Financial Landscape in the Western Balkans
Focus on the Challenges of the Banking Systems

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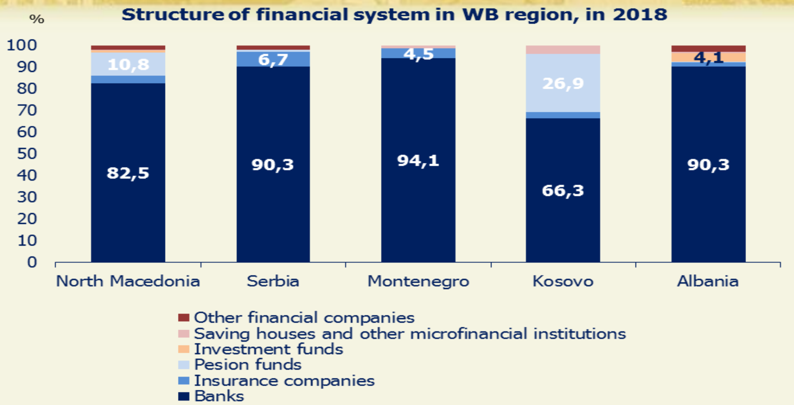
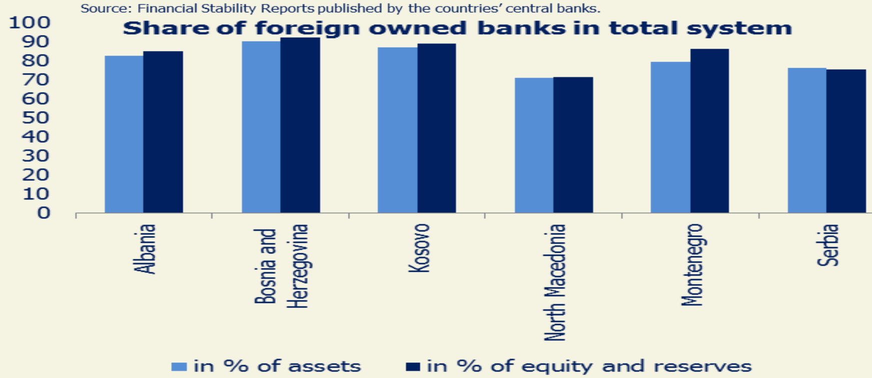
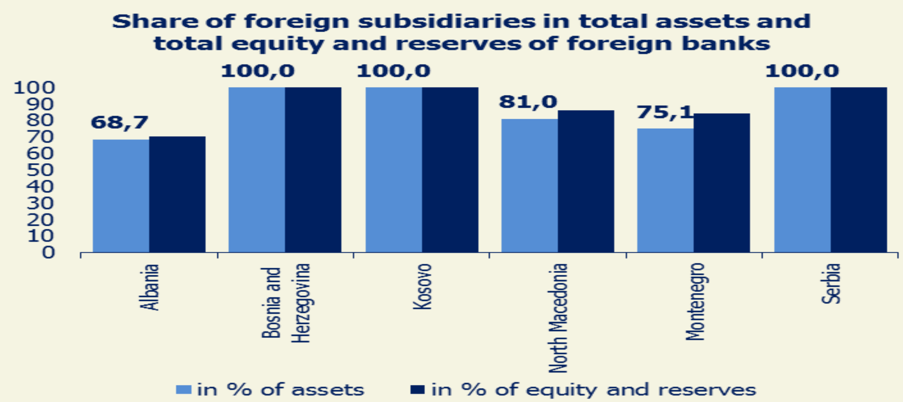
Financial Landscape in Western Balkans – Main Features

- **Financial system bank dominated –** key pillar for financial stability and real convergence
- **Although major distress was avoided during GFC**, spillover effects have been felt**...**
- ...given the **dominant foreign ownership** (70-90%) and systemic importance of foreign banks...
- **...despite that subsidiaries were dominant** form and cross-border exposure moderate
- **The spillover effects mostly felt in a couple of segments:** funding, access to capital, stricter liquidity, exposure limits, combined with NPLs....
- ....have lead to **lower credit growth** despite ultra accommodative monetary policies



