A Comparison of Financial Performance of Domestic and Foreign Banks in Kosovo by Using DuPont Model

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Abstract: The aim of this study is to compare financial performance of the domestic and foreign banks in the banking sector of Kosovo during the period of 2001-2007. We will use the DuPont financial analysis model to measure the comparative performance between domestic and foreign banks. Through this model, we have shown the factors that has driven banks to higher or lower Return on Equity (ROE).The research results show that foreign banks have been more efficient and profitable, thus having a higher ratio of Return on Assets (ROA) and Return on Equity (ROE).The foreign banks' high ratio of Return on Equity is a result of a higher interest margin (PM), which indicates that foreign banks have made a better costs management and a larger use of financial leverage. Moreover, the results indicate that despite the domestic banks' higher ratio of Assets Utilization (AU) compared to foreign banks, the main factor that has contributed to worsening of domestic banks' profitability was the high costs of loans provisioning due to poor quality of the loan portfolio. This outcome suggests that domestic banks mostly had clients with less creditworthy and did not possess the adequate techniques to manage loan risk as foreign banks have

Keywords: Return on equity; Return on assets; Net profit margin; Asset utilization; Equity multiplier,

JEL Classification: G21; G24

1. Introduction

The banking system in Kosovo is the most important sector within the financial system built after the war through quite a liberal license granting system. Their operations are based on the universal principle of banks delivering a wide range of financial services to businesses, individuals and institutions.

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Given that the non-banking financial institutions are not developed and their role as intermediary institutions in channeling financial savings on investments is irrelevant, commercial banks are almost the only source of funding.

This shows that Kosovo's economy, particularly small and medium enterprises' large dependence on commercial banks. Therefore, the development of the banking sector and the improvement of their financial performance contribute to economic growth through their financial intermediation role.

A characteristic feature of the Kosovo's banking sector that differs from other banking systems of transition countries is that it was established with the entry of foreign banks.

Thus, a proper commercial banking was firstly created in 2000 - 2001 through the entry of private banks with foreign capital. Market share of banks with foreign capital has steadily increased as the improvement of banking services and competition did. Given that the establishment of Kosovo's banking system started with foreign banks, this has also allowed foreign banks to have a larger access in deposits and customers' trust.

We may therefore highlight that the increase of foreign banks' share has led to a greater stability in the financial sector and has provided for a wider range of financial services and new banking techniques.

The banking sector's performance assessment is vital to a new banking system set up without any experience in the modern banking because the failure of the banking system may result in a series of negative impacts on the depositors, other financial institutions, businesses and the economy as a whole. Therefore, in- depth analysis of the banking sector's performance assessment is more than necessary. This is the reason behind the research on the Kosovo banking sector's financial performance by using the DuPont financial analysis model.

2. Literature Overview

Many researchers have been made looking into the financial performance assessment of banking sector in different countries. Usually, the banks' performance has been assessed through accounting approaches using the financial ratios and the econometric approach. The accounting methods use financial ratios for assessing the banks' performance.

Moreover, the DuPont model, as a financial analysis technique, is primarily used as a tool to analyze financial ratios of the companies or industry. This model was later used for assessing the banking sector's performance according to an upgraded version Cole, 1973, Dietrich (1996), Saunders (2000), Koch and MacDonald 2002

and Vessel et al (2004) taking into account the specifics of the activity of banks as well as the balance sheet and their success.

There is quite a rich literature when it comes to the assessment of domestic and foreign banks' performance.

Claessens, Demirguc-Kunt and Huizinga (2001) studied the performance of domestic and foreign banks in eighty countries including developing and developed countries from 1988-1995. They examined how the net profit margin, overhead expenses, taxes paid and profitability differs between domestic and foreign banks and found that foreign banks perform better in term of profitability in developing countries, but it's totally the opposite in developed countries.

Demirguc-Kunt and Huizinga (1999) present similar results. They show that foreign banks have generally higher profits and margins compared to domestic banks in developing countries, while the opposite is true in industrial countries.

