Banking Sector Developments in South-eastern Europe

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Introduction

The creation of a viable and sound financial system in Southeastern European (SEE) countries has been a fundamental aspect of the transition to a market economy. Building such a system has proven to be very difficult and challenging.

Various studies and assessment reports have confirmed the view that in the beginning of the transition process the financial sector was weak, underdeveloped and shallow. During the second half of the 1990s banking reform efforts were impeded either by internal setbacks or by external causes. After a decade of efforts the banking system at present, and to varying degree for each country, still faces a number of problems. And yet, there is a consensus that economic performance, macro economic stability and long term growth depend on the extent to which financial institutions and markets carry out their activities efficiently within an adequate infrastructure.

This is not an academic finding, but a practical lesson that has led to action. The governments of SEE countries, with the collaboration and assistance of international financial institutions have taken concrete and far reaching measures to reform financial institutions and markets. Their combined efforts aim to create a system that is institutionally sound, administratively competent and more responsive to the needs of emerging market conditions.

During the last few years, the World Bank and the International Monetary Fund (IMF) have introduced and implemented numerous initiatives affecting all aspects of banking and financial market development. The legal, institutional, regulatory and supervisory framework of financial institutions has been consistently improved and strengthened. Using a variety of ways and means and the experience gained from past successes and failures, the World Bank and the IMF have laid the foundation for a new and contemporary banking system.

Through the implementation of economic adjustment, surveillance and stability programs, these organisations have provided the broader context for the restructuring of each country's economy which is a prerequisite for effective banking reform. In a more specific context, through monetary policy management programs, visiting missions and resident advisors, they have greatly helped the promotion and the implementation of specific policies leading to the reform of the banking system.

Other international institutions such as the EBRD the OECD, the BIS and the EIB, as well as the ECB and bilateral initiatives between the SEE and European Union countries, have contributed further to the reform process and, more generally, to the economic restructuring in the region.

Despite all these efforts, academic studies and assessment reports of international organisations point to the fact that the banking system with significant variation between countries, is still characterised by some weaknesses, fragility and fragmentation while some banking institutions are seriously undercapitalised.

A new wave of reforms guided by the international financial institutions, concentrates its efforts on bank re-capitalisation; liquidation of insolvent institutions; mergers, acquisitions and other forms of cross participation schemes necessary for the consolidation of a fragmented market; and the improvement of the administrative efficiency and capability of the banking sector. Recently, deposit insurance schemes and loan collateral policies are being introduced.

II

Reviewing progress so far in the banking sector, it seems that in many occasions, the development of institutional guidelines and principles has outpaced the needs of the real economy and the restructuring effort in other sectors. This is clearly shown in progress made in numerous areas. BIS principles have been introduced, the independence of central banks has been legislated and a transparency and accountability framework has been adopted. This is a very noteworthy record compared to progress made in other sectors.

The future success of banking and financial sector reform in SEE countries will be determined to a considerable extent by the commitment and the capability of public authorities to implement market oriented reforms in other sectors of their economies.

Many weaknesses and problems faced by the banking sector relate to or are partly caused by:

- an incomplete and problematic privatisation process
- the accumulation of non-performing loans particularly to state banks
- the lack of transparency and accountability in public and private transactions
- the legacy of weak corporate governance
- the lack of public confidence to public institutions.

The more protracted this relationship becomes the more difficult it will be for the banking system to address issues related to the large number of insolvent institutions, improper lending and deposit-taking practices, leading to serious prudential concerns.

III

The reform effort in the banking sector must continue to tackle and resolve methodically and effectively the problems still outstanding. The objective should be to consolidate the system fully, enabling it to withstand internal and external shocks and respond effectively to the risks, demands and challenges associated with an increasing competitive environment both nationally and regionally. By doing so it intents to contribute to the broader European convergence project at the level of institutions, macroeconomic stability and social cohesion, as necessary preconditions for investment in the region and sustainable growth.

Banking Systems in the South Eastern European (SEE) Countries: Facts and Figures.

After the fall of the communist regimes in 1989, much of the banking sector in the SEE countries was still underdeveloped and centrally planned, while money had only a limited role as a medium of exchange. In all countries there was need for immediate reform process of the banking system.
The implementation of a reform process improved the banking sector in all the transition countries. This reform process usually consisted of the establishment of a two-tier banking system, the privatization of state-owned banks, the closure of insolvent banks, the write-off of non-performing loans, the establishment of a new regulatory regime according to the BIS standards, the entry of foreign banks, etc.

Banking system reform index

Reforms and economic development are at a very different stage in these countries. In general the banking sector in SEE countries has developed significantly in the past 6 years. However, there are still many challenges ahead for the banking sector in the SEE countries, while it is less developed relative to the Central Eastern European transition countries.