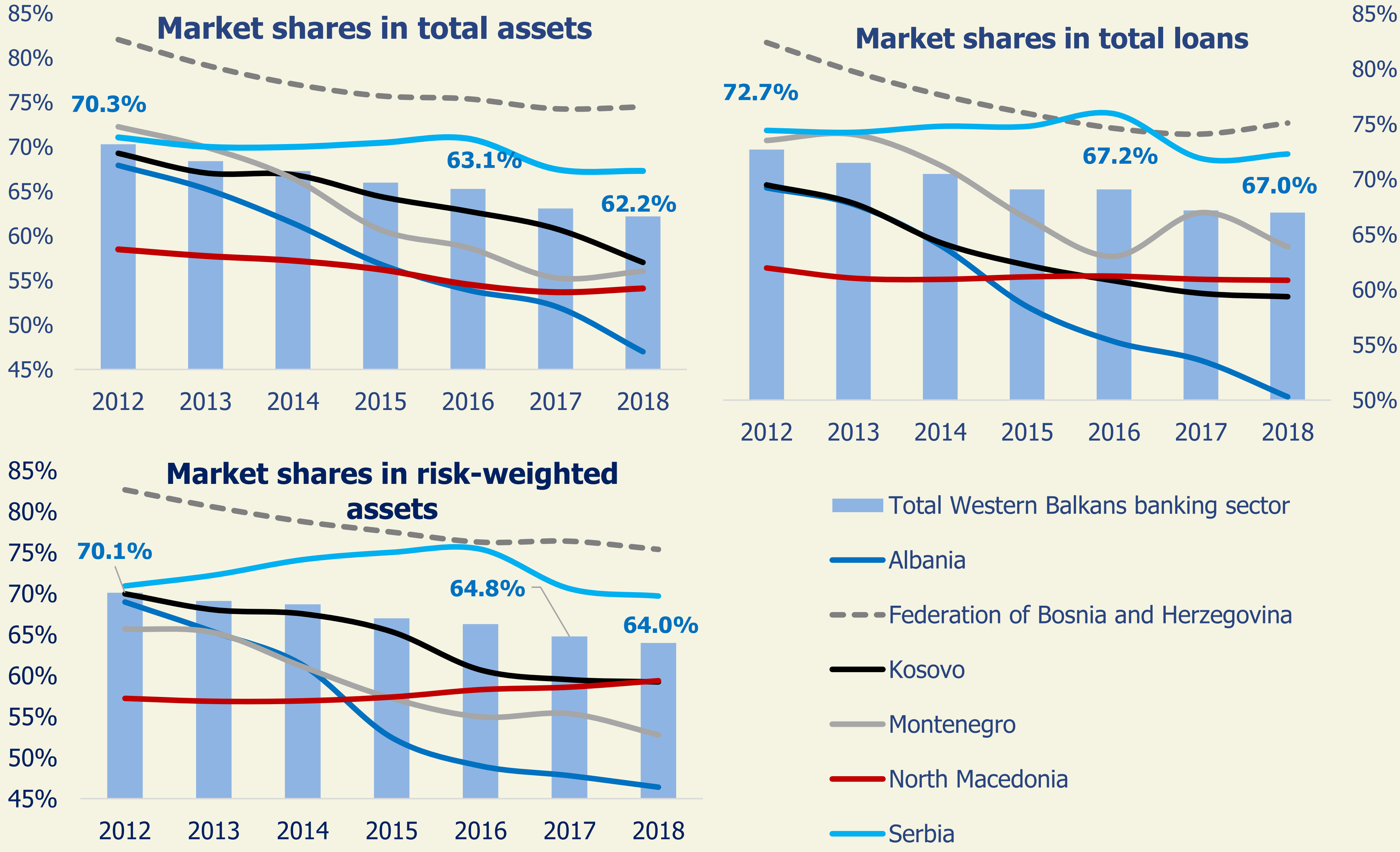
Source: Financial Stability Reports published by the countries' central banks.





