



• Centar za politike i upravljanje
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Strengthening the Financial Sector

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Summary

The growth of domestic consumption prompted by bank credit expansion significantly affected the economic growth in BiH until 2009, prior to the beginning of the global economic crisis. That period is marked by new immersions of European banks to BiH market, a large demand for natural persons and enterprises with loans, whereas growth rates were approaching the 30% on an annual basis, while annual growth rates of GDP were, in average, amounting to over solid 5%.

By the beginning of the recession, contraction of economic activity appears, as well as a downfall of credit placement, for 3.2% in 2009. After coming out of recession, credit growth remains between 1% to 3% on an annual level, and as such, it is not in a condition to contribute more significantly to the growth of GDP.

The banking sector in BiH has a potential of a more significant contribution towards the growth of economic activities. The limiting factor in that context is the fact that banks are still facing consequences of economic crisis – relatively low profitability and an undermined quality of bank debit. Balance sheets of banks remain burdened with significant levels of poor-quality demands which leave pressure on the capital, on profit, and limit the capacity for new crediting, and are therefore limited in contributing to the economic growth. Despite that, signs of consolidation and strengthening of the financial sector are visible in the prior year and a half, whereby all the more significant indicators of the state the sector is in are showing relatively positive trends. However, it remains to be followed whether these credits are followed by a continuous and adequate credit growth and whether there is any significant impact on the growth of GDP.

Changes in the financing model of banks, which is all the more directed towards domestic sources, deposit growth and low-interest rates require the continuation of the conduct of measures which will ensure adequate availability of credits for productive purposes. The very process of deleveraging of big bank affiliations represents a significant risk prompted by what is going on in European markets and regulatory pressures. In the context of the impact of credit expansion on the growth of GDP, a potential credit expansion directed towards current consumption should be differentiated from investment credits. A greater share of consumer credits which are used for domestic goods and services, as well as investment credits directed towards the increase of business capacities of medium and small enterprises, would result in a more significant growth of economic ratios, primarily the GDP.

A strengthening of the financial sector and crediting expansion (which shall reach growth rates of 7.1% in the following three years) are significant segments of economic policy in BiH, comprised in the EFF program with IMF. Other two goals of this program concern the policies of encouraging the development of private sector, restructuring of fiscal spending with the aim to increase public investments. Positive shifts are visible in the implementation of regulatory reforms in the financial sector, which primarily have the stabilizing quality to it, and the question that remains is that of the degree in which these contribute the expansion of the banking sector and credits.

The potential for credit expansion, apart from the earlier enlisted factors of supply, also depend, in a significant amount upon the quality and volume of credit demand, primarily those from the enterprises. Apart from the relatively good capitalization and bank sector liquidity, on the one hand, and the growth of industrial production and export, on the other, a smooth growth trend of placed credits still does not affect enough the growth of GDP. It is evident that banks are still more prone towards crediting the state and investing in foreign markets.

Economic policies and the IMF program

Defining of the priorities envisaged by the Reform Agenda was preceded by discussions with the international financial institutions and the EU. Those measures were representing a base for negotiations on individual program of financial and technical support¹. Economic policy in BiH is nowadays, in a good part, comprised in the Extended Fund Facility (EFF) arrangements with the International Monetary Fund (IMF) concluded in September 2016. The purpose of this program is conducting policies which will contribute the stability of the balance of payments and ensure the expansion of investment consumption, in order to make better use of economic potentials, as well as maintain the macroeconomic stability. In order to achieve the GDP growth scenario between 3% and 4% in the following five years, it is envisaged, among other things, that the credit growth rates in the private sector should amount to 3.6% in 2017, 5.1% in 2018, all up to the total of 7.1% in 2021. The last indicators of credit growth point at a positive trend which could, if it is continued, lead towards the accomplishment of this part of the scenario.

Period	Credits in total (million BAM)	Credits for Population (million BAM)	Credits for unfinanced enterprises (million BAM)	Credits for general government (million BAM)	Credits for other sectors (million BAM)
Dec 2010	14.580	6.315	7.733	461	71
Dec 2015	16.866	7.785	7.841	1.135	105
Dec 2016	17.201	8.076	8.075	963	87
Jan 2017	17.180	8.062	8.034	1.003	80
Maj 2017	17.749	8.331	8.405	980	101

Table 1: Credit growth from 2010 to the first half of 2017²

In addition to that, an important presumption for the accomplishment of the planned growth rates is precisely public investments which should be growing, in the upcoming five years in double-digit rates, i.e. that their share in GDP grows from 3.5% in 2015 to 7.2% in 2020. Such scenario implies that public investments in 2020 reach the level of 2.62 billion BAM on an annual level (in relation to 987 million BAM in 2015).