The following table exhibits the improvement of the SEE countries banking sector over the past 6 years, according to the EBRD Index of Banking System Reform:

SEE Countries' Banking System Reform Index		
	Year	**EBRD Index of Banking System Reform**
Albania	1998	2,0
	2003	2,3
Bosnia/Herzegovina	1998	2,3
	2003	2,3
Bulgaria	1998	2,7
	2003	3,3
FRY (Serbia/Montenegro)	1998	1,0
	2003	2,3
FYR Macedonia	1998	3,0
	2003	3,0
Romania	1998	2,3
	2003	2,7

Source: EBRD

According to the EBRD index of the banking system reform, all SEE countries are classified around 3. This classification means "*there has been progress in establishment of bank solvency and of a framework for prudential supervision and regulation, while there is significant lending to private enterprises and significant presence of private banks*[1]".
There have been steps forward the transition of the banking sector in all countries. However, much remains to be done in order to strengthen the regulatory framework, to increase financial intermediation and to privatize the remaining state-owned banks.
In the following years the banking sector in the SEE countries is expected to increase its profitability, the loan portfolio quality and the capital adequacy ratios.

Banks' Loan Portfolio Quality

During the 1990's, all SEE countries have experienced problems from the poor quality of their loan portfolio. Most of these problems were inherited from the old regime, where the credit risk evaluation was irrelevant, the regulatory framework was inefficient and the bank's credit policy was just a government instrument used according to the needs of the centrally planned economy.
During the transition period and especially during the last six years, all SEE countries have taken measures to improve their banking system asset quality, such as the write-off

[1] EBRD Transition Report 2003, p.17.

of non-performing loans, the enforcement of the regulatory framework according to the BIS standards and the application of risk management systems.
The following table presents the SEE countries banks loan portfolio quality in terms of non-performing loans to total loans.

SEE Countries' Banks Loan Portfolio Quality		
	Year	**Non-Performing Loans/ Total Loans (%)**
Albania	1998	35,4%
	2002	5,6%
Bosnia/Herzegovina	1999*	58,7%
	2002	11,5%
Bulgaria	1998	11,8%
	2002	10,4%
FRY (Serbia/Montenegro)	1998	13,1%
	2002	28,5%
FYR Macedonia	1998	50,3%
	2002	35,7%
Romania	1998	58,5%
	2002	2,3%
Greece	2003	3,4%
EU Large Banks	2002	2,7%

Source: EBRD, Bank of Greece, ECB

*There is no available data for 1998

With the exception of Serbia/ Montenegro and FYR Macedonia, the loan portfolio quality has been improved substantially in all SEE countries. In FYR Macedonia, the banking sector crisis and the economic downturn has seriously affected the loans portfolio quality, while in Serbia/ Montenegro, where economy is only now recovering from the war conflict, most of the banks have a large amount of non-performing loans in their portfolios inherited from the past.
The share of non-performing loans to the total loans portfolio is still high relative to the EU banks. However, the introduction of efficient credit scoring systems and the improved corporate performance will further improve the SEE countries banks' loan portfolio quality and will converge the above ratio to the EU average.

Financial Intermediation

Financial intermediation remained low during the first decade of transition, mainly due to the weak depositor's confidence caused by the financial crises in Albania, Bulgaria and FYROM during the 90's. In addition, the low amount of household deposits and the conservative credit expansion policies, led to ineffective financial intermediation by banks.

Over the last six years, the level of financial intermediation increased significantly in the SEE countries. The deposit base was increased while the adequate legal protection of the lenders, the introduction of modern credit risk management techniques and the good performance of the enterprise sector, led to high credit expansion. However, financial intermediation in all SEE countries is still low relative to the EU banks average.

The following table presents the evolution of the domestic credit to the private sector as a percentage of the GDP in the SEE countries.

SEE Countries' Banking System Intermediation		
	Year	**Domestic Credit to Private Sector (% of GDP)**
Albania	1998	0,6%
	2002	4,7%
Bosnia/Herzegovina	1999*	8,9%
	2002	12,0%
Bulgaria	1998	12,2%
	2002	18,0%
FRY (Serbia/Montenegro)	1998	11,2%
	2001	5,6%
FYR Macedonia	1998	17,7%
	2002	14,4%
Romania	1998	11,6%
	2002	8,4%
Greece	2003	26,3%
EU	2002	48,5%

Source: EBRD, Bank of Greece

*There is no available data for 1998

The level of financial intermediation is closely related to the general economic growth. The following years, credit expansion is expected to grow rapidly and converge towards the EU average, as the Balkan economies rate of growth continues to be high.

Banks Ownership Structure

The privatization of state-owned banks is a crucial element of the effective transition of the SEE countries banking system. In all SEE countries there has been delays in the privatization process mainly due to government policy reluctance.

The following table presents the asset share of state-owned banks. Over the last six years there has been steps forward in the privatization process. In Bosnia-Herzegovina, in FYR Macedonia and in Bulgaria, the asset share of state-owned banks is below 15%, since the privatization process in these countries was quite effective. In Albania and Romania, the forthcoming privatization of the Albanian Savings bank and Banca

Commerciala Romana, is expected to lower the percentage of the state-owned banks below 10%. The privatization process is delayed in Serbia and Montenegro since the transition process has only began recently and investors' interest is still low. However, the Serbian government intends to offer three large state banks for sale in the first half of 2003.