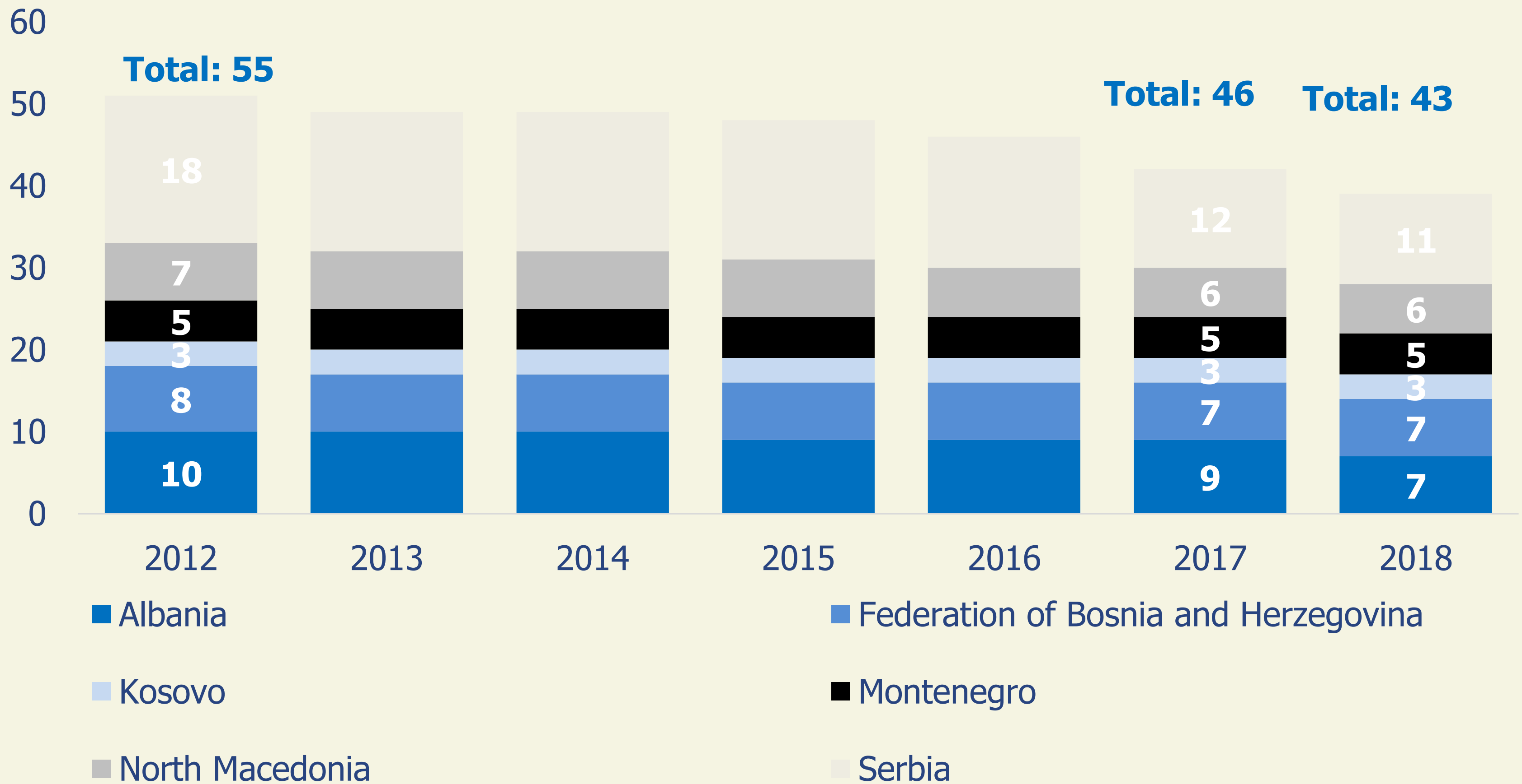
Structural Changes Ongoing

Banks with EU parents are losing market shares, on account of rising share of banks with foreign non-EU parents



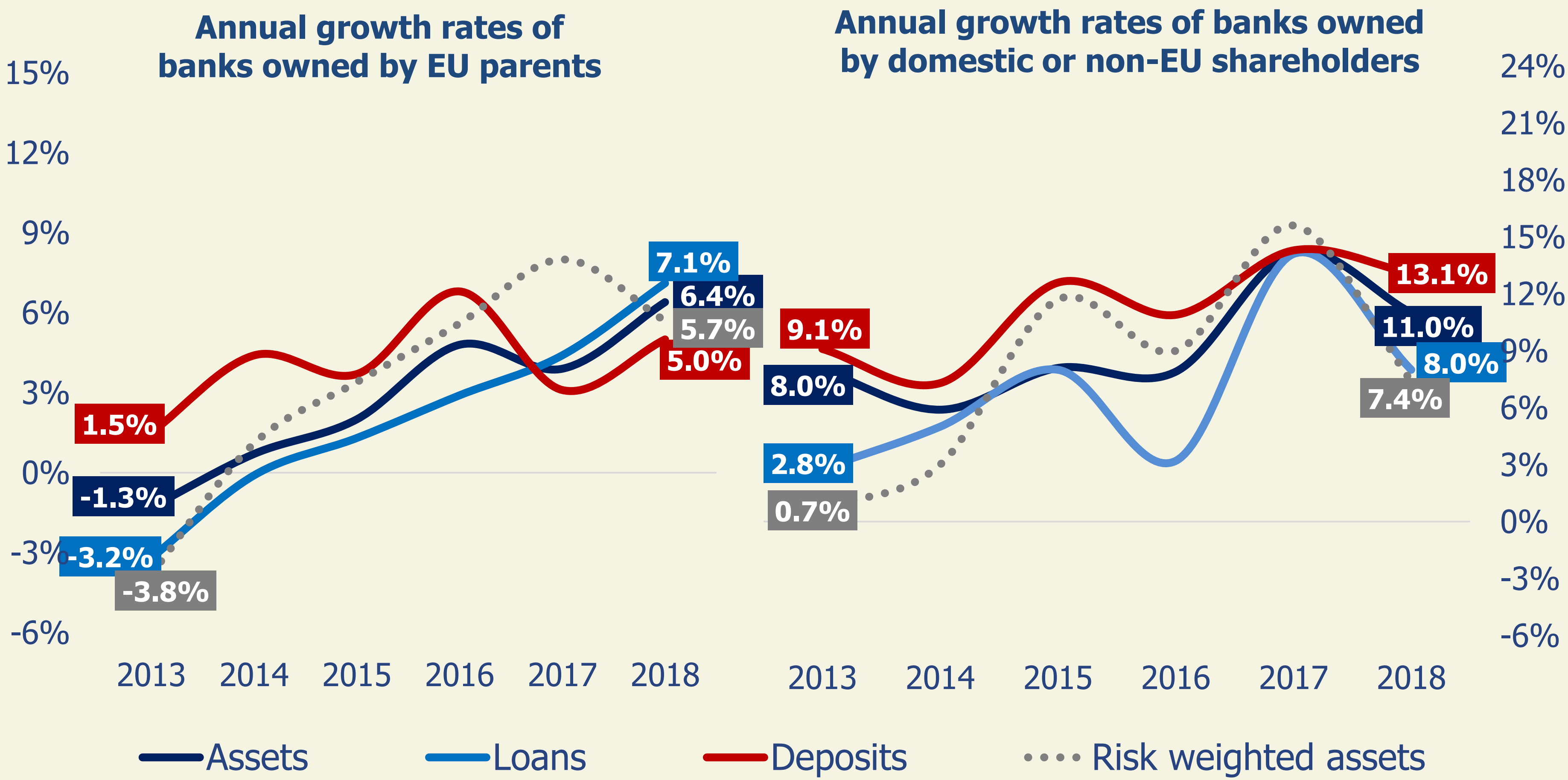
Decline of Number of Banks with EU Parents