¹ Reform Agenda for Bosnia and Herzegovina for the period 2015–2018

² Pieces of information on the flux of macroeconomic indicators (for the period of January 2010 – December 2016), BiH Directorate for Economic Planning

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Nominal GDP (in billion BAM)	26.19	26.74	27.3	28.21	29.11	30.43	31.98	34.01	36.34	38.76
Investments share in GDP	18.1%	17%	17.8%	16%	17.1%	18.3%	19.3%	20.6%	21.2%	22.2%
Public investments share in GDP	5.1%	5%	5.3%	3.5%	4.4%	5.1%	5.9%	6.9%	7.2%	7.6%
Level of public investments (in billion BAM)	1.336	1.337	1.447	0.987	1.281	1.552	1.887	2.346	2.616	2.945
Public investments growth		0%	8%	-31%	30%	21%	22%	24%	12%	13%

Table 2: Public investments share in nominal GDP³

It is already now clear that the planned scenario will not be easily accomplished. The expected economic growth from 3.0% in 2016 is not accomplished, and according to preliminary data of the Agency of Statistics for Bosnia and Herzegovina, the growth rate of GDP in 2016 was amounting to the modest 2%, whereby the largest contribution to the growth rate of real GDP comes from industrial activities. Also, the IMF has recently significantly lowered the medium-term forecasts of GDP growth in BiH. Causes for these negative fluxes can be looked for in the insufficient progress of administering structural policies comprised in the EFF program with IMF, especially the measures which are in line with the ensuring of investment consumption of the public sector expansion.

The Goal of the EFF arrangement with IMF

Through the very program, three key goals are to be accomplished:

1. The increase of economic growth potential through stimulating of development and employment within the private sector, intensifying structural reforms for the advancement of the business environment and attracting of investments.
2. The advancement of structure and quality of public expenditures, by lowering, at the same time, the public debt;
3. Recovery of credit growth, and ensuring financial stability by conducting structural reforms.

Apart from these three goals, it is important to strengthen the unique economic space in BiH, by enhancing cooperation and coordination among all the levels of government.

³ Request for Extended Arrangement under the Extended Fund Facility, August 2016, p. 29

Short- and medium-term measures for the strengthening of the financial sector are comprised in the document entitled Financial Stability Assessment Paper (FSAP), a joint document of IMF and World Bank from 2015, which is fully harmonized with the IMF program. Hence, only in a simultaneous implementation of measures from different areas, is it possible to accomplish the enlisted goals and their measures, exactly due to their consequential relation to BiH economy.

Hereinafter, we will be dealing with the part of the program which has to do with the strengthening of the financial sector and its contribution to growth in BiH. As the level of credit activity evenly depends upon both supply and demand for credits, in the same manner, the accomplishment of the planned scenario within the EFF will not be possible to achieve without achieving the planned rates of growth of public investment consumption. However, hereinafter, we will direct ourselves towards the part primarily tied to factors of credit supply in BiH.

The condition of the banking sector

According to the data of the Central Bank of BiH and the entity banking agencies, by the end of 2016, 23 banks were active in BiH, and the total amount of banks was lowered due to the process of joining the Moja Banka Sarajevo and the Investiciono-komercijalna banka Zenica⁴, and the Privredna banka Sarajevo and BOR banka⁵, as well as the liquidation of the Banka Srpske. These processes have resulted in a total enhancement of the capitalization of banks.

Apart from that, the process of reorganizing business conducting in two system-wise important banks at the level of affiliations is completed. At the end of 2016, all the banks have satisfied the prescribed levels of capital adequacy, except one smaller bank which was recapitalized in 2017.

According to the data from the *Financial Stability Report* for 2016 by the Central Bank of BiH, in 2016 the total balance of the banking sector has increased by 5.4% and amounted to 25 billion BAM. In the structure of bank liabilities, domestic deposits have marked a growth of 1.25 million BAM or 7.6%. Unfavorable structure of deposit maturity (76.9% belongs to the period smaller than one-year time), which, in part, is caused by the lowering of passive interest rates, and a lack of other chances for investments of individuals, but also a low living standard. An increase in the trend of reprogramming of short-term into long-term credits is visible as well.

Type of deposit	Growth (in million BAM)	Growth (in percentage)
Population sector	811.7	8.3%
Governmental institutions deposits	158.7	11.1%
Private unfinanced enterprises	157	6.0%

Table 3: Domestic deposits growth in 2016⁶

⁴ The bank now does business as ASA Banka Sarajevo.