Sabi (1996) compared the performance of foreign and domestic banks in the process of transition into a market-oriented economy in Hungary. This study shows that foreign banks are more profitable than domestic banks and did not expose to a greater liquidity or credit risk the results indicate that foreign bank profitability is higher than the average profitability of the domestic banks although importantly, in the post-crisis period, the gap between foreign and domestic profitability become closer.

Chantapong (2005) by studying domestic and foreign bank performance in Thailand concluded that foreign banks are more profitable than the average domestic banks' profitability.

Havrylchyk and Jurzyk (2006) Paper on Profitability of Foreign and Domestic Banks in Central and Eastern Europe: Does the Mode of Entry Matter? Where data for 265 banks in the Central and Eastern European Countries for the period of 1995-2003 have been used, analyses the differences in profitability between domestic and foreign banks. They show that foreign banks, especially Greenfield institutions, earn higher profits than domestic banks.

Kraft, Hofler and Payne (2006) studied the Croatian banking system and found that the new private and privatized banks are not more efficient than public banks and that privatization does not immediately improve efficiency, while foreign banks are substantially more efficient than all domestic banks.

In regard to researches on the domestic and foreign banks' performance in Kosovo, the literature is that rich.

Toçi (2009) studied the efficiency of banks in South-East Europe with special reference to Kosovo by using non- parametric methodologies. He showed that foreign banks were more efficient than domestic ones.

Balaj (2011) studied the impacts of the foreign bank's presence on the performance of domestic banking sector in Kosovo by using OLS regression technique. He has find that the foreign banks have higher net interest margin and profit than the domestic.

3. Research Objectives

The main purpose of this paper is to assess and compare the financial performance of domestic and foreign banks in Kosovo. The second purpose of this research is to reflect the factors that have had a positive and negative impact on the Return on Equity of domestic and foreign banks.

4. Methodology and Data Sources

In order to reach the objectives of this research, I will use the DuPont financial analysis model to assess and compare the financial situation between the domestic and foreign banks in the Kosovo's banking market.

This model has also been used in assessing the banking sector's performance, but in a version modified by various writers as Cole1973, Dietrich 1996,Saunders (2000), Koch and MacDonald (2002), Vensel et al. (2004), taking into account the specifics of the activity of banks as well as the balance sheet and their success.

The data used in this paper are provided by the Central Bank of Kosovo and include annual records from the balance sheet and income statements of banks.

Seven banks are included in this research, out of which five are domestic banks and two foreign banks dating from 2001 to 2007. This research period may be deemed as a short-term one to give significant results. But, in early 2008, the structure of Kosovo's banking system changed and there are only two domestic banks and four foreign banks.

The reason for conducting this researching on such a short period of time by using the DuPont model is to reflect the factors that led to worsening of the domestic banks' performance.

5. Establishment and Development of Banking System in Kosovo

By the end of 1999 Kosovo started with the political, economic and social establishment and transformation with the aim of integrating into the European Union. Regardless of the efforts and achievement made over the last years, the Kosovo economy is still facing structural and law enforcement problems.

The establishment e new relevant institutions included the banking system as well. After the war, Kosovo was administered by the United Nations Organisations. Hence, the international and national authorities engaged to establish a banking sector in accordance with international standards and creating a suitable environment to attract foreign capital into the financial sector. The result thereof was the establishment of the Banking and Payments Authority of Kosovo in 2019, which in 15 of June 2008 was transformed into the Central Bank of the Republic of Kosovo.

Central Bank of Kosovo is the highest authority in the financial system operating as the regulatory and oversight authority on commercial banks. In April 1999, the legal framework (Regulation no.1999/21 on the Banking and Payments Authority of Kosovo) was established for the licensing of banking and non-banking institutions. This regulation paved the way to the process of licensing new private banks and regulating the banking system by the Central Bank.

This legal framework allowed the entry of foreign banks and other financial institutions into the financial sector of Kosovo which also marked the creation of the Kosovo banking system.