- The crisis braked the entry of new foreign capital, even put the risks of divestment to the fore
- Western Balkans witnessed EU-banks exits, with non-EU banking groups fulfilling the gap



Activities of the Banks Owned by EU Parents Grow at a Slower Pace…

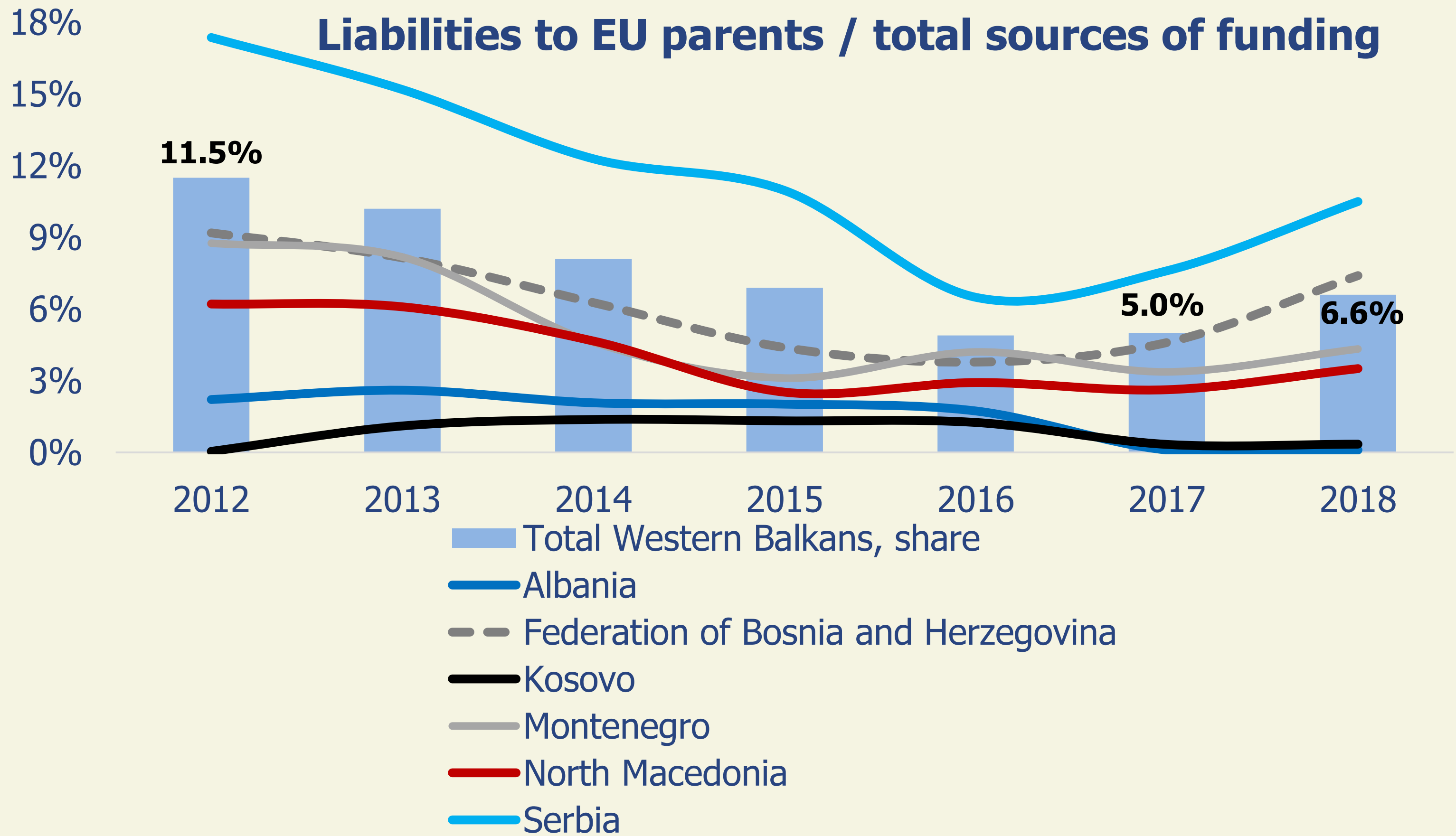
Parent bank deleveraging and adjustment to post-crisis financial regulation with side effects on banks' activities in host countries



Seems Deleveraging Has Stopped but Their Share in Total Sources of Funding Is Rather Modest…