⁵ The bank now does business as Privredna banka Sarajevo.

⁶ *Financial Stability Report*, The Central Bank of BiH, 2016., p. 46



A trend of lowering the dependency of the banking sector from foreign financing is visible as well, so in 2016 obligations towards non-residents have amounted to 11.8% of the total bank liabilities. According to the data of the Central Bank of BiH, from 2010, the level of domestic deposits has increased for 5.64 billion BAM, while, at the same time, liabilities towards non-residents have been lowered for 2.78 billion BAM. In addition to the positive balance, when it comes to the substitution of financing sources, the stability of such model is negatively affected by the unfavorable maturity of domestic deposits.

According to the data of the Central bank of BiH and the entity banking agencies, the credits mark a growth of 2.3% in 2016, and the growth is more significant with the crediting of enterprises (4.6%) in relation to the sector of the population (3.6%) which is a change in relation to the former period. Indebtedness of the governmental sector with banks has increased for the total of 1.4% in relation to the previous year, and in the end of 2016, it amounts to 8.2% of the total bank debit. The same trend is continued in the first quarter of 2017 (the annual growth rate amounts to 5.5% by the end of March). In the sector of the population, mortgages and credits for business activities are marking a decrease, while non-purpose consumer credits are the only ones marking significant growth rates.

A strong deposit growth has positively affected the growth of liquidity of bank debit, including cash, the Central Bank reserves, and deposits by foreign banks. Also, by the middle of 2016, the applying of the decision of the Central Bank of BiH on the change in obligatory reserve requirement rates, the broadening of the base value and introducing of negative fees onto reserves the above obligatory requirements, begins. In the same period, for the first time, we have a situation that the amount of total foreign bank debit marks a larger value than the foreign bank liabilities.

The banking sector of BiH at the end of 2016 was adequately capitalized, and the rate of the adequacy of capital grows and it is significantly larger than the prescribed regulatory minimum. In the same period, the rate of the adequacy of capital has increased from 14.9% to 15.8%. System-wise important banks were adequately capitalized, although some of them still have issues with high levels of low-quality debts.

The ratio of low-quality towards total number of credits, at the banking sector level, is lowered from 13.7% to 11% in 2016 (population: 8.6%, enterprises: 14.7%). The issue can be the concentration of low-quality credits with five banks in the system. In 2016, banks have written-down 127.2 million BAM of bank debit assessed as a loss. Also, the potential risk implies the grand share of credits with variable interest rate. New entity laws on banks enhance providing solutions of low-quality debts through regulating of the trade by bank placements. The additional incentive should come through changes in the tax law, ensuring of a special tax treatment for the buyout of low-quality demands and by establishing institutes of personal bankruptcy.

According to the data of the Central Bank of BiH, the net profit of the banking sector in the past year has been amounting to 219 million BAM, in relation to 32 million BAM in 2015. Out of the total number of banks, nineteen of them have accomplished a profit of 283 million BAM, while four banks had had a loss of 65 million BAM. In comparison, in 2015 the same nineteen banks had a similar level of profit (279 million BAM), while the remaining seven banks have shown a loss of 247 million BAM. It is interesting that the profit has been concentrated in two large banks with over 47% of the total profit of the banking sector.



In 2016, the return on the stock capital has been amounting to 7.3% in relation to the modest 2.0% in the past year. The data that over 33% of the total income of banks is not coming from interests but from different fees, is concerning. The liquidity of the banking sector in 2016 was at a pleasing level, bearing in mind large deposit growth, and limited growth of credit placements.

The stability of the sector

Findings of the stress tests conducted by the Central Bank of BiH based upon data from the end of 2016 show a stability of the sector and resistance towards possible shocks. In addition to satisfactory capitalization at the level of the entire sector, results show that there is a significant number of banks which would, in case of the realization of assumed shocks, need additional capital. However, in the situation of a more extreme scenario and insufficient capitalization of a greater number of banks or banks of systemic significance could lead to threatened stability of the entire sector.

Due to a modest recovery of economic activity in the former period, a modest advancement of the quality of bank debit and positive financial operations of microcredit organizations has happened. Insurance companies also mark a positive result at the end of the year. On the other hand, leasing and investment funds are facing negative financial results and balance contractions. Even though the entire bank debit of the non-banking financial sector has marked an increase, the trend of decreasing the participation of non-banking financial institutions in the entire bank debit of the financial sector is still continued.