Notwithstanding the difficulties in the establishment of the banking system, which were justified with the poor professional qualification, scarce legacy in the banking area and poor institutional management in general, the Kosovo banking system's development over the years is vulnerable in some respects, where the institutional framework, the banking system and loaning services have made progress. The ownership structure of the banking system as of the end of 2007 consisted of two foreign-owned banks and four domestic banks with private capital, while in early 2008 we have six foreign banks and two domestic banks.

Kosovo banking sector's structure has changed over the years. In 1999, there was no bank operating in Kosovo and all the functions of commercial banks were performed by the Banking and Payments Authority of Kosovo. In 2007, there were seven commercial banks operating in Kosovo, out of which five had a domestic capital and two had a foreign capital, as shown in the Table 1.

This indicates that the banking sector during the research period had the lowest number of banks with foreign capital in the region, which shows the foreign investors' less interest in the banking market in Kosovo.

Table 1. The Kosovo Banks' ownership structure (number of banks)

Ownership	2001	2002	2003	2004	2005	2006	2007
Domestic Banks	-	5	5	5	5	4	2
Foreign Banks	2	2	2	2	2	2	5

Source: Central Bank of Kosovo http://www.bqk-kos.org

75

In regard to the banking sector's size related to assets, foreign banks manage the largest part (75%) of the total assets of the banking sector, while domestic banks manage only 24% of the banking sector assets as of the end of 2007. See Table 2.

Domestic banks have had an increasing trend in their funds share until 2014. After 2005, particularly 2006 when the Credit Bank bankrupted, there is a decline of the shares in the banking sector's funds and a decreased number of domestic capital banks from five to two. Large banking market domination by the foreign banks is noticed in the category of loans and deposits, which represent 77% of the banking sector loan and 59% of the total banking sector deposits

Table 2. Structure of funds, deposits, and loans of domestic and foreign banks

	2001	2002	2003	2004	2005	2006	2007
Foreign Banks							
Assets	74%	73%	64%	62%	66%	71%	75%
Loan	44%	41%	52%	56%	66%	73%	77%
Deposit	51%	54%	56%	57%	58%	59%	59%
Domestic Banks							
Assets	26%	27%	36%	38%	34%	29%	24%
Loan	56%	59%	48%	44%	34%	27%	23%
Deposit	49%	46%	44%	43%	42%	41%	41%

Source: Author's calculation

6. Banks Performance Assessment through DuPont Model

One of the most important goals of the banking sector is to achieve high profit ratios as a result of the banks intermediary activities between lenders and borrowers. The main policy of commercial banks is to earn the highest profit changing between the active and passive interest or by directly participating in the economic activity.

Earning a high profit to an acceptable risk is not a target easily achievable by shareholders/owners of the bank because they need to have professional staff to achieve it.

In order to measure efficiency and performance, many authors have used financial ratios such as the Return on Equity ratio and Return on Assets, as tools for measuring the banks' profitability.

In order to see how banks in Kosovo have performed during the research period and assess the banking sector, we will provide a financial analysis by using the DuPont model. The DuPont financial analysis model is based on Return on Equity (ROE).

Return on equity (ROE) means not only a figure that indicates the return on capital but it also implies a complex variable, which we should break down in order to see the factors that have led to ROE.

The DuPont model, as a financial analysis technique, is used to analyze financial ratios of the companies or industry and to assess the banking sector's performance according to an upgraded version Cole, 1973, Dietrich (1996), Koch and MacDonald 2002 and Vensel et al (2004) taking into account the specifics of the activity of banks as well as the balance sheet and their success. In addition, Saunders (2000) provides a model of financial analysis for financial institutions based on the DuPont system of financial analysis Return on Equity model. Based on the DuPont financial analysis model, Return of Equity is affected by three factors: the Profit Margin (PM), Assets Utilization (AU) and Equity multiplier (EM).