Parent banks financing averages 6.6% in 2018, down from 11.5% in 2012, but rising in recent years

- Serbia with the highest share (10.5%) and Albania with the lowest (0.1%)



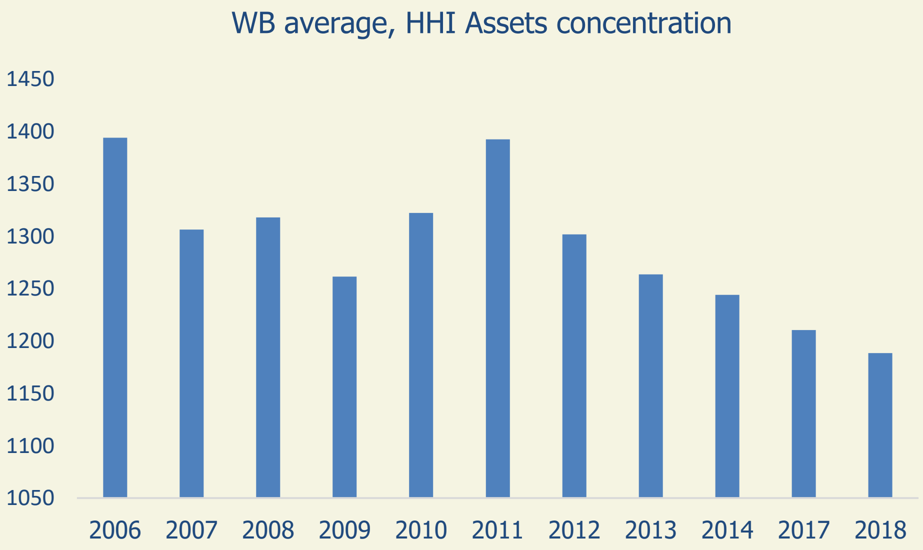
Given the Withdrawal of EU Banks and Mergers and Acquisitions – Are We Still Overbanked and Concentrated?

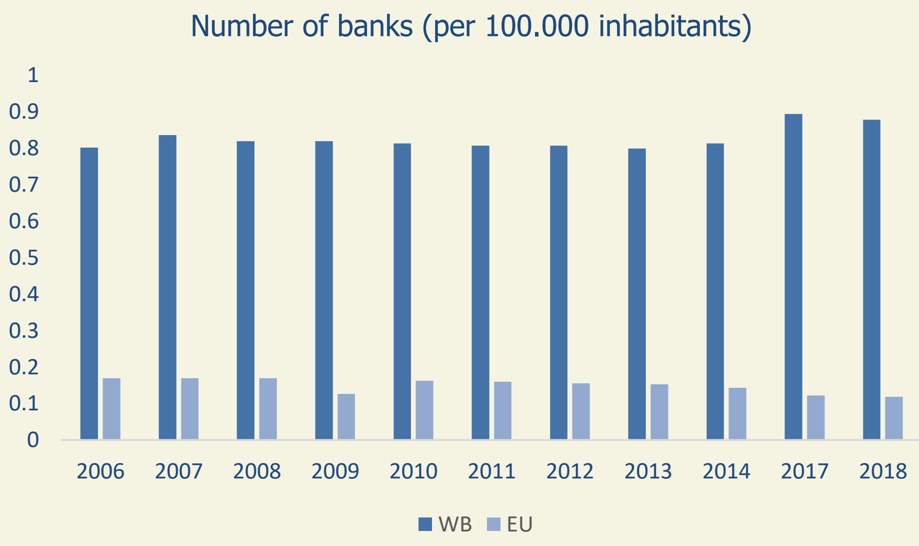
- **The overall number of banks scaled to the size of the population seems large for the size** of the countries, and well above the indicator for the EU

- **Consolidation efforts in the domain of medium and small banks –** possible remedy for enabling level playing field, exploiting economies of scale, increasing the competition and efficiency of the banking system in the region

- **The dominance of several banks in overall banking activities remains prevalent in the WB**

- Concentration of assets declining, but HHI above the threshold of 1000, indicating a room for further adjustment





Will These Structural Changes Continue and What Are the Implications?

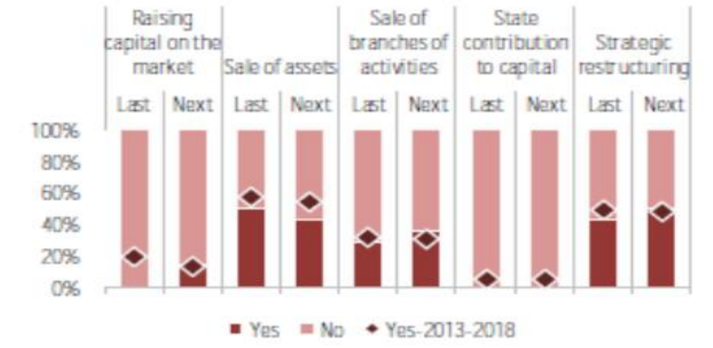
EIB Survey:

- **about 40% of banking groups,** continued to increase capital ratios through sale of assets and restructuring, only 10% raised capital on market (similar 2013-2018 average)