Of course, the total stability and strength of the financial sector significantly depend upon external factors, primarily, upon the growth of European economy, a policy of leading central banks, deflation of pressures. In that context, more significant risks in relation to slow and imbalanced recovery of certain Eurozone economies, slow advancement in the implementation of structural reforms and high public debt of certain countries, as well as the ongoing political risks in the EU. The condition of European banking sector is marked by low profits and high rates of low-quality debts in some of the countries. Banks achieve their incomes via different fees and provisions, during low-interest rates and insufficient credit growth. High risks in the banking sector of Italy represent a threat towards the entire banking sector of EU, and in Bosnia and Herzegovina as well.

Even though, during 2016, a relatively positive trends in relation to the growth of industrial production, the growth of export, fiscal consolidation, and modest employment growth, were all marked, all of it did not significantly reflect upon the decrease of domestic risks in the sector, as well as a more significant growth of credit demand. The lack of investing into infrastructural projects, unfavorable business climate and competitiveness of BiH economies, as well as a low credit rating, have limited the possibility that positive trends from the real sector in 2016 strengthen domestic consumption more significantly. A limited growth of indebtedness of households is mostly stimulated by the growth of indebtedness of the population by bank credits, what contributed to low credit interest rates⁷. The growth of population deposit is caused by the growth of funds on the transaction accounts and on-demand deposits, while savings stagnate.

⁷According to data from the Central Credit Register, household demands were amounting to 8,75 billion BAM at the end of 2016, and in relation to the end of 2015 it has marked a growth for 3,9%.



According to the Central Bank of BiH data, a weak demand of enterprises for credits and the absence of a stronger credit expansion, are main traits of this sector in 2016 and one of the factors which are limiting a more significant recovery of BiH economy. Positive economic indicators in the real sector have affected the lowering of credit risks and the ability of enterprises to atone their obligations. The share of low-quality credits has declined, but it still amounts to the high 14.7% with a high concentration in some economic sectors.

According to the Central Credit Register, the total banking sector demands towards enterprises amount to 9.6 billion BAM (growth of 1.5% in relation to 2015). The largest contribution to the growth of the exposure of the banking sector comes from the processing industry, agriculture, construction, hotel, and catering trade. The trend of lowering the exposure according to businesses which, in great part, depend upon domestic demand is evident. Great exposure to the trade sector (32.7% of the total of banking sector demands) represents a significant risk, additionally emphasized by circumstances in which the Concern "AGROKOR" is in.

Average interest rates on credits for enterprises in 2016 have an ongoing trend of a downturn.

The regulatory framework

For the ensuring of the scenario of economic recovery, envisaged by the EFF arrangement with IMF, adoption of a new framework which regulates the work of banks in BiH is planned. An overview of activities, in line with changes of regulations with the goal of strengthening the financial sector in BiH, will further on be presented. The planned set of five laws in this area, up until now the entity Laws on Banks and changes of the Law on the Banking Agencies of RS, are adopted, and it is expected that the adoption of changes and amendments to the Law on the Banking Agency in FBiH, and changes and amendments to the Law on Deposit Insurance on the state level.

The recently adopted entity laws on banks, in the part which is in connection with supervision, are broadening the authorization of the banking agencies, strengthening prudential requests, as well as managing standards. Also, the term of system-wise important banks is being defined and advancements in relation to managing with recovery are introduced, as well as measures of prompt interventions in crisis situations. A more modern legal framework for restructuring of banks is defined, with the goal of a more efficient management with crisis situations, both at the level of individual banks, as well as the entire financial system.

With changes and amendments to the Law on Banking Agencies at the entity level, broadening of authorizations and jurisdiction of banking agencies are all envisaged. These changes and appendices in RS were adopted in 2016, while changes and appendices of the Law on Banking Agencies FBiH is still in the process of adoption. Changes and appendices are enabling the implementation of new laws on banks by strengthening corrective and implementation jurisdictions of supervisors, by introducing the supervision of banking groups on a consolidated basis, arranging the all-encompassing framework for the restructuring and abolishing special obligatory reserves for deposits of the public sector.



The adoption of Laws on Deposit Insurance is envisaged also, within what broadening of authorization of the Deposit Insurance Agency is envisaged, by providing greater autonomy to this Agency during the distribution of extraordinary premium funds from the account of the Central Bank of BiH, and monitoring of how banks do businesses.

In addition to the described legislative activities, entity agencies on banking in 2016 were working on drafts on the risk management of the liquidity of banks, which introduce minimal standards for liquidity risk management, envisage the implementation of resistance tests and drafting of plans for the advancement of risk management processes and recovery in case of unforeseeable situations. Also, a proper cover of all capital risks is defined.