The starting point for applying the DuPont model to analyze the bank performance is the calculation of the Return on Equity ratio.

$$Return\ on\ Equity\ (Roe) = \frac{NetIncome}{TotalEquity}$$

The Return on Equity measures the income the bank earns for each euro of capital invested in the bank. Banks that report high ratios of Return on Capital show that the Return on Equity (ROE) is linked to the Return on Assets (ROA) by the equity multiplier (EM), which is equal to the total funds compared to the total capital as follows:

$$ROE = ROA * EM$$

$$ROE = \frac{NetoIncome}{TotalAstets} x \frac{TotalAstets}{TotalEquity}$$

Thus, the equation shows that a higher or lower ratio of Return on Equity may be obtained by either increasing ROA or by increasing the financial leverage (EM).

Return on assets measures the banks profit for each unit of invested funds. It indicates the management of efficiency in using its assets to generate earnings.

Equity Multiplier (EM) of the bank compares the funds in relation to the bank's capital, where the high value of this equity multiplier shows the highest amount of financing through debt in relation to the shareholders' equity. The high EM ratio may lead to the increase of ROE but also the risk a bank bankrupt (Peter Rose 2002).

The second step in braking down ROE consists in braking down the Return on Assets (ROA) to Profit Margine and Assets Utilization (AU).

$$ROA = \frac{NetIncome}{Totaloperatingincome} x \frac{Total\ operating\ Income}{Totalassets}$$

$$ROA = PM\ x\ AU$$

Profit Margin (PM) shows the amount of after tax profit that the bank is able to generate for every euro of earned income. The profit margin is obtained by dividing net income by total income.

This ratio provides us with very important information about the efficiency of banks, which during their businesses could achieve a higher profit margin if they would be able to control costs and keep loan losses to a low level.

In order to show that the banks' efficient management of their expenditure, it is necessary to break down the operating costs components as well: Interest Expense ratio, Non-interest expense ratio, Provisions for loan loss ratio and Tax ratio (Saunders (2000)

Assets Utilization (AU) is another very important component having an impact on ROA.

Assets Utilization ratio indicates the extent of efficiency in using assets to generate earnings. Assets Utilization ratio is obtained by dividing total income with total assets. The greater the use of assets is the greater is the bank's ability to generate earnings from their assets.

Assets Utilization is influenced by the risk management practices of the bank interest rate, liquidity management and the structure of assets (Koch et al 2002)

7. Analysis of Financial Performance of Banks in Kosovo by Using DuPont Model

The results of the domestic and foreign banks' performance analysis based on DuPont model are presented in the following Tables 3 and 4.

Table 3. Analysis of domestic banks' performance through DuPont model

Financial Ratios	2001	2002	2003	2004	2005	2006	2007	Average
Return on Equity (in %) ROE	0.40%	11.19%	14.72%	10.49%	5.45%	4.53%	9.77%	8.08%
The components of ROE= ROA x EM								
Return on Assets (in %) ROA	0.02%	1.28%	1.74%	1.17%	0.54%	0.46%	1.22%	0.92%
Equity multiplier (in times)	16.41	8.75	8.47	9.00	10.01	9.87	7.98	10.1
The Components of ROA= PM x AU								
Profit Margin (in %) PM	1.76%	13.21%	17.28%	11.45%	4.87%	4.87%	12.07%	9.36%
Asset Utilization (in %) AU	1.37%	9.70%	10.06%	10.27%	11.32%	9.48%	10.12%	8.90%
The Components of Pm = IE+ OE+PLL+ Tax / Total Asset								
Interest expense (in %) IE	0.19%	0.76%	1.10%	1.52%	1.92%	1.73%	1.75%	1.28%

Noninterest expense (in %) OE	0.98%	5.46%	5.10%	4.78%	5.55%	5.07%	5.11%	4.58%
Provision for loan loss ratio (in %) PLL	0.16%	1.96%	1.73%	2.45%	3.22%	1.80%	2.04%	1.91%
Tax (Tax)	0.02%	0.24%	0.39%	0.37%	0.09%	0.42%	-0.01%	0.22%
The Components of AU = II+ OI / Total Asset								
Interest income (in %) II	0.51%	4.91%	6.09%	6.86%	7.75%	6.21%	6.67%	5.57%
Noninterest income (in %) OI	0.86%	4.79%	3.97%	3.41%	3.57%	3.28%	3.45%	3.33%