- and this trend is expected to continue in the following period

- banking groups **essentially assess market potential in the region as medium** and their market positioning as satisfactory

Strategic operations to increase capital ratio

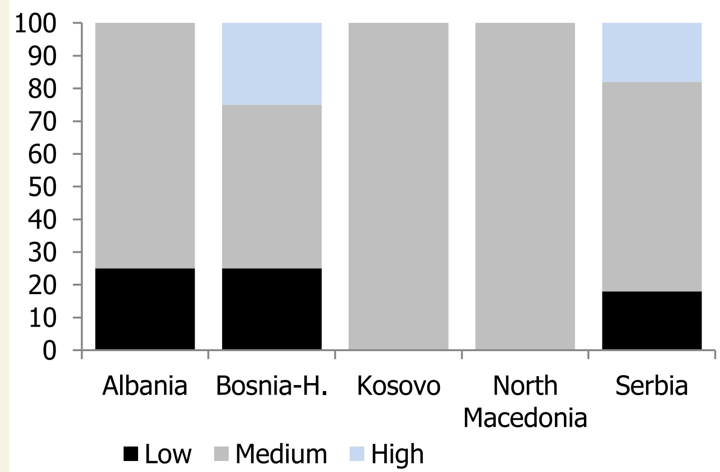


Source: EIB – CESEE Bank Lending Survey.

*Rising exposure of international banking groups not likely, sale of assets might be expected, and in confluence with the overall subdued global prospects, **might create challenges concerning the quality of the ownership structure, sources of funding, which in combination of NPLs, although trending down,** may slowdown the credit activity.*

Thus a focus on policies to attract fit and proper investors, including through tackling overbanking, further reduction of NPLs and policies that promote domestic resources of finance needed…

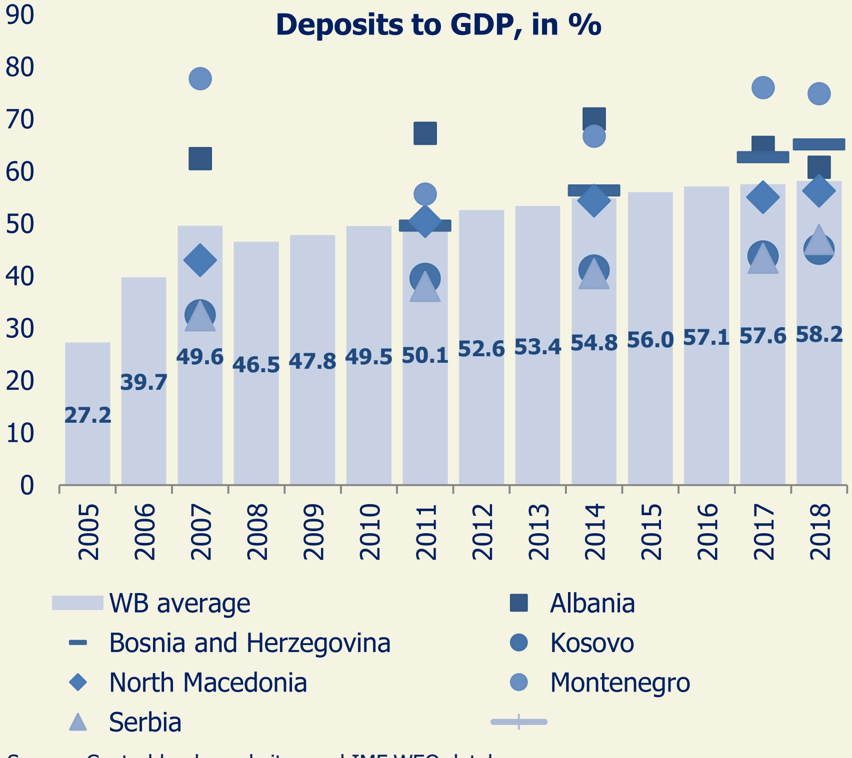
Market potential



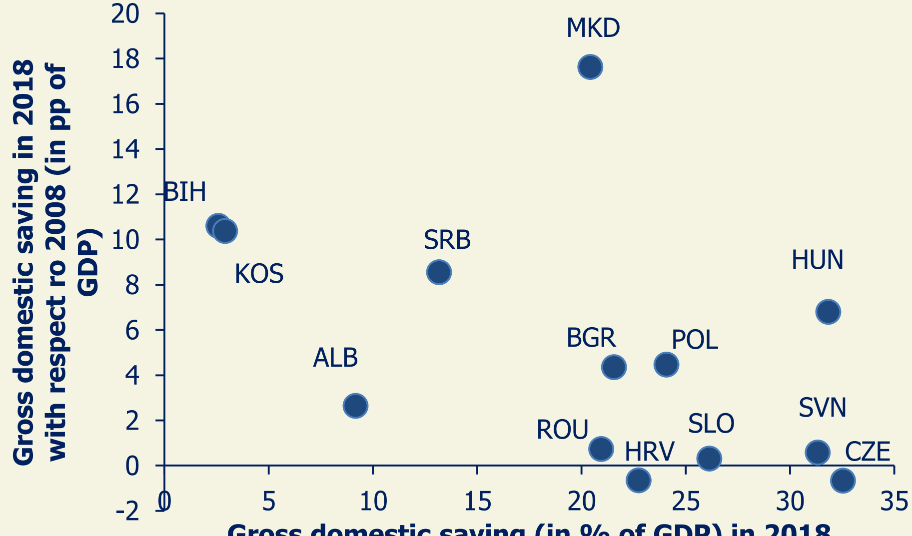
Source: EIB CESEE Bank Lending Survey.