SEE Countries' Banks Ownership			
	Year	**Total number of Banks**	**Foreign Owned Banks**
Albania	1998	10	8
	2002	13	12
Bosnia/Herzegovina	1998	n/a	n/a
	2002	n/a	n/a
Bulgaria	1998	34	17
	2002	34	26
FRY (Serbia/Montenegro)	1998	104	3
	2002	50	12
FYR Macedonia	1998	24	6
	2002	20	7
Romania	1998	36	16
	2002	31	24
Greece	2003	59	20

Source: EBRD, Bank of Greece

The privatization of the SEE countries banking system was characterized by the entry of foreign banks in the market. Foreign banks usually enter the market either by acquiring local banks (state-owned or private) or by establishing subsidiaries and branches. The entry of foreign banks was very important, since they introduced modern risk management techniques and financial management know-how. Foreign ownership is a necessary condition for the efficient transition of the banking sector.

The following table presents the SEE countries' banks ownership structure.

SEE Countries' Banks Ownership		
	Year	Asset share of state-owned Banks
Albania	1998	85,6%
	2002	54,1%
Bosnia/Herzegovina	1999	75,9%
	2002	6,2%
Bulgaria	1998	56,4%
	2002	14,1%
FRY (Serbia/Montenegro)	1998	90,0%
	2002	35,6%
FYR Macedonia	1998	1,4%
	2002	2,0%
Romania	1998	75,3%
	2002	43,6%
Greece	2003	49,0%

Source: EBRD, Bank of Greece

*There is no available data for 1998

Over the last six years, the number of foreign banks has significantly increased in all the SEE countries, with the exception of FYR Macedonia where the banking sector has experienced a small crisis in 2001 and foreign investors are hesitant to enter the local market.

Banks' Capitalization

During the last six years, there has been an improvement in the Capital Adequacy Ratio of the SEE countries banking systems. In all countries, the banks are on average well capitalized, with the solvency ratio well above the regulatory minimum.

In Albania, Bulgaria and Romania, the regulatory minimum capital adequacy ratio is 12%, due to the experience of some episodes of financial crises during the 90's. The regulatory authorities in these countries are expected to harmonize the minimum C.A.R. to 8% in the near future, since the banking system has been stabilised and is well capitalised.

The following table presents the SEE countries' banks capitalization in terms of the capital adequacy ratio.

SEE Countries' Banks Capitalisation			
	Year	**Capital Adequacy Ratio**	**Regulatory Capital Adequacy Ratio**
Albania	1998	-1,8%	12,0%
	2002		
Bosnia/Herzegovina	1998	n/a	8,0%
	2002	n/a	
Bulgaria	1998	37,0%	12,0%
	2002	25,2%	
FRY (Serbia/Montenegro)	1998	n/a	8,0%
	2002	30,4%	
FYR Macedonia	1998	25,2%	8,0%
	2002	28,1%	
Romania	1998	10,3%	12,0%
	2002	24,8%	
Greece	2003	12,8%	8,0%
EU Large Banks	2003S	11,4%	8,0%
Source: National Central Banks, Bank of Greece, ECB			

In the future, the C.A.R. is expected to fall in lower levels, (but above the regulatory minimum), after the forthcoming increase of the risk weighted assets of the banks. This increase will mainly occur due to the expected credit expansion of financial institutions.

Banks' Profitability

The profitability of the SEE countries banking sector, has improved significantly over the last six years. This was a result of the general reform of the banking system (write-off of non-performing loans, privatization of state-owned banks, introduction of modern banking techniques, credit expansion) and the high intermediation spread in these countries.
The table below presents two indexes of the SEE countries' banks profitability, the Return on Assets and the Return on Equity.

SEE Countries' Banks Profitability			
	Year	**ROA**	**ROE**
Albania	1998	-1,8%	-82,3%
	2002	1.2%	19.1%
Bosnia/Herzegovina	1998	n/a	n/a
	2002	n/a	n/a
Bulgaria	1998	1,7%	15,8%
	2002	2,1%	16,2%
FRY (Serbia/Montenegro)	1998	n/a	n/a
	2002	n/a	n/a
FYR Macedonia	1998	2,0%	8,2%
	2002	1,5%	6,9%
Romania	1998	0,1%	1,0%
	2002	2,6%	18,3%
Greece	2003	0,9%	12,8%
EU Large Banks	2003S	0,4%	11,4%

Source: National Central Banks, Bank of Greece, ECB

In the future, the financial institutions in the SEE countries should find different sources of profitability, since the intermediation spread is expected to fall as the economies stabilize, the interest rates fall and the competition among banks increase.
The financial institutions should seek for these new sources of profitability in the retail banking and the asset management, while they should try to increase their market share. On the other hand they should control their operating expenses and expand their activities quite careful, in order to minimize their losses from bad loans.

Conclusions

Overall, the banking sector of the SEE countries has developed significantly in the past six years. However, it still faces many challenges.
The EU accession and the possibility for adopting the euro in the future, the implementation of the new Basel II treaty, the strengthening of the regulatory framework and the financial performance are some of the challenges for the SEE countries banking sector.

The growing economic strength in the area, will allow the financial institutions to improve their performance and expand their activities. However, so far, the convergence towards the EU banking sector is low, but is expected to increase in the near future.