Source: author's calculations

Table 4. Analysis of foreign banks' performance through DuPont model

Financial Ratios	2001	2002	2003	2004	2005	2006	2007	Average
Return on Equity (in %) ROE	54.62%	5.80%	15.61%	26.86%	28.59%	26.81%	29.61%	26.84%
The Components of ROE= ROA x EM								
Return on Assets (in %) ROA	1.74%	0.31%	0.82%	1.83%	1.79%	2.25%	2.78%	1.65%
Equity multiplier (in times)	31.43	18.56	18.97	14.65	15.98	11.91	10.64	17.45
The Components of ROA= PM x AU								
Profit Margin (in %) PM	43.48%	5.40%	10.99%	22.13%	20.37%	22.35%	24.48%	21.32%
Asset Utilization (in %) AU	4.00%	5.79%	7.49%	8.29%	8.78%	10.08%	11.37%	7.97%
The Components of Pm = IE+ OE+ PLL+ Tax / Total Asset								
Interest expense (in %) IE	0.27%	0.72%	0.78%	1.04%	1.38%	1.71%	1.89%	1.11%
Noninterest expense (in %) OE	1.77%	4.24%	4.53%	4.54%	4.72%	4.58%	4.92%	4.19%
Provision for loan loss ratio (in %) PLL	0.10%	0.22%	1.07%	0.68%	0.42%	0.93%	1.02%	0.64%
Tax (Tax)	0.11%	0.29%	0.29%	0.19%	0.47%	0.60%	0.75%	0.39%
The Components of AU = II+ OI / Total Asset								
Interest income (in %) II	1.68%	3.34%	4.71%	6.46%	7.49%	8.23%	9.00%	5.84%
Noninterest income (in %) OI	2.32%	2.45%	2.78%	1.83%	1.29%	1.85%	2.37%	2.13%

Source: Author's calculations

The results presented above show that both domestic and foreign banks did not record any negative return on equity and assets during the research period.

However, foreign banks were more profitable than domestic banks, where the average return on equity and assets ratios for the period 2001-2007 to foreign banks was 26.84% and 1.65%, whilst 8.08% and 0.92% to the domestic ones.

Foreign banks have achieved a higher return on equity ratio than domestic banks during the period, except for 2002 when the domestic banks' ROE was 11.19 % and the foreign banks' ROE was 5.80%.

Foreign banks have had an increasing trend since 2003, whilst domestic banks have had a significantly increasing trend since 2001-2003, which afterwards suffered a decline since 2004. This shows that foreign banks have been more efficient in managing their capital compared to domestic banks.
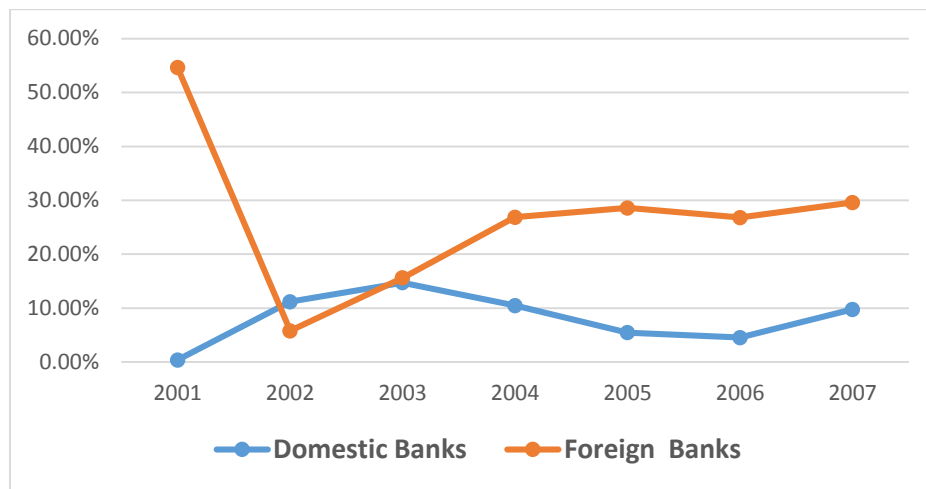