Will These Structural Changes Continue and What Are the Implications?

- Positive side: Most of the countries managed to **increase the reliance on deposit funding** in the last couple of years…
- …but overall domestic savings rate remains moderate, which encompassed with the possible lower external financing may negatively affect credit activity
- **In general, more balanced financing model of the growth should be expected as we can not expect significant capital inflows as prevalent in the pre-crisis period**



Source: Central banks websites and IMF WEO database.



Source: World Bank database.

Have These Developments Affected Traditional Banks' Business Model?

- **Traditional business, extending loans, funded by local deposits has remained the dominant source of revenues for the banks in the region**

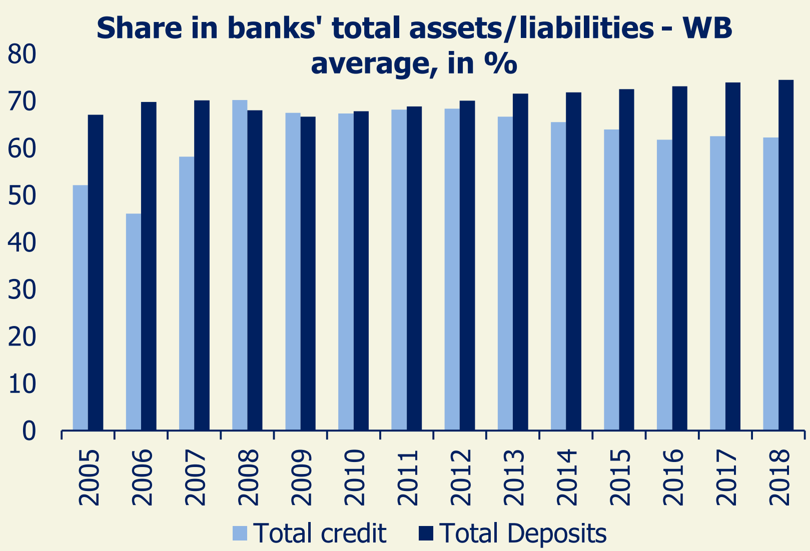
- On average, the share of credits in total assets somewhat declined and is more than 60% of assets (less than 50% in the EU11)

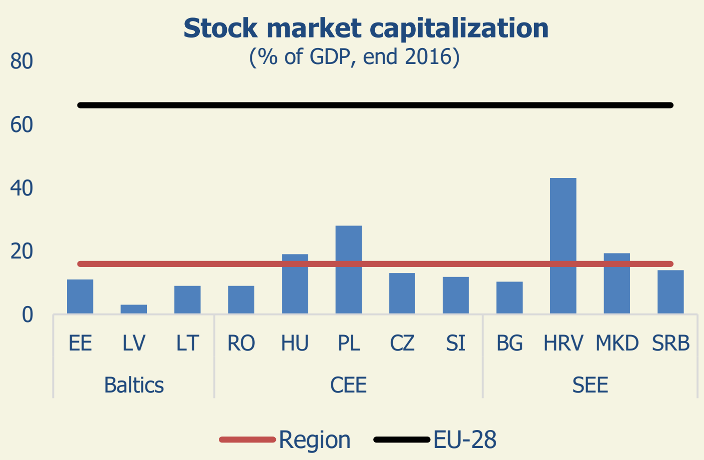
- On average, the share of deposits increased and is above 70% of total assets (about 60% in EU 11)

- Deposits to credit ratio further improved reaching 125%

- **Underdeveloped capital markets in WB - one of the main causes, indicating prevalence of the current business model on a medium run**

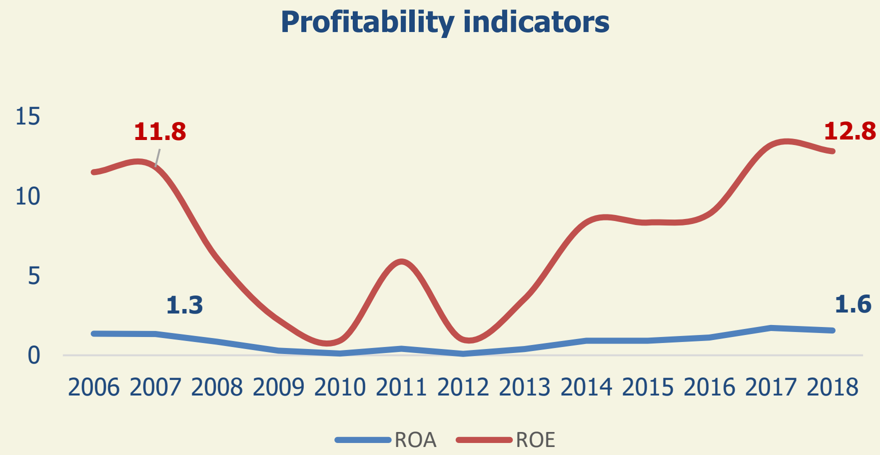
- Shallow and underdeveloped capital markets, effectively limits the variety of possible assets and liabilities to which banks could gain exposure