With the goal of strengthening the non-banking sector in both entities, a Law on changes and amendments to the Law on Securities Market, and Law on Investment Funds in FBiH was adopted. Also, a Law on changes and amendments to the Law on Insurance Companies of RS and the new Law on Insurance in FBiH which regulates the starting, business-doing, supervision and the stopping of insurance companies, and the obligation of parting life from non-life insurances are all adopted. Bearing in mind the complete domination of banks and a truly weak availability of other instruments of financing, greater attention should be devoted to the support of developing of the financing instruments of the corporative sector, from strengthening the leasing sector, stock exchanges, capital and other investment funds, in that way stressing the business practice in which the finding of funds for business operations does not necessarily mean indebtedness.

The side of demand

The arrangement with IMF when it comes to the side of demand envisages a whole series of structural reforms which will enhance the development of private sector and the growth of employment. Those measures of the support of private sector should result in a greater need of the enterprises for financing in order to increase their business operations. The first goal of the EFF program is: „The increase of the potential of economic growth by stimulating development and employment within the private sector, intensifying structural reforms for the advancement of business climate and attracting of investments“. Under the scope of this part of the program, it is planned to advance the functioning of the labor market with the aim to stimulate new employment by decreasing fiscal burdening of enterprises, corporative restructuring and increasing of the efficiency of enterprises owned by the state, including privatization. In addition, enhancement of the insolvency and bankruptcy instruments is envisaged as well. This ambitious agenda is only partially accomplished, by the adoption of the Labor Law on the entity level, the adoption of the Insolvency Law in RS in 2016 (whereas the same Law is in the process of adoption in FBiH). New Insolvency Law will advance the initiation of timely insolvency process with determining a board of monitoring and sanctioning of the debtors who do not start the procedure on time. It will decrease the price of the procedure and enable financial and operative restructuring of debtors, simplify the process of reorganization and protection of trustee rights. However, the largest part of this package of measures in relation to, primarily, the fiscal unburdening of enterprises and reform of a bulky sector of public enterprises and other companies in state ownership, shall yet be accomplished and in such a manner, eventually, initiate the expected effects on the economic growth.



Instead of a conclusion – remarks and additional questions to be analyzed

1. Relations between credit and GDP growth

Within the EFF program, the expected GDP growth is based, in fact, upon, two presumptions:

- that the package of laws will first of all lead to credit growth;
- that, then, the credit growth will lead to the acceleration of GDP growth.

It is hard to claim, with a lot of persuasiveness, that these two relations are reliable.

Namely,

- for the growth of credits, except credit supply, a demand for them is also necessary, whereby it is necessary to conduct the first two pillars in the IMF arrangement so that the release of credit potential does not necessarily mean the growth of crediting. That will also largely depend upon the perception of risks of the very banks and quality of field projects.
- The growth of crediting does not necessarily come prior to the growth of GDP. Empirical research has shown that there is a strong feedback between these two macroeconomic variables, whereby, oftentimes, the growth of GDP comes prior to credit growth, what requires to repeat the consistent implementation of a package of measures on the side of credit demand. Additionally, if the growth of crediting happens, there is a possibility to deteriorate the current deficit in the balance of payments, if the growth stimulates the increase in import (which, in BiH and all the Western Balkan countries is very high) through consumption and investments.

2. Which type of credits stimulates domestic investments the most?

Before anything else, this is about investment credits, which should have been, in the biggest possible part, encompassing small and medium-size enterprises which should be the base of every accelerated and long-term growth of GDP. If we are talking about consumer credits, it is necessary that those are mainly conditioned by purchasing domestic goods, i.e. it is necessary that they are accessible to people with lower incomes which, traditionally, spend more domestic goods (in relation to the imported ones), in order for the growth of domestic credits not be used as a stimulant of economic growth in the environment.

3. Causes and effects of industrial production growth

As in most of the countries in the region, faster growth of industrial production and GDP in 2015 and 2016, is, by and large, a result of temporary factors. It is about, primarily, the downfall of oil price (and the consequential decrease of gas price), and we know that all the economies of the Western Balkan are dependent upon import. The decrease in oil price has directly affected the decrease of oil derivatives retail prices.

That has increased the real available income of population and economy and enabled a larger final consumption and investments. Apart from that, the growth of industrial production is also supported by the growth of external demand, and the growth of exporting incomes, in return, affects the further growth of production capacities. However, if the additional acceleration of industrial production growth is planned, that, nevertheless, requires a more significant credit support.