Figure 1. Return on Equity (ROE) 2001-2007

Source: Author's calculations

The broken down return on equity (ROE) ratio shows that the domestic banks' low profitability was due to the return on assets (ROA) by 0.92% and equity multiplier (EM) by 10.1 times. Meanwhile, the high increase in foreign banks' ROE was generated by ROA of 1.65% and the equity multiplier of 17.45 times.

Based on the results described above, we may conclude that foreign banks not only had higher return on assets ratio, but the high return on equity (ROE) ratio was due to a larger use of financial leverage rather than the profitable use of assets.

This shows that foreign banks were more efficient in managing their capital compared to domestic banks, but also a higher risk.

The financial leverage ratio for the 2001 to 2007 period shows that foreign banks have a higher financial leverage ratio of 17.45 compared to the domestic banks with 10.1 times.

As a result of the high financial leverage ratio, it is clearly evident that the foreign banks have been able to generate a higher ROE than the domestic banks.

The equity multiplier presented also in the figure below shows that foreign banks have had higher level of risk than domestic bank.
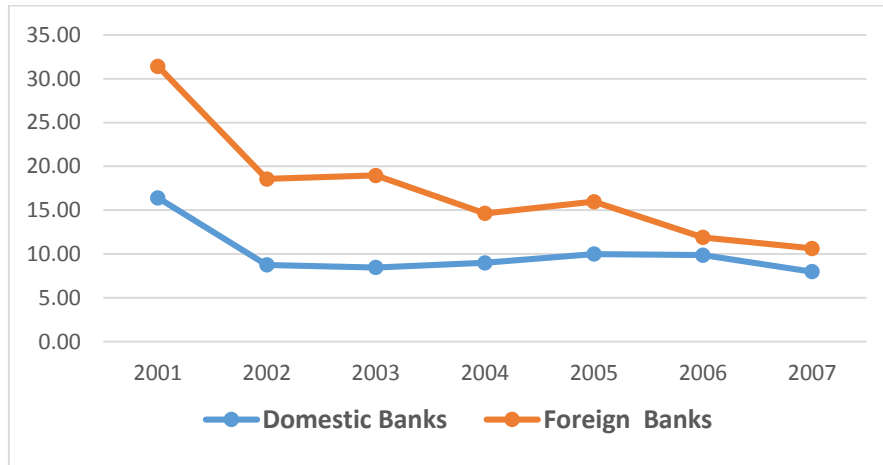

Figure 2. Equity Multiplier (EM) 2001-2007

Source: Author's Calculations

In regard to the return on asset ratio as a measure of performance and a generator of the return on equity during 2001- 2007, as seen from the Tables 3 and 4 and Figure 3, foreign banks have generated an averagely higher return on assets ratio 1.65% than the domestic banks 0.92%

During 2002 and 2003, domestic banks had a higher of return on assets ratio compared to foreign banks. But from 2004 to 2007, the domestic banks' return on assets has had a declining trend.

Foreign banks have had a continuously growing trend of the return on assets ratio, except for 2002 when there was a decline from 1.74% to 0.31%. This continuously growing trend of foreign banks' ROA has positively contributed to the growth of ROE.
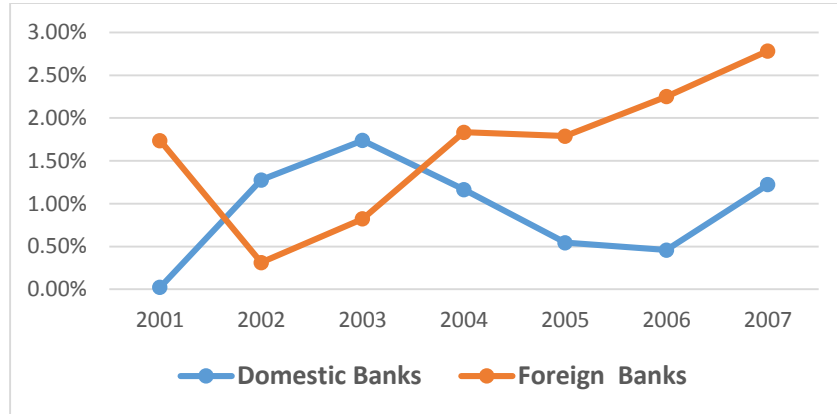
Figure 3. Return on Assets (ROA) 2001-2007