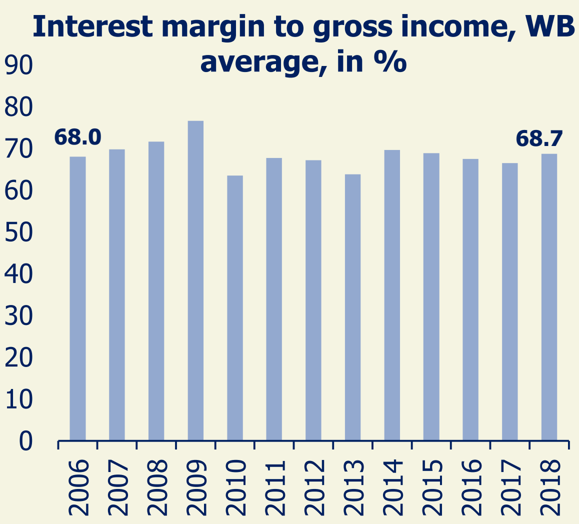


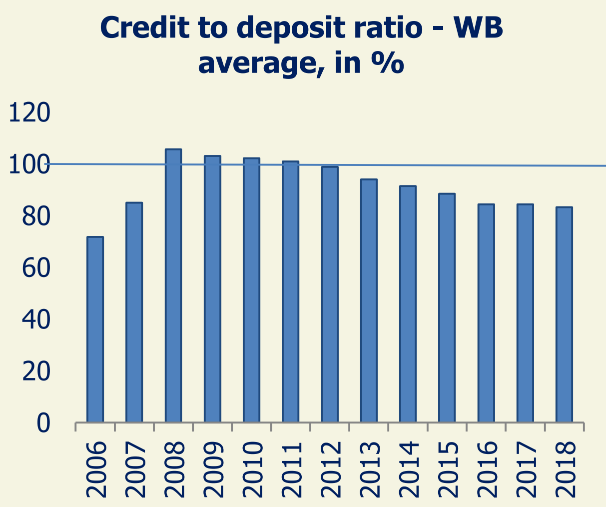


Business Model amidst Low Interest Rate Environment – Challenges for Profitability?

- At the current juncture, seems that **profitability indicators are improving** across the board, and the region is well positioned in that respect
- In most of the countries **profitability above the pre-crisis level,** with share of the **net-interest income** in the gross income being relatively stable
- Loan to deposit ratio well bellow 1, indicating **space for increasing interest bearing assets** and maintain the profitability
- Seems room to **increase productivity** and efficiency of banking operations
- The traditional business model of the banks in WB countries seems **still viable, and** with capacity to sustain the profitability of the banking system and **provide for organic growth of their capital**
- **Yet, given the prolonged low interest context, vigilance needed**







Traditional Business Model and the Rapid Wave of Digitalisation and Innovation?

- **Rapid increase in innovation in the financial sector stemming from new entrants** on the market-fintech companies offering new tailored to customer products- **stronger competition for banks coming outside of the banking system**

- The **two largest fintech segments** in the region, each comprising a quarter of all fintech companies, are payment transactions and peer-to-peer lending

- **In general, the impact of the banks difficult to assess** (some estimate that a significant portion of banks' revenues, especially in retail banking, is at risk over the next 10 years, others claim that banks will be able to absorb or outcompete the new competitors, while improving their own efficiency and capabilities – BIS, 2018)

- **In principle, new environment creates pressures for modernization and digitization o**f incumbent players in the area of client selection, payments services, digitizing the lending and investment activities, wealth management, which can **eventually lead to changing business models**

- On the other hand, **digitalization means new types of risks**, that regulators have to understand, address in an appropriate way and calibrate regulation to preserve financial stability

- In this light we have recently created an **innovation hub** as a point of contact with the industry to support innovations, but also to raise our understanding of risks stemming from new financial products

Recap

Future of banking in WB is likely to be shaped by the legacies from the global crisis, new financial regulation and by the new evolving fintech segment. Main challenges ahead:

- **Preserving quality of the ownership structure**

- **Reshaping funding models with more balanced sources of financing-emphasis on domestic resources (domestic sources)**

- **Further improvement of proper management and resolution of NPLs** to remove obstacles for organic growth of capital and activities of banks

- **Increase of efficiency and productivity, and level of financial intermediation** to preserve the viability of the business models amidst low interest rate environment

- **Overall, traditional business model seems viable and to remain prevalent at least in the medium run (**given the shallow and underdeveloped capital markets)

- **Still, rapid digitalization of the financial services poses threats, but opportunities as well, and may notably reprofile banking business models**

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