions regarding the relationship of financial Institutions with their stakeholders, the KCC representative thinks that communication among these actors is still at an unsatisfactory level. The CBK representatives suggest that the relationship of Financial Institutions and stakeholders is condensed to quality of reporting and disclosure. There is a "reporting framework" which all Financial Institutions have to follow as well as there are strict regulation regarding the publishing of audited reports and financial statements. In additions, all banks and insurance companies have to disclose in 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 Financial Institutions towards their stakeholders, according to CBK representatives.

Protection of shareholders' rights and related party transactions should be regulated by law was the opinion of KCC representative. The CBK representatives confirmed that for their institution there is a clear definition of what related party transaction is, and there are limits in place as far as the amounts of loans for bank management and employees are concerned. A crucial point in this aspect is the division of the post of CEO and Board Chairman which contributes to the independence of these two bodies.

Finally, when asked whether they think the OECD principles on corporate governance are being implemented the KCC representative replied that it might be partially, due to regulation which touches upon these principles, but there is room for improvement. According to CBK representatives, all insurance companies comply with these principles since 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 and this is expected to increase the management standards and improve corporate governance.

To sum up, the role of stakeholders is not regulated and both banks and insurance companies in our survey have exhibited shortcomings.. The perception of some of stakeholders namely representatives of business community ( Chamber of Commerce and AKB) is that financial system, banks with very high interest rates and short repayment periods are not enough meeting needs of businesses for long term capital investment needs. Also SME surveys during several last years have constantly shown that access to finance and loan conditions appeared to be listed among key barriers in doing business in Kosovo[16]. As was shown in section 2.3.1 in table 3, the credit depth/intensity expressed by private loans/GDP ratio shows the poor supply of credit to Kosovar businesses and households compared to neighboring countries. This is reflected in a constant high credit

[16] SME Surveys, Riinvest 2004, 2005, 2008

demand, despite high interest rates. It should be noted that the high interest rates are also explained by perceived risk due to inefficient judiciary. However all this explain that there is not enough attention paid to issues of common concerns between key stakeholders: 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."

Table 10: Disclosure and transparency

| Questionnaire/Questions | Answers | Number of Banks | Number of Insurance Cos. |
|---|---|---|---|
| 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[17] |
| | 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 |

In our survey, all banks and insurance companies replied positively to the question about the publication of financial statements and operating results. This was expected to be so since this is required by the rules and regulations governing these

[17] One insurance company did not reply to this question since it was the first quarter of its functioning and there were no audited reports yet.

industries.[18] It was not the same response when they were asked about the publication of strategic objectives. Some banks (about 1/3) and most of the insurance companies (over 2/3) do not publish their strategic objectives.

The publication of names of major shareholders, based on the survey results, is an unregulated matter and it is up to individual institutions to address it, but all respondents replied positively to the question "Do you publish the names of your large shareowners?". However, there were variations amongst banks in terms of the threshold for declaring a shareholder, majority of respondents either did not provide an answer nor were sure whether there is a set limit of ownership for a owner 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 7% ownership is necessary for an owner to be declared. For insurance companies it was simpler. Of all respondents only one replied negatively to having a threshold for declaring a shareholder, the rest did not provide an answer. Once again, this could be explained by the small number of shareholders (between 1 and 4) and perhaps the respondents assumed that it is obvious that all shareholders are disclosed.

According to the survey results, banks are quite transparent when it comes to publishing information[19] about their board members. Two thirds of the banks responded positively to the question about publishing such information, one third publish full CVs and the qualifications of their board members. In addition, only half of them 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 remains that one third of banks in our survey do not publish any information on their board members. None publish any information on remuneration of the bank managers, or board members.

It was the same with insurance companies. Two thirds publish information about their board members; however, according to the survey, they publish only the names and percentage of ownership (two thirds). One company in our survey responded that only a short profile of the board member is published[20]. 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 intriguing results of the survey are the fact that all banks have responded negatively to the question on independent board members.[21] In this aspect, insurance companies were different from banks since the responses from the insurance industry were that two thirds have independent directors on their boards which still leaves one third of the insurance companies that responded negatively to this question. Half of

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[18] 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.

[19] We have 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)

[20] We have found out that only one insurance company publishes the list of names of the board members and 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.

[21] What makes this intriguing is the fact that according to Regulation 1999/21 section 17, two of the board members should be non-executive directors.

the banks and insurance companies in our survey disclose to the regulatory authority the remuneration of board members and mangers. The other half consider the remuneration of board members and mangers as confidential information.

In respect to related party transactions, all banks but one replied positively to having policies on dealing with companies in which board members/managers (on both respective questions) are important shareholders or employees. The response from insurance companies to the question on related party transactions is similar to the one of banks since all but one responded positively to having policies in place when dealing with companies in which board members are important. Interestingly enough though, only one responded negatively to the question if there are procedures addressing related party transactions with companies in which mangers are important shareholders or employees, the rest of the respondents did not reply at all to this question. In past, two or three years ago this appeared to be serious problem. The failure to implement sound standards at the corporate governance leaded to serious problems at least to 2 Kosovar banks, one of which Kredit Bank Prishtina went to bankruptcy (2004). The main problem appeared to be a conflict of interest of certain members of BoD in these banks through issuing credits for their own or related businesses and associated with the 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 disclosing information is regulated for banks and insurance companies. It is also required by regulations to publish the audited reports on a timely manner in national newspapers.[22] All banks in our survey publish their financial statements and operating results in their own website. In addition to the website some banks publish in national newspapers only their balance sheets. One third of banks in our survey responded that they contract a different independent audit every third year and the remaining two thirds every fifth year. The independent audit in all banks reports to shareholders (AGM) and for half of banks in our survey it reports to the board of directors too. Publishing of audited reports is different for insurance companies since it is not regulated as it is for banks. All insurance companies in our survey publish their reports only on their web sites and only few in addition to web sites publish this information in their annual reports too. When appointing 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, in our survey the independent audit reports to the board of directors in approximately 85% of responses, with approximately 15% additionally report to the central bank of Kosova and another 15% approximately additionally report to the shareholders.

To summarize, banks and insurance companies in our survey appeared to be very diligent about issues related to transparency and disclosure. Banks in general publish more information than insurance companies. Perhaps, the fact that the regulatory bodies have paid more attention to this aspect has resulted in better compliance with the OECD principle.

[22] UNMIK Regulation No. 1999/21, Section 34.

*4.5 The Responsibilities of the Board*

The corporate governance principles 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 of Corporate Governance 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". The following tables summarize the findings of our survey in terms of board functioning.

Table 11: Responsibilities of the board

| Questionnaire questions | Answers | Number of Banks | Number of Insurance Cos. |
|---|---|---|---|
| Average (%) of 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 | - | 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 |
| | Other | 1 | 2 |
| Does the board decide on a 'corporate governance policy'? | Yes | 5 | 5 |
| | No | 1 | 1 |

The participation of board members in the board meetings, according to our survey is very good for banks (100%) and relatively good for insurance companies (2/3 of companies have between 80 and 100% participation). Although most banks did not have a system of penalties (3) the remaining banks in the sample had quite severe measures in place for non-attendance: if the board member fails to attend three meetings (in one bank's case it is two meetings), the board chairperson may request his/her replacement. For insurance companies, it was slightly different. Only one applies penalties for non-attendance, three do not, while the remaining companies did not respond. The penalty mentioned by the insurance companies for not attending a board meeting is: the per diem payment will not be paid.

According to our survey, the Board of Directors of banks seemed to have met more often during 2008 than insurance companies. Three banks had 12 or more board meetings while the remaining met on quarterly or bimonthly basis. The majority of insurance companies during 2008 met on monthly basis (5) and only one met more than once a month.

In the survey all banks replied that their boards deal with: corporate strategy; major plans of action; risk policy; annual budget; and the business plan. All insurance companies responded that their boards deal with: corporate strategy; major plans of action; and risk policy. Two of them replied that their boards also deal with: annual budget; and the business plan, too. Half of the banks have the corporate strategy approved by the board for a three years period and it is five years for the remaining half. One-third of insurance companies approve the corporate strategy for a period of three years and for the remaining two-thirds it is five years.

All banks and insurance companies declared that their boards set performance objectives for the management. The performance objective most frequently used by the boards was the 'market share' but quite often the 'number of clients' is used as a performance target too. Boards of banks also use qualitative performance criteria such as the quality of the portfolio; the proportion of the successfully implemented projects; the achievement of set goals like increasing of deposits; development of certain lines of business, etc. Other objectives used by boards of insurance companies are not as elaborate as the ones in the banking industry. Only one insurance company has mentioned the 'development and training of staff', and the 'creativity' as performance objectives for managers. 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 overall profit of the bank; increase in the number of bank clients; achievement of objectives as set up in the short- and medium-term plan; etc. For insurance companies 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 board of directors and the management. In the remaining bank this is done by the internal audit committee[23]. For two-thirds of insurance companies in our survey it is the board of directors alone who deals with these issues and for the remaining one-third of the companies' board of directors and management jointly monitor the implementation of strategic plans and corporate performance and oversee of major capital expenditures.

[23] One bank, in addition to internal audit committee has internal audit council too.

Banks in our survey appear to have more and better quality committees than insurance companies. All banks have audit committees in contrast to only five insurance companies; some banks have remuneration and appointment committees while insurance companies have none of those; all banks have risk committees in contrast to one-third of insurance companies having this committee. 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. The implementation and monitoring of these practices is very similar for both industries in our survey. Reports by different levels of management as well as from the internal audit person/committee are used to monitoring and implement corporate governance practices.

However, form at least from the part of the interviews there is an impression 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, the functioning of boards according to our survey appears to be in a good state although there are slight differences on how Bank and Insurance Company's boards work. The main failure in complying with the sixth OECD principle is the lack of attention for stakeholders. This is symptomatic for both industries in our survey.

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