Source: Author's calculations

In addition, the results obtained from braking down ROA into profit margin and asset utilization shows that the domestic banks recorded an average profit margin (PM) of 9,36 %, whilst foreign banks 21.32 %. Domestic banks have had a declining trend of PM from 2004 to 2007, whilst foreign banks reported an increase in PM in 2001, after a decline in 2002, which then continued to have a growing trend until 2007 (see Figure 4).
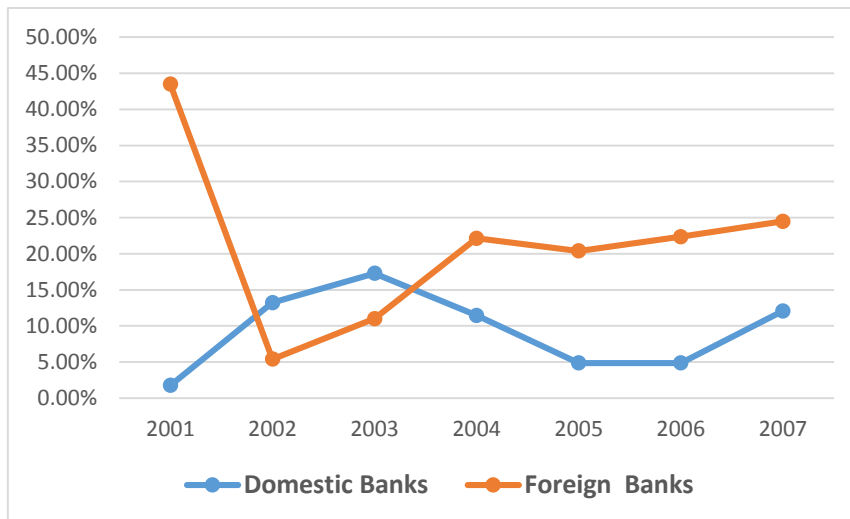

Figure 4. Profit Margin (PM) 2001-2007

Source: Author's calculations

This high rate of foreign banks' profit margin shows that they were able to better control costs and loan loss compared to the domestic banks.

This finding is also supported by the results obtained by breaking down the overheads components, which have an impact on the profit margin (PM). During 2001 -2007, the overheads of domestic and foreign banks increased significantly as a result expanding their activities by opening branches and banking subsidiaries as well as investing in technology and human resources.

However, domestic banks have had more overheads (non-interest) against total assets than foreign banks. This was due to the opening of a larger number of bank branches and sub-branches and the larger number of employees compared with foreign banks.

Many important factors that have driven foreign banks to higher average PM ratios were: low provisions of loan losses over total assets by 0.64%, while domestic banks' were 1.91%; better control of interest cost by 1.11%, while domestic banks' were 1.28% and better control of non-interest expenses where foreign banks have had on average of 4.19% compared to domestic banks that had 4.58%. This indicates that foreign banks had the lowest rate of costs, meaning that foreign banks have had a better control of costs and were more profitable.

On the other hand, the main factor leading to the reduction of the profit margin and the decline of domestic banks' ROA and ROE is the large increase in provisions of loan loss due to poor quality of the loan portfolio from year to year. In 2004 and 2005 there was a significant increase of provisions by 2.45% and 3.22%.

The increased loan loss provisions can be supported with the assertion that domestic banks have mostly had clients with smaller lending capacities and did not possess the adequate techniques to manage loan risk as foreign banks did.

In regard to assets utilization during the period 2001- 2007, as shown in Table 3 and 4, domestic banks have achieved a higher average Asset Utilization ratio 8.90% than the foreign banks 7.97%. This shows that domestic banks have been able to obtain high assets yields.

Domestic banks have had a growing trend in the use of assets from 2002 to 2005, and foreign banks have achieved higher yields than domestic banks in 2001, 2006 and 2007 by 4.0%, 10.8% and 11.37% respectively (see Figure 5).
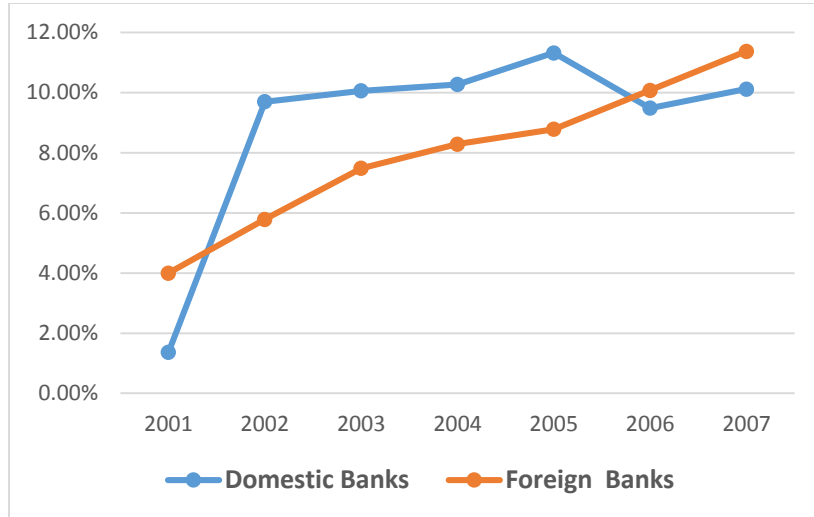
Figure 5. Assets Utilization (AU) 2001-2007

Source: Authors' calculation

The results presented Tables 3 and 4 by breaking down the total operation income and to interest and non-interest income, which have an impact on AU, shows that during the period 2001 -2007 domestic banks had an averagely lower interest income ratio 5.57% compared to foreign banks 5.84 %.

When it comes to the non-interest income component, we notice that domestic banks had an averagely higher non-interest income ratio over total assets of 3.33% compared with foreign banks 2.13%.

Therefore, we may say that domestic banks' non-interest income is one factor that influenced the high assets utilization ratio.

Our conclusion is that the difference in the assets utilization between domestic and foreign banks is as a result of the larger loan share in relation to total assets. Hence, although domestic banks have issued fewer loans in general, the loan share in their total assets was higher than those of foreign banks.

During 2001 - 2007, the loan share in total assets of the domestic banks averaged to 47%, whilst the loans share in total assets of foreign banks was 37 % (see Table 2)

8. Conclusion

To evaluate and compare the performance of domestic and foreign banks for the period 2001-2007 in this study we used DuPont model. According to DuPont model the return on equity of banks is influenced by three factors: Profit margine (PM), Assets utilization AU and Equity Multiplier (EM).

Our results show that foreign banks have higher ratio of Return on Equity and Assets. The foreign banks' high ratio of Return on Equity is a result of a higher interest margin (PM), which indicates that foreign banks have made a better costs management and a larger use of financial leverage.

Moreover, the results indicate that despite the domestic banks' higher ratio of Assets Utilisation (AU) compared to foreign banks, the main factor that has contributed to worsening of domestic banks' profitability was the high costs of loans provisioning due to poor quality of the loan portfolio

The increased loan loss provisions can be supported with the assertion that domestic banks have mostly had clients with less creditworthy and did not possess the adequate techniques to manage loan risk as foreign banks have.

Further work could be focused on the identification of factors that affect ROE and ROA indicators by using econometric